The ADCR 2011: Is there Space for Development-Friendly Trade and Industrial Policies in Arab Countries?

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Comments should be addressed by email to the author(s)
# Acronyms and Abbreviations

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<th>Acronym</th>
<th>Description</th>
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<tr>
<td>AC</td>
<td>Arab countries</td>
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<tr>
<td>ADCR</td>
<td>Arab Development Challenges Report</td>
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<td>ASCM</td>
<td>Agreement on Subsidies and Countervailing Measures</td>
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<td>EAP</td>
<td>East Asia &amp; Pacific</td>
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<td>ECA</td>
<td>Europe &amp; Central Asia</td>
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<td>EPA</td>
<td>Economic Partnership Agreement</td>
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<td>EU</td>
<td>European Union</td>
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<td>FAO</td>
<td>Food and Agriculture Organization</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FTA</td>
<td>Free Trade Agreement</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>HICs</td>
<td>High Income Countries</td>
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<td>LAC</td>
<td>Latin America &amp; Caribbean</td>
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<td>LDCs</td>
<td>Least Developed Countries</td>
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<td>LIC</td>
<td>Low Income Countries</td>
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<td>MDGs</td>
<td>Millennium Development Goals</td>
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<td>MNCs</td>
<td>Multi-national Corporations</td>
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<td>MPRA</td>
<td>Munich Personal RePEc Archive</td>
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<td>NAFTA</td>
<td>North American Free Trade Association</td>
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<td>NAMA</td>
<td>Non-agricultural Market Access</td>
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<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
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<td>PTA</td>
<td>Preferential Trade Agreement</td>
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<td>QIZ</td>
<td>Qualifying Industrial Zones</td>
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<td>R&amp;D</td>
<td>Research and Development</td>
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<td>SAS</td>
<td>South Asia</td>
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<td>SSA</td>
<td>Sub-Saharan Africa</td>
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<td>TRIPS</td>
<td>Agreement on Trade-Related Aspects of Intellectual Property Rights</td>
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<td>TWN</td>
<td>Third World Network</td>
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<td>UN</td>
<td>United Nations</td>
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<td>UNDP</td>
<td>United Nations Development Programme</td>
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<td>UNSD</td>
<td>United Nations Statistics Division</td>
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<td>WDI</td>
<td>World Development Indicators</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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Introduction

The plethora of trade agreements and economic reforms over the last few decades, though varying among different countries, has pushed forward substantial economic and trade liberalization in the Arab region. These agreements, particularly those with developed country partners, “lock-in”, through binding commitments, the orientation of development policies in a number of critical policy areas and result in significant changes in the economic costs, opportunities and incentive structures for public and private sectors throughout the region. This imposes a degree of urgency and confers high saliency to an assessment of the contextual position of the Arab countries in the world economy, thus an understanding of the dynamics of the global market, and the impact of trade policies, including trade agreements, on the prospects for achieving the MDGs and human development at large.

An observation of the region’s trade and industrial stylized facts shed light on the poor performance of Arab economies, which have been herded onto the low road of development and have been unable to achieve structural change and successful integration into the global market. An exploration of the reasons behind the Arab region’s failure to attain the expected improvements of liberalization is beyond the scope of this paper; however, with these stylized facts at hand, it becomes imperative to question whether or not there is policy space to adopt development-friendly trade and industrial policies. In this paper we shed further light on Arab trade and industry performance, where structural retardation is clearly manifested, and we review policy room for development-friendly trade and industrial policies.

Trade and Industry Stylized Facts

Structural retardation in the Arab region was accompanied by substantial trade liberalization. Trade is integral to the economies of the Arab region. According to data from the World Bank and UNSD, the ratio of trade (exports plus imports) to GDP of the region² averaged over 84% in the 2000s, one of the highest ratios among developing regions and significantly higher than during the early 1980s (approximately 60%).³ Since the 1980s, most Arab countries initiated trade reforms that boosted non-oil exports. However, the increased market access benefited mostly industries with static comparative advantage, particularly those closely linked with petroleum. Thus, by and large, the increased intensity of trade has not been indicative of a story of successful integration into the global economy. Over-reliance on oil resources has retarded structural transformation in the Arab economies.⁴ It is not surprising, therefore, that the region continues to host a rather primitive export structure, predominantly composed of primary products (fuel exports comprising 70% of exports). This stands in contrast to the import structure, which has remained diversified by comparison (Figure 1).

Figure 1: Structure of merchandise imports (% of total merchandise imports) for Arab countries, 1995-2009

Source: Authors estimates based on data from WDI, UNSD and WTO
Note: Arab countries included are Egypt, Jordan, Morocco and Tunisia as oil-poor countries and Kuwait, Oman and Saudi Arabia as oil-rich countries
For the majority of oil-rich countries, fuel exports account for well-above 80% of total merchandise exports. Oman has the lowest share of fuel exports at 81% and a relatively diversified structure of non-oil exports, including machinery and transport equipment, consistent with its economy exhibiting signs of a positive structural transformation.

Figure 2: Structure of commodity exports for oil-poor countries, 1995-2009

Source: Authors estimates based on data from UN ComTrade. Note: Oil-poor countries included are Egypt, Jordan, Morocco and Tunisia

As reflected in Figure 2, the export structure of oil-poor economies is more diversified, yet has been dominated by textile and clothing up to early 1990s. This subsector has witnessed declining exports since 1995, largely due to the phasing out of preferential trade arrangements such as the multi-fiber agreements. The evolution of trade has been marked by major divergences amongst different members of this group. For example, while Egypt experienced the steepest plunge in its textile and clothing exports, Jordan witnessed an increase in the share of its textile and clothing exports, arguably as a result of the (qualifying industrial zones) QIZ agreement with the USA. The relative demise of textiles and clothing is not in itself cause for alarm. What is more worrying is the reflection of structural retardation of the region in terms of the very slow rate of increase in high value added exports, such as machinery and equipment.

Figure 3: Structure of commodity exports for Egypt (A) and Tunisia (B), 1995-2008

Source: ibid. Note: Legend of figure 1 applies

Tunisia, Jordan and Morocco have, however, been diversifying into higher value-added exports, such as machinery and equipment. Within the group, Tunisia hosts the highest share of machinery and transport equipment exports (including telecommunications equipment, automatic data processing machines and electrical machinery, etc). Morocco, despite being a later-comer, has also achieved a significant increase in the share of this technology-intensive sector as a share of merchandise exports (rising from 3% in 1995 to 19% in 2009). Despite some fluctuations, Jordan’s machinery and transport exports’ share of merchandise exports has remained rather stagnant since 1995. In a context of an economy
more heavily based on petrochemical and chemical industries, this trend was far less pronounced in Egypt. Thus, Egypt’s export structure is clearly less diversified today than many of the smaller non-oil Arab economies, which once looked up to Egypt as a model for industrial development during the 1960s and 1970s. Figure 3, which compares the commodity export structures of Egypt and Tunisia, clearly reveals this divergence.

Figure 4: Structure of manufacturing for oil-poor (A) and oil-rich (B) countries in 1990s and 2000s

Underlying this generally weak trade performance of the Arab region is a weak manufacturing sector. As noted earlier, the Arab region is the least industrialized region of the world, accounting for a meagre 12% of the region’s GDP, the lowest amongst all other developing regions. Moreover, this small share of manufacturing is heavily concentrated in the production of lower value added petroleum related, food, chemical and rubber and plastic products, which together make up nearly 60% of the total manufacturing output of the region (Figure 4). Consequently, the region is only able to trade in elementary goods.

Figure 5: Machinery and equipment as a share of total manufacturing output, 1990-2006

The brighter side of the story is that, despite the overwhelming share of petroleum industries, Arab countries, including oil-rich countries, are diversifying into other sectors such as food and beverage and metals industries. The industry profile of Jordan, Morocco and Tunisia, in line with the increasing trend of the share of machinery and transport exports, shows a clear increase in the share of machinery and equipment output. The translation of this increase in share of manufacturing into an increase in the share of exports could be interpreted as an indication of gains in competitiveness for these countries. However, Tunisia appears to be the main driver of this trend as the share of this technology intensive sector increases from 5.3% to 12.8% of total manufacturing over the 16 year period observed in Figure 5. Simultaneously, aided by foreign investment, this sector’s contribution to Tunisia’s
merchandise exports nearly trebles to reach 25.1% in 2009. It is also interesting to note that the share of Tunisia's machinery imports did not increase over the same period. Tunisia thus defies the regional trend in several aspects and confirms its place as an economy that underwent a meaningful structural transformation.

**Figure 6: Manufacturing base for Egypt (A) and Tunisia (B) in 1990 and 2006**

![Graph showing manufacturing base for Egypt and Tunisia in 1990 and 2006](image)

Source: ibid.

Textiles and clothing sector makes up the second highest share of the manufacturing sector of oil-poor countries. Since 1990, Egypt and Morocco, in particular, have taken large hits to their textile industries, which have declined in their share of their total manufacturing from 15.5% and 17.3% to 11.5% and 14%, respectively. The decline in the share of this sector of industry, concomitant with the decline in the share of exports of this sector, a decline especially dramatic for Egypt, is an indication of the lack of competitiveness of these sectors. Given Egypt's industrial profile, it is not surprising that a major proportion of its exports sector is taken up by lower value added petroleum, mineral and chemical products (Figure 6-A). To sum, for much of the region, including its largest country, the transition to indiscriminate premature liberalization at a time of low productivity levels has rendered manufacturing uncompetitive and exports concentrated in primitive products and natural resources.

**Figure 7: Structure of service exports for Oman (A), Egypt (B) and Tunisia (C), 1996-2009**

![Graph showing structure of service exports](image)

Source: WDI

The trend is broadly similar for trade in services, as the majority of Arab economies specialize in low value added services such as travel and transport services as opposed to the more vibrant communications and financial services. Still, there are clear distinctions between the oil-poor and oil-rich economies, as services play a less important role for the latter (8%-10% of total exports in the 2000s). For oil-poor countries, the corresponding share
was 45% in 2009. Within oil-rich countries, the structure of service exports for Oman appears to be more balanced. Indeed from 1996 onwards, Oman was able to diversify its base of service exports from one that is almost entirely reliant on travel and tourism to one where tourism, transport and communications services have a relatively equal contribution.

Finally, it is worthy to note some of the important demarcations amongst the economies identified in our analysis of commodity trade that also resonate in services. In this regard, the distinction between Egypt and Tunisia is quite remarkable. The former, which has witnessed a large decrease in its share of service exports, has become more reliant on low-value added tourism. Tunisia’s service export sector, on the other hand, hosts a larger contribution from the more dynamic sectors such as transport and communications services, which are crucial for the promotion of a knowledge-based economy since 1995.

**Growth vs. Development: Lessons from the East-Asian Experiences**

Although speculations into the reasons behind the shortcomings of the Arab region are beyond the scope of this paper, the stylized facts presented here highlight the lack of diversification away from extractive industries. Overall, these stylized facts reveal that the manufacturing sectors of the majority of oil-poor and oil-rich Arab countries have remained disappointingly rudimentary with no significant transformations in their trade structures. The data also reveals that majority of Arab economies are increasingly becoming import-oriented and that oil has become embedded as the prime commodity supporting the backbone of the internationalization of the region’s trade and production, reinforcing the subordinate position of the Arab region in the global hierarchy of production. This is exemplified best by the fact that, although the region hosts one of the highest ratios of trade to GDP among developing regions, its overall share in world trade remains largely insignificant.6

Such has been the performance of the region, for which against the conventional wisdom of neoliberalism, despite increasing liberalization measures and openness to capital flows, the expected improvements in access to the world’s major markets, foreign investments, technology transfers and ultimately faster and more sustainable economic growth with sufficient employment opportunities did not materialize. Instead, the highly volatile Arab growth experience was highlighted by an accelerated growth fuelled by massive capital inflows, where different sectors, agents, and income classes were left to respond in the absence of a national development agenda. Some sectors and groups successfully managed to keep up, while others failed miserably and lagged behind. The widely cited Asian experience, on the other hand, featured an accelerated growth led by specific sectors and groups, mainly the manufacturing sector, which were handpicked and provided with tools that warrant high growth rates. Consequently, the high growth rates of such sectors eventually generated high overall economic growth, and more importantly, this growth was sustained. Economists have expended a great deal of effort deriving explanations for the East Asian “miracle”. Nevertheless, the prime goal here is not to review the large body of literature on the Asian growth experiences, rather to pinpoint some key factors that distinguished such growth experiences from the Arab growth experience. We then aim to consider whether the Arab region can alter its course and adopt radically different trade and industrial policies, which would place it on an East Asian like development trajectory.

Over the last four decades, the four East Asian Tigers—South Korea, Taiwan, Hong Kong, and Singapore and the newly industrialized economies of South East Asia (Indonesia, Malaysia and Thailand) have sustained rapid economic growth more than twice as fast as the rest of East Asia, roughly three times as fast as Latin America and South Asia, twenty five times faster than Sub-Saharan Africa and outperformed the industrial economies and oil-
rich Middle East and North Africa region. Meanwhile, poverty levels were rapidly dropping and the quality of human capital increased dramatically. Moreover, the Asians succeeded in maintaining equitable income distribution that was correlated with growth from the get go. For instance, the income share of the highest 20% of the Korean population was only 37% of total income in 1998 compared to over 60% of total income in Egypt.\textsuperscript{7} High tax rates on upper income classes and maintaining real wages at reasonable levels were complemented by high taxes on luxury consumption, which mostly feeds into services, as well as luxury imports. In order to establish an efficient mechanism to guide investment, rather than being led by the market government intervention has itself led the market. Governments deliberately altered the incentive structure by going against the market to boost infant and other industries, which would have otherwise failed.\textsuperscript{8} Hence, the visible and carefully selective hand of social planners replaced the invisible hand of the market in selecting agents that were allowed to maximize their interest in a way that ensured the overall long-run maximization of social interests. In striking contrast, the mismanagement of rent-seeking behaviour of the elite and the poor implementation of “free” market policies after decades of centralized and inefficient rule have squandered the enormous potential of the region for economic development, and the majority of Arab society has been alienated from the right to development. Moreover, the Asian growth experience\textsuperscript{9} was a successfully modelled transition from import-substituting industrialization to manufacturing-based export-led growth that was remarkably rapid and balanced. Even while agriculture was declining in relative importance, highly dynamic agricultural sectors, characterized by rapid growth in output and productivity levels, succeeded in keeping up with the growth in manufacturing sector.

The Asian model of development, guided by an understanding that free trade is not enough to bring export success on its own, exemplifies the potential of state-guided industrial and trade policies to pioneer the creation of new productive capacities and to position the economy at the “innovative end of ‘the product cycle’” where the highest value-added is located.\textsuperscript{10} The East Asian economies have acquired foreign technology through strategic planning, using hard-earned foreign currencies for acquiring advanced technology, vital machinery and industrial inputs,\textsuperscript{11} and focusing solely on developing their own indigenous industrial capacity, rather than being hard lined into export production platforms for foreign multi-nationals. Instead, the governments of East Asia had a selective attitude towards foreign investment and even in instances where foreign investors were welcomed, as in the case of Singapore, subsidies were employed to guide TNCs towards industries that were considered strategic.\textsuperscript{12} And when the private sector was reluctant or unable to undertake strategic investments, the governments or SOEs played an important role in jumpstarting certain industries and constructing dynamic comparative advantages.\textsuperscript{13} Today, more than ever, in the context of a fiercely competitive and consolidated global market, it becomes an imperative for governments in the Arab region to effectively use the dynamism of market forces and adapt them to the local socio-economic context to push their economies upward in the hierarchy of the international division of labour, in a similar way as the East Asian economies have done.

**Is the Asian model still replicable?**

The world trading system has undergone enormous changes in the last decade or so, and the global environment is less favourable to the replication of the Asian model today. Several emerging market economies have already selectively replicated components of the East Asian model and have siphoned away considerable shares of global trade. Since 2000, non-OECD countries, as a bloc, have been running trade surpluses, representing 36.4% of global exports and 33.2% of global imports in 2008 (compared to 25.1% and 26.2%, respectively, in 1995).\textsuperscript{14} Despite these promising trends, it’s important to understand that most developing countries, including the Arab countries as previously stated, continue to remain marginal in
both investment and trade, as the majority of worldwide trade, investment and capital flows remain concentrated amongst Europe, Japan and North America. Furthermore, rapid economic, particularly trade, liberalization throughout the Arab region, anchored in internationally binding agreements, has especially complicated the replication of the East Asian model. The ability of developing countries to use trade in order to support local development and local employment is now heavily taxed and curtailed by the current structure of the international trade regime.

Unfortunately, trading rules that favour free trade have been crafted in sectors where the developed countries are stronger but not where they are weak (e.g. agriculture or textiles), and the potential gains from increasing liberalization remain very little for developing countries compared to developed countries. The estimated gains for developing countries are not only small but are projected based on dubious assumptions on the expansion of export shares and market access to developed economies and underestimate the costs of trade liberalization, such as loss of tariff revenue, productive capacity and jobs, just to list a few. With the increase of binding constraints on trade and industrial policies, however, developing countries forego actual potential of expanding their market access by being deprived of the tools necessary for successful competition in a highly consolidated global economy, with more advanced emerging market economies already headway in the playing field. For example, projections based on the more recent rounds of NAMA debates reveal that half of the benefits expected to flow to developing countries by 2015 are to be captured by just eight countries—Argentina, Brazil, China, India, Mexico, Thailand, Turkey, and Vietnam.

The saliency and urgency of trade and industrial policies within this trade institutional context as well as the need to acquire a more realistic understanding of the industrial and trade policy space left for the late comers of today has become even more of an imperative. Developing countries today face a global economy with increasing fragmentation of production processes across national borders, higher thresholds for successful integration into the global value chains, and increasing pressure for constant upgrading and technological advancement. Furthermore, the “internalization” of global trade is taking place through a highly vertical order of trade amongst MNCs and the share of these intra-firm transactions of world trade is growing. As much of “global”, more accurately international, activity and production becomes increasingly concentrated, the prospect of fruitful economic integration for developing nations without state intermediation is very dim. The opportunities of the global market differ vastly for developed and developing nations. This is no better represented by the fact that “only between 10% and 30% of the technological activity of multinationals is likely to be located in foreign subsidiaries” and much of this activity such as R&D and production of high value-added parts is likely to be located either nationally or amongst the developed nations.

Moreover, emerging economies, which have covered some distance on the ladder of global industry already, now face the limits of their customized export-led growth strategies. The challenge of demand shortage as the developed world’s economies become debt saturated and constrained by fiscal austerity is becoming a pronounced challenge, alongside the legal binds of multilateral agreements. As a result, now, a new comer has to run the race crippled, with a substantial portion of the market shares siphoned by emerging economies and must compete in an environment where both the private and public sectors of developed economies are saturated with debt. Such is the brave task facing Arab economies, which together currently only make up 5.8% of total world merchandise exports and 3.1% of total world exports in services.

Nonetheless, the complexity, the global conflict of economic interests as well as the developing status of most Arab countries offers great room for manoeuvrability despite significant policy space contraction for late comers. The boundaries of the exogenous policy
space, created by FTAs, are not necessarily immutable. The current trade policy framework, being the result of the consent of sovereigns, international rules and disciplines can, in principle, be modified in time as well. That has been in effect the experience in the WTO. During the post Uruguay Round period, as a consequence of the dismal results in terms of development gains for developing countries and the worldwide demise of the Washington consensus as a legitimacy provider for domestic and international policies, the dynamics of multilateral negotiations have been signalled by the struggle by developing countries to retain and regain policy space. The dropping out of three of the four "Singapore issues" (competition, investment and transparency in government procurement) from the WTO work program decided at the 2003 Cancun Ministerial Meeting is an expression of the first objective. Most notably, the last round of multilateral trade agreements in 2008 has collapsed under the brunt of the global conflict of economic interests, after it failed to meet the expectations set for a “Development” round.

The Doha “development” round is still undergoing negotiations, and developed countries continue to attempt to further reduce the policy space available to developing countries. The provision for infant industry protection of up to 8 years in the WTO had come under serious threat in the highly controversial NAMA negotiations. Although current proposals, negotiated in 2008, allow least developed countries to protect their key industries, to break patent laws for a period of time, or to be exempted from TRIM obligations for 5 to 7 years, once a sector is liberalized, tariffs in that sector cannot be raised again. Such binding constraints do not account for the fact that industrialization is a lengthy process and that countries should be allowed more policy space for newly emerging infant industries, as well as the flexibility to reverse rates if the country underestimated adjustment costs. The latest agreements of the Doha “Development” Round proposed a “simple Swiss” formula that maintains steeper cuts for higher tariffs, which entails that higher tariffs are reduced relatively more than lower tariffs, but applies separate coefficients for developing and developed countries to allow developing countries more “flexibility”. Despite its attempt to provide “special” and differentiated treatment, this Swiss formula subjugates developing countries to significantly greater reductions in their tariff rates (especially by percentage points), entailing enhanced market access for the developed countries in defiance of less than full reciprocity conditions.

Moreover, the current trade regime limits developing countries’ ability to diversify into higher value added manufacturing industries through tariff escalation, which discourages the use of forward linkages in the processing of and manufacturing of raw material exports. The FAO has demonstrated that tariff escalation stands as a major obstacle in the way of developing nations’ efforts for the vertical diversification of agricultural products. This issue represents a serious constraint for developing countries burdened with chronic food insecurity. Such limitations on policy space equally concerns the Arab region, which once self-sufficient in food production today is highly dependent on imports for its cereals and food consumption. To make matters worse the regions agricultural sector makes up only 12% of the region’s GDP despite its much larger share of employment of 30%, a clear manifestation of the sector’s lack of productivity. Here too developing countries have some room for manoeuvrability, room which has already been used through the application of export taxes. Export taxes have been heavily employed by developed economies and continue to serve as a useful source of government revenue and most importantly as an effective means of protecting domestic value added processing by acting as an indirect subsidy to more dynamic industries.

The success of this strategic response of course varies and depends, among many factors, more importantly on the market power of the exporting country. Although export taxes are not restricted by the WTO currently, the European Union has serious interests vested in passing through its proposals (presented in 2008) for curbing the use of this policy tool for non-agricultural products, which it views as a threat to its competitiveness, in the near
The European Union currently restricts the use of this policy tool as well as quantitative restrictions in stipulation through numerous FTAs, preferential trade agreements PTAs and economic partnership agreements EPAs. In addition, in practice many developed countries have started to increasingly resort to the use of non-tariff barriers to replace tariff cuts. Currently the use of anti-dumping is on the rise, but the rules allow each country to establish its own standards for determining whether dumping is taking place and provide many loopholes. The use of anti-dumping measures and sanitary and phyto-sanitary standards, which are also allowed, often work against the interest of developing countries. More importantly, non-tariff barriers are quantitatively and qualitatively more complex than tariffs and agreements, and their reductions are likely to be slow.

Notwithstanding the limitation of policy space imposed by multilateral and bilateral trade agreements, Arab states still have a significant degree of freedom to formulate well-informed flanking policies. The lessons learned from the global financial and economic crises prompted developed and developing countries to move towards higher degrees of state interventions and strengthening market regulations. Both developed and developing countries came to realize and appreciate the negative impacts of globalization and market deregulation, in particular and neoliberal economic policies, in general. Regional and South-South cooperation offer a viable venue for the advancement of development friendly trade policies and retrieval of previously lost policy space.

In a number of areas policy space has been regained, for example, among others: (i) the amendment introduced to the TRIPS agreement allowing access to affordable drugs to developing countries suffering from epidemics; (ii) the extension of the transition periods under the same agreement for LDCs; and, (iii) the extension of the timeframe for elimination of export subsidies to a number of developing countries; and, (iv) the granting of a number of waivers allowing to depart from obligations. Furthermore, experience has demonstrated that regional agreements among developing countries, due to enforcement limitations and the political negotiated nature of the processes, have by and large not significantly infringed on the policy autonomy of participating countries. This is the case of the Arab region also. Regionalism has not been effectively streamlined into the countries national development policies and the degree of compliance with their commitments at the regional level has been for the most part, very limited to the extent that those commitments did not directly collide with national economic policies.

There are other potential tools beyond tariffs and subsidies for implementing development friendly trade and industrial policies, such as, inter alia, coordination policies, technical assistance and information provision. Moreover, as long as export performance requirements are equally applied to domestic and foreign producers, they are not prohibited under TRIMs, and state-run firms and skill building policies are still compliant with WTO standards. For example, Taiwan and Singapore have achieved remarkable dynamic industrial progress through extensive use of state-owned enterprises. In fact, Singapore has one of the largest SOE sectors in the world, where almost all of the land is government owned. SOEs could be established in sectors where capital market failures are more pronounced. Skills upgrading policies, which include government sponsored training and education policies, are available as policy instruments, as well as other forms of government support, such as providing overseas marketing information services through state export agencies. These policy instruments require adequate institutional capacities.

Another alternative to unfeasible trade protection can be support for domestic undertakings through subsidies. Fortunately, for the majority of the Arab countries fiscal analysis has indicated that substantial space exists for the use of subsidies and the financing of the costs of other development-friendly trade and industrial policies. The WTO Agreement on Subsidies and Countervailing Measures (ASCM) has imposed considerable constraints on industrial policy options, and the use of almost all subsidies has been banned except in

\[9\]
agriculture, R&D, and regional development, where the developed countries most actively use them. The existing rules, however, leave a certain margin for subsidies by developing countries and the Agreement on Agriculture also provides some policy space to support the agricultural sector through, inter alia, its de minimis provisions. In the ASCM, most developing countries are sheltered from action by the requirement that the complainant has to demonstrate injury before taking action. Bilateral agreements with the US and the EU are silent on the question of subsidies for goods, deferring on this issue to WTO rules.

Moreover, WTO rules on subsidies apply to trade in goods only. Thus, there is ample policy space to use these instruments in the case of services. US bilateral agreements explicitly exclude subsidies from the rules on trade in services. Government procurement policies that grant preferences to local production over imports have been actively used to promote domestic sectors. The Government Procurement Agreement in the WTO is a plurilateral agreement to which very few developing countries are signatories. The bilateral agreements, on the other hand, incorporate strong rules about government procurement extending national treatment to imports. Trade in services, which has been growing faster than trade in goods since 1980s, constitute a very dynamic segment of world trade. Although, much of the gains in services trade are dominated by China, India and South Africa, developing countries stand much more to benefit from increased trade in services than trade in goods. Moreover, in its most current form the GATS agreement is one of the most flexible WTO agreements, whereby a developing country has the choice to sign up for liberalization in any service sector of its choice and can decide the extent of liberalization. Furthermore, services can be utilized to provide indirect support to the manufacturing sector in the form of subsidized services. Thus far, developed countries have pushed for liberalizing skill-intensive services, in sectors like banking, insurance, and information technology. The existing policy space in trade in services proposes a promising venue for Arab governments to pursue, but requires careful delineation, assessment, coordination and leverage for negotiations.

Another viable venue for Arab countries to better position themselves to benefit from the opportunities of the fiercely competitive and consolidated global market could be through regional integration. Rather than solely focusing on further liberalizing intraregional trade, regional integration could be centred around building regional industrial capacities and structural linkages and discovering production complementarities, for better export competitiveness. Large Arab investments, particularly by the Gulf countries, in developed countries can offer more than high returns on petrodollars, can be utilized to induce technological transfers. The same investments can utilize intra-firm trade, create interlinked supply chains with significant value added produced in the Arab region and even serve to establish marketing outlets for exports.

Successful integration requires coordination and harmonization of existing regional agreements, and pushing for industrial and trade agendas in the WTO as a regional bloc. Together, Arab countries constitute a large market with a great degree of homogeneity in output and exports that allow for supply chain integration and healthy manageable competition, which provides incentives for efficient cost structures, higher productivity and quality enhancements. Meanwhile, the region possesses significant degree of heterogeneity in terms of factors of production and environment, including land, climate, natural resources, labour and capital, allowing for the establishment of specialization and comparative advantage. A large labour force, ranging from unskilled to highly skilled workers, closely connected to a sizable network of professional Arab expatriates in developed countries offers no less than the success factors effectively utilized by India, for instance, particularly in developing its computer software industry.

These trends open up new possibilities for Arab countries to attract foreign direct investment (FDI) and reap technological spill-overs and for indigenous producers to become part of the
global buyer-driven or producer-driven networks of transnational corporations (TNCs), particularly in the EU. The growing competition for FDI, however, in conjunction with the ongoing process of global production shifting have left developing countries with less time to reap the potential benefits of foreign direct investment, raised the threshold for host country firms’ participation in global value chains and increased the pressure on indigenous companies for constant upgrading. Firms from developing countries need to rapidly increase their capabilities to effectively participate in this new global economy and the state needs to support such efforts. For example, a study on Costa Rica and Mexico, considered the success stories of the region in terms of attracting FDI, found that the positive knowledge spill-overs that were expected did not materialize because of the absence of coherent government policies to advance national capabilities, overcome market failures and support the integration of national producers into TNC’s global production networks. As early as the 1970s, Tunisia, for example, employed a targeted approach to attract investment in sectors that had higher dynamism and technology spill overs and implemented policies such as local content requirements. Unfortunately, the state’s ability to adopt a targeted approach to FDI in the same way that Korea and Taiwan did has been severely restricted under the current TRIMs agreement. Policy tools such as export-import balancing requirements, domestic content requirements, foreign ownership ceilings, and technology transfer conditions are no longer available for use.

For example, over the last decade Egypt has received large inflows of FDI, representing up to 9.3% of its GDP. Unfortunately, in the absence of policy interest in developing manufacturing, much of the FDI has been channelled into real estate, tourism, purchasing of privatized companies, with a significant proportion into the small petroleum sector. State interventions, providing greater incentives for FDI that bring along technological transfers in key productive sectors and allow for a higher domestic value added and vice versa, are direly needed. However, even when the international trade regulatory regime does not constrict a government’s ability to do so, various FTAs or bilateral or regional agreements may severely infringe on a state’s ability to promote development friendly policies. In Mexico’s situation, for instance, according to Chapter 11 in NAFTA “foreign investors [were given] the right to take the host country government to special international arbitration bodies of the World Bank and the United Nations if they [thought] the value of their investment [had] been reduced due to government action”, which was broadly defined. Mexico’s state was rendered incapable of imposing any conditions on FDI ranging from nationalization to environmental regulation. Thus the problem was not only one of the absence of such policies, but also that state capacity was legally constrained from being able to make effective use of the opportunities Mexico aspired for in committing to the North American Free Trade Agreement.

However, it is critical to note that a country’s available policy space is a contested space. Differences in development-mindedness of governments and in their ability to push the boundaries of the available space can make it larger or smaller. In the end the question is whether governments have the political will to retain and use the available policy space left and the political will to regain space that was given up earlier. Countries in the Arab region cannot afford to be locked in static comparative advantages; they have to move up the ladder to dynamic competitive advantages. The alternative is just a default option that would not address the social problems in the Arab countries. The state’s leadership of the economy in this respect is indispensable, not only in the adoption of a developmentalist framework, but also in fostering a better understanding of the global market, nurturing south-south cooperation and pioneering regional initiatives to gain more leverage in international trade negotiations.
Industrial policies and the new approach to development

The emerging neo-developmentalist perspective is grounded in the realization that market forces acting alone are not capable of lifting developing countries onto the road of development. Intervention is needed to ensure sustainable long-term increases in productivity, creating jobs at a rate in accordance to the pressing needs of developing countries, while raising the standard of living for the majority of the population. The basic tenet of this approach is that state intervention in the economy is necessary if developing countries are to escape from their present situation and initiate an accelerated process of convergence with the developed world.

Neo-developmentalist basically argues for an alternative approach to development which differs from the neo-liberal prescriptions in some significant ways. It encompasses an alternative policy package that includes, among others: (i) development-friendly macroeconomic management aiming at minimizing growth variability and financial volatility and assuring competitive exchange and interest rates through market-based management mechanisms; (ii) active industrial policies supporting domestic productive sectors addressing market failure an realizing positive externalities; (iii) emphasis on equity and distributive, targeted pro-poor policies in contrast to the “trickle-down effects.” notion embedded in neo-liberalism; (iv) a pro-active fiscal policy which identifies sources and agencies for resources to finance developmental programmes expanding the available fiscal space and the utilization of fiscal policy to smooth the economic cycles. These policies have to be complemented with an environment-friendly approach which does not opt for short-term economic gains at the expense of long-term environmental degradation.

There are several lessons learned from the Asian experience that are still applicable. First, as Stiglitz (2001) has correctly noted, “The fact that all economies in the region applied industrial policies suggest that those policies were an important component of their development strategies, this at the margin of our highly imperfect econometric techniques are successful or not in quantifying this assertion.”

Second, development will not be feasible unless countries adopt policies where the expansion of indigenous technological capacities is at the core of achieving structural change and competitive advantages in higher value-added goods and services. This calls for the expansion of knowledge-based assets that will lead to increased investment and productivity growth. Today, a country’s competitive advantage is determined by innovation rather than factor endowments and by the ability to diversify up the value chain and not get stuck at a particular static comparative advantage. The technological and knowledge race is fierce, and countries that are able to master new technologies and innovation will have competitive advantage at the expense of the rest. The question is whether firms in developing countries by themselves without any support from the state will be able to participate effectively in such a race.

Third, as stressed by Hausman and Rodrik (2003), highlighting the problem of “self discovery,” state intervention is needed in order to overcome entrepreneur’s risk aversion in situations in which investments are deterred, because while bearing the risk of failure, investors may end up sharing the benefits with later arrivals to the business. The rationale for intervention in these cases is not very different than that underpinning the intellectual property protection regimes. The difference is that in the latter case, innovation is a protectable matter in order to accrue rents justifying its efforts and promoting more investment in innovation. In the case of self discovery, the business idea is not protectable by IPRs. What is interesting is that while there is strong consensus in most of the neo-liberal camp about the benefits of IPR protection, a similar rationale is disputed when applied to supporting new business ideas and/or relatively risky and large investments that could be
deterred because of the risk of incurring in all the costs while confronting uncertainty about the future benefits.

Different combinations offer a range of possibilities. The old industrial policies associated with import substitution industrializations, now discredited and unfeasible, were low in challenge and high in support mainly through protection from foreign competition. On the contrary, the neo-liberal prescriptions, recommending high challenge to be generated by market forces alone and very low support, has failed Arab as well as most developing countries. The industrial policies being suggested today by many analysts are centred on policies encompassing high challenge, which will come anyway from market forces and globalization, in conjuncture with state enforced parameters and high support by means different than just trade protection. Therefore, no one is proposing a return to the policies of the past. Those policies played their role in their moment, but are certainly not viable or appropriate in the current context of globalization.

An early argument in favour of state intervention is that of “infant industry” or dynamic comparative advantage arguments. Simply stated, it highlights the fact that firms or industries learn by doing and move in time down the cost curve until reaching international competitive levels. Confronting competition from foreign producers that have already moved down the cost curve will impede these activities to develop in developing countries. Therefore, support is needed to allow firms’ time to transit to higher levels of competitiveness. This line of argument is generally not disputed. The dispute is, rather, over the instruments that were being used and what can now be used, to allow firms to become competitive. While trade protection is increasingly becoming an unviable policy for most of the Arab countries that, there are other instruments that can be utilized for providing support to domestic productive sectors (e.g. among others, indirect and in-kind subsidies, financial instruments, land allocation, government procurement practices, public-private joint ventures, state funded and managed quality control and R&D and technological support) that would generate similar outcomes. Many of these instruments have been utilized successfully in the more recent waves of industrial economies, such as India, Brazil and Turkey, who are facing the same challenges as Arab countries.

State intervention oriented to support the upgrading of technological and overall capabilities of domestic firms has been widely discussed in the literature. Among others, Dasgupta and Stiglitz (1985) have shown that industrial policies are important for dynamic learning effects; and, Rodrik (2006) suggests that public support is crucial to help build technological capabilities to help provide the inputs that enable producers to produce new and more sophisticated products. The centrality of this type of intervention is not disputed and is also feasible. In the case of developing countries, the main debate is, again, regarding the instruments that should and can be utilized.

While orthodox economists favour horizontal measures, upgrading the educational system and developing national innovation systems, other analysts call for selective and more targeted forms of intervention. A crucial issue here is timing. Even though nobody could disagree with the importance of upgrading education and implementing national innovation systems in developing countries, such undertakings demand a very long time to fruition. The imperatives imposed by globalization do not afford the luxury of waiting. Developed countries pour massive amounts of public resources to support R&D and the emerging Asian economies are rapidly catching up. Selective and targeted interventions, through i.e. subsidies for R&D and upgrading business capabilities and specialized skill training programmes, among other possible measures, are needed if promising productive sectors in the Arab countries will be able to achieve adequate levels of competitiveness in the medium-term and diversifying into higher value-added products and services.

Productive sectors might confront temporary difficulties arising from competition but they
have the conditions for being competitive once those problems are overcome. In the absence of support, the productive capacity is dismantled and a sector with potential might be lost. Interventions in these cases should aim at supporting restructuring and avoiding losing capital and accumulated knowledge. Some argue that in these cases capital will migrate to other more productive activities, therefore the net effect for the economy will be neutral or even positive. However, perfect capital mobility does not exist in reality. Capital is embodied in specific assets and does not easily migrate from one activity to another. In addition, capital movements are induced and often distorted, by investors’ false notions and/or expectations of profits and losses, tempting speculation, own attitude towards risk and limited information and/or foresight. Therefore, it would be socially inefficient to eliminate such capital, in particular if the present value of future income that it would generate is greater than the resources needed to maintain it in activity. Similarly, state intervention is needed to ensure an orderly market exit of non viable firms, aiming at rescuing as much capital and knowledge as possible.

**Concluding Remarks**

The stylized trade and industrial facts presented in this paper showcase the manifestations of the structural retardation in the Arab region, evinced by Arnim et al. (2011). Structural retardation was accompanied by substantial trade liberalization, which has failed the Arab region. Today, the Arab countries together represent only an insignificant proportion of world trade, and the relatively small boom witnessed in exports has been attained in oil-related sectors at the expense of other productive sectors. Services are accruing increasing importance for the Arab region, but generally consist of low value services with little knowledge and technology spill-overs to the rest of the economy. Meanwhile, service sectors with significant linkages to the manufacturing sectors are small or declining in their relative share.

The trend in the regions’ import and export structures simply enumerate the degeneration of the manufacturing sector of the Arab region, which is the least industrialized amongst developing regions. With the exception of some regional winners of course, the majority of Arab countries continue to serve as the blue-collar workers of the world’s sophisticated production hierarchy and depend on imports for almost everything down to bare necessities, even the cereals they consume, from the rest of the world.

This trade imbalance unfortunately persists in a region with enormous potential for economic development, where the over dependence on oil in the region has crowded out interest in policies to develop a competitive manufacturing base. The corruption that has marred its political structures has also tainted the economic structures of the Arab region, which hosts an industrial base that cannot transform its own natural resources to produce goods and services that can be used locally. As a result, liberalization policies and economic reforms in the region have been accompanied by little to no transformations in the structure of its economies and the composition of its trade.

To make matters worse, during the last couple of decades of trade liberalization and other neo-liberal economic reforms, a developing nation’s policy autonomy has now been severely constricted. The means through which developing countries could develop dynamic comparative advantages and successfully diversify into new industries, tools once used by the East Asian economies as well as the developed economies themselves, such as foreign ownership caps, local content requirements, tariff protection, or subsidies are no longer available. The current levels of tariffs and restrictions imposed through the TRIPs, TRIMs and GATs bind and impede the ability of late-comers to follow the East Asian development trajectory with ease, and further trade liberalization in the Arab countries threatens to “lock-in” the orientation of development policies in a number of critical policy areas.
Arab countries, thus, should carefully assess the implications of negotiating proposals on the table in the WTO and of trade liberalization proposals in FTAs, evaluating, from a human development perspective, the implications for the domestic industry of alternative commitments. Assessing the potential implications is necessary in order to suggest appropriate flanking policies to promote productivity improvements in critical sectors. Some Arab countries, Morocco and Tunisia for example, are implementing interesting programmes to support their industry. It would be beneficial to assess the efficacy of such programmes and the extent to which best practices could be shared among Arab countries. It is also necessary to explore what measures could be taken at the regional level to support national efforts aimed at enhancing the productivity and competitiveness of the firms; and ways and means to turn regional integration into an effective mechanism for the development of industries in the Arab region.

The Arab region stands much to lose lest it take control of the small window of policy space left. The state’s leadership of the economy in this respect is indispensible and its political role is more salient for securing favourable terms in multilateral agreements and for ensuring more successful integration into the global hierarchy of production. Internal constraints on policy space, depending on the size of the country, institutional capacities of the state or the availability of resources, may also make it difficult for many countries to take advantage of the external space still permitted. Nevertheless, fiscal space analysis has indicated that substantial internal policy space exists for many Arab economies to promote development friendly trade and industrial and social policies. Its utilization, however, would depend, on the political will and the overall orientation of the development policies being pursued. Hence, the utilization of the effective policy space for a capability-based development strategy will ultimately depend on the emergence of a development-oriented leading political coalition willing to shift gears and implement policies outside the variants of neoliberal conventional wisdom.

The crucial ingredient for development friendly growth, then, is “a capable and largely developmentally oriented state.” This in turn requires a genuine rejection of the primacy of the market and unfettered trade liberalization and a better understanding of the Arab region’s context within the global hierarchy of production. For the Arab region this implies leadership in devising an industrial vision, for taking advantage of regional pacts when possible, i.e. in energy sector, to exploit mass scale production capabilities through regional projects while excluding others from the same market share, and in herding political will to guide domestic and foreign investment away from a low-value added economy towards a dynamic and knowledge-based economy. Moreover, the countries of the region must cooperate better in the “green” rooms of trade negotiations, and developing states must have the playing field “tipped” in their favour if they are to have the prospects of moving up the value chain of global production and fully benefit from the opportunities present. Thus, in this sense, with the current global market conditions at hand, “the national governments of poor countries have a duty to employ every means at their disposal to promote the industrial advance of their countries and thereby lift their citizens out of poverty. There is no ‘ethical’ duty for poor country governments to obey the laws of the international ‘level playing field’ established by the rich countries. Rather it is their ‘duty’ to manipulate these arrangements so as to benefit the growth of output and income in their own country”.

Endnotes

1 The authors would like to extend their appreciation for the indispensible research support of Asmaa Abdel-Nabi and the comments and guidance of Mohammad Pournik.
2 The countries covered include only: Egypt, Jordan, Morocco, Tunisia, Kuwait, Oman, Qatar and Yemen and Saudi Arabia (due to limitations in data)
References to the region are based on the small sample of countries for which data is available. According to UNCTAD Stat Database WD 2006 WDI 2006 Amsden 1989

The model has not been constant and has been tailored to country specific and global circumstances. In fact, the South Korean government strongly discouraged spending foreign exchange for purposes other than industrial development through various luxury consumption taxes, import bans, high tariffs and excise taxes. For further details please refer to Chang 2008, Bad Samaritans Chang 2006: 29, Bad Samaritans Nolan 2005: 148 and Evans 1995: 6

Palley 2011

Hirst and Thompson 2000

Chang 2008: 13

Gallagher 2008, table 1

Gallagher 2008

Gallagher 2007: 115 titled “Putting Development back in the Doha Round”

Nolan 2009

Gallagher 2009: 90

Palley 2011

Palley 2011

Palley 2011

The corresponding figures for the region’s share of total world imports of merchandise and services in 2010 are 4.3% and 6.3%, respectively. UNCTAD Stat Database

Chang NAMA 2005: 94

Shafaeddin 2009

Chang 2005 NAMA

http://www.wto.org/english/tratop_e/markacc_e/guide_dec08_e.htm

For a more in depth explanation of this see Shafaeddin 2009: 12

Stiglitz 2006: 88

TWN 2009: 13

TWN 2009: 12

TWN 2009: 3

ibid

Chang 2008: 29

This was employed by the government of South Korea, Chang 2008: 14

For further details refer to background paper “Is there Fiscal Space for Financing an Arab Development Transformation?” by Roy et. al. 2011

Ayala and Gallagher 2005

Chang 2005:15-18

Gallagher 2008

Gallagher 2007

Khor and Ocampo 2010: 11

Stiglitz 2006: 78

Stiglitz 2006: 89

Nolan 2009

Paus and Gallagher 2006

Chang 2008, 95-96 and Khor and Ocampo 2010: 12

Achcar 2009

To make matters worse, these arbitration procedures were closed to the general public even for observation, Chang 2008: 244

AbuGhattas and Paus 2006

According to Amsden 2001, knowledge-based assets comprise a set of managerial and a technological skill allowing a firm to produce a product at above prevailing market prices or below market costs and determines a country’s long-term growth.

Paus and Shapiro 2007

There are important qualifications to the infant industry argument. First, the reduction in costs over time should compensate for the higher costs during the period of assistance. Secondly, assistance should be linked to
performance by the recipient. Lastly, the appropriate support should be granted aiming towards factors that create knowledge or learning for the firms.

59 Lin and Chang 2009:6
60 Nolan 2005:145
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