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Modernizing the Arab economies

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- **Arab economies and societies - the rich no less than the poor - have failed to develop for political as well as for structural economic reasons.**
- **The economies' weakness is due to governmental control, to the exclusion of foreign investors and to social systems of more or less "absolute welfare", causing not only immense social spending but also inefficiency and incompetitive attitudes.**
- **Financial reforms at least in the poor Arab countries have been quite successful in reducing debt service ratios, decreasing budget deficits and curbing inflation. But recent measures of structural change, requiring openness to foreign investors and privatisation, are applied only hesitantly.**
- **The growth of world oil demand will not necessarily be met by the Gulf states. They have to invite back the oil companies as suppliers of technology and capital by offering them more attractive financial terms.**
- **The stagnation of political reform processes, that have been brought virtually to a halt by the events in Algeria in 1992, produces unhappy societies, likely to be less stable, and prevents economic innovation.**
- **A force which should be accelerating economic change is the gradual move towards peace in the Middle East, hopefully intensifying Arab-Israeli economic contacts and minimizing the Arabs' feeling of having to defend themselves against a mainly hostile world.**

Fifteen years ago the Middle East was an area of prime economic interest to governments and businesses all over the developed world. The industrialised countries were heavily dependent on Gulf and North African oil, and were constantly worried about the possibility of those supplies being cut off.

The region was nearly as important as a market for industrial exports. It was rich - by far the richest market in the developing world. At one point in the later 1970s there was as much construction activity under way in Saudi Arabia as in the United States. People in both the Middle East and the Western world believed that

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government spending on development projects, both in the oil states and in countries receiving aid from those states, would create fast growing and increasingly modern and sophisticated economies. According to a wide belief there was in progress an important transfer of economic power, from the West to raw materials producers in Asia, Africa and Latin America.

Now the Middle East has become something of an economic backwater. Part of the reason is simply that demand for its oil has decreased, causing oil prices to fall. In real terms the governments' revenues per barrel are now reckoned to be roughly what they were in November 1973. There is another, less obvious, problem. It is that for all the money spent on them - or perhaps because of their money - the Middle East economies and societies have failed to develop. They have changed much less in the last fifteen years than the countries of the Far East and South East Asia, which have developed through human ingenuity and hard work.

It has been striking how at the economic summit conferences held in Casablanca and Amman in October 1994 and 1995 - when Arabs, Israelis, Americans and Europeans have discussed the region's development - the emphasis in delegates' speeches has been on how out of date the region has become. Shortly before the first of these meetings one of the most successful of the Gulf bankers summed up his feelings on the region in a private conversation. He suggested that after the great ideological conflicts of the twentieth century the early decades of the next century - perhaps the whole century - would be a period mostly of economic change. In itself this was not a controversial, or even original, analysis. What would have alarmed the governments in his region was his assessment of the Arab world's prospects. ***"Will the Arabs be among the leaders of this change?"***, he asked. ***"Will they participate at all? In the early stages I honestly think not. The problem is partly one of governments. They do not allow their people sufficient freedom, to criticise, demand change and take economic initiatives. But it is also one of Arab businessmen. They are corrupt, selfish, very short term minded and too prone to grovelling to their governments - looking to the governments, not the markets or society, for their incomes."***

Causes of weakness

The basic manifestations of the Arab world's economic failure are its low growth, which applies throughout the region, and the fact that in the major oil producers most economic activity remains dependent on the governments' spending of oil revenues. The richest countries in the region - Saudi Arabia and the Gulf states - have recently added

high budget deficits to their problems. In 1994 these deficits ran to an average of 9 per cent of their gross domestic products. Saudi Arabia has built up a debt - mainly domestic - that is equivalent to about $100 bn. Much of the governments' high spending in Saudi Arabia and Kuwait stems from the Iraqi invasion of 1990, the military campaign that followed and the work to repair the damage done by the occupiers. Another important cause for their difficulties is that in all the Gulf countries the populations are increasing as fast as it is possible for human populations to reproduce themselves. The governments are faced with growing social spending commitments and the need to build new infrastructure, particularly power stations and sea water desalination plants, on which all the populations, even in the Saudi cities inland, depend for their drinking water. They have also to maintain the ageing infrastructure built in the 1970s.

The poor countries - all the Middle Eastern states outside the Arabian Peninsula, including several that are significant oil exporters - have failed to generate growth that is in any way self sustaining. Their economies are very inefficient and unproductive. Egypt, which has the biggest Arab population of some sixty million, has visible and invisible exports of only some $5 bn - made up of oil revenues, Suez Canal dues and tourist spending. In spite of more than 40 years of "development" being the government's main objective, since Nasser's coup in 1952, the country's industrial exports are negligible. **In all the poor Arab countries there is high unemployment, generally estimated at 15 per cent or more of the work force. Every country is saddled with a large foreign debt, though thanks to austerity measures imposed on the governments in recent years the debts are largely declining as a proportion of GDP.**

The rich and poor Arab states are more similar than one might suppose. Since the oil price explosion of 1973-4 the poor have received a great deal of money from the rich - in aid, workers' remittances and investments - and this has led their governments and peoples to adopt some of the habits of the rich. The governments pay subsidies on basic foodstuffs. The middle classes - most conspicuously in Jordan, where there is much private capital that has been earned in the Gulf - have a standard of living that is well above what they might achieve from the resources from their own economies. Property prices are high. Investors look for big short term profits.

Rich and poor are influenced by the same social and political ideas. All the Arab peoples are preoccupied with the idea of national independence. This has led to the governments encouraging import substitution industries, which have often been very inefficient. It has also led to an obsession with preventing foreigners from "exploiting Arab wealth". This idea applies particularly

in the oil states, where the popular belief is that oil is a God-given Arab birthright which the outside world is intent on stealing. Most Arabs have a greatly exaggerated idea of the importance of their oil to the world economy. Their protective attitude extends to land and all the other productive parts of their economies. Behind it is a very simplistic view of what is wealth and how it is created. People see wealth not as something dynamic that is created by human activity, but as something static, like a pile of gold. On this analogy, the more they allow others to take the less there is for themselves.

These ideas have been much reinforced in the last fifty years by the conflict with Israel. This has strengthened nationalist sentiment and made the Arabs feel that they have been confronting the whole world, because they have been very aware that until recently popular sentiment in the industrialised countries was generally pro-Israel. This has made the struggle for economic independence seem even more important. It has also served to justify authoritarian government; regimes have been able to argue that while they are in a state of war normal freedoms have to be suspended. It has come to seem natural to the governments that they should control all aspects of their nations' lives.

In most Arab countries - Egypt, Iraq, Syria, Yemen, Sudan, Libya, Tunisia and Algeria - the governments that emerged in the 1950s and 1960s were socialist. Their leaders believed in control on ideological as well as practical grounds. Nowadays the governments that run these states remain republican, but they no longer have any ideologies. They stand for no principles other than the maintenance of their own security, against threats from real and imagined enemies. In two of the "socialist" states - Syria and Iraq - the leaders have even been moving towards making the presidency hereditary in their own families.

The combination of nationalist, authoritarian and socialist ideas has led Arab governments to take over much of their economies. In the socialist states private assets were nationalised in the 1960s. Elsewhere the governments took the lead in investing in big projects - mines, strategic industries, even big hotels - because they felt their private sectors lacked sufficient capital or could not be trusted with important parts of their economies. A side effect of state control is that very little intra-regional trade has developed. The governments have hedged about their economies with tariffs, import licensing systems and bureaucratic regulation designed to protect their weak industrial sectors. Much of what regional trade investment is takes place in the context of inter-government protocols, often related to single projects.

Foreigners have been largely excluded from the Arab economies. In the socialist countries foreign companies were nationalised in the

1960s, and it is only in the last six or seven years that the more moderate states - those such as Egypt and Tunisia that are reforming - have been making efforts to invite them back. In the Gulf states and Saudi Arabia much of the oil industry and some of the foreign banks have been nationalised, but the main force working against a foreign presence has been the governments' desire to reserve the most profitable activities for "nationals". Only citizens of these states are allowed to own real estate, equity shares in local companies and import agencies, and in most other types of business, particularly contracting, foreign companies are required to have local sponsors or partners. The sponsors/partners may contribute to the capital cost of a venture, or they may just take a share of its profits.

One result of the limited foreign presence in the oil states is that local business practices have remained unsophisticated, very slow moving and in some ways uncompetitive. Many businessmen have little grasp of how Western markets operate, and partly as a result of there being no taxes in their own economies, have primitive ideas about accounting. Most still think of income not as the annual percentage yield on an investment, but in terms of the number of years (fewer than five, they hope) it will take them to recover their capital, before they can move into the happy realm where their revenues become virtually "pure profit" as they put it. Few see the benefit of giving themselves "unnecessary costs" by investing in the proper maintenance of their assets or paying good salaries to attract able managers.

The Middle East is receiving little of the massive international flow of investment capital that has developed in the last ten years. This is partly because foreign companies find it difficult to invest in the region, but also because its lack of sophistication and slow growth have given it rather low demand for capital. Given that many bankers believe the world will face a capital shortage in the next ten years, brought about by continued high demand in the newly industrialising economies and the recovery of demand in the developed world, the region may receive even smaller sums in the future.

Subsidies have increased the backwardness and isolation of the Arab economies. In Saudi Arabia, and even more in the Gulf states, governments traditionally have seen their main business as being the enrichment of their citizens. This they have done through charging them virtually no tax, subsidising basic foodstuffs, water and energy, and providing industrial and agricultural investors with free land, cheap or interest free loans, and grants. It goes without saying that education and health services are provided free, with free foreign university education and specialist medical treatment where necessary. Citizens have been virtually guaranteed employment by their governments. Families receive allowances for every child. In Kuwait the rate is about $200 per child per month. It is reckoned in that state that 85 per cent of the government's oil revenues is spent on wages, benefits and subsidies. The rest of the state's spending is financed by minor amounts of tax and tariff revenue and the income (and sometimes principal) of foreign investments.

This system of "absolute welfare", as it has been called, makes Gulf and Saudi citizens secure and comfortable. What makes many of them extremely rich is the privileged opportunities they have for making money in importing, contracting and real estate development, together with various devices the governments have for pushing capital into their hands. These devices, which vary from state to state, are normally based on land gifts and land purchase. The system is most formally organised in Abu Dhabi. Here most of the land in urban areas has already been bought by the government. Compensation has been paid to every Abu Dhabian family, on the basis that everybody at some point had grazing rights to an area of land, and every family has been given a new plot of land on which it can build a house, using the compensation money. Every seven years the compensation is augmented, to reflect the rising value of land. Payments are normally in the range of \$100,000 - \$200,000. To provide some further income, the Buildings and Social Services Committee allocates to individuals or families plots of land zoned for the construction of office, retail and apartment buildings - the last to be let to foreigners. The "owners" chose between several artists' impressions of what their buildings might look like, and then the Committee pays for the construction of the building, leases it and maintains it, retaining 80 per cent of the revenues to cover its costs and giving the "owner" 20 per cent. This extraordinarily generous system has had the effect of spreading income from property more evenly than in Saudi Arabia or Kuwait and is making Abu Dhabi a much better planned and more attractive city than its neighbours.

The Kuwaiti authorities have spent even more on land purchase than the Abu Dhabians, and they have regularly compensated their citizens for commercial losses. They have bought loss making companies from private investors, and in the late 1970s and 1980s they supported the stock exchange on such a scale that they came to own large majorities in every public company in the state.

The poor Arab countries have not been able to enrich their citizens, but they have provided them with jobs and subsidised them. The government of Gamal Abdul-Nasser in the early 1960s guaranteed jobs to all Egyptian university graduates, partly so it could build itself a constituency of middle class supporters. Later the system was extended, unofficially, to high school graduates - and copied in other poor Arab countries. Nasser began subsidising basic foodstuffs for his people, and the subsidies were greatly increased, and extended to some industrial products, by President Sadat in the 1970s. Again, the same policies were adopted by other Arab countries. The subsidies grew fastest in the later 1970s and early 1980s, when governments were tightening internal security and further restricting the freedom of their people. They were afraid of their societies being affected by the chaos in Lebanon and the Iranian revolution, and they saw subsidies as a means of compensating their people for their repression.

The whole framework of subsidies, state enrichment programmes and state jobs has had a weakening effect. It has produced inefficiency and uncompetitive attitudes. In the rich countries people have very inflated ideas of what is a reasonable profit on a business, and little notion of how much knowledge and hard work is required for a company to make a profit when it is facing a normal amount of competition. One of the results of this is that many Gulf citizens investing in the West find themselves drawn to dubious middle men, who promise them returns that would seem normal in their own countries but would most likely be obtained by fraud in Europe or America.

In all Arab countries the availability of jobs (until recently) in the bureaucracies and state companies has given large parts of the middle classes, and others, the feeling that a post and a salary is their right. It has eroded the link in people's minds between their performance in their jobs and what they are paid. Many have come to see their jobs as being for life and their salaries as a means of their governments looking after them, in a material sense. These attitudes have led to state companies' employees having no concept of their being obliged to provide the best possible service to the public, let alone their having to improve their service because some other organisation is competing with them. The hallmarks of state organisations throughout the Arab world are second rate goods and smiling service provided by people who have no idea of how poor a job they are doing.

Reform

Most of the poor Arab countries were forced to begin to reform their economies in the late 1980s, when their foreign debts were reaching levels above 100 per cent of their GDPs and debt service was consuming two thirds or more of their foreign exchange income. The governments had to reschedule their debts and the International Monetary Fund, representing the Western governments, imposed reforms on them. In a few cases governments organised the refinancing of their debts themselves and had no need of IMF mediation - but they still implemented the same types of reforms and quietly sought the Fund's advice.

The reforms were designed mainly to control the governments' budget deficits, which in some countries were around 10 per cent of GDP. It was the deficits that had led to excessive foreign borrowing. A secondary objective was to bring the countries' external current accounts into balance. The IMF insisted that currencies were devalued and exchange controls dismantled, with the ultimate purpose of the currencies being made fully convertible. Multiple exchange rates, designed to provide invisible subsidies to certain types of imports and exports, were abolished. **The devaluations and removal of multiple rates helped make visible to governments and their peoples just how much they were living beyond their means. Then direct subsidies were reduced as far as possible,** which in most countries has meant that they have been removed from energy products altogether and are now given on a reduced scale on just three or four essential food items. Governments' spending was further cut by their reducing the hiring of new employees. In Egypt the government had already begun to economise by delaying the employment of graduates for several years after they had finished their courses, in the hope that they would go abroad or find work in the private sector. **In most countries the tax systems were made more efficient, with income tax rates being lowered (to make people more willing to pay) and the burden of revenue raising shifted from direct to indirect taxation. As a means of controlling inflation, discouraging consumption and encouraging saving, the IMF insisted that the banks should pay interest rates that were positive in real terms.**

Where these financial reforms have been applied thoroughly - which to date has been in Morocco, Tunisia, Egypt and Jordan - they have been remarkably successful. Debt service ratios have been reduced to tolerable levels, helped in Egypt's and Morocco's cases by some debt forgiveness, and budget deficits have been cut to around 2-4 per cent of GDP. Inflation has been curbed, private saving encouraged. Even committed reformers, though, have not been able to bring themselves to implement every detail of the IMF's prescription. Morocco, which has been reforming for longest and has certainly been the most successful, has yet to make its currency fully convertible. Egypt, which implemented financial reform with surprising zeal in 1991 and 1992, has recently begun again to set a (slightly unrealistic) rate for its currency, rather than allowing it to float freely.

A second phase of reforms, which has generally been supervised by the World Bank, has been labelled "structural change". This has involved the removal of import licensing systems and the lowering of tariffs, with the purposes of making domestic industries more competitive. Those countries that had domestic price controls have re-

duced their scope. Foreign investment has been permitted and/or encouraged. Banking systems have been switched from socialist models, which used to prevail even in non-socialist states, to modern systems of prudential controls and Cooke ratios. The banks are no longer being told how much to lend to each sector and what rates to charge to each type of borrower, they are being allowed to operate more like banks in the Western world. In Egypt they have yet to address the enormous problem of the debts they are owed by state industries, most of which have no ability to repay. **Commercial legal systems are being updated - or in the nominally socialist reformers (Egypt and Tunisia) reconstructed almost from scratch. State industries are being privatised and, so that shares in newly floated companies can be traded, stock exchanges are being revived.**

Even more than with financial reform, however, there are hesitations. Most countries have retained quite high tariffs on a large number of items. Foreign investment is encouraged in some sectors but restricted or banned in others. Tunisia still insists that foreign individuals or institutions who might wish to invest on its stock exchange obtain the permission of its central bank and pay a small fee. So far this has prevented any foreign investment at all. The system is soon to be replaced by one that will allow foreigners to invest without the bureaucratic hurdles but will impose a limit on their holdings in any one company. The stock exchange remains part of the Finance Ministry.

The greatest difficulties have applied to privatisation. One state, Morocco, has embraced the idea with a growing enthusiasm. It has already sold a significant part of the state's commercial assets and, while it is selling the remainder of the companies it has on its list, it is beginning to privatise "strategic" companies and utilities, which in 1989, when the list was prepared, were considered too sensitive to be included. In the last twelve months Tunisia has begun to follow Morocco. It sold some small state holdings to private buyers at the beginning of the 1990s, then stopped the sales and began again early in 1995 after deciding that part of each company it sold should be floated on the stock market. In a sense this is more ambitious than the Moroccan policy, which does not always involve floatations, but the Tunisian authorities are being cautious in selling only small parts of their holdings in most companies and in not publishing any list of the companies they intend to privatise. So far they are understood to have no intention of selling their controlling interests in the commercial banks, but this policy may change.

Jordan and Egypt are being even more cautious. The Jordanians have talked of a privatisation programme but decided that a safe first step would be "commercialisation", which means making state enterprises into independent companies and having them run at a profit for three years before a decision is taken on whether they should be sold. In Egypt in 1991 the government drew up a list of 314 companies, representing only the less sensitive sectors of the economy, yet the only assets it has sold outright have been the Pepsi and Coca Cola franchises, a boiler maker, some hotels and some Nile cruise boats. Under pressure from the IMF, the government changed tack at the end of 1994 and began to sell through the stock exchange 10 per cent stakes in some well known and relatively attractive companies. By November 1995 it had made about a dozen issues and was running out of immediately saleable companies. It said it was going to use the proceeds of the sales to restructure more companies to make them profitable.

It is worries about increasing unemployment that are most responsible for the delays in privatisation programmes. In Egypt it is reckoned that state companies are over-staffed by anything between a third and 600 per cent, and restructuring either before or after they are sold is bound to cause heavy redundancies. The government fears that millions may be thrown into permanent unemployment and the hands of the militant Islamists. The same fears existed in Tunisia and Morocco in the early stages of their privatisation programmes, but in those countries, where the economies are more vigorous and the companies less severely over-staffed, they proved unfounded. The Tunisians have found that some of the companies they privatised in 1990-91 have become so much more efficient that they have been able to expand and take on more staff. In Morocco there is a tacit agreement between buyers and the Ministry of Privatisation that companies will try to grow into their work forces, which, given the moderate growth of the economy, has been found to be a realistic target.

The other important causes of official nervousness are the governments' fear of losing "control" of parts of their economies and populations, and bureaucratic resistance. Government management of economies has provided jobs and a sense of self-worth for an army of civil servants. Company presidencies in Egypt have made dignified posts, with salaries, for retired generals. The system pays badly but offers such benefits as housing, cars and pensions, together with opportunities for petty corruption and possibilities for individuals to create jobs for friends and relations. The prospect of this world being swept away has alarmed officials, and governments, particularly in Egypt, have taken note of their views. They fear that if they are to lose the confidence of their middle classes they will be undermined from within and left vulnerable to pressure from the bottom of society.

In the rich Arab countries, governments have only come to face the necessity of reform since they realised that their budget deficits were not temporary but structural. This has been the accepted wisdom since 1993. Financial reform in these countries has been

a matter of cutting spending. This might seem simple on paper, but in any country it is fraught with practical difficulties. The citizens of the oil states have come to see the benefits they are given as a natural right, and in Saudi Arabia they have been encouraged in this view in the last ten years by King Fahd's repeated use of such phrases as "just entitlements and privileges", which he has promised will be continued. Attempts to alter the system, the governments fear, will lead to their people protesting that they should act first to curb the greed and corruption of some of the members of the ruling families, who are still accumulating vast fortunes, particularly from commissions on defence contracts. The rulers are incapable of doing this as they cannot bring themselves to act against close relations, especially their own brothers and sons. **Without a conspicuous anti-corruption drive, reductions in benefits and subsidies play into the hands of Islamist opponents of the regimes,** who already refer to the minimal charges levied for water, telephone calls and energy as "taxes". Sensitivity to attacks on his family led King Fahd in 1992 to reverse some increases in the prices of gasoline and electricity which had been introduced a year earlier. In 1993 and 1994 his government economised by its time-honoured methods of delaying payments to contractors, deferring new projects and ordering ministries to stop hiring new staff. It was not until January 1995, after a large number of opposition figures had been arrested, that the government announced significant increases in the prices of telephone calls, domestic air travel, water, electricity and oil products.

Privatisation in the rich countries has scarcely begun. It is only in the last year that the Kuwait government has sold some of the shares it acquired in its stock market support operations. Qatar, Oman and the United Arab Emirates have plans to privatise some of their utilities. All the governments in the region are talking to consultants about more expensive privatisation programmes. **Once the programmes start they should move more quickly than in the poor countries.** The Gulf and Saudi governments have none of the enormously overstaffed, out-of-date, perpetually loss-making industries that the Egyptian government is finding so difficult to sell. There are already proper stock exchanges in the Gulf, and governments are less worried about privatisation making large numbers of nationals redundant.

The forces that work against reform are the usual instinct for "control" and the fact that most government enterprises, being vehicles for the payment of subsidies to the people, will not be able to pay dividends to shareholders without considerable financial reorganisation. Also, traditionally the Arabian Peninsula governments, while presiding over basically capitalist economies, have had little faith in their private sectors as responsible long term investors. They know how chaotic are the annual general meetings of most public companies. They have been careful in licensing even quite small industrial operations; not for environmental planning reasons, but in order to avoid large numbers of bankruptcies they have wanted to have only the more professional businessmen invest. They are nervous about relinquishing control of utilities, national airlines and major gas based industries such as petrochemicals - let alone selling shares in their national oil companies.

The idea of liberalising the foreign investment regime is equally sensitive. It is not too difficult for the governments to allow foreign companies to invest in utilities, provided they can negotiate satisfactory pricing and profit regimes. The governments of Oman, Bahrain and Qatar have already signed contracts, or are negotiating with foreign companies, for the construction of power stations on a "Build Own Operate Transfer" (BOOT) or "Build Own Operate" basis. **What is much more difficult is the opening to foreigners of the parts of the economies where the private sectors have made their fortunes. Real estate, stock markets and the importing business remain largely closed.** Small recent changes have been the Oman government's opening its stock market to foreign mutual funds, which may own up to 49 per cent of listed companies, and the Bahrainis giving permission for foreigners resident on their island for three years to own up to 1 per cent of a company. The Dubai government has thought of licensing a big property development in which foreign companies operating in the Emirate would be allowed to buy leases, which would exempt them from the normal sponsorship rules.

Inviting back the oil companies

Rather separate, in Arab eyes, from the main body of foreign investment rules is foreign investment in the oil industry. This is a highly sensitive and important area in which governments' policies are beginning to change.

The Arab producers, like the other members of the Organisation of Petroleum Exporting Countries (OPEC) took control of their oil industries in the 1970s. The Western concessionaire companies were either nationalised outright or obliged to sell majority shares in their operations to the governments. In some cases, even where the governments took 100 per cent of their assets, the companies kept an important role behind the scenes as advisors, operations managers and preferred purchasers of crude oil. This was what happened in Dubai, where the government took control in only a nominal sense, and Saudi Arabia. Where they retained equity shares or managerial roles the companies continued to have access to crude on advantageous terms, but in other countries the take-over of the concessionaires involved the price of the crude they bought - if they wished to continue buying - being raised to international market levels.

At the time of the take-overs the fact that

Gulf oil was being made less attractive to the companies did not seem to matter, because the world was becoming increasingly dependent on it. But since the late 1970s the picture has changed. Energy conservation in the industrialised world, the development of new oil resources and the exploitation of alternative sources of energy, particularly gas and nuclear power, have destroyed OPEC's hold on the market. OPEC output fell steadily from the beginning of the 1980s until the autumn of 1985. Then Saudi Arabia, which had borne the brunt of the fall, began selling its oil at open market prices, much reduced since the beginning of the decade, and precipitated the collapse of OPEC's price structure in February 1986. This caused OPEC's output slowly to recover. It climbed from 16m barrels a day in 1985 to 25m b/d in 1992 - which was still some 7m b/d below the peak level of 1977. Since 1992 it has been on a plateau, and according to the more conservative forecasts it is expected to stay flat in 1996.

The immediate causes of the plateauing of OPEC output have been an exceptional surge in British and Norwegian production, the recovery of output in the former Soviet Union from its collapse in 1991 and the maintenance of output in some areas where it had previously been declining. Behind these developments have been some very important technological changes - notably the introduction of 3-D seismic surveys, horizontal drilling (which makes wells more productive), sub-sea well-head completions and a big reduction in the capital costs of offshore platforms. Recently it has also been realised that in many fields there may be oil below the salt layers that traditionally have been thought to mark the bottom of reservoirs. The effect of these changes has been to reduce the cost of finding and developing new oil fields, make commercial deposits that were previously uneconomic, and increase the amount of oil the industry expects to recover from fields. The normal recoverability factor used to be around 35 per cent of the oil in place; now oil companies are talking of figures of up to 60 per cent.

The Gulf states and the rest of OPEC are affected by these developments not just in the simple sense that they make more oil available elsewhere in the world, but by the fact that the oil companies which have the new technology have equity stakes in these other sources of oil. Naturally, the companies draw the supplies they need for their refining and distribution operations from these sources before they buy from OPEC. What has happened is that by reducing the roles of the oil companies and by offering unattractive financial terms, the Gulf states, with the biggest and cheapest reserves of oil in the world, have made themselves the companies' last choice for supplies. The only way the producers could have pursued their nationalisation policies and avoided this consequence, would have been for them to have invested on a large scale in downstream operations. Only Kuwait has done this, and now neither Kuwait nor any of the other producers has the money to invest.

Opinions are divided on whether beyond 1996 the global supply pattern is going to change. World oil demand is growing by between 1m b/d and 1.5m b/d every year, with the growth being generated entirely by the newly industrialising countries. It used to be believed that this demand could only be met by the Gulf, and there are still some forecasts that suggest this. The International Energy Agency predicted early in 1995 that world oil demand was set to rise from about 68m b/d this year to between 92m b/d and 102m b/d by 2010, with almost all the increment coming from OPEC and principally from the Gulf. **But other forecasters are suggesting that non-OPEC output will continue to expand, under the influence of new technology. The conventional wisdom at the time of the first oil crisis in 1973-74 was that there was little new production to be had outside OPEC and the North Sea, yet since that date non-OPEC production has grown by 15m b/d to its current level of 42m b/d. If non-OPEC output continues to grow at this rate less than half of the new demand up to 2010 will be met by OPEC, and, presumably, a smaller proportion by the Gulf.**

If the Gulf states start to believe that their oil production is going to remain static, or increase slowly, and if they continue to need bigger revenues, as they are bound to do, they will want to gain access to the markets through having a bigger oil company presence on their territories. Already Oman, Qatar and Kuwait have agreed to, or are discussing, production sharing arrangements on new acreage or for fields which need to be redeveloped. Iraq will invite back foreign oil companies once United Nations sanctions are lifted, and Iran is already anxious to involve foreign companies in the development of its gas and might apply the same policy to its oil fields if it were not so nationalistic. Algeria is leasing new acreage and old proven fields to foreign companies. The two countries in the Gulf that will probably be last to change their policies are Saudi Arabia and Abu Dhabi - Saudi Arabia because it still has a close relationship with the old Aramco shareholders (Exxon, Texaco, Chevron and Mobil) and Abu Dhabi because its concessionaires have retained 40 per cent equity stakes in its operations.

A further force which will encourage a change of policy in the Gulf is the need for capital for the maintenance and expansion of production. This on its own, though, will not have a decisive influence, because the return on investment in the development of Gulf oil is so good that governments would be bound to make capital available somehow - if necessary by borrowing. **What will be more important is the Gulf states' need for new technology. The oil fields in the region are about to reach the end of their lives as easy producers.** They are about to need more elaborate systems of water and gas injection than they have at present. It maybe that Saudi Aramco will be able to organise such work on its own. **Elsewhere the governments' national oil companies may**

know how to do the work in a technical sense, with the help of foreign contractors, but they do not know how to do it economically. For this they will need the assistance of foreign oil companies.

Political obstacles

Open economies, such as some Arab governments feel they ought to create, generally go with open or reforming, political systems. This is important to foreign investors, as many delegates stressed at the Amman economic summit in October 1995. **European, American and Far Eastern companies want to feel that the region is stable for the long term and has the same political and economic ethos as newly industrialising countries with which they are familiar elsewhere in the world.**

There are pressures for political reform within the Arab world. There is a feeling among the Arab intelligentsia, and much of the rest of the population, that the authoritarian regimes the region has endured for the last thirty or forty years are morally bankrupt. They have failed to give their people free civil societies, economic prosperity or victory over Israel. The sense of the need for change is strengthened by the fact that many of the rulers, monarchs and republican leaders, are old and have been in power for many years. Some, including King Hussain of Jordan, King Hassan of Morocco and even Sultan Qaboos of Oman, seem to be interested in developing democratic institutions which might play a greater role in running these countries after their deaths.

Stronger pressure for change has come from economic reform. When governments have had to tell people that budgets have to be balanced and subsidies reduced, and that they can no longer guarantee jobs for graduates, they have felt obliged to propose some form of political liberalisation in exchange - especially as many of the subsidies were instituted in the 1980s to compensate for a gradual loss of freedoms at that time. Economic reform has also brought proposals from the business community that it be consulted in the drafting of new financial legislation. In Morocco a dialogue has already begun.

In the late 1980s several Arab governments embarked on cautious reform. In 1989 King Hussain recalled his parliament after a sharp cut in subsidies early in the year led to riots in a part of the country normally considered most loyal. Throughout the late 1980s and the first years of the '90s there were slow changes in Egypt. The press and judiciary became steadily freer, and opposition parties were legalised. The same reforms were begun in Tunisia, and from 1993 in Morocco. The most radical reforms, economic and political, were introduced in Algeria, where overnight in 1989 the country was given a free press, the legalisation of opposition parties and the promise of free elections.

It was events in Algeria, where the elections were cancelled in January 1992 when it seemed the Islamists might win, that have brought the reform process virtually to a halt. King Hussain has continued to allow his parliament to function and hold free elections, and King Hassan had the confidence to begin reforms after the Algerian debacle, but did not permit them to go very far. In Egypt and Tunisia, however, the presidents have been so scared by what they saw in 1991-92, and by the virtual civil war that has been waged in Algeria since 1993, that they have stopped reform and even put the process into reverse. Both Hosni Mubarak in Egypt and Zine El-Abidine Ben Ali in Tunisia are worn by the cares of office, unimaginative and preoccupied with "control".

Politics in Egypt and Tunisia and in most of the rest of the Arab world has stagnated. This not only worries foreign businessmen. It produces societies that are unhappy and in the long term are likely to be less stable. In Egypt particularly the government would be better able to deal with the challenge of Islamist terrorism if it were earning the respect of the mainly non-Islamist middle classes by continuing reform.

The lack of freedom prevents innovation. Because people in these societies do not believe their governments will allow change - and anyway are restricted in their freedom of speech - they do not discuss new ideas. There is not the flow of controversial ideas in books, newspaper articles and conference discussions that there is in free societies. This is bound to have an impact on business. It hinders the adoption of new business practices and the formation of new companies to provide new services and make new products. It makes it more difficult for governments to see how they should tackle the problems that are produced by economic reform. It slows the introduction of new commercial legislation.

A force which should work in the opposite direction, accelerating economic change, is the gradual move towards peace in the Middle East. Peace will remove the justification for authoritarian rule usually given in Arab countries, and it should eventually lead to a cut in defence spending. It should also cause the Arabs to make comparisons between their own slow growing economies and the remarkably dynamic economy of Israel The Israelis, with a population of five million, have a GDP of some $70 bn. This compares with the Jordanian GDP of only $5 bn, produced by a population of about four million, and an Egyptian GDP of little more than $50 bn, produced by sixty million. The Egyptian figure excludes the country's large black economy.

Some Arabs fear that if they open their doors to the Israelis their economies will quickly be taken over by their former enemy, and certainly many Israelis imagine that across their borders there is an "Arab economy", with a

strong flow of trade and investment between the states. They talk of integrating their country into the Arab economy, tapping its labour force (through investing in Arab countries) and its markets, and building projects which would use Israeli technology. In short, **they see themselves exploiting their position in a potentially rich area of the world which has hitherto been closed to them. Few of them realise that there is very little inter-Arab trade, and little inter-Arab investment outside the real estate sector. Most likely in the next few years many Israeli businessmen and foreign policy officials will be disappointed - and Arab fears of their being overwhelmed by the Israelis will fade.**

As well as having the fragmentation of the Arab world working against them, the Israelis will be hampered by the fact that it will take much longer for the Arabs to accept them than for them to accept the Arabs. Israel has said repeatedly, especially in the context of its talks with the Syrians, that it wants its peace with the Arabs to be a real one, leading to the whole range of contacts that exist between friendly neighbours. It wants to be accepted as a natural part of the Middle East. Most of the Arabs feel differently. They are prepared for peace with the Israelis, but not for friendship. The different attitudes of the two sides are reflected in the figures for tourist and business visits between Egypt and Israel since the Camp David Peace Agreement of 1979. In the last fifteen years some half a million Israelis have been to Egypt, but only four thousand Egyptians have travelled in the opposite direction.

The prospect for the next few years, therefore, is for Arab-Israeli economic contacts to be composed mainly of projects encouraged by governments, such as the Israeli-Egyptian oil refinery in Alexandria and the Israeli-Jordanian Dead Sea bromine plant, both of which have been announced in the last twelve months. What would change the picture would be a final settlement between the Palestinians and Israelis, defining the vexed issues on borders, the status of Jerusalem and the settlements on the West Bank, and Palestinians' "right of return". Palestinian and Israeli businessmen know each other well, and if their borders were opened and they felt able to work together there would be major flows of trade in both directions and Israeli investment in the Palestinian state. Jordan, with its big Palestinian population, would become closely involved in this trade.

The Arabs' feeling of wariness towards Israel is echoed, in a small way, in their attitudes towards the rest of the world. The Arab-Israeli conflict, in which they have suffered nearly fifty years of humiliation, has left its scars. The Arabs feel that much of the rest of the world has been hostile to them during this period. They are also separate from most other peoples and countries in that the great majority of them are Muslim - and the religious aspect in their thinking is important. This is not only because God tells

Muslims through the Quran that they are special, as the recipients of His final message to mankind, but also because Islam at present is undergoing a revival, stimulated by the economic failure and political unhappiness of much of the Muslim world. Therefore, even if their economies do begin to modernise, the Arabs are not likely suddenly to embrace the materialist, secular, global culture of successful newly industrialising countries elsewhere. The Arabs feel they are different.

Their view of themselves was well illustrated at two conferences on economic development in south-east Asia, which were sponsored by Cairo University and the newspaper, Al-Ahram, in the winter of 1994-95. At the meetings businessmen and government officials from Singapore and its neighbours spoke about their countries' extraordinary economic success, and Westerners in the audience imagined that the Egyptians present - who, significantly, were mainly middle aged academics and journalists rather than businessmen - would ask the speakers how their methods might be applied in their own country. But their reaction was completely different. What most questioners wanted to know was not how south-east Asia had been able to modernise, but how it had managed to keep its cultural identity.