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THE POLITICAL ECONOMY OF MONETARY POLICY
IN RESOURCE-RICH ARAB ECONOMIES

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Abstract

This paper investigates the role of political institutions and interests in shaping monetary policy in the resource-rich Arab economies. The paper first reviews the literature on the political economy of monetary policy, central banking and exchange rates. The paper then studies these determinants in Arab economies differentiating between populous (or labor abundant) economies and non-populous (or labor scarce) economies. Political-economic determinants of monetary policy such as sectoral groups' interest/preferences, rentier state, governance and the need to attract international capital inflows are considered.

JEL Classification: F5, P4

Keywords: *Political Economy, Monetary Policy, Resource-Rich Countries*

ملخص

تبحث هذه الورقة دور المؤسسات السياسية والمصالح في صياغة السياسة النقدية في الاقتصادات العربية الغنية بالموارد. تقوم في هذه الورقة أولاً بمراجعة الأدبيات حول الاقتصاد السياسي للسياسة النقدية، والبنوك المركزية وأسعار الصرف. ثم تقوم بدراسة هذه المحددات في الاقتصادات العربية والتفريق بين الاقتصادات من حيث عدد السكان (أو العاملة الوفيرة) وغير من حيث عدد السكان (أو العمالة الشحيحة). وتعتبر المحددات السياسية والاقتصادية للسياسة النقدية مثل المجموعات القطاعية، الفائدة / الأفضليات، الدولة الريعية، والحكم، والحاجة إلى جذب تدفقات رؤوس الأموال الدولية.

1. Introduction

The choice of optimal macroeconomic policies including exchange rate arrangements in resource-rich economies (RREs) has been lately given more attention in the economic literature (Breedon et al. 2011; Sachs 2007; Schmidt-Hebbel 2012; Heal 2007; Arezki et al. 2011, IMF 2012). The problems of pro-cyclicality of fiscal and monetary policies linked to boom-bust dynamics of oil prices dominate some of the discussions in addition to policies needed to ameliorate the possible negative effects of resource richness such as Dutch disease effects. In IMF (2012) a general framework for fiscal, monetary and exchange rate policies is advanced mainly for low income resource rich countries in need of harnessing resources for economic development. RREs adopt mostly the fixed exchange rate regime as their main monetary policy strategy (Cobham 2011; Shahin 2011). There are no monetary policy frameworks that are geared towards domestic targets whether inflation or employment. Of all Arab countries that are contemplating a move towards inflation-targeting, none is resource rich (Bracke et al. 2009).

Bracke et al. (2009) argue that inflation targeting has been adopted increasingly by Mediterranean countries as a result of the inability to manage the fixed exchange rate regime and/or controlling inflationary expectations under such a regime. While this may be true for countries that are faced with capital inflow shortages or are vulnerable to inflation, the resource rich economies' oil-generated capital inflows make them able to manage the exchange rate. While this technical ability of maintaining a fixed exchange rate regime is important in explaining why such regimes are maintained in RREs, it is also crucial to investigate the political economy of such monetary policy framework.

In contrast, the political economy of fiscal expenditures and taxation in RREs is fairly understood. In this paper, the political economy of this monetary policy choice is studied. The main political-economic determinants of policy as studied for developed countries are sectoral groups' interest/preferences, relations between industry and finance, relative power of capital and labor and international economic relations (Epstein 1982/1992; Epstein and Schor 1989/1990/1991; Gibbs 1987; Maxfield 1997; Hening 1994; Eichengreen and Leblang 2003).

In this respect, two peculiar characteristics of RREs (especially non-populous ones) make the study of political economy of monetary policy more elusive than in resource-poor economies. Oil richness in the Arab world has led to the rise of the rentier state—a state that does not rely on taxation of the surpluses generated by a productive economy but has its revenues originating in extractive industries (Karl 2004). Rulers in rentier states can potentially rise above the political economy and have relatively high independence from societal group interests.¹ Second, in RREs there is dominance of fiscal distributional mechanisms as evidenced in stark fashion during the response of GCC countries and Algeria to the Arab Spring. These countries used large expenditures and transfers to the population as means of preventing social and political unrest (Althani 2012; Davidson 2012). The dominance of the fiscal distributional mechanisms represent the main way of the rise of importance of political economy in RREs policy choice after the initial period of the independence of rulers from societal interests right after the discovery of oil.

However, political-economic determinants such as the rentier state, role of the private sector in the economy, the peculiarities of labor markets and the degree of necessity of attracting international capital inflows are aspects that may shed some light on the monetary policy choices undertaken by governments in RREs. The paper shows that these factors play an important role in the choice of the fixed exchange rate regime as the main monetary policy

¹ Rentierism has not only affected RREs but most Arab economies especially the countries that export labor in addition to receiving tourism and Arab investment such as Egypt, Jordan and Lebanon (Owen 1981). This rentier link has become an important part of the political economy of the Arab world.

framework for RREs. Although, the distributional aspects of this monetary policy framework are marginal given the current fiscal channels, there are currently no political-economic incentives for a move towards inflation targeting, central bank independence or in general adopting internal targets for monetary policy.

This paper is organized as follows. Section 2 provides an overview of the literature on the political economy of macroeconomic policy. Section 3 delineates the economic and political effects of oil-richness. Section 4 applies the concepts of political economy of macroeconomic policy to RREs. Section 5 discusses the political economy of fixed exchange rates. Section 6 provides conclusions.

2. Political Economy of Macroeconomic Policy

Economic policy is a function of politics, events and ideas. Historical observations and political economic analysis has shown both theoretically and empirically that economic policy is not independent from the political economic structures prevalent in society. In addition, economic theory has played a major role in presenting governments with policy options. However, the power of economic ideas is largely mediated through political institutions and interests. Moreover, economic or political events have large influence on economic policy. Historically, the Great Depression and World War II have been pivotal in the acceptance of Keynes' ideas in the Western world (Hall 1989). The current economic crisis or The Great Recession has forced governments to adopt long-forgotten Keynesian policies. Many prominent economists have recently advocated the need for a major change in the conduct of macroeconomic policy (Krugman 2012; Stiglitz 2012; Sachs 2011; Blanchard et al. 2010).

Prior to this nascent shift in thinking about macroeconomic policy, central bank reforms in the 1980s have stressed the importance of central bank independence from political authorities and the primacy of price stability as the objective of monetary policy. This coupling of central bank independence and inflation targeting has grown out of the New Classical theoretical models of Kydland and Prescott (1977) and Barro and Gordon (1985). Rogoff (1985) has shown that an independent conservative central bank that has higher inflation-aversion than all economic agents and groups in society and is protected from the political influences will produce less inflation-bias than a normal central bank. The relationship between central bank independence and low inflation has been corroborated by many researchers (Cukierman et al. 2002; Loungani and Sheets 1997; Sturm and Haan 2001).

Despite the apparent theoretical underpinnings of such policies, protecting central banks from political influences was seen in itself as a product of the dominance of finance and the rentier class in the economy. Posen (1993/1995) has shown that central bank independence is neither exogenous nor sufficient for the generation of low inflation. Independent central bank preferences were determined endogenously by the financial sector opposition to inflation. This view on the power of finance over economic decision making process in capitalist economies is not new. For example, the return to the gold standard in the interwar period at pre-war parity in Great Britain was driven by political considerations, the power of the rentier and the doctrine of sound finance. Keynes was vehemently against this policy given the effect of this exchange rate policy on output, wages and employment (Keynes 1963).

Stiglitz (2012) has argued that monetary policy and the central banks have been captured by financial interests and the banking sector. The anti-inflationary policies conducted by the central banks have benefited the financial sector and hurt employment and wages and had detrimental effects on the distribution of income in the US and elsewhere. In this respect, it has been shown that central banks can increase rentier income in the economy by raising real interest rates and lowering inflation (Epstein 2003) and in the 1980s and 1990s there has been a secular rise in the GDP share of rentier income in many industrialized countries (Epstein and Power 2003). Krugman (2010) provides a political-economic explanation of why the central

banks and the ECB in particular during the 2008 crisis raised interest rates as the world economy went into recession. Invoking Keynes' argument that Ricardian economics in its defense of free markets "attracted to it the support of the dominant social force behind authority" and Kalecki's thesis that capitalism needs unemployment to maintain wage discipline, he went on to say "monetary policy that obsessively fights even the hint of inflation...serves the interest of creditors...as opposed to those who borrow and/or work for a living." Hence, the trade-offs inherent in macroeconomic policy outcomes such as inflation and unemployment have a political-economic implication as groups and private sector players may have different preferences regarding the rankings of such outcomes.

Gibbs (1987) has shown that macroeconomic policy regarding unemployment-inflation targets reflects the political preferences of political parties in industrial democracies that are a reflection of the economic and class interests of their constituents. Right wing parties conduct monetary and fiscal policies that ensure price stability while left wing parties pursue policies that aim at full employment. The macroeconomic objectives of balance of payments equilibrium, unemployment, inflation, economic expansion are ranked differently by different political parties. Franzese (1995), on the other hand, has advanced that the costs of central bank independence is lower when the economy has prevalence of collective wage bargaining and traded goods sectors.

Maxfield (1997) provides a political-economic framework for the study of the conduct of monetary policy in developing countries. She argues that in developing countries the international dimension to the politics of central bank independence is significant. The international framework analyzes the impact of the need for international creditworthiness and balance of payments equilibrium on the domestic politics of the different sectoral groups and the government in relation to the degree of independence of the central bank. Discussing several cases of central bank independence in developing countries, Maxfield (1997) reaches the conclusion that the more a country's need for capital inflows and foreign investment, the higher is the push by the financial sector and the government for an independent central bank. In relation to foreign investment, the more asset-specific it is, the less pressure for central bank independence. In countries, where capital inflows goes into financial markets and the banking system, the more pressure there is for central bank independence that protects returns on such investments. In countries, where government debt is held by foreign investors the pressure for central bank independence is also higher.

In relation to the political economy of exchange rate arrangements and determination, private sector and group preferences also play an important role (Henning 1994; Freiden 1994). These preferences could be, for example, the outcome of the structural relationship between banking and industry or as a result of conflict between labor unions and industrialists. In the context of exchange rate regime choice, domestic political conflict over the value of the local currency is reflected in the preferences of the producers of tradable goods for a depreciated currency and the producers of non-tradable goods and services for an appreciated currency. Eichengreen and Leblang (2003) discuss with relevance to our topic at hand the political economic considerations of exchange rate choice and the hierarchy of monetary policy autonomy versus fixed exchange rate policy. In this respect, committing to a fixed exchange rate can lessen the pressure for redistributive policies emanating from interest groups in society. For example, the extension of democratic suffrage in Europe in 1920s and 1930s reduced the ability of governments to defend the currency values at all costs. Alfaro (2002) focuses, on the other hand, on the distributional impact of exchange rate appreciation in temporary stabilization programs and shows that, under certain plausible conditions, the owners of non-tradables gain from real exchange rate appreciation experienced under temporary stabilization programs.

3. The Economic Impact of Oil

Although, a region that in medieval time enjoyed prosperity that rivaled countries in the West, the MENA region in modern times at least since the 19th century has been a laggard region (Kuran 2004). In non-traditional measures of economic development success that go beyond economic growth, the region has deficits in three areas: the freedom deficit, the women's empowerment deficit, and the deficit, relative to wealth, of human knowledge (Henry 2003). The democracy deficit peculiar to the MENA countries is largely explained by the presence of oil (Elbadawi, Makdisi, and Milante 2011). The MENA is a diverse region that according to the World Bank classification includes the following countries: Egypt, Jordan, Morocco, Tunisia, Lebanon, Djibouti, West Bank and Gaza, Algeria, Iran, Iraq, Syria, and Yemen, Saudi Arabia, United Arab Emirates, Kuwait, Libya, Qatar, Oman, and Bahrain. The region's countries are further classified into three groups: resource rich and labor scarce, resource and labor abundant and resource poor but labor abundant (Almonsour 2008). In this respect, the common thread that unites and divides the economies of the region is the availability of oil. No other region in the world has such geographical agglomeration of oil-rich countries and where oil had such an important impact on economic development and influenced prospects for economic growth (Karl 2004). The classification of selected countries is presented in Table 1.

In addition to boom-bust dynamics, the presence of oil raises the specter of the resource curse, an economic pathology that afflicts countries rich in natural resources. The resource curse manifests itself through different symptoms: Dutch Disease, rent-seeking behavior, democratic deficit (Ross 2001) and armed civil conflict and the rise predatory states (Olsson 2007). The predominance of oil in the economy leads to economic and political effects. The economic effects are represented by the Dutch Disease effect where the discovery of natural resources leads to reallocation of resources from productive sectors of the economy to the oil and/or to the services sectors. The presence of natural resources leads eventually to the predominance of the natural resource sector and the non-tradable services sector such as the construction industry. The political effects are represented by the persistence of authoritarianism that results from the ability of rulers to distribute the oil rents in a fashion that stifle internal opposition and legitimize their rule amongst the populace. These effects, although originally formulated to study the experience of Middle Eastern and other developing economies, have been also shown to be prevalent even in the oil rich states of the US federation such as Texas and Louisiana (Goldberg et al. 2008).

The rentier structure of the economy in RREs has had an impact on the structure of the economy where consumption comes at the expense of investment and allocation at the expense of production. The MENA economies have been for quite a while (at least up until 2001) living off resource depletion geared towards consumption. Arrow et al. (2003) have shown that in the period 1976-2001, genuine investment as % of GDP in the MENA has registered -7.09% the only such negative figure for all regions of the world except sub-Saharan Africa while gross investment without the accounting for resource depletion was 14.7%.

Sachs (2007) has delineated three specificities that differentiate income from oil resources from other sources of income and hence have different macroeconomic implications. First, oil is a rent. Second, oil prices are highly volatile. Third, oil revenues can act as collateral for international borrowing. These features manifest themselves in state ownership of oil resources and hence of rents and their transformation into financial, physical capital or consumption, in their effect on macroeconomic stability and in rise of international debt of oil producers in times of oil export booms. The Boom-Bust cycles of oil are important in the populous oil rich countries such as Algeria and Saudi Arabia as per capita income plunges drastically during periods of low oil prices accompanied by population growth. In Saudi Arabia per capita income decreased from \$28000 to \$6800 between 1981 and 2001. However, in the small states of the

GCC where oil reserves per capita are 43 times larger than countries like Algeria and Venezuela, the rentier-distributive policies can be maintained for longer times (Karl 2004).

Dutch disease effects are well known and documented in the experiences of many resource-rich countries where real exchange rate appreciation leads to the reallocation of resources to the non-traded goods sectors and lead to the contraction of traded sectors such as manufacturing due to the profit squeeze engendered by the real exchange rate appreciation. This reallocation of resources has severe effects on long-term economic growth if the traded sectors are technologically advanced while the non-traded sectors are low productivity service sectors. In addition, such reallocation can have significant distributional effects as unemployment rises in the traded sectors such as manufacturing and agriculture. As pointed out by Ross (2007), these effects can be prevalent despite the fact that more jobs are generated in the other sectors. These effects are realized because of limits on intersectoral labor mobility, lower wages in the other sectors, and mismatches created by gender, older worker, rural workers and the less skilled. The “Dutch disease” effect, although may not be relevant in the context of GCC countries since no significant industries existed before the discovery of oil, leads to the prevention of the rise of industries. Hence, one could conclude that once a country becomes rentier state then it will always remain a rentier state. Small rentier economies like the GCC states may not be able to diversify their economies. Dubai for example has a diversified economy. However, it is still dependent on oil income by the fact of the rentier link. The rise in asset prices and tourism is directly linked to oil prices. It’s trading sector, airport and port activities are linked to oil wealth. To counteract Dutch Disease dislocations, Sachs (2007) proposes a national development strategy that build infrastructure in order to raise productivity in the traded sectors and hence counteract these negative effects.

There are, however, studies that have shown that the negative effects of oil are overstated. First, there are countries that are resource rich that have had a positive experience in growth and development. Second, some studies have shown that institutions matter in the transmission mechanism from oil richness to growth and development. In a study of the resource curse and rentier theory in the US, Goldberg et al. (2008) state that there is counterevidence to the thesis that resources lead to lower growth. In California, the gold rush when combined with high wage equilibrium led to high levels of economic growth. Wright and Czelusta (2004) argue that many countries richly endowed with mineral wealth such as Australia, Chile, Peru and Brazil have experienced mineral production growth in tandem with economic growth and technological progress. Van der Ploeg and Poelhekke (2011) survey the empirical work on the Dutch Disease effect and show that given good quality institutions and openness, resource richness can lead to economic growth although there is large evidence on the resource curse and its negative effect on institutions. Elbadawi and Soto (2012) show empirically that the resource curse exists conditional on the quality of institutions, Countries with good institutions such as inclusive politics and political checks and balances can transform rents into drivers of economic growth.

4. Political-economic Trajectories

4.1 Rentier states and developmental-distributive states

The effect of oil on the social structure is extensive (Karl 2004). Prime among these effects is the non-existence of surplus generated from the populace but from rents generated in an extractive way. The rentier aspect of the economy has given way to the rise of the rentier state. The rentier state idea was developed by Mahadavy (1970) and popularized by Beblawi and Luciani and in their book *The Rentier State*. The rentier state with its independence of revenue from taxation can rise above political economy and dependence of its rule from societal group interests. In addition, the state is able to create new classes that profit from its relation with the rulers through rent distribution as happened in Saudi Arabia (Luciani 2013). Goldberg et al.

(2008) show empirically through a study of US economic growth which includes three states with abundant natural resources: Oklahoma, Texas, Louisiana and West Virginia that there exist both economic and political manifestations of the resource curse. In a case study of Louisiana, the authors show that the administration of Governor Huey Long represented a government similar to current rentier states where redistribution, populism and extra-legal authoritarian governance were produced by the state's access to oil rent which led to clientelism and low taxes that were instrumental in electoral politics. Rentierism also took additional forms in the GCC countries where land rentierism and the Kafala system also created sources of rent income to the population independent of production activities (Davidson 2012).

The state and politics in RREs in the Arab world followed two trajectories: the rentier state in NP-RREs and for a period in the 1960s and 1970s developmental-distributional state in P-RREs. The developmental-distributive state was ideologically conceived in what became later known as Arab Socialism in Algeria, Iraq and Egypt. The commitment to redistribution and welfare state which Laabas and Bouhouche (2011) called the "authoritarian bargain" predated the oil boom of the 1970s but was solidified in the 1970s. The historical difference in state formation between P-RREs and NP-RREs is due to the struggle against colonialism in Algeria, for example, and the revolt against the monarchy in Iraq and the establishment of the Iraqi republic in addition to the ideological bent of the ruling political parties in the post-independence period.

In the developmental-distributive phase of the Iraqi and Algerian history, the middle class basis of the regimes has prevented them from transforming the economy radically as developmental states in East Asia have done like South Korea and Taiwan. The incessant need and desire to cater to middle class consumption needs have diverted funds generated by the oil sector from investment towards consumption. For example, in 1980, the Algerian government reforms mainly were directed at making imported durable goods cheaper in order to alleviate the shortages that existed in the previous period. This has led to a rise in the debt levels of Algeria and when coupled with the oil price drop in 1986 led to structural reforms and IMF agreements. In the 1970s the transition in the Arab socialist states was led by a new alliance between the rulers and the commercial bourgeois class solidified by the policy of '*infitah*' in addition to oil revenues. This bias has also laid the foundation for the rise of corruption and a political class that siphoned state resources. The degeneration of the political systems in Iraq and Algeria in the 1980s paved the way for the structural adjustment reforms in Algeria while in Iraq the war and conflict trumped any possible political developments in that direction.

4.2 Rise of the private sector?

The developmental-distributive states have degenerated in the 1970s by the creation of the alliance between a nascent crony capitalist class and the ruling regimes (Owen 1981). This relationship has developed further during the structural adjustment period and liberalization period where the main beneficiaries of privatization, market reforms and liberalization of trade and finance were the crony capitalists. However, the solidification of the power of such class did not lead to the rise of an independent entrepreneurial capitalist class that would have led to growth and development and rise of a middle class and job creation that was expected from such liberalization (Luciani 2013). Luciani (2013) argues that this class remained dependent on the state and did not "graduate" to become an independent class.

This "impossibility" of the rise of a private sector or entrepreneurial class in these countries has a theoretical explanation. In the case of Algeria, the rulers enjoy higher autonomy from the private sector than their counterparts in the GCC countries do. Joffe (2002) argues that state control is "mirrored by the occult control of the economy exercised by unaccountable elites and the army leadership." More generally, Ross (1999) has argued that the rentier theory does not fit poor labor abundant economies such as Algeria. In a theoretical study of political

economy of Arab states and applied to the Algerian case, Clement (2004) rejects the rentier theory explanation of the Algerian economy. He describes the Algerian state as a “Bunker State” where a Praetorian regime detached from society and polity is in constant political and military warfare to maintain its power. Clement attributes the non-existence of civil society and interest groups in the Algeria to its colonial past where the war for independence destroyed the elite and its civil society. Clement says that “Algeria may be better viewed as a military outpost...property rights in Bunker states are insecure and hence private sectors are marginalized” (p. 3). Algeria in the post-independence period set up a one party system. The ruling party the FLN instituted state-led development and distributive policies. The development model instituted with the Boumeddiene era starting in 1965 was based on a socialist state-led development based on an import-substitution strategy that gave priority to heavy industry (the industrializing industries) (Henry 2004; Wernefels 2002). Despite such an orientation, the Algerian state remained divided due to competing ruling group’s interests and the “rentier” mentality trumped the developmental aspects of the Algerian post-independence project. At the time, Algeria although rich in oil cannot be considered a rentier state as oil revenues represented only 12% of government revenues and only \$5 per capita in 1963 (Laabas and Bouhouche 2011). Only after the oil boom in post-1973 did oil become a major source of revenue for the Algeria where today it contributes 60% to Algeria’s budget revenues (Bélaïd and Abderrahmani 2012) and 90% of exports. The Algerian economy experienced fast growth in the period 1962-1978 where real per capita GDP more than doubled. The Algerian state provided universal schooling and health care since 1973 and subsidized consumption (Martin 2003). This social contract started to suffer cracks in the late 1970s and ended in 1986 as of the economic reforms starting in 1980 and later intensified in the 1986 as a result of the collapse of the price of oil. The structural reforms were also accompanied by a change in the monetary policy stance and an increase in the independence of the central bank (Zouache and Ilmane 2009).

In the second path in the GCC countries, Luciani argues that such a class did form and became independent relatively from the state through the networks that it established in the markets and private sector. In the UAE, for example, the private sector grew after the 1980’s crisis and subsequent reforms. The share of the private sector in the GDP rose from 15% in 1971 to 50% in 2012 (Almezaini 2013). Moreover, since the 1980s the states in the GCC countries have reduced capital expenditures and increased public wages and employment schemes which led to a lessening of the state’s power over the private sector revenues and led individuals to have a higher say in the economic decision making process which will eventually lead to increased role of the private sector in politics (Hodson 2013). However, the distributional aspects of the rentier state that are highly meshed with consumption patterns still form a fetter on the rise of a productive class. Althani (2012) says "the bulk of hydrocarbon rents is allocated among the native population, and a large portion of this is spent on imported luxury goods. As a result demand for locally produced consumer goods is low, which in turn impedes the development of industry based on local markets" (p. 41).

These two paths will have a significant impact on the political economy of policy in the future: in the former developmental-distributive states, the state will remain immune from private sector pressure to implement monetary and fiscal policies except pure rent sharing policies while in the GCC states the rise of independent business interests may lead to specific demands on policy in a fashion similar to advanced countries.

4.3 From private sector to business and class politics

A complicating factor that takes more importance in resource rich economies is that sectoral interests do not translate automatically into policy influence such as the effect on central bank independence. Sectoral influences are a function of the role of these sectors as political constituencies. Maxfield (1997) following presenting the results of Posen (1993) says “Sectoral

influence is a function to the extent to which political authorities are vulnerable to interest group pressure.” Moreover, economic crises do not guarantee the implementation of subsequent reforms. Rodrik (1996) argues that although economic crises maybe harbingers of reform adoption by states and governments, the actual casual effects are not automatic.

According to Hertog (2013), the private sector in the MENA region at large has been assuming a larger role in the economy but in general capitalists in the MENA are not coherent, do not act as a class and are not export-oriented. Their effect on policy is very weak. Economic policy, however, is not totally independent from class or group interests. Merchant classes although losing a great part of their power after the discovery of oil remain a powerful player inside and outside the state and benefit from exchange rate appreciation. In some countries such as Bahrain and Oman where rent per capita is low despite the small population, regional, sectarian or class interest play a role in the political economy. Currently many economic policies cater or respond to class interests or populist demands in Arab RREs such as: labor market policies (nationalization vs. foreign labor), housing policies (in Kuwait pushed by populist dominate parliament), land granting policies (granted to benefit class allies of rulers), government expenditures/investment policies (deviation from Hartwick rule, profits, wages, social wage,...), exchange rate arrangements (benefits non-tradable goods sectors).

Valeri (2013) argued that in the Arabian Peninsula the pre-oil era witnessed a partnership between the rulers and the merchant class. In the post-oil era, the rulers gained fiscal independent and the power of the merchant classes dwindled. The withdrawal of the merchant classes form decision making was compensated by the sharing in the oil revenue. Karl (2004) mentions specifically that in Kuwait and Qatar the distribution of oil rent eliminated the influence of merchant classes in the political sphere. In Kuwait, with the discovery of oil, the rulers have gained independence from merchant class as they became fiscally independent (Atallah 2011; Azoulay 2013). Atallah (2011) argued that in the pre-oil period, the rulers had to strike a compromise with the merchants and setup a parliament in order to guarantee their acceptance of imposition of taxes. In other Gulf States such as Bahrain, Qatar, Oman and UAE, the British colonial power insured that rulers are fiscally independent from merchant classes and provided them with the military might that weakened the commercial classes. In Dubai, the British supported the rulers in 1938 to disband merchant-supported consultative council by force. In Oman, British policies of banning gun trade and slavery led to a reduction weakened the commercial class. Alnezai (2013) on the other hand argued that in the coast of Oman, merchants did exert political influence prior to the discovery of oil. In Saudi Arabia the merchants were forced to finance the military conquest of the Saud family. This military coercion subdued the merchant class that surrendered political power. In addition, developments in Qatar with regard to the loss of pearl industry led to the loss of power of the merchant class.

This change of relation between state and merchant classes as a result of the discovery of oil has taken sometimes different manifestations. For example, in Bahrain there is currently still a distinction between the rulers and the merchant class. The merchant class depends on the balance of power between the different components of the ruling family. In Oman, on the other hand, the merchant class is meshed with the ruling structures. The Qaboos reign is dependent on the business class for regime stability (Valeri 2013).

Oman and Bahrain are the more dynamic societies of the GCC countries and the relatively least resource-endowed. Oman is unique amongst the GCC countries in that it experienced prolonged civil conflict in the 1960s when Marxist rebels fought government forces in the province of Dhofar (Halliday 1974). Bahrain also has an active civil society and has active left and Shiite Islamic opposition groupings. Both countries had various economic activities before the discovery of oil. Bahrain was the main pearling center in the Gulf before 1914 and Oman

had one of the main significant settled agriculture in Arabia (Owen and Pamuk 1998). Foreign private sector workers comprise between 50% and 90% of workers in the Gulf. In Saudi Arabia foreigners comprise 98% of the manufacturing workers, 97% of construction workers, and 93% of the service sectors (Karl 2004), in Oman and Bahrain the nationals working in the private sector outnumber those working in the public sector (Valeri 2013). Looney (2008) categorized the reasons for successful development in the post-oil period in Oman and Bahrain into five areas: limited oil reserves and awareness of their eventual exhaustion, early diversification of economy, investment in education, economic freedom and good governance.

The limited reserves of oil have pushed these countries to attempt to diversify their economies early on and more recently both countries have launched economic reforms, diversification and search for a new economic development model since the end of the 1990s. (Looney 2008; Valeri 2013). For Oman, the coming of Sultan Qaboos to power in 1970 marked the beginning of an era of liberalization and economic development that relied on diversification, national investments and efficient public sector development. Bahrain, a country that has clearer class and sectarian divisions, in addition to limited oil reserves, faced more severe developmental challenges than Oman and other oil-rich countries. Like Oman, the diversification of the economy and the prospects of exhaustion of oil reserves formed according to Looney (2008) “the persistent themes in Bahraini development planning.” Bahrain initially emphasized heavy industry but now relies on the country being the center of banking, communication and transportation in the Gulf. An interesting aspect on the role of political economy on Bahrain is the experience of the Economic Development Board established in Bahrain in 2001 whose labor market policies conflicted with business interests. Bahrain’s policy of mass labor importation that provided cheap labor to the economy has favored business interests at the expense of employment of nationals (Valeri 2013).

In addition to Oman and Bahrain, the Kuwaiti political space is vibrant with various sections of society mainly confessional active in parliamentary politics. The parliament in Kuwait has become a fulcrum of political contest in the Kuwaiti society. It has become a focal point for populist politics and demands for distributional policies such as housing laws.

The economic reforms of the 1980s and 1990s in Algeria led to better macroeconomic conditions in terms of inflation, budget deficits and balance of payments. However, at the “microeconomic level” the reforms led to deterioration of social conditions, higher unemployment and loss or shortages of social services such as housing which were instrumental in fueling the violence of the 1990s (Joffe 2002; Martin 2003). In addition, a reduction in consumption imports led to the weakening of the middle class. In this respect, the “bunker state” of Algeria is a result of the failure of economic reforms at a time of low oil prices. In the same vein as the authoritarian countries suffer from “authoritarian persistence” despite democratization, the developmental-distributive states suffer from “welfare persistence” where the population expects the maintenance of their social consumption basket. In the wake of economic reforms, drop in oil revenues and the economic stagnation represented by the in productivity, the Algerian state decided to move from a DD state to a Bunker State. Martin (2003) has argued that the economic reforms were done from above where social groups including business interests and labor did not push nor approve of such reforms. In a more benign interpretation of the “bunkerization” of the Algerian state, Martin says “the government does not carry out its role as mediator among the different interests and pressure groups (workers and unions/entrepreneurs/farmers; exporters/importers). Instead, the government superimposes opaque power structures on these fracture lines” (p. 16). Moreover, according to Joffe (2002) the parasitical economic elite that gained more power during the reforms of the 1980s undermined reforms that were attempted and instituted in the 1990s and prevented the

reforms from launching a dynamic that would have benefited the private sector and engendered the rise of a competitive productive economy.²

Moreover, Werenfels (2002) has shown that factional conflict within the ruling rentier class and the “rentier mentality” has led to a sabotage of the privatization process in Algeria that started in 1994. The liberalization of the import sector has led to a rise of monopolistic and oligopolistic rent distribution networks that involved the ruling elite cronies and even the combatants during the civil war in the 1990s. However, the rise in the price of oil in the post-2003 period may have allowed the Algerian state to leave the bunker and return to a quasi-developmental-distributive state. In accordance with a five year plan from 2010 to 2014, most of the oil revenues (70%) will be reinvested in Algerian economic development projects (Álvarez 2010). However, Algeria remains a rentier economy that hinders the usage of oil revenues to build up a more diversified economy.

5. The Political Economy of Fixed Exchange Rate Regime

RREs economies mainly use the fixed or pegged exchange rate regime as their main monetary policy framework. The choice of fixed or pegged exchange rate regimes in the RREs limit the financial market development necessary for the development of advanced monetary policy instruments such as open market operations or a central interest rate similar to the federal funds rate in the US. According to Cobham (2011), MENA countries should move towards what he called an Advanced Monetary Framework that goes beyond fixed exchange rate regimes and according to Shahin (2011) should develop a more efficient transmission mechanism for monetary policy than under the current exchange rate regime system that subordinates internal monetary policy to the exchange rate peg where local interest rates follow the US federal funds rate. Hence, political economy considerations need to explain the framework and institutions such as the central bank independence rather than specific instruments. In this respect, the fixed exchange rate regime is chosen due to the absence of political economic interests in internal objectives of monetary policy whether employment or price stability. Central bank independence is also uncalled for as central banks act in a way to maintain the exchange rate determined by political authorities using foreign exchange reserves that are in many countries partially outside the control of central banks.

In a study of the exchange regime choice for small rich economies that included two GCC countries Oman and Bahrain, Breedon et al. (2011) find that not only do these countries predominantly choose fixed exchange rate regimes but that such choice is optimal since they do not find any relationship between macroeconomic volatility and the type of exchange rate regime. This regime delivers exchange rate stability with no macroeconomic costs although there are no monetary policy frameworks that are geared towards domestic targets whether inflation or employment. The employment objective is largely irrelevant in the rentier state as output is determined by the state' effect on aggregate demand through huge expenditures, infrastructure investment and housing provision. Second, labor markets as discussed earlier are dominated by imported labor with a huge reserve army of "voluntary" unemployment (Davidson 2012). As for inflation, of all Arab countries that are contemplating a move towards inflation targeting none is resource rich (Bracke et al. 2009). Moreover, inflationary expectations are not considered a threat to the economies despite the inflationary pressures since 2003. This can be understood from the political economy of the RREs. Inflationary expectations do not automatically translate to wage increases and the real exchange rate appreciation pressures are not threatening to any export sector. Hasan and Alogeel (2011) have shown that for Saudi Arabia and Kuwait, external factors play the major role in inflationary

² Dillman (2000) stated that “There are few parallels in the rentier world, save perhaps in Nigeria and Indonesia, to the wide-scale conversion of army officers and high-ranking *cadres* into pseudo-private entrepreneurs and predators through privatisation, deregulation of importing, liquidation of local public companies, and joint ventures between multinationals and the remnants of state companies” as quoted in Joffe (2002).

pressures. First, since imports form a large share of domestic demand, the effect on the local price level is through mainly an increase in the foreign price level. Second, through what they called ‘flexible labor policies’ that led to an increase in foreign labor inflows. The latter affects the domestic price level through the effect of the rise of the foreign price level on the reservation wage of foreign workers. According to Hasan and Alogeel (2011), merchants can pass the increase in the price level to consumers hence maintaining their profits. Inflationary pressures in the non-tradables sectors are mitigated through the flexible labor policies and government subsidies. Finally, monetary discipline required to maintain the fixed exchange rate regime is helped by capital outflows that mop up excess money supply. In this respect, Almonsour (2008) has shown that in RREs, capital outflows are an endemic phenomenon. The sovereign funds that move capital out of the GCC also add to this capital outflow. From the above we can discern a political-economic structure that supports the choice of the fixed exchange rate regime as a monetary policy framework in RREs. Moreover, it is interesting to cite the study of El-Achkar and Shahin (2009) that showed that there is no relationship between de facto exchange rate arrangements and price stability in 18 MENA countries in the period 1975-2005 which included RREs such as GCC countries and Algeria. This lends further support to the idea that the choice of the fixed exchange rate regime in RREs must have been for different reasons other than achieving price stability.

Moreover, the social and economic structures of the rentier states prevent the rise of an export oriented productive sector. As Henning (1994) articulated “without clearly articulated private preferences...policy [*exchange rate policy*] is more likely to be detached from the interest of the sectors engaged in international competition.” In rentier states by and large such sectors are non-existent. The economy is dominated and will be dominated by mainly import merchant classes, service economy, real estate sectors and non-tradable sectors; all are oblivious to a large extent to real appreciation of the exchange rates under fixed exchange rate arrangements and inflation. Adam and Cobham (2009), using a gravity model to assess the desirability of alternative exchange rate regimes for MENA countries, have shown that by and large for oil producing countries a change of exchange rate regime (like pegging to the Euro) would not lead to a change in trade patterns. In this respect, Martin (2003) argued that despite the devaluation of the Algerian Dinar between May 1999 and November 2000 by more than 20% this has not led to an increase in non-hydrocarbon exports.

There are few studies that formally construct indexes for central bank independence in the MENA region (Gisolo 2009; Sadek et al. 1996). Gisolo (2009) provides two indexes for resource rich economies of Algeria and UAE that show a high level of independence for both. Schnabl and Schubert (2009) using the concept of debtor central banks that are prevalent in developing countries show that in oil producing countries of the MENA region, specifically Algeria, Iran, Kuwait and Saudi Arabia, net foreign assets dominate the balance sheets of central banks due to intervention in foreign exchange markets to stabilize the currency. Current account surpluses generated by oil export revenues lead to appreciation pressure on the currency, pushing the central banks to intervene in these markets. Moreover, in these countries, sterilization of excess liquidity generated by such operations is either done through government deposits with the central bank or stabilization funds (Saudi Arabia, Algeria and Iran) or OMO (Kuwait). In the former cases, such a sterilization measure necessitates close coordination between government and central banks with respect to monetary targets. Hence, the existence of reserves outside the central banks makes the independence of central banks very precarious in RREs.

In most Arab RREs, central banks have a higher level of economic independence than political independence. This can be explained by the fixed exchange rate monetary regime where there is absence of internal objectives while political dependence is a feature of the autocratic regimes. Economic independence in a fixed exchange rate regime with no internal objectives

is unimportant as the traditional argument for economic independence with respect to targeting inflation in the spirit of Rogoff is of no relevance in such a context. In the case of Algeria, political independence however was surprisingly larger than in GCC countries as inflationary developments in the late 1980s and 1990s took hold of the economy and Algeria was subjected to structural adjustment and IMF programs. Zouache and Ilmane (2009) say that from 2001 the Algerian central bank started to have one objective which is price stability and that since 2003, despite reduction in its legal independence, its de facto independence increased. The developments in the legal/de facto independence of the Bank of Algeria was subject to political and economic pressures stemming from the economic crisis starting in 1986 and the violence of the 1990s. The Algerian authorities abrogated in 2003 the Law on Money and Credit that gave higher independence to the Bank. This abrogation allowed the monetizing of budget deficits. However, despite such change, the Bank of Algeria gained de facto independence after 2003 due to the rise of price of oil and the resultant positive fiscal balance which led the central bank according to Zouache and Ilmane (2009) to “follow the suggestions of the IMF and of the central bank independence literature that is to target a unique inflation rate in a public manner” (p. 103). This anomaly can be explained only in political-economic terms a la Maxfield (1997). As the Algerian economy became dependent on foreign inflows in forms of foreign debt, the need for an independent central bank became larger. Hence, despite its decreased legal independence, the Bank pursued policies with a higher de facto independence than many other GCC countries (Gisolo 2009). Hence, the political-economic context of central bank action in unstable political environments is more important than formal independence. It should be noted that this is not a symptom of Arab or Third World exceptionalism. Hening (1994) mentions that the German ReichBank, although formally independent after the post-WWI period, monetized the huge fiscal deficits of the Weimar republic.

In NP-RREs, there is no need to attract foreign capital flows hence the need for an independent central bank is less pronounced. On the contrary, capital outflows (Almonsour 2008), savings funds, international rates of return dominate the PE of NP-RREs. It is interesting in this respect that Brendon et al. (2011) find that in small rich economies, the extensive use of international financial markets is not for smoothing output shocks but in their words “for some other purposes”. In RREs, most foreign investment is asset specific hence also less pressure for CB independence. Sectoral groups/preferences are largely absent. There is no organized national or foreign labor force. Industry is minimal. However the commercial class is significant and powerful and has played a major role in politics in countries like Kuwait. Since government borrowing from internal markets is low in RREs, then the pressure for CB independence is less. Given that the costs of CB independence is less in economies with collective wage bargaining and large traded goods sector, then the adoption of CB independence in RRCs should be less since these countries have no collective wage bargaining and their traded goods sectors are weak due to Dutch Disease effects.

6. Conclusion

One of the main effects of the non-existence of surplus generated from the populace but from rents generated in an extractive way is that it makes the problem of distribution and redistribution mechanisms generated by monetary policies marginal in rentier states. It is a fact that the huge distributional powers of the state stemming from oil rents largely trumps other forms of distribution such as monetary policy.

The development of the private sector and its independence in many GCC countries may pave the way for political developments that lead to a different economic policy as competing economic interests may be reflected in a more balanced way. For example as Goldberg et al. (2008) has shown in Texas, the democratic governance structure allowed the conflicting producing and consuming interests to balance each other. On the other hand, the disintegration of the developmental-distributive state in Algeria and Iraq has led to pathological political-

economic outcomes where in Algerian civil war led the state into becoming what Henry (2004) called a “Bunker State” and the state in Iraq to become a space for confessional struggle for power and economic rents, in effect becoming a “failed” state. This crisis and rise of formalization in ex-developmental-distributive economies in addition to loss of state control gave way to a class of crony capitalists that adulterated the process of rent distribution, and in Algeria to the rise of a tarabando economy—a parallel economy that derives incomes from, smuggling which flourished after the state ended its foreign trade monopoly. This mix of cronyism and informality had stifled the growth a productive economy including fettering the growth of the private sector including labor unions which would have translated into class and group interests in certain economic policies whether fiscal, monetary or exchange rate policies.

In GCC countries despite the increased levels of private sector independence, the formation of collective private sector interests and preferences is still in its infancy. For example, in Kuwait despite the rise of mass politics in the 1980s where a new class of full-time politicians arose amongst the Shia merchants, the rentier aspect of the state prevented the rise of horizontal class alliances and maintained vertical patronage relations. Hertog (2013) says “loyalty to the system still seems to be the most rational choice for the entrepreneurial class which is the main obstacle to the maturation of independent class-based business politics”.

The prospects for modern fiscal and monetary policy institutions and frameworks in resource rich countries hinges on the political developments in the post-Arab spring and on social development. In addition, economic diversification, labor market nationalization, the exhaustion of current account surpluses generated by oil will also pave the way for a different monetary policy frameworks but that remains a possibility only in the distant future.³

³ Elliott House (2012) says that in Saudi Arabia according to some financial experts, foreign assets will be drawn down to minimal levels by 2030 spurred by consumption and investment outpacing oil exports starting 2014.

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Table 1: Classification of Selected MENA Countries According to Resource and Labor Abundance

	Labor Abundant	Labor Scarce
Resource Rich	Iraq Algeria ~ Saudi Arabia	Bahrain Oman UAE Qatar Kuwait ~Saudi Arabia
Resource Poor	Tunisia Egypt Lebanon Jordan	

Table 2: Political-Economic Factors in RREs

Country	Position in International Economy	Groups	Group-State Relation
Oman	~	Business Interests	Strong
Bahrain	~	Merchant Class Labor unions	Weak
Kuwait	No	Merchant Class/Parliament*	Moderate
UAE	No	Almost None	Weak
Saudi Arabia	No	Merchant class Manufactured Classes	Weak
Qatar	No	Merchant class	Weak
Algeria	Yes	Crony Capitalists	Strong/dominated by state

Notes: *Populist policies by the parliament (e.g. housing laws).

Table 3: The Political Economy of Fixed Exchange Rates

Framework ⁴	Political Economy
<i>Fixed Exchange Rate</i>	No export sector (opposing appreciation) No labor unions (favoring internal objectives of monetary policy)
Effects <i>Inflationary Expectations</i>	Merchant class maintains profits through markups Flexible labor policies favored by capital Government Social Wage (rentier state) K-outflows to maximize returns

⁴ In contrast, Indonesia in the 1960s and 1970s, because of the political orientation of the Sukarno regime and the strong labor unions, did devalue the currency which led to growth in the manufacturing sector (Ross 2007).