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

Adeel Malik

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Send correspondence to:
Adeel Malik
University of Oxford
adeel.malik@qeh.ox.ac.uk

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Abstract

Revisiting macroeconomic policies and outcomes of Arab resource-rich economies (RREs), this paper synthesizes the political economy considerations that underpin policy choices. The paper argues that, in the context of Arab RREs, fiscal and financial sector policies play a particularly important role in absorbing natural resource rents. Fiscal policy is highly pro-cyclical and rooted in the underlying political settlement, which is based on extensive distributional commitments. Financial systems are deep but are known for restricted financial access to vast areas of economy. Given the excessive dependence on hydrocarbon rents and the prevalence of fixed exchange rate regimes, the external constraint remains more binding. Even where monetary policy has greater room to operate, existing policy frameworks are not geared towards domestic targets, such as inflation and unemployment, and are largely determined outside the purview of macroeconomic policy. I argue that the political objective function is essential for understanding these macroeconomic arrangements. With weak productive constituencies and few institutional constraints, macroeconomic policy involves limited feedback from the private sector and upholds the interest of the sovereign. In this milieu, institutional constraints on fiscal policy are more important than central bank independence. The paper also discusses the stability implications of current macroeconomic arrangements, arguing that stability in Arab RREs is almost entirely predicated on the uninterrupted flow of oil rents rather than resilient institutional structures.
JEL Classification: E4, Q1, P1

Keywords: Political Economy; Arab resource-rich economies, macroeconomic policies

ملخص

بإعادة النظر في سياسات الاقتصاد الكلي ونتائج الاقتصادات العربية الغنية بالموارد، تجمع هذه الورقة اعتبارات الاقتصاد السياسي التي تدعم خيارات السياسات. وتدفع الورقة بأن سياسات القطاع المالي والنقدي تلعب دورا هاما في استيعاب إيجارات الموارد الطبيعية في سياق برامج إعادة الإعمار الريفية العربية. تكمن جذور السياسة المالية شديدة التقلبات الدورية في التسوية السياسية الأساسية التي تقوم على التزامات توزيع واسعة النطاق. فالنظم المالية عميقة ولكنها معروفة بقيود الوصول المالي إلى مناطق شاسعة من الاقتصاد. ونظرا للاعتماد المفرط على الإيجارات الهيدروكربونية وانتشار نظم أسعار الصرف الثابتة، يظل القيد الخارجي أكثر إلزاما. وحتى عندما تكون للسياسة النقدية مجالا أكبر للعمل، فإن أطر السياسات القائمة ليست موجهة نحو أهداف محلية، مثل التضخم والبطالة، وتحدد إلى حد كبير خارج نطاق سياسة الاقتصاد الكلي. وأرى أن وظيفة الهدف السياسي ضرورية لفهم ترتيبات الاقتصاد الكلي. وفي ظل ضعف الدوائر الإنتاجية وقلة القيود المؤسسية، تنطوي سياسة الاقتصاد الكلي على ردود فعل محدودة من القطاع الخاص وتدعم مصلحة السيادة. وفي هذه البيئة، تكون القيود المؤسسية على السياسة المالية أكثر أهمية من استقلالية البنك المركزي. وتناقش الورقة أيضا تداعيات استقرار ترتيبات الاقتصاد الكلي الحالية، معتبرة أن الاستقرار في سياسات الاقتصادات العربية يعتمد بشكل كامل تقريبا على التدفق المتقطع للإيجارات النفطية بدلا من الهياكل المؤسسية الصامدة.

1. Introduction

The disappointing growth performance of resource-rich countries is a much-debated stylized fact in development economics. Although the associated debate on whether natural resources are a curse or blessing for developing countries remains unresolved, the excess volatility associated with primary commodity dependence is known to have profound consequences for growth and development. Oil and mineral producers are especially subjected to price fluctuations in global markets. The resulting terms of trade instability is an important source of growth fluctuations, accounting for as much as half of the output volatility in developing countries (Mendoza 1995, Kose 2002, and Broda 2004). Such volatility has economy wide consequences, reflected in particular, through distortionary macroeconomic policies.

Volatility in commodity prices leads not only to output volatility, but also permits pro-cyclical fiscal policies, which exacerbate booms and bust cycles in growth (Frankel 2011, van der Ploeg 2011, IMF 2012)[1]. Commodity shocks can also have a marked impact on savings, both public and private. Positive price shocks can lead to investments booms and oil price falls are typically associated with contractions in investment expenditures. Even the financial sector is not immune to such cycles, as credit booms during periods of high oil prices are a common feature of resource-rich countries. Primacy commodity dependence is associated with multiple economic failures. By inducing an appreciation of the real exchange rate, resource-related capital inflows can also undermine the competitiveness of manufacturing.

Despite this significance of external shocks and their associated economic ills, it is not shocks *per se* that retard development but the absence of institutional coping mechanisms to deal with such shocks. Two countries faced with a similar external shock might respond differently to these shocks depending on their underlying institutional strength. Why do trade shocks serve as economic opportunity for some countries and devastating liability for others? Why some countries are able to develop resilient institutional structures and others not is ultimately rooted in political economy.

Over time, the emphasis has shifted from the inadequacy of domestic policy responses to the politics of policy. If the key macroeconomic challenges of natural resources are price volatility, profligate fiscal policy, inadequate savings response, Dutch Disease, and the like, then the policy prescriptions are relatively straightforward. Affected countries can learn from successful experiences around the world, ranging from Australia and Norway to Chile and Botswana. No matter how simple and desirable good policies are, the principal constraint remains political, since good policies are usually politically sub-optimal. Through their distributional implications they can disturb the political order. Such insights are the well-established terrain of political economy today (Acemoglu and Robinson 2012).

In this paper, I revisit the macroeconomic experience of Arab resource-rich economies (RREs) through a broad political economy lens. As a resource-rich region par excellence, a lot has been written on the taxonomy of macroeconomic policies in Arab oil exporters. Less attention has, however, been placed on developing an integrative political economy account. Past work has tended to focus on oil-producing states in Africa and Latin America (e.g. Humphreys et al. 2007; Collier and Venables 2011). It may be fair to argue that, despite the many promising contributions to the field, including Pesaran and Nugent (2007) and Cobham and Dibeh (2011), a political economy analysis of macroeconomic policies in the Arab world is considerably underdeveloped. This paper seeks to make a humble contribution in this regard.

Before proceeding further, a few clarifications are in order. While the remit of this paper is broad, covering a vast terrain of policy and geography, the main objective is to develop a

[1] van der Ploeg finds that boom-bust cycles driven by pro-cyclicality is one of the main contributors to the adverse effect of recourse dependence (p.387). His 'nonlinear specification suggests that the resource curse is operative only for countries with a volatility of unanticipated growth exceeding 2.45 percent per annum' (van der Ploeg 2011, p. 388).

political economy account of fiscal policy that is both accessible and convincing. For completeness sake—and to develop broader linkages with other macroeconomic policies—complimentary perspectives on financial, exchange rate and monetary policy will also be offered. My principal concern is to shed light on how macroeconomic policies are mediated by the underlying balance of economic and political power and concerns for regime stability, which remain paramount in across the Arab RREs, defined in this paper to include the economies of Saudi Arabia, UAE, Kuwait, Qatar, Bahrain, Oman, Iraq, Algeria and Libya. To keep the discussion manageable, issues of institutional design, such as the make-up of budgetary institutions, will remain peripheral to my analysis. Given that this paper is mainly geared towards mapping broad political economy contours of macro policy, some of the claims should be treated as hypotheses or intellectual pointers deserving of further research.

The remainder of this paper is organized as follows. Section 2 provides a brief synopsis of the relevant political economy literature. Section 3 focuses on the political economy of fiscal policy, whereas financial sector arrangements are analyzed in section 4. Section 5 briefly reviews the monetary and exchange rate arrangements. Finally, section 5 offers some concluding thoughts.

2. The Politics of Policy

Studying the effects of external shocks often entails an analysis of macroeconomic distortions associated with a country's natural resource specialization. But, as argued before, the adoption of incorrect policy choices is itself informed by political economy. This section offers a selective review of studies emphasizing the primacy of politics. The politics of policy is crucial to understanding the patterns of spending, taxation and trade. Robert Bates' account of African political economy provides a good illustration of this. In his seminal contribution, Bates (1981), he described how overvalued exchange rates were essentially a policy instrument to transfer resources from the large agricultural sector to urban interests, a manifestation of the bargaining power of urban interest groups. The logic applies with equal force to resource-rich societies, where oil windfalls have traditionally been directed to public investment projects with low rates of return. This begs the question: why are unviable projects selected in the first place? Robinson et al. (2005) offer a cogent political economy explanation. Such 'white elephant' projects often constitute an inefficient redistribution favouring select political groups. The quality of public institutions could have a marked impact on the efficiency of resource use.

Similar arguments have been crafted for the quality of public spending. As Auty (2001b) observes: 'the transparency of public finances achieved by Botswana's consensual democracy has proved more effective than the secrecy that characterized the finances of Saudi Arabia's paternalistic monarchy which ... accommodated high levels of rent-seeking behaviour.' Tanzi and Davoodi (1997) furnish evidence on how corruption increases the level of public investment but reduces the productivity of this investment. Similarly, Mauro (1995) argues that corruption can decrease growth by reducing the quality of public investment, especially that in public infrastructure. It is partly due to this politics of policy that higher public investment facilitated by resource windfalls has generally failed to translate into growth.

Public spending can also be influenced by conflict and instability, which resource-rich countries are especially prone to. Incumbents in these countries have an incentive to spend more money in the present, rather than save and surrender it to political rivals (van der Ploeg 2011). Of course, the causal road can go the other way: countries prone to conflict may depend more on natural resources (Frankel 2011). If the challenge in fiscal policy in RREs is to smooth consumption, then the institutional structures in place must provide the adequate incentives. For example, when fiscal rules exist, and are consistently enforced, they can tie the hands of rulers. The success of Chile and Norway in avoiding the resource curse is partly rooted in their ability to enforce fiscal rules and prudently manage natural resource funds (Frankel 2011;

Schmidt-Hebbel 2012). The mere existence of fiscal rules is insufficient without an enforcement capacity, which, in turn, depends on the existence of independent economic and political constituencies with countervailing powers to check the political sovereign.

Institutional design matters too. Evaluating the petroleum funds in Alaska, Norway, and Alberta, Torvik (2007) regards the management of oil funds in Alberta as being less successful than the former two cases. The difference, he argues, can be explained by the fact that the funds in Alaska and Norway were governed by largely independent bodies, whereas Alberta's fund was governed by a political investment committee. At the same time, sound rules provide no insurance against failure either. Using Chad's example, Humphreys and Sandbu (2007: p.26) argue that 'the question then is whether NRFs can be used to realign incentives in a way that makes them self-enforcing'. Ultimately, it boils down to whether the underlying power structure is defined by strong checks and balances. With the concentration of political power in a few hands, natural resources often become a liability. In this milieu, positive price shocks end up being wasted, whereas negative shocks get amplified and result in substantial output losses.

That political institutions tend to amplify the harmful effects of shocks is confirmed by cross-country empirical evidence. As Rodrik (1970) showed, although much of the developing world was exposed to external shocks in 1970s, there were more severe growth collapses in societies that were deeply divided and had weak institutions of 'conflict management'. Rodrik (1999) showed that social conflicts can interact with institutions in ways that could serve to exacerbate the initial effect of a negative shock. Societal divisions based on differences in ethnicity, religion, geography or income can give rise to intense social conflicts. When domestic institutions are weak, such conflicts remain unresolved and can lead to economic uncertainty, diversion of resources to unproductive activities, and a failure to adjust policies and prices in response to shocks.

Conversely, countries with strong institutions are more resilient to shocks. Furnishing evidence on the connection between institutions and growth persistence, Acemoglu et al (2003) demonstrates that a historically determined component of institutions is strongly correlated with output volatility. Countries with superior institutions tend to exhibit less volatility in output growth. Importantly, once the effect of institutions is controlled for, there is no additional explanatory power in variables capturing the role of macroeconomic policies. In fact, as Sala-i-Martin and Subramanian (2003) show for Nigeria, macroeconomic distortions, such as Dutch disease effects, have little explanatory power relative to the role of institutions in shaping the resource curse. In a similar vein, Isham et al. (2002) suggest that the effect of a country's natural resource export structure on growth is primarily mediated through institutions. In particular, countries abundant in point-source natural resources tend to have extractive institutions. Even if the favorable effect of institutions is pretty well-established, existing literature is relatively agnostic on the underlying mechanisms. Some proposed channels include the following.

First, resource abundance tends to support patronage-based systems that entail a paternalistic distribution of natural resource rents. It can help to establish powerful vested interests that benefit from rent-seeking and block economic and political reforms. As Auty (2001a) notes: "the political state in most resource-abundant economies tends to be a factional oligarchy or predatory state that deploys the resource rents to promote sectional interests at the expense of a coherent economic policy and long-run social welfare." Natural resource abundance can create opportunities for rent-seeking and misgovernance (the so-called "voracity effect", as in Lane and Tornell 1995), and spawn inefficient bureaucracies, elite capture, corruption and government inefficiency (Gelb 1988; Auty 1990; Lane and Tornell 1995). Resource poor countries, by contrast, are more likely to "spawn developmental states" (Lal and Myint 1996).

They may also find it easier to move to labor-intensive stages of competitive diversification and develop laws to protect property rights.

Second, flawed policies are more likely to persist in resource-rich countries. For example, resource abundant countries were able to maintain policies aimed at protecting infant industries far longer than resource-poor countries. Oil abundance is particularly related to low political development. As Ross (2001) argues oil rents are often used to reduce taxation, which weakens demands for political representation and political accountability. Beyond its effects on economic activity, trade shocks can also disrupt the social and political fabric of a society. Natural resource dependence can deepen social cleavages within a society, raising likelihood of distributional struggles and the probability of civil conflict. In resource-scarce economies, competitive pressures are more likely to take hold, which can foster private sector activity and push for the rule of law and protection of property rights.

While politics provides a cross-cutting dimension in analyzing macroeconomic outcomes in RREs its role is relatively under-studied in the context of Arab economies. In the following discussions, I aim to rectify this by initiating discussion of the political economy considerations that underlay macroeconomic policies and outcomes.

3. The Political Economy of Fiscal Policy

Fiscal policy holds the key to understanding macroeconomic outcomes in resource-rich Arab states, where an overwhelming proportion of government revenues come from oil and hydrocarbon proceeds. Shaped largely by revenues and expenditures rather than taxes, fiscal policies remain highly pro-cyclical in the region. This means that fiscal balances are highly sensitive to movements in oil prices. The correlation between oil price changes and fiscal balance ranges between 85-87 percent in Saudi Arabia, UAE and Bahrain.[2] Fiscal policy in Arab RREs is defined by high and variable levels of public spending and a weak tax effort. Apart from public investment in prestige projects, a pet item during boom years, these economies spend a disproportionately high share of their public expenditures on salaries and subsidies. Fiscal policy is also the prime medium to facilitate the generous provision of health, education, and social safety nets.

While the salient facts and features of fiscal policy are widely known, our knowledge of the deep political economy structures that drive these policy outcomes is surprisingly inadequate. This section attempts to provide a political economy understanding of these facts. For an analysis of core fiscal policy indicators, the interested reader is directed to Diwan (2014). Let us begin with the received wisdom. Fiscal policy emanates from deep political economy structures that shape the crucial spending and taxation decisions: How much to spend? Where to spend? Who to tax? Fiscal policy is connected with a society's core distributive struggles that shape competition over power and resources. It can therefore be viewed as an articulation of the underlying political settlement or social contract. Fiscal policy is also central to the viability of a political settlement, since the latter is sustainable only to the extent that the 'distribution of economic benefits is compatible with the distribution of power' (Khan 2010).

Nowhere is this more applicable than resource-rich societies that are defined by the rentier state literature as 'allocative states' whose prime function is to channel rents to society (Luciani 1987). Fiscal policy in this milieu is the prime vehicle through which rents are distributed to citizens, elites and politically important constituencies. It is particularly significant in the Arab context where the very survival and stability of regimes is connected with sustaining an unwritten social bargain that trades welfare distribution against political acquiescence (Yousef, 2004; Malik 2014). Politics is central to understanding the longevity of the region's 'cradle to

[2] Magda Kandil, 2016, "Oil price fluctuations and the economies of the GCC", Research and Statistics Department, Central Bank of the UAE, Abu Dhabi.

grave' welfare systems that ensure a wide spectrum of entitlements to its citizens, ranging from education and health to housing, jobs and credit. In crude political economy terms, these welfare expenditures are part of the state's patronage commitments that are used to purchase mass consent. It is thus impossible to talk about the classic fiscal policy concerns, such as salaries and subsidies, without understanding their role in sustaining the political order.

As distributive states with limited extractive capacity, fiscal policy in Arab RREs is largely about spending rather than taxes. The relative insignificance of taxation, especially direct income taxes, is significant in political economy terms, since this enhances the state's autonomy from society. The political economy challenge of taxing the rich and redistributing it to the poor is less relevant in this context, since Arab RREs are distributive rather than redistributive states.[3] Thus, the theoretical premise around elite resistance to democratization due to a possible threat of redistribution holds little explanatory power. Similarly, the presumed connection between taxation and representation, implied by the rentier state theory and expressed in the dictum "no taxation without representation" has little analytical value in the Arab context (Herb 2005).[4]

Emanating from a complex European reality the tax logic for representation is not directly applicable as a textbook model. A weak tax effort in Arab RREs has not precluded the need for legitimacy and responsiveness to public demands. In fact, 'citizens of rentier states have just as much reason as people who pay taxes to want their rulers to govern wisely and in their interests' (Herb 2005).[5] Gulf rulers have stronger ties with their populations than is commonly understood. Even the most repressive Arab regimes actively seek alternative sources of legitimacy, and depend on alliances, coalitions, and pacts with powerful societal groups. Ruling families protect the interests of tribal clans, merchant families and other groups with bargaining power. Where indigenous populations are small citizens typically have personal access to rulers. Admittedly, neither such citizen access nor tribal alliances are substitutes for representative democracy, but they are important for understanding the resilience of authoritarianism in the face of volatile rent streams and negative oil shocks.

Despite the inapplicability of these conventional fiscal policy elements, political considerations lie at the heart of policy choices and macroeconomic outcomes. Like other resource-rich countries, Arab RREs face some key decision nodes regarding the conduct of fiscal policy. Each of these decisions carries political economy implications. The first decision concerns the point of accrual of resource revenues. Are they largely concentrated in the accounts of national oil companies and the associated oil ministry or directly in the fiscal coffers of the state? A related issue is whether oil revenues are transparently published, recorded and accessible to the public. Both issues are crucial for determining the extent of extra-fiscal space and the limits of *de jure* fiscal policy in explaining macroeconomic outcomes. The next decision logic concerns the levels and composition of public spending. In this regard, the two inter-related decisions on how much to save and spend are fundamentally guided by politics. Of relevance here is the problem of time inconsistency in fiscal policy. Optimal political responses in periods of low oil prices may not be the same in periods of high prices. In resource-rich countries the issue of time-consistency largely concerns savings from resource windfalls. Positive price shocks are perceived as permanent whereas negative shocks are treated as temporary. In this background, it is difficult to pre-commit governments to save during periods of high oil prices.

[3] Resource-rich states are redistributive only in the sense that they tax oil income and distribute it to society.

[4] In fact, regimes are often dependent on other non-parliamentary forms of representation where rulers need to dynamically respond to citizen needs.

[5] Unsurprisingly, therefore, variation in tax regimes, within and across MENA countries, has limited predictive power in explaining political outcomes.

The composition of public spending reveals the type and strength of distributive commitments. Arab RREs spend a disproportionately larger amount of resources on salaries, subsidies and security. Large sums are annually spent on the wage bill. In the GCC states between 40 to 60 percent of government budgets are consumed by expenditures on wages and social service provision. For the region as a whole, the proportion of workers employed by the state is close to double the global average. This is mainly because government remains the employer of first resort with public employment serving as the prime means for rent distribution to constituents. This is complemented with spending on subsidies for both food and fuel. The average Middle Eastern country, regardless of whether it is a net exporter or importer of oil, also spends a staggering proportion of their revenues on energy subsidies. About one-half of global energy subsidies are disbursed in MENA, which amounts to nearly a third of the region's oil-surplus and 8.5% of its GDP.

Although salaries and subsidies are economically inefficient forms of rent distribution, they are fundamentally embedded in the underlying political settlement. For example, public employment is widely understood as a key tool for political appeasement of citizens. Among the many political purposes, it serves, state employment forecloses avenues for class-based politics that independent incomes from the private sector might help to spur. In a similar vein, subsidies are a blunt political instrument for preserving social stability. Subsidies are not purely welfare instruments for the masses but also benefit privileged actors in the commercial and industrial sectors due to their pro-rich and urban bias. Spending on health, education and subsidized housing similarly bolster the authoritarian social contract. Arab RREs spend a greater proportion of its GDP on education than other developing or resource-rich economies. Such generous budgetary contributions to health and education remain an anomaly, especially when compared with other oil-rich nations in Africa or Latin America. Its political economy significance is discussed in the next sub-section.

Beyond the universal welfare entitlements for citizens, Arab RREs spend a staggering proportion of public expenditures on defense and national security, a significant part of which is believed to be earmarked for internal security (A precise breakdown between spending for internal and external security is usually unavailable). This is not surprising since authoritarian stability rests on the twin pillars of patronage and control, repression and (re-)distribution. Public spending on security, together with salaries and subsidies, form part of a broader narrative on national security where security of the state is often indistinguishable from regime security. Prima facie, spending on internal security is expected to be higher in labor-abundant RREs with comparatively fewer rents to distribute and more people to control.

In thinking about the politics of public finance, spending on citizens should be carefully distinguished from that on elites. If welfare spending is directed towards appeasing citizens, infrastructural projects are an important means of distributing rents to elite constituencies, usually key individuals close to the royal circle, higher members of civil and military bureaucracy, merchant and business elites and key clans and kinship networks. Although there are several instruments for dispensing patronage to elites, infrastructure spending offers a particularly important means of distributing contracts to connected or insider elites. Such contracts could thus be construed as rents that help to generate personalized commitments for elites. In the GCC such contracts have traditionally played a pivotal role in buying off old merchant constituencies and subordinating them to ruler interests. Infrastructure contracts worth billions of dollars are distributed to major construction and procurement companies in the GCC. In Algeria, the prime beneficiary of such projects is the military-bureaucratic oligarchy. Contracts for many such projects are usually awarded without competitive bidding, and there is little clarity on the determinants of project selection.

Oil-funded public investment generates plentiful opportunities for taming political and business elites through construction contracts, import licenses and land acquisition deals. The construction sector—a key beneficiary of resource-windfalls—depends, in turn, on the import of foreign labor that is organized through a sponsorship system (*kafala*) that generates additional rents for local sponsors, without whose permission migrants can neither enter (and leave) the country nor change jobs.

The support for real estate, construction and hospitality sectors is closely intertwined with alignment of elite incentives with regime stability (see section 4 for more discussion). While infrastructure spending is a pet item for resource-rich economies, especially during periods of resource booms, the scale of such spending is rather exceptional in Arab RREs. In 2015 alone the GCC projects market was estimated at US$ 172 billion, with Saudi Arabia and Qatar leading the show. By 2030 the GCC mega projects are predicted to have crossed the mark of US$1 trillion.[6] Apart from permitting elite circulation of wealth, such spending drives much of economic activity in construction and services. As I will argue later, these contracts are also important means of recycling wealth globally through contracts for foreign companies.

3.1 Fiscal policy and the politics of development

The above discussion highlights the crucial role of fiscal policy in understanding the politics of Arab development. This section provides some brief encounters on the subject. Public investment is a good place to start such a discussion, since it is a key element of the state's modernizing vision. Global evidence suggests that positive terms of trade shocks have a more pronounced effect on investment. Commodity price booms typically translate into investment booms (Collier et al. 1999). This is borne by the Arab experience where fiscal claims for infrastructure spending have growing in periods of high oil prices, which has contributed to the pro-cyclicality of fiscal policy. In terms of composition of investment booms, commodity shocks fed into booms in public investment, especially grandiose and wasteful projects described by the political economy literature as 'white elephant projects'. These are projects that carry low economic and social returns but have greater political or prestige value (Robinson and Torvik 2005).

While these insights are applicable to Arab RREs, the picture is arguably more differentiated in GCC countries, where the elevation of economic diversification among national priorities has gradually shifted public priorities towards development of education cities, ports, roads and, recently, railroads. While prestige and politics continue to incentivize public investments, they are also an integral component of the national vision for development that is used to strengthen legitimacy of rulers. In short, prestige investments are not just a mechanism of rent distribution but are also part of the broader symbolic resource for ruler's modernizing vision.

In labor-abundant RREs, such as Iraq and Algeria, public investment fueled early industrialization efforts in 1960s and 1970s. Being part of the state's interventionist economic agenda, these investment programs proved as largely inefficient. Algeria provides a relevant example of such rent deployment towards inefficient investment. The oil windfalls of 1974-78 and 1979-81 generated rent that was equal to about 27-29% of non-oil GDP annually. Algeria absorbed this rent domestically by pursuing a strategy of rapid capital-intensive industrialization. About four-fifths of the windfall was invested domestically and almost 92% of the investment was in the public sector. However, "the efficiency of investment was half the expected level" with total factor productivity (TFP) growth remaining negative during much of 1970s and 1980s (Auty, 2003). Another feature of these investment booms was that they were generally associated with investment in structures due to greater public infrastructure spending (and residential property) as opposed to imported equipment. This can potentially

[6] Saudi Gazette, April 9, 2015.

raise the price of non-tradable capital goods relative to non-tradable consumer goods, making construction booms potentially "more powerful" than Dutch Disease type effects.

Beyond these investment patterns, fiscal policy occupies an important intermediary position in the politics of development. In the ensuing discussion, I offer some brief glimpses into how fiscal policy allows us to navigate through the larger discourse on Arab political economy. A distinguishing feature of the region's development experience is its priority spending on social sectors. The Arab world spends twice as much on expenditures on social protection as Eastern Europe and sub-Saharan Africa. Clearly, the region's substantial resource rents have afforded a massive expansion of public goods provision, whose scale is phenomenal. Starting from extremely low provision, most Arab RREs have significantly enhanced their stock of social and physical infrastructure (schools, hospitals, roads, ports, etc.). As a result, the Arab rentier experience has produced radically different patterns of human development compared to its non-Arab resource-rich counterparts. Enhancing access to health, education and social services to majority of their populations, Arab states have made impressive gains in human development. As (Eibl and Hertog, 2016) rents had a more profound impact on mortality reductions in Arab resource exporters than the non-Arab counterparts, especially the African oil exporters. Similar patterns exist for other indicators of health and education.[7]

While fiscal policy acts as a key enabler in this favorable record of spending and outcomes, the larger question social scientists face is why a typical Arab oil exporting nation chooses to spend more on human development than a typical oil-rich country in sub-Saharan Africa? Three aspects of this puzzle are worth mentioning. *Firstly*, the Arab exceptionalism on human development—if one could characterize it as such—remains a poorly understood anomaly even after taking into account the region's considerably high resource rents per capita. *Secondly*, the human development gains were partly the fruits of early state building efforts afforded by the discovery of oil at a formative moment. Some further nuances are to be noted in this context, however. While resource riches helped to develop the social and physical *infrastructure* of the state, the latter overlaps only imperfectly with what is conceived as development.

Importantly, the remarkable expansion of social services is not limited to Arab RREs alone, since resource-scarce countries of the region share similar progress on human development. In the popular Arab republics nationalist and ideological impulses might hold some explanatory power. Universalization of access to social services was initiated in a 'moment of enthusiasm' when Arab nationalists with socialist leaning sought to incorporate the mobilized citizenry through expansion of health and education. Even in resource-rich countries, pre-oil history must have served as a constraining influence on elites. Algeria provides an apt example. For rulers of the newly independent state who inherited a highly urbanized citizenry with a successful legacy of popular mobilization against the French it made good political sense to extend the reach of basic public goods to ordinary citizens.

Thirdly, the ostensible progress in human development that Arab RREs achieved is ultimately self-undermining as it entails an enduring tension between entitlements and empowerment. As argued before, the extensive welfare regimes in Arab RREs are part of a political bargain of sorts where welfare distribution is exchanged for political acquiescence. Therefore, public provision supports a precarious model of human development that enhances access but undermines agency. By fostering dependent and immobilized social classes, it also freezes the state-society relationship.

Fiscal policy is thus intimately connected with conceptions of the Arab state—its formation, endurance and capacities. Oil rents afforded the creation of a centralized state with its elaborate

[7] In 1990 low-income Arab countries did not fare much better on the HDI than sub-Saharan Africa; in 2007 they surpassed the levels achieved by most developing countries (Malik 2012).

bureaucratic structures. To the extent that a degree of political centralization is important for economic development to occur, resource windfalls helped to foster state capacity at a crucial formative moment in the history of these states. However, this centralized Arab state has not necessarily proven to be cohesive. The bureaucratic expansion afforded initial resource windfalls defied the Weberian logic. It was typically a means of cementing alliances with different loci of power in society. State employment was used to win the loyalty of important tribes and merchant families. The latter benefited mostly from state contracts and protection of their commercial privileges as middlemen. However, beyond its minimalistic functions, state capacity remains weak in several of its core dimensions. As previously mentioned, Arab RREs lack sufficient extractive capacity in terms of its ability to collect taxes from its constituents. Also severely lacking is the legal and regulatory capacity needed for competitive markets, an issue I discuss in more detail in the section on finance. Perhaps more importantly, Arab RREs suffer from internally fragmented state structures, often described as "segmented clienteles"[8] that are vertically connected with the ruler's office but have limited horizontal coordination (or communication) between them. This prevents public policies and institutions from acting as coordination and commitment mechanisms—a classic unfulfilled role of institutions.

4. Why Fiscal Dynamics Matter?

Fiscal policy dynamics reveal the primacy of politics. The fiscal policy stance in periods of falling oil prices, for instance, can provide important clues to fiscal commitments that are politically more binding. Government expenditures that are resilient to boom and bust episodes in oil revenues tell us a great deal about politically sensitive items in the budget. Temporality also matters through timing and sequencing (Pierson 2004). Which budgetary items are prioritized and when this happens can be crucial to explaining outcomes. For example, it can be argued that the initial spending priorities got locked-in over time, creating powerful hysteresis effects. Even if part of early state building efforts, public employment, subsidies, free health and education came to be understood as entitlements, making them irreversible over time. With rapid population growth adding new claimants to this welfare regime, its sustainability is coming under growing challenge. In short, the dynamic representation of fiscal policy exhibits the classic path dependence features that make initial policy priorities more resistant to change over time, since early institutions are reinforced through positive feedback. This section situates the fiscal dynamics of Arab RREs in the political economy context.

4.1 The politics of adjustment

Most Arab RREs witnessed an initial fiscal bulge after the discovery of hydrocarbons. The early fiscal expansion received a further impetus in 1970s, when, the spike in oil prices, afforded major public investments. While the distributive claims were more manageable in the decades of 1950s and 1960s and easily affordable during the oil boom in 1970s, the 1980s witnessed growing strains on the social contract, however. This was particularly manifest in North Africa where demographic changes induced by high population growth were combined with dwindling natural resources. These fiscal exigencies are arguably less acute in Arab RREs, where resource revenues provide greater cushion to the middle classes in lean periods. Still, many resource exporters, such as Saudi Arabia and Algeria, had to undergo painful fiscal adjustments in the wake of falling oil prices and rising debt levels in 1980s. When fiscal adjustment became unavoidable, the burden of adjustment fell disproportionately on middle classes and the poor. Fiscal dynamics are therefore crucial for understanding the age of protest politics. It is not a coincidence that the popular mobilization spearheaded by the FIS in Algeria took place during a period of fiscal contraction. The shrinking resource envelope is believed to have contributed to the discontent of the Algerian middle classes. Similar arguments have been

[8] Here I borrow from the notion of "segmented clientelism" used to describe Saudi Arabia's governance structure. See (Hertog 2010) for a detailed argument.

made to explain the rise of the *Sahwa* opposition in Saudi Arabia in the 1990s. Two decades later, it was precisely the erosion of this middle-class contract, precipitated by declining public spending, that ignited popular grievances in North Africa in the run-up to the Arab spring (Diwan and Cammett 2014).

This explains why expenditures targeted towards middle classes are usually protected during downturns. Indeed, spending on government wages, subsidies and core social services in Arab RREs has been largely resilient to negative shocks to oil prices. Expenditures on salaries and subsidies exhibit greater downward stickiness even though they rise disproportionately with increasing oil prices. In general, the region's dependent middle classes have remained opposed to a large-scale reform of the subsidy system. Another item that has evaded large cutbacks is spending on defense and internal security. This is understandable given that authoritarian stability in many Arab societies rests on robustness of the coercive apparatus of the state (Bellin, 2012). Together, the strong inertia in public spending on redistribution and repression accords well with our prior knowledge on the durability of authoritarianism.

The brunt of fiscal adjustment is, however, borne through reductions in public investment. As a lead contributor to private investment, such shifts in public investment spending drive investment cycles and underpin the pro-cyclicality of fiscal policy. There is a potentially important political dimension to such volatility of public investment. While fiscal policy is prone to expanding claims by elites in boom years such commitments are more restrained in periods of low oil prices. Another important, yet understudied dimension, which exacerbates the pro-cyclicality of investment, is the project rush caused by an uncoordinated expansion of infrastructure projects during boom years. With supply of materials fixed in the short term and with heavy dependence on imports, the project glut across GCC states causes severe capacity constraints. The recent oil boom saw planned construction outstripping capacity, which resulted in cost over-runs and price distortions. A further complicating factor is the uncertainty associated with oil prices. Since sharp falls in oil prices lead to cancellations and severe project delays, project bidders demand higher risk premiums during boom years, which makes public investments even costlier during upturns and feeds into pro-cylical fiscal policy.

Like other resource-rich states, pro-cyclicality of fiscal policy remains a ubiquitous reality in Arab RREs where macroeconomic cycles closely correlate with oil price movements. The fact that subsidy commitments are locked over time means that the associated fiscal cost increases during periods of high oil and food prices. There is thus an in-built mechanism for growing expenditure commitments during periods of high oil prices and in response to political shocks (e.g., salary rise in wake of the 2011 Arab uprisings). In Saudi Arabia alone the post-Arab Spring fiscal package, consisting of salary hike, expansion of public employment, housing access and various social benefits, carried a price tag of US$110 billion (equivalent to 19% of GDP). Clearly, such spikes in spending are reflected in fiscal cycles: the non-oil primary deficit doubled after 2004 in Saudi Arabia. On the other hand, there are few in-built policy mechanisms to dampen the impact of oil price shocks. Given the weak extractive capacity of Arab RREs automatic fiscal stabilizers play a limited role. This is manifested in the asymmetric adjustment of revenues and expenditures: expenditures usually adjust faster in response to oil price cycles than revenues.

In resource-rich economies, fiscal dynamics entail an important commitment problem: How to pre-commit rulers to prudent fiscal policy during boom years? This is a particularly relevant form of time inconsistency in fiscal policy. While, in other RREs where political turnover is relatively higher, the issue is largely about inconsistent fiscal incentives of different political governments. Political incumbents are often incentivized to leave behind fewer savings for successor governments. Given that political regimes in Arab RREs are more durable, the more important issue from a political economy standpoint here is long-run fiscal sustainability. The

break-even oil price for budgets has also consistently shot up in most oil-exporters (In Saudi Arabia it will increase from $80 in 2011 to $98 in 2016)[9]. There is growing realization that current levels of welfare provision, especially relating to subsidies and public employment, are unsustainable. However, despite growing concerns about fiscal sustainability, there are limited political incentives for any individual ruler to contain spending. This is easy to understand: even if prevailing fiscal regimes are unsustainable for the country over the long-term, they are sustainable over the lifespan of the ruler. This commitment problem can be particularly severe in countries with aging monarchies. A prime example is Saudi Arabia where public expenditures have quadrupled since the early 2000s.

In the Arab RREs pro-cyclicality is partly driven by the imperatives of regime stability—essentially the need to neutralize the political effects of economic shocks. When certain types of expenditures adjust to changing oil prices or when they prove resilient reveal the nature of political sensitivities around protecting core constituencies.

4.2 The impact of political dynamics on fiscal policy

So far, I have painted a static picture of the political economy context. However, just as fiscal policy evolves in response to economic shocks so do political incentives that underpin economic policy choices. This is important to take into account as actors represent a dynamic element in the institutional playing field. Their preferences, constraints, strategies and understanding of the social world evolve over time. In fact, regime durability is built as much on change as inertia. How do political economy structures calibrate themselves to change and what is its significance for fiscal policy? This is a vast topic in its own right but, to highlight its significance, I discuss how the oil boom of 1970s generated social learning for policy makers and how recent collapse in oil prices is generating new incentives for radical economic reform. Both of these illustrations underscore the primacy of political incentives.

After witnessing the 1970s oil boom—and the ensuing bust in 1980s—Arab RREs embraced the oil price hike in the decade of 2000s with a slightly differential policy response. While the usual caricature of fiscal policy still applies, there were arguably some changes on the margins. A key difference, relative to the 1970s, is that spending on infrastructure has been comparatively more restrained during the second oil boom. The nature and direction of investment displayed some differences. Driven by the greater urgency of diversification, GCC countries have directed greater investments towards rail infrastructure, and educational and financial institutions. The destination of overseas investments is also more diversified, with greater cross-border investments in Asian and MENA countries.

There has also been a more robust saving response to the second oil boom. Learning from the harsh fiscal realities of 1980s, most Arab RREs have devised explicit strategies to set aside a growing proportion of their resource windfalls for future. Sovereign Wealth Funds (SWFs) have emerged as important saving and investment vehicles during the second oil boom, growing both in size and significance. In the GCC alone the combined assets of SWFs exceed US$1.8 trillion. Algeria has saved more than US$200 billion in cash reserves. Apart from facilitating overseas investments, these savings are providing a needed cushion in the present low oil price climate. While these differential policy responses might be rooted in social learning of policymakers, they are also a product of the demands imposed by growing GCC populations.[10]

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[9] IMF (2012: p. 11).

[10] The question, however, still remains: Is the recycling of petro-dollars fundamentally different across the two oil booms? Prestige investments and acquisitions continue to be important. The SWFs and their associated investments represent merely a change of form rather than substance.

Let me now turn to the second issue: How the recent oil price shock is incentivizing economic reform in Arab RREs? The sharp reduction in oil prices that began in 2014, with the price oil plummeting from over $100 a barrel to around $40, has necessitated some fundamental economic adjustments, some of which have been long-standing concerns but too politically sensitive to be broached in a serious manner. For example, since the start of 2015, many Arab RREs have started instituted serious subsidy reforms. Bahrain and Oman slashed gas subsidies while Saudi Arabia and UAE have increased the price of fuel by nearly 40%. Bahrain has reduced even subsidies on meat and poultry. Serious plans are being considered for a gradual introduction of taxes, starting with corporate and value-added taxes. With dwindling reserves, there is a renewed push to tap global bond and debt markets. Wider discussions on public sector consolidation are also underway. Saudi Arabia and Kuwait are considering the privatization of healthcare institutions and selected SOEs. Even in Algeria where the resource crunch is most acutely felt and where reform is often slow to initiate, serious economic reforms are on the table.

Despite the controversial history of previous economic reforms, plummeting oil prices have clearly started to shake up the status-quo on economic policy. This poses an interesting irony. While the revolutionary upheaval in 2011 failed to generate a single important economic concession, the oil price crash has begun to change the rules of the game. Saudi Arabia has long faced a housing challenge that was partly festered by peri-urban land held idle by connected elites. After hesitating for several years, the Saudi government was recently able to impose a tax on idle land, which effectively tantamounts to the ruling elite taxing itself. In fact, many reforms that have been recently introduced—or are currently under discussion—were ‘no-go areas’ just a decade ago. What has, then, prompted policymakers to consider these reforms? Clearly, the answer lies in how economic shocks change the political incentive structure.

That economic crises can serve as creative institutional moments has long been recognized by the political economy literature. Without such crises, neither India nor Turkey could have initiated economic and political liberalization. This underscores a larger political economy point. Rulers are often motivated to give concessions when there is fire under their feet, what Acemoglu and Robinson term as the “revolution constraint on elite preferences”. Elites tend to resist genuine reform unless they face ‘systematic vulnerability’. In the context of Arab RREs, then, resource scarcity can act an important driver of institutional change since it breaks down the political equilibrium that sustains sub-optimal economic policies.

4.3 Mapping the de facto regime for fiscal policy

Like any other policy arena in MENA, there is a discernible gap between the *de jure* and *de facto* domains of fiscal policy. Large components of spending evade fiscal accounting. The routine recourse to off-budget spending compromises the integrity of the fiscal process. The absence of clear fiscal rules, under-developed institutions and deep pockets permit a wide scope for discretionary spending. A related complication is the tight segmentation between the affairs of the Ministries of oil and finance, which are both governed by different decision logics. Rulers can often directly tap into the accounts of the ministry of oil or treasury. A consolidated fiscal picture often does not exist. This permits considerable fungibility of natural resources, which is further worsened in the absence of a full disclosure of the finances of state petroleum companies. There is not public disclosure of the finances of Saudi Aramco, for example. Unlike many African and LAC countries, the Arab RREs remain outside the purview of the Extractive Industries Transparency Initiative (EITI). Fiscal policymaking faces special challenges in an institutional context where there is limited distinction as to whether oil is a public or private resource.

There are also vast zones of ignorance in the design and conduct of fiscal policy. In some instances, this is simply a byproduct of incomplete information. Qatar only provides a broad accounting of its budget, with limited information on the break-down of items, individual allocations and actual spending. In fact, it is hard to find a detailed break-down of total outlays in most GCC states.[11] Despite the growing significance of SWFs their operations are usually opaque, with little public knowledge about their investment strategies. Withdrawal rules of such funds are neither well-spelled out nor consistently implemented. In most Arab RREs there is little knowledge about the number and strength of veto players concerning major fiscal policy decisions. Activities of many public-sector enterprises also remain off the fiscal radar screen, with such quasi-public spending believed to be particularly important in Algeria, where public sector banks are repeatedly recapitalized through outright cancellations of their debts, purchase of NPLs[12] and liquidity injections. In GCC countries many popular instruments of patronage, such as land sales and other benefits, are fiscally unaccounted. Contingent liabilities in the geo-political domain serve as an additional fiscal burden. This includes oil and budgetary support for regional allies, purchase of military equipment and the cost of regional military engagements. Resource-rich countries of the Gulf are effectively financing the social contract of Yemen, Egypt and Jordan. Interestingly, despite the painful consolidation of public expenditures necessitated by falling oil prices, cash support for Egypt and other neighbouring states, still remains an untouchable item in the budget. Once again, political economy is crucial to understanding this. The fiscal cost of these sizeable external commitments is ultimately driven by the need to sustain the authoritarian pact at home.

Summing up the discussion so far, five key dimensions of fiscal policy are worth highlighting. *First*, by governing the distributive regime fiscal policy plays a central role in sustained the political order in Arab RREs. It sustains both cooption and coercion—the twin pillars of authoritarian stability. *Second*, while resource-riches enhance a regime's autonomy from societal pressures, this autonomy is more pronounced in earlier stages of state-building. Once initial spending priorities are well-established, it is difficult to change course, which reduces state autonomy over time. *Third*, oil-induced fiscal contractions do spur creative institutional moments, however short-lived. *Fourth*, there remain large black holes or unmapped spaces in fiscal policy across most RREs. *Fifth*, resource-rich Arab economies have limited institutional resilience to absorb economic shocks. The ability to cope with shocks rests almost completely on extending the resource envelope. *Sixth*, the plausibility of counter-cyclical policies is directly connected with the political objective function. Such policies are unlikely in a milieu where few productive constituencies exist to exercise countervailing powers on the 'sovereign', and where the underlying political settlement militates against economic surprises that could disrupt the prevailing social order.

5. The Political Economy of Finance in Arab RREs

If fiscal policy is the crux of political economy, financial sector arrangements serve as its linchpin. The analysis of financial sector is central to evaluating macroeconomic pathologies associated with fiscal, monetary and exchange rate policies in Arab RREs. Despite this significance, the global literature on political economy of resource-rich societies has paid only passing attention to finance. Rectifying this neglect, recent studies suggest a greater role for financial sector arrangements in explaining the disappointing growth performance of resource-rich societies. Cross-country empirical analysis demonstrates that countries abundant in natural resources have systematically lower levels of financial sector development (Beck 2011). According to Bhattacharyya and Hodler (2010), resource rents only hinder financial development in countries with weak political institutions. Related evidence highlights the role

[11] In most cases the category, "other", represents a large number.

[12] Denotes non-performing loans.

of finance in absorbing the negative shocks emanating from global price fluctuations (Poelhekke and van der Ploeg 2009). Much of this evidence is cross-country in nature, and makes few references to Arab economies. In this section I will summarize the salient characteristics of financial sectors in Arab RREs, emphasizing alongside differences across countries and developing the underlying political economy of finance. I do not aim to provide a comprehensive coverage of the terrain. Given the paucity of detailed information on this subject, my discussion relies on relevant statistics and information from IMF and World Bank reports.

Prima facie, Arab RREs generally defy the adverse characterization predicted by the global literature. Apart from Libya and Algeria, which fall in the low to medium financial development category, Arab RREs are considered as financially developed. This assessment is based on a variety of indices based on qualitative and quantitative data, containing such dimensions as financial depth, ratio of private sector credit to GDP, asset ratios of deposit money banks, financial market openness, and other institutional dimensions. The banking sector in GCC, in particular, is considered to be "well-developed, profitable and efficient" (Creane et al. 2013). With few exceptions, the banking sector in these economies extends reasonably high levels of credit to the private sector, when considered as a share of GDP. The region has one of the highest deposits to GDP ratios in the world. In most countries, financial systems are also deep, as measured by the M2 to GDP ratio. With the exception of Iraq, Algeria and Yemen, levels of financial openness remain high. Like most aggregate economic indicators, the region posts much better performance than sub-Saharan Africa but lags behind other developing regions.

However, beyond these broad markers of financial development, significant weaknesses remain. I highlight below at least five such areas of fragility.

First, although banking sector profitability remains high, at least in GCC, it is largely dependent on oil riches. Banks are generally more profitable in periods of high oil prices. The total assets of banks, their net earnings, and disbursement of loans show more robust expansion in boom periods. *Second*, the average ratio of private sector credit to GDP masks the considerable underlying variation over time. Patterns of credit expansion are highly variable over time, mimicking, perhaps, the volatility in oil prices (see Figure 1, which charts the evolution of private sector credit to GDP in Saudi Arabia). *Third*, when it comes to measuring financial development, there is usually a weak mapping from concepts to indicators. This is particularly true in the context of Arab RREs, where the private sector usually acts as a disguised public sector. Overlapping patterns of ownership of banks and firms further blurs the boundary between the public and the private. Relatedly, the banking sector is predominantly owned by the government and there is also a high lending exposure to connected actors. *Fourth*, the non-bank financial sector is generally under-developed, with only a nominal presence for equity, insurance and bond markets. *Fifth*, the financial sector has witnessed a weak pace of reform. With the exception of Africa, most regions have made more significant progress on financial development than the Middle East. Even within MENA, the Arab RREs have been slow reformers (Creane et al. 2003). As financial development increased in Egypt, Jordan and Tunisia, the region's resource-rich countries have generally lagged behind. This partly emanates from the weak incentives and pressures for such reform in RREs.

As Moore (1987) suggested for Lebanon, political economy is often central to explaining financial sector arrangements. To develop a political economy understanding of financial development, I focus on the following four aspects of the banking sector: government ownership, asset concentration and exposure to connected lending, excess liquidity, and governance.

5.2 Patterns of state-ownership

A ubiquitous feature of the financial sector in Arab RREs is the significant presence of the state in the banking sector, either through direct ownership or indirect control. A cursory comparison of the data on state-ownership of the banking sector reveals that Arab RREs are less reliant on state-ownership of the banking sector compared their non-Arab resource-rich counterparts (La Porta et al. 2000). With the Arab world, a marked difference exists on this account between North African and GCC economies. Banks in Algeria and Libya are predominantly state-owned. In 2012 six state-owned banks accounted for 86 percent of Algeria's banking system assets. Although the *de jure* state ownership of banks is less prevalent in the GCC, the banking sector is largely owned by families tied to the royal circle. Such family-controlled banks pretty much function like the quasi-public sector banks. Although only around 7 percent of the banks in Bahrain are state-owned, members of the royal family have significant controlling stakes in the banking sector. Similarly, the UAE offers a dynamic space for the financial sector but remains prone to government interference.

What can help to explain these differences in *de jure* state ownership of banks? Prima facie, it appears that economies that are more labour-abundant and known for their socialist legacy of state-intervention are more prone to direct government control of banks. Given the more extensive distributional commitments in these countries, the banking sector can be used to distribute rents to citizens and favoured constituents. A typical example comes from Iran, a non-Arab context, where the financial sector under Ahmadinejad's administration has served an important distributive function in the guise of subsidized loans for small businessmen. This is not an alien practice in Arab RREs, where financial instruments are used to appease politically important constituencies. Various countries, including Saudi Arabia, Algeria, Iraq and Libya, have used specialized credit institutions to channelize credit to priority sectors or remote regions. The sectoral distribution of loans in Saudi Arabia suggests that a considerable proportion (31%) is directed at the "other" category, which primarily consists of consumer loans.[13] Subsidized housing loans are a popular instrument of rent distribution in Saudi Arabia. Disbursement of specialized credit often requires direct state intervention in financial markets—through a capping of interest rates, for example. It is partly for this reason that labour-abundant RREs are more likely to manifest forms of financial repression, a topic broached later in this section. Regardless, these patterns are consistent with the evidence that state-owned banks charge lower interest rates and tend to favor larger firms and borrowers in 'depressed regions' (Spienza 2002).

In comparison, high rent per capita economies—where labour is relatively scarce relative to natural resources—may face less compulsion for direct ownership of banks. Instead, the financial sector typically serves as a means to generate rents for connected elites. Since private banks operate under a government license, granting of such licenses to favoured parties can be an important instrument to tie the interests of elites with that of the prevailing political order. Private ownership of banks is less threatening in high rent per capita economies where it is generally easier to deter more politically inexpedient forms of credit expansion. Given the scale of natural resource windfalls, state-owned enterprises and large government entities are major clients of the banking sector. A key role for the sector, therefore, is liquidity management for such government entities. As the principal owner of land and the prime distributor of business contracts, governments have little difficulty in shaping the direction of credit.

For these reasons, I would like to argue that the *de jure* ownership of banks is less consequential for evaluating financial sector arrangements in Arab RREs, especially the high rent per capita economies. While past empirical analysis has argued that state ownership of banks is associated

[13] Arguably, in such instances, special government vehicles (such as SIDF, REDF, and SCB in the case of Saudi Arabia) have played a more important role with commercial banks allowed to operate more freely.

with lower levels of financial sector development and weak protection of property rights (La Porta et al. 2000; World Bank 2001), the evidence has subsequently been assessed as “less robust” (Yeyati et al. 2004). Greater state ownership of the banking system can also be linked with efforts to contain the impact of oil price volatility. RREs may find it easier to manage financial responses to oil shocks if the state has larger controlling rights over the banking system. Additionally, state-owned banks can also be used, in principle, to address market failures. However, as the MENA experience suggests, ownership is not the only means to control the financial sector. The state can use indirect means to control the banking sector. Regardless, financial sector remains an important part of the paraphernalia of control that generates predictable forms of capital accumulation. By controlling finance rulers can also control its linkages with the rest of the economy. Kuwait provides a pertinent example, where large government owned banks hold significant stakes in investment companies, which, in turn, exert control over commercial and industrial groups (IMF 2013). Such linkages, both in the productive and political domains, exist across much of the Arab world.

More than ownership, Arab RREs stand out for high levels of asset concentration in their banking systems. A handful of large banks control the bulk of banking system assets. The figures are suggestive. In Saudi Arabia twelve incorporated banks control 95% of total bank assets; seven largest banks control 85% of assets (IMF 2011). The three largest Saudi banks, all of which are at least partially government-owned control 45% of the assets. The Libyan government owns 5 of the 15 commercial banks, representing 60 percent of total assets (IMF 2013). In Bahrain the top 5 off shore banks and top 2 investment banks control 75 percent of total sub-sector assets (IMF 2006). In Oman government or quasi-government institutions own more than 26 percent of the total banking system (Bologna and Prasad 2013), and the three largest banks control 65% of total assets. The deposits and credit are also highly concentrated in Qatar (IMF 2014). Such high asset concentration can potentially indicate limited competition in the banking sector, and is a feature of resource-rich countries, general. Countries that experience greater volatility of output growth tend to have higher levels of bank concentration.

5.3 Excess liquidity

Although IMF reports consistently praise banks for their adequate liquidity, excess liquidity can also be a manifestation of underlying structural weaknesses of the financial sector. Emerging markets typically accumulate reserves as a way to promote financial stability. In the Arab RREs, however, banks tend to maintain higher levels of liquidity than required by law (IMF 2006). Liquid assets represent 50% of total assets in Qatar (IMF 2014). A variety of reasons can help to account for this. First, banks in Arab exporters face high reserve requirements. This applies even in economies such as Bahrain, considered otherwise as financially developed, but where high reserve requirements have been described as a “tax on intermediation”, providing evidence of a mild form of financial repression (IMF 2006). Similarly, Saudi Arabia maintains a high capital ratio at 17.9% (IMF 2014). Second, in many RREs there is a dearth of lending opportunities outside the oil sector. Absence of a vibrant private sector further contributes to this. Third, even when there is demand for credit by private businesses regulatory and legal weaknesses prevent banks from meeting their investment needs.

Excess liquidity of the banking sector is not uncommon in resource-rich economies where hydrocarbon revenues provide the main funding base for banks. The intermediation capacity of the financial sector is therefore largely dependent on uninterrupted flow of external revenues. This is also true in Arab RREs where the ‘endogenous dynamics of depositing institutions’ have a limited role to play. Government deposits typically represent a large amount of total deposits even in countries with depleting oil reserves. In Oman, for instance, such deposits account for roughly a third of all deposits (Bologna and Prasad 2013). Financial intermediation

in such situations is largely about liquidity management for public or quasi-public sector institutions. This is most evident in Algeria where the bulk of financial intermediation takes place between state-owned banks and the public sector.

Another relevant dimension is the excess volatility associated with oil price fluctuations that forces central banks and financial institutions to adopt a more conservative outlook. In a context where deposits themselves remain vulnerable to volatile oil revenues, excess liquidity is often a key instrument to maintain financial stability. In most Arab RREs even the liquidity of the banking sector is influenced by oil price-induced shocks. Excess liquidity in the banking sector can therefore be a natural response to volatile terms of trade. From a political economy perspective, however, the important thing is that Arab economies tend to ensure resilience against economic shocks by building liquidity rather than strong institutions. I will take up the institutional dimension in subsequent pages.

From a bank's perspective maintaining excess liquidity may be a prudent strategy in the face of an underdeveloped institutional infrastructure for finance. However, it restricts credit expansion to parts of the economy where it is most needed. Increasing oil prices drive up government expenditures and expand bank liquidity. But, due to limited intermediation capacity, this is not translated into greater credit for the private sector. This helps to explain why the Middle East has the lowest bank credit to deposits ratio in the world, leaving behind even sub-Saharan Africa.

5.4 Financial access

A key anomaly in Arab RREs is that financial depth does not translate into financial access. Despite enjoying a high ratio of private credit and deposit to GDP, financial systems remain largely inaccessible. Although countries where exports are dominated by primary commodities tend to have lower financial access, credit is more concentrated in the Middle East than in other regions. Banks in the region have one of the most concentrated loan portfolios in the world, measured as the ratio of the top twenty exposures to total equity (242%; 182% in GCC; World Bank 2012). Banking systems in Arab RREs have large exposures to a handful of borrowers. For example, Saudi Arabian banks, many of which are state-owned, are known for their high exposure to handful of borrowers (such exposure has, at times, amounted to 50 percent of banks' own funds). In Algeria banks have an unusually large exposure to SOEs: Just three public sector borrowers account for 38 percent of total loans. This indicates a strong preference of banks to engage with large connected borrowers, and is a reflection of historically-embedded patterns of advantage for large business groups.

Existing lending patterns tend to favor real-estate projects, infrastructure (including oil and gas) and public-sector corporations. In the GCC the real estate sector is particularly attractive for banks. It remains a highly profitable area for bank activity. In Kuwait, real estate represents 18.5 percent of total investment and 60 percent of total collateral (IMF 2013). Real estate credit has also grown by 30 percent in Saudi Arabia, albeit from a small base, and it represents a significant portion of banks' portfolio in the UAE. In Bahrain, too, the real estate sector is a key beneficiary of bank lending. The preference for real estate lending is partly rooted in politics. Given that in many RREs land is largely owned by the state, it provides an important safety valve against independent capital accumulation. Even where some of the most valuable land is privately owned it is mainly held by connected actors.

Outside the GCC, large resource riches often translate into a large deposit base for banks but limited credit for the private sector. Here, banks are largely engaged with credit intermediation for public sector enterprises. This applies, in particular, to Algeria and Libya. Algeria suffers from a perverse form of segmentation between the activities of public and private sector banks. While state-owned banks are the lender of first resort for public enterprises the private sector is overwhelmingly served by private banks. Such segmentation prevents the healthy exposure

of state-owned banks to risk-taking activities in the private sector. Moreover, lending to the public sector can benefit private interests in many labor-abundant RREs, since public sector in these countries typically masquerades private oligarchic interests of the military, intelligence and connected businesses.

Beyond these regional differences, the ‘unconnected’ private sector across most of these economies has weak financial access, and has to depend mostly on internally generated funds. Like RREs elsewhere in the world, banks are hesitant to engage in long-term lending without adequate state guarantees. Few loans mature after five years. Where it is more prevalent—the GCC, for example—long-term lending is mostly extended by state institutions. Banks have limited capacity and incentives for risk taking. In this milieu, it is not surprising that the small and medium enterprises (SME) are especially credit-constrained. The MENA has the lowest share of loans channeled to SMEs (Rocha et al. 2011). This ratio is even lower in resource-rich countries, especially in the Gulf where only 2 percent of total bank lending is directed at SMEs. Data from enterprise surveys paints a similarly bleak picture (only 20 percent of SMEs in MENA have reported receiving a bank loan).

Bank-level indicators of financial access reveal a similarly defective provision. Bank penetration and access to finance is lower in most MENA countries than countries with comparable income levels (Demirguc-Kunt and Klapper 2012). While financial inclusion for adults is somewhat better in the GCC economies, Algeria, Iraq and Yemen lie at the lower end of the scale. The region’s labour-abundant economies are particularly weak in extending financial access. Saving Kuwait, Oman and UAE, a tiny percentage of adults in Arab RREs have reported receiving a loan during the previous year. The ratio was abysmally low in Saudi Arabia (2.14), Algeria (1.5) and Yemen (0.93). This presents a sorry picture of financial inclusion in a region otherwise known for high levels of deposits and private credit. On this score, the Arab RREs fit the general pattern for resource-rich economies. Adults in countries whose exports are dominated by primary commodities are systematically less likely to have an account at a formal banking institution. This negative association between primary exports share and presence of a bank account is obtained after controlling for income and size of countries.

5.5 Institutional bottlenecks

Financial markets in Arab RREs are hampered by a variety of legal, regulatory, and institutional constraints. The basic institutional ingredients for effective financial intermediation, such as credit information and collateral registries, are either missing or underdeveloped (see Figure 2). In Libya credit information does not exist in a systematized form, and Algeria lacks any centralized collateral registry (there are 48 land registries; the information base is highly fragmented)[14]. In Saudi Arabia—as in many other Arab RREs—there is no registry for movable collateral. This prevents effective credit risk assessment and monitoring of loans. Where the data exists, it suffers from incomplete coverage, weak quality and fragmentation. Most countries also lack a domestic credit rating agency, and suffer from poor contract and property rights. Legal rights for creditors are severely underdeveloped. The MENA countries have one of the lowest rankings globally on the legal rights index (see Figure 3).

Even the ill-defined legal frameworks suffer from weak enforcement, with debt collection and out-of-court settlements being especially difficult. Special enforcement courts are usually non-existent. All of this highlights the weaknesses of financial infrastructure that severely constrain financial development.

The financial sector is also beset with two other related challenges: competition and transparency. Banking sector in MENA is less competitive than most other regions, with the

[14] IMF (2014; p. 29).

GCC particularly lagging behind on this account (Anzoategui et al. 2010). Greater state involvement in the financial sector and institutional bottlenecks restrict banking competition. In some countries, private and state-owned banks operate in segmented domains, restricting competition amongst banks. Algeria, for example, imposes restrictions on public sector enterprises (PSEs) against 'making deposits in private banks'. This deprives private banks an important source of deposits and PSEs lose oversight by private banks. In several countries there are no restrictions on the maximum percentage of capital owned by a single entity. At the same time, significant entry barriers remain for new entrants into the financial sector. Entry is deterred by high capital requirements, high rejection rate of applications for new banking licenses, and a larger number of compliance procedures. The discretionary and fragmented nature of decision-making means that, typically, either powerful connected actors at home or influential foreign parties are given permission to operate in the financial sector.

There are also lingering issues of transparency, especially in relation to absent or incomplete disclosure of investment strategies and lending practices of state banks. Much less is known about the operation of specialized credit institutions (SCI) operating in priority sectors. In Saudi Arabia, where their operations are extensive, only aggregate balance sheets of SCIs are published by SAMA. Little information is provided about their 'operations, strategies, and investment policies'. In Algeria banking supervision reports submitted annually to the President remain confidential. Supervisory arrangements of the banking sector tend to be fragmented, offering limited coordination between concerned agencies and avoiding a consolidated oversight of the sector.

Another concern is the corporate governance of financial institutions. In many countries the same politically connected actors sit on multiple boards, sometimes on both sides as creditors and borrowers. Such conflicts of interest are particularly rife in labour-abundant RREs. In Algeria's state-owned banks the chairman of the board is typically also the Managing Director of the bank, which creates 'potential conflicts of interest between oversight and management functions'. The dominant role of the state means that, in Algeria, 'the government is the largest bank owner, it acts as a regulator, and it is the main client (through the SOEs)' (IMF 2014: p. 27). Although Arab RREs have generally enjoyed financial stability, thanks to deep pockets and excess liquidity, episodes of bank failures are not uncommon. From the failure of Al Khalifa Bank in Algeria to the 2009 financial crisis in Kuwait, crisis management has remained weak.[15] Crises are rarely treated as learning opportunities that could pave way for far-reaching institutional reform. Instead, the standard response is government recapitalization of banks, deleveraging or complete liquidation. Such bail-outs create major moral hazard dilemmas and undermine incentives for structural reforms.

Bank failures have also repeatedly exposed weaknesses of the legal framework for bankruptcy and restructuring. The process of bank dissolution and debt recovery is often costly, protracted and complicated. This can prevent banks from undertaking risk and lending to unconnected actors. In labor-abundant economies, such as Saudi Arabia and Algeria, there is no separate resolution framework for banks. Instead, banks are subjected to general corporate bankruptcy provisions that have traditionally penalized corporate failure through the application of criminal codes. Bank management in Algeria can be subjected to the Algerian Criminal Code, which incentivizes them to keep non-performing loans on the books for a prolonged period and waiting for government intervention. Algeria also lacks a legal framework for the acquisition of non-financial firms and personal bankruptcy. Even the relatively developed financial markets of GCC are not immune to such legal shortcomings. Macro prudential regulation is generally weak across the region. The non-bank financial sector, consisting of stock, mortgage, bond, insurance and inter-bank markets, is relatively under-developed in MENA. In all Arab

[15] The 2009 crisis in Kuwait mostly affected the unregulated investment firms.

RREs capital markets are noticeably underdeveloped. This has profound implications for the conduct of monetary policy, and will be separately discussed in section 5.

To summarize, even if financial markets are relatively deep in some Arab RREs, the institutional infrastructure is chronically underdeveloped. By denying institutional coping mechanisms for dealing with economic shocks, a weak regulatory framework undermines financial stability in the long-run. This means that even financially developed economies, such as Barhain and UAE, remain vulnerable to shocks, especially given their high exposure to real estate lending.[16]

5.6 Differences in financial structure

As the above analysis suggests, there are clearly differences in financial structure across the Arab RREs. This begs the question: What explains the greater prominence of the financial sector in some countries, and what drives the differences in underlying institutional arrangements? A broad evaluation of the performance characteristics reveals a marked difference between the labor-abundant RREs and the high rent per capita economies of the GCC. The former suffers from generally weaker levels of financial development, partly manifested in the low ratio of private credit to GDP (13.5% in Libya and 16.7% in Algeria, for example). The state has a domineering presence in the financial sector of labor-abundant RREs. These economies also stand out for the greater prominence of SOBs and Specialized Credit Institutions (SCIs). Another feature of their banking systems is the high share of non-performing loans. As a share of gross loans, non-performing loans in Algeria's government banks stood at 12.6 percent. Partly as a consequence of excessive state involvement, there is also a greater informalization of the financial sector. Although capital flows are generally liberalized across the region, financial systems in labor-abundant RREs exhibit some form of financial repression. With its pervasive exchange controls that maintain negative real interest rates on dinar assets, Algeria presents a clear evidence of financial repression. Although the GCC economies are immune from such direct interventions, their banking systems face high reserve requirements. There is also an explicit or implicit capping of interest rates in some economies.

With multiple claims on rent distribution, labor-abundant RREs seem to have a greater political imperative to exert direct control over the financial sector. With their statistic ideological orientation, these economies were also prone to developing inefficient state-owned enterprises. Financial sector has also been used to generate rents. Partial liberalization of the banking sector, for example, has allowed regimes to control the allocation of licenses and generate new rents for insiders. As the lead banker of the public sector, the financial sector is often used to safeguard oligarchic interests masquerading as claims by state enterprises. Financial sector, in this milieu, provides an important mechanism for rent distribution. As Henry and Springborg (2010: p.108) note: 'The banking system is a major asset for these regimes as long as insiders hold the levers of financial power, for they then extend the regime's reach and patronage networks into the private sector'.

While, in principle, financial markets are needed to facilitate inter-temporal consumption and business investment, their distributive function trumps the productive logic in highly centralized extractive regimes. Although, by conventional yardsticks, financial structures of GCC economies are arguably more 'developed', the political economy of finance points to underlying structural weaknesses. In countries with a shrinking base of natural resources, for example, financial sector offers a politically safe avenue for economic diversification. In Bahrain, the assets of wholesale banks equal 480 percent of GDP; those of retail banks equal 270 percent of GDP (IMF 2013). However, this regime of high finance does not pose a political

[16] See IMF (2013) and IMF (2014) for further discussion on this.

threat since the bulk of lending is geared towards connected parties and real estate. Thus, even where depleting oil reserves have incentivized a move towards diversification, real estate, construction and financial sectors have been the preferred avenues for diversification.

Although this diversification strategy is politically more palatable, as it permits controlled forms of accumulation, it does not offer a hedge against oil-induced volatility. Admittedly, there are strong theoretical reasons to argue that a well-developed financial sector, by reallocating and aggregating resources in times of distress, can prevent harmful contractions in the economy. Equally, however, financial fragility can amplify shocks in bad times by eroding liquidity and leading to credit crunches.[17] Like many Latin American oil exporters, external shocks and financial fragility are a fact of life in Arab RREs. Despite the size and significance of their financial sectors, UAE and Bahrain remain vulnerable to financial bubbles.

6. Role of Monetary Policy and Exchange Rate Arrangements

This section seeks to highlight the salient political economy dimensions of monetary policy and exchange rate arrangements in Arab RREs. By and large, the scope and operation of monetary policy remains limited for a variety of reasons. The first has to do with the impossible trinity of international macroeconomics. Saving a few, most countries in the group permit high levels of capital mobility and follow a fixed exchange rate regime. This leaves little room for monetary policy. Hardly any country in the cohort has a floating exchange rate arrangement. With the exception of Kuwait, Algeria, and Libya, all other Arab RREs maintain a hard peg to the US dollar. Kuwait maintains a basket peg, while Algeria and Libya maintain a managed float, allowing greater scope for monetary policy (See Table 1). Where permissible, liquidity management remains a key concern of monetary policy. With inflationary pressures largely subdued in this cohort, macroeconomic stability remains a paramount concern.[18] Policy makers are particularly cautious about restraining the impact of external shocks.

Given the widespread use of conventional pegs with the US dollar, the monetary anchor of choice in all Arab RREs (except Yemen) is the exchange rate target. There is limited scope for counter-cyclical monetary policy using interest rates. Several countries in the region tend to rely on indirect monetary policy tools, the most important of which are reserve requirements and repurchasing agreements. Foreign exchange swaps and reverse swaps are also used in Bahrain, Oman, Saudi Arabia, and the UAE. Reserve requirements (RR) are arguably the most common monetary policy instrument in Arab RREs. Central banks typically enforce the RR on both domestic and foreign policy deposits, with the required ratio ranging between 5-10 percent (Gray et al. 2013). In Kuwait and Iraq the RR ratio exceeds 15 percent. Some countries also require that reserves be maintained in foreign currency against deposits denominated in foreign currency. Most central banks in the region tend to implement a one-month maintenance period for reserves. Adjustments in the RR ratio allow countries to mop up excess liquidity associated with rising capital inflows. Saudi Arabia has frequently deployed such adjustments to manage liquidity.

Although, there are few restrictions on the determination of interest rates in most countries, the interest rate channel of monetary policy plays a less significant role, since the sensitivity to changes in policy interest rate remains low. Therefore, the loss of monetary policy independence may be less costly for Arab RREs that maintain an exchange rate peg and almost perfect capital mobility. There is continuing debate globally on the appropriate role of monetary policy and choice of exchange rate regime in resource-rich countries. It is argued, however, that under conditions of fiscal indiscipline a fixed exchange rate regime might deliver greater

[17] Global literature suggests that the relationship between financial development and macroeconomic volatility can be non-monotonic: beyond a critical threshold higher levels of financial development can actually increase vulnerability to shocks (Aghion et al. 1999).

[18] Algeria and Yemen have faced slightly higher inflation levels than other RREs.

stability than price level targeting (Aylev 2012). A fixed regime can achieve this through a better insulation of the economy from external shocks. While the pro-cyclicality of fiscal policy is a central concern in Arab RREs, monetary policy is effectively insulated from fiscal pressures. Except for Sudan and Yemen, monetization of fiscal deficits is rare. As a result, fiscal dominance, which is often the bane of monetary policymaking in developing countries, is a relatively insignificant concern in Arab RREs. However, 'government activities for monetary purposes' remain a dominant feature of central banks in the region. Government deposits are an important component of overall liabilities in central bank balance sheets. On the other side, foreign assets command an overwhelmingly large share of total assets. Importantly, 'lending to banks' is a noticeably insignificant component of these balance sheets.

Two other challenges that constrain monetary policy actions are: underdeveloped debt markets and lack of political independence. I describe these two constraints below before venturing into an analysis of exchange rate arrangements.

6.1 Underdeveloped debt markets

There is a deep connection between financial sector arrangements and the conduct of monetary policy in Arab RREs. All countries in the cohort lack developed markets for government securities. Under-developed debt markets, whether primary, secondary or money markets, remain a universal feature of these economies. This limits the scope and efficacy of monetary transmission instruments even in countries, such as Algeria and Libya, where managed float of the exchange rate permits greater room for monetary policy (Cobham 2011). Limited or weak secondary markets for government securities reduce the effectiveness of open market operations of central banks. Even liquidity management, which remains a prime task of central banks, becomes difficult in the absence of developed debt markets. While underdeveloped secondary markets are not unique to MENA, they are particularly difficult to justify in Arab RREs that have used the financial sector as a means for economic diversification.

A key casualty of weak financial markets is that all Arab RREs find it difficult to build a benchmark yield curve, which reduces the effectiveness of monetary policy instruments. Although there have been occasional bond issues (largely *sukuk*) bond markets are generally shallow, 'sporadic and inefficient'. More than 50 percent of *sukuk* issuance is concentrated in the UAE, and is primarily directed towards the real estate and banking sectors. Besides, given their exotic nature and continuing uncertainties in the underlying governance arrangements, it is difficult and costly to build a 'critical mass' of *sukuks*. A structural barrier to the development of debt markets is excess liquidity and its ineffective sterilization. The dominant sterilization instruments, such as reserve requirements, and prevailing issuance practices hinder the development of debt markets. A characteristic feature of these debt markets is that the investor base remains undiversified, with limited participation by foreign investors or non-bank institutions. Markets are defined by a mutual accommodation between governments and the banking sector, the latter – together with public sector entities – constitutes a 'captive demand' for new issues. This is partly a consequence of excess liquidity, dominance of the public sector and lack of alternative instruments. Banks and public enterprises, in this milieu are incentivized to maintain 'highly concentrated buy-and-hold portfolios'. Little competition is offered by institutional investors, such as mutual funds, who are protected by government generated rents through opportunities for 'regulatory, accounting and tax arbitrage' (Garcia Kilroy and Silva 2011). Lack of competition, in turn, impedes efficient price formation and reduces the liquidity of secondary markets.

In political economy terms, the above pathologies of debt markets in MENA strike a familiar chord in a region where markets are traditionally viewed as a domain of privilege rather than competition. These economic arrangements ultimately underscore the primacy of the political. The political sovereign in Arab RREs has been reluctant to concede space to the private sector.

In this milieu, market is a controlled space, whose form and function must be neutralized to serve the prevailing political order. As a controlled domain, Middle Eastern markets are primed to produce concentration and fragmentation. Both of these elements are vividly displayed in debt markets as well. While successful bond issuance requires a strong secondary market, the latter may be resisted as it can empower the private sector. Secondary markets are difficult to control, since bonds continue to trade in these markets rather then held to maturity by banks. When banks accumulate assets through bond purchases, it tends to decrease lending to the private sector.

The dominance of the public sector, large banks, concentrated portfolios (even auction allocations are concentrated in the region), and weak financial and regulatory infrastructure emanate from this political logic of control. Fragmented debt markets are a natural outcome of this institutional environment. Independent market linkages that could foster competition and empower private agents are a difficult power proposition, since they can raise the possibility of a horizontal association between market actors that defies the vertical control of the state. In this backdrop, it is hardly surprising that the majority of trades in money markets take place between the central bank and banks, rather than banks and banks. Inter-bank markets are either inactive or limited.[19]

6.2 Lack of political independence

Both inflation targeting and central bank independence are relatively meaningless constructs for Arab RREs. Monetary policy is not geared towards domestic targets, such as inflation and unemployment. With central bank balance sheets predominantly shaped by the external sector—mainly revenue flows from hydrocarbon exports—monetary policy is guided by the external sector. In most contexts, central banks operate in a macroeconomic framework where exchange rate stability remains the paramount concern. There is hardly any borrowing from domestic markets. Despite the limited role assigned to central banks, whatever limited powers they enjoy are exercised in a constrained manner. Most countries lack a comprehensive framework for monetary policy. Some countries central banks even lack the power to sterilize or to control foreign reserves, which undermines their role in financial stability. In this backdrop, it is not surprising that most Arab RREs display low levels of central bank independence, especially political independence.

Political economy considerations are central to explaining this. Clearly, central banks in the region operate in a dependent framework where they are subordinated to the demands of the external sector and the political objective function. As rentier states, key macroeconomic variables, such as output, employment and inflation, are outside the purview of monetary policy. Instead, fiscal policy remains a more important driver of these outcomes. As subsequent discussion will emphasize, productive constituencies are considerably weak to demand and receive any policy signals. Inflationary expectations play little role in wage determination. Wage increase is largely decided through executive action by the state, which is also usually the lead employer in the formal sector. With their excessive reliance on cheap foreign labor, labor market arrangements in the private sector, at least in the GCC, are also determined through a separate logic (Dibeh 2014).

Another limiting factor for the design and conduct of monetary policy is purely political. A predicate policy framework that cultivates reputation and credibility through consistent policies is an alien concept in Arab RREs. Rule-based decision-making sits uncomfortably in an institutional milieu where policy makers face few checks and balances on their power[20]. It is therefore unsurprising that central banking in the region is defined by an absence of

[19] This is especially true in Saudi Arabia, UAE, Qatar, Oman, Libya and Algeria.

[20] It should be noted that some of these checks on political power can be informal as is the case with GCC countries.

transparency and clear commitments. Many central banks refrain from regularly publishing statistics and reports, and have few sophisticated instruments to conduct monetary policy. Monetary policy is often subjected to overriding instructions from central authorities. All of this translates into limited political independence. Compared to other emerging economies, central banks in the region rank well below on political independence (Laurens et al. 2009; see Table 1). In fact, on this account, Arab RREs perform worse than even the MENA region, on average.

An interesting departure is offered by Algeria, which stands out for its relatively high levels of de facto central bank independence. How can one explain the Algerian exception? As before, political economy considerations are central to understanding this anomaly. The institutional opening in Algeria arose from a potent mix of economic pressures and political violence since the 1980s, which resulted in both high inflation and unemployment. Algeria was obliged to seek external donor support and sign up on the IMF's structural adjustment programme. Central bank independence was a key concession in this process and, although legal independence granted to the central bank was revoked in 2003, the de facto independence only increased with time (Zouache and Ilmane 2009). The Algerian experience underscores a larger point. Where political instability and unemployment are higher and foreign exchange reserves are more precarious, it is more likely to witness a move towards independent central banks and more flexible exchange rate arrangements. This is also consistent with the approach in Edwards (1996).

6.3 The political economy of fixed exchange rates

The choice between fixed and flexible exchange rate regimes is often described as a choice between good and bad macroeconomic policy. To the extent that policies are themselves endogenous to institutions it is fair to say that this choice is ultimately embedded in the political realm. This is also true for the fixed exchange rate regimes that remain a pervasive feature of Arab RREs. Although a fixed regime remains a popular choice for resource-rich economies and closed political regimes with fewer veto players (Steinberg 2012), in the Arab context, this choice can be underpinned by a number of factors specific to the region.

A first obvious reason relates to sustainability. Given the extra-ordinary scale of their foreign exchange reserves, Arab RREs – especially the GCC countries – have little difficulty in sustaining a peg. The scale of foreign exchange reserves is exceptional even when compared with other oil exporters in Africa and Latin America. In 2012, for example, foreign exchange reserves of Saudi Arabia were nearly thirty times higher than those in Angola, one of the highest rent per capita economies of Africa. Even Algeria—a relatively rent per capita Arab economy—accumulated three times more reserves than Angola (WDI 2012). Departures from the pegged regime are more likely where reserves are relatively more precarious, such as Algeria, which has witnessed a precipitous fall in its external reserves since 2012. This partly explains the country's choice of a managed float. The importance of reserves is borne out in global studies suggesting the greater propensity of economies with high reserves to import ratios to adopt fixed exchange rate regimes (Daly 2007). Despite this, the GCC economies have defended their pegs even during periods of falling reserves and growing debt, as was the case in 1980s and 1990s. Thus, beyond the role played by reserves, some political economy explanation must be in order.

Speaking about the region more broadly, hydro-carbon wealth tends to shield Arab RREs from the underlying economic compulsions that determine common choices around monetary and exchange rate arrangements. Oil riches, in this regard, tend to suspend the normal economic logic. Similarly, the loss of monetary policy autonomy that results from a fixed exchange rate regime does not impose a high cost in Arab RREs. In any case, monetary policy has limited room to play in a milieu where central banks lack independence and financial markets are

underdeveloped. While achieving internal and external balance can be challenging in the absence of conventional monetary instruments, as is the case with fixed exchange rate regimes (Jones, 1968), this is more sustainable in resource-rich countries where resource wealth allows policymakers to separately deal with the two domains.

A related second reason for this choice has to do with economic structure. The structural economic and political factors traditionally emphasized by the literature do not predict the de facto exchange rate arrangements in Arab RREs. The dominance of the public sector and the relative insignificance of the export sector signal the absence of an independent economic constituency that might wish to see its interests articulated through monetary and exchange rate policies. Even in the GCC where the private sector exhibits greater strength merchants have failed to emerge as an independent force that is able to influence government policies. The weak state of private manufacturing, especially of exports, means that there are limited private economic stakes in exchange rate arrangements. Whatever limited export manufacturing exists in the region exhibits little sensitivity to changes in real exchange rate.[21] Thus, the contention in Steingberg (2012) that exporters tend to prefer fixed exchange rates because they value price stability is unlikely to apply in Arab RREs. Given the absence of an export lobby, competitiveness is not thus a major issue at stake. However, as per Broz and Frieden (2006), the overall size of trade in a country might be a stronger predictor of exchange rate choice. This has some relevance for Arab RREs where, given the high degree of import dependence, the fate of merchant classes is directly connected with import agencies and licensed distribution of foreign products. The import cartels who constitute an important economic constituency in Arab RREs are direct beneficiaries of a stable exchange rate framework.

Another plausible factor impinging on the choice of an exchange rate regime is the imperative of price stability in a region that is heavily dependent on food imports and where affordable food prices are a central feature of the social pact. Beyond food, popular consumer interests constitute an important political constituency for exchange rate stability, given that most goods are imported in RREs. However, evidence suggests that price stability is not the core determinant of exchange rates arrangements in MENA. A recent study, El-Achkar and Shahin (2009), fails to establish a strong relationship between exchange rate arrangement and price stability in MENA using data over the period, 1975-2005. Inflationary pressures emanating from the rising cost of food imports is typically contained through subsidies (Hasan and Alogeel 2011). Flexible labour policies have also played a supplementary role in absorbing price shocks. Regardless, the fiscal cost of devaluations can be high, which makes the external constraint more binding.

A fourth argument revolves around capital mobility. In Arab RREs a fixed exchange rate arrangement typically coincides with a highly liberalized capital account regime that imposes few, if any, restrictions on the cross-border movement of capital. From a purely macroeconomic standpoint, this can spring from a pragmatic concern of draining liquidity from the system and preventing the dangers of Dutch Disease evident in so many other resource-rich contexts. But there is also a complementary logic for capital mobility rooted in an underlying political economy framework that is excessively dependent on the import of labour from developing countries and export of capital to developed markets. If low-skilled foreign workers are important for sustaining the segmented labour regimes in GCC states, capital mobility is needed to facilitate outward remittance flows. This labour market arrangement is clearly

[21] The MENA region is shown to have witnessed significant misalignment of the real exchange rate during the 1970s and 1980s, with a tendency towards overvaluation (Nabli and Véganzonès-Varoudakis 2004). From 1985 to 1999 the degree of exchange rate overvaluation averaged 22%, higher than any other region besides CFA Africa (Veganzones-Varoudakis, Keller, and Nabli 2003).

significant from a political economy standpoint, since reliance on cheap foreign labor acts as an insurance against the possibility of class struggles emanating from labor politics.

Arab RREs are not just exporters of hydrocarbons but also the net exporter of capital. While overseas investments are a natural response to limited absorptive capacity of the domestic economy, the export of capital is also partly geared towards aligning the interests of external constituencies with domestic political order. Arab resource-rich states face the imperative of sharing their resource wealth, not just with their citizens, but also with key external constituencies. Trillions of dollars are invested abroad in acquisition of foreign companies and banks, purchase of company shares, infrastructure projects, US treasury bills and other modes. Foreign assets of the Saudi Arabia's financial system (including SAMA) are estimated at 130 percent of GDP. Many a times such investments by sovereign wealth funds and high net worth individuals are not purely driven by economic returns but, equally, by a geo-political logic that treats these investments as instruments for buying leverage with important foreign capitals. Supplementing such overseas investments are arms purchases, fiscal support for neighboring governments, charitable donations, and the like. These external flows are sometimes binding external commitments that help to sustain the authoritarian bargain at home.

High net foreign assets are also a natural byproduct of specialization in a highly internationalized commodity that inserts the region in global commodity and finance circuits. This globalization of commodity and finance, in turn, is intertwined with class formation at home (Hanieh 2011). Capital connects not just financial markets but also Khaleeji elites who are equally mobile and have personal interest in a liberalized capital regime. The political significance of capital mobility has received attention in comparative politics, but largely in a localized context. Asset mobility has been described as a crucial intervening variable in the democratization literature. It has been argued that democratization may be less threatening to the elites when assets are mobile, since this can lower the risk of redistribution (Boix 2003). Arab countries furnish contrasting evidence on this account, however. Here, capital mobility can bolster authoritarian structures through an interplay between domestic political and geo-political arenas. This remains a largely under-studied domain of political economy.

Summing up, while conventional pegs remain a stable arrangement, thanks to plentiful external reserves, their sustainability is directly connected with the uninterrupted flow of external rents. This can also be said about the stability of the overall macroeconomic framework. Important questions remain about the sustainability of pegs in the face of falling oil prices and divergent economic cycle in the United States. As the Russian case has recently illustrated, the ability of foreign reserves to buy credibility is limited, especially in times of falling oil prices. Additional risks are posed by the possibility of divergent economic cycles of Arab RREs and the US, which can create large interest rate gaps. In the medium term, a combination of low oil prices, sluggish growth at home and high interest rates in the US can be a combustible mix.

7. Concluding Thoughts

Macroeconomic pathologies of resource-rich economies (RREs) are widely recognized in the literature. Arab economies with rich natural resource endowments share the macroeconomic challenges associated with such economies: boom and bust episodes of economic growth, pro-cyclical fiscal policies, large public sectors, weak financial intermediation, and fixed exchange rate regimes that leave little room for independent action by central banks. While the Arab RREs fit this general macroeconomic profile, the underlying the economic and institutional arrangements are sometimes different. In this paper I have used a broad political economy lens to analyze macroeconomic policies and outcomes in Arab RREs. I have argued that political economy considerations are central to understanding both the salient performance characteristics of Arab RREs as well as the subtle differences that distinguish their macroeconomic experiences.

Revisiting the Arab experience, a number of distinguishing characteristics can be highlighted. Thanks to abundant oil revenues, most Arab economies in the cohort operate under a soft-budget constraint and a weak tax effort. With a fixed exchange rate regime and the primacy of the external sector, fiscal and financial policies gain particular prominence from a political economy standpoint. The distributive social pact is enforced through spending on salaries, subsidies and social services. In fact, fiscal policy is central to sustaining a political order based on the twin pillars of rentierism and repression. Like other RREs fiscal policy is highly pro-cyclical in Arab economies, which is partly explained by rising distributional commitments in good times and contractions in public investment during bad times. A comparison of fiscal policy dynamics during the two oil booms reveals a more robust savings response during the second boom. However, there are few institutional constraints on fiscal policy, and a large part of the fiscal domain remains unmapped.

Reviewing financial sector arrangements in the region, this paper has argued that conventional indicators of financial development provide an incomplete picture. Although most Arab RREs enjoy considerable financial depth this does not necessarily translate into financial access. Firms and households remain credit constrained in many countries. The bulk of lending is directed at real estate, public infrastructure and quasi-public sector activities. Like in most other economic spheres, the state has a domineering presence (whether direct or indirect) in the banking sector. The state's absence is most acutely felt, however, in areas where it is most needed, such as the provision of an enabling legal and regulatory infrastructure. Under-developed financial markets, in turn, restrict the scope for monetary policy. Monetary policy operations remain limited in countries with a fixed exchange rate regime. External anchor remains a binding constraint. In this context, the commitment problem is more relevant in the fiscal domain. Institutionalized constraints on the fiscal regime are therefore more important than central bank independence.

Most Arab RREs lack a clearly defined macroeconomic framework that specifies domestic economic targets and is supported by explicit instruments to achieve these. Policy trade-offs are neither explicitly recognized nor discussed. While price stability, job creation, infrastructural development and macroeconomic stability remain important concerns, governments tend to purse them in a fragmented, top-down fashion rather than through a coherent policy framework. In both the design and implementation of policies, discretion trumps rule-based decision making. In this backdrop, macroeconomic policies reflect the imperative of political—not just economic—stabilization. In fact, the political objective function is essential for understanding macroeconomic policies and outcomes. Despite the universal dependence on external rents, Arab RREs do exhibit differences in economic and policy arrangements, which are often driven by the politics of policy. Depending on the mix of labor and resource endowments, a classic distinction is made between high and low rent per capita economies. The importance of such differences can be gleaned from an analysis of the banking sector. The state remains a more dominant economic force in the banking sector in labor-abundant RREs. Economies in this cohort also suffer from more intrusive economic controls, reflecting the need to create additional rents to meet more extensive distributional commitments. For a given level of distribution, these economies also display more robust spending on repression and face more serious challenges relating to fiscal sustainability.

With prevailing arrangements, macroeconomic stability rests on a single pillar: revenues from hydrocarbons. Economic stabilization is largely about resource injections rather than deep institutional reform. Despite having accumulated considerable financial savings during the second oil boom, many Arab RREs remain vulnerable to low oil prices in the medium term. For instance, with its current fiscal outlook, Algeria is likely to draw down its excess reserves during the next four years. Even the wealthier GCC states are facing renewed fiscal risks in the wake of a sharp plunge in oil prices. Kuwait will run a deficit this year and the IMF predicts a

budget deficit for Qatar in 2016. Saudi Arabia is also facing growing strains in public finances. Throughout the region there is an inherent tension between stability and resilience. Stability is largely achieved by adjusting the distributional equilibrium rather than building institutional resilience. For example, in the wake of 2011 Arab uprisings fiscal policy has been extensively used to attenuate the impact of regional political shocks. The general approach to dealing with external shocks is to accumulate excess liquidity, manage the degree of exposure to global markets and rely on arbitrary economic controls rather than market-based instruments. Rather than acting as a shock absorber, financial sector is itself prone to oil-induced credit cycles and volatility.

Although this paper has discussed macroeconomic arrangements in individual policy arenas, there is admittedly a strong connection between fiscal, financial and monetary policy arrangements. Future work needs to consider more integrated accounts—general equilibrium analysis of sorts—that reveal how distortions in one sphere spill-over into other domains. These linkages are especially important to map in resource-rich economies, where both external revenues and the public sector play a dominant role in shaping macroeconomic outcomes. In these economies shocks emanating from global oil markets are propagated to the rest of the economy. There is abundant manifestation of this in Arab RREs. Oil booms translate into excess liquidity, which, through ineffective sterilization, shapes the conduct of monetary policy. Volatility of hydrocarbon revenues also leads to volatility of private credit.

An overriding political economy concern that afflicts all spheres of macroeconomic policy is the absence of intermediate institutional structures that could dampen the effect of external shocks. Such institutional resilience is not the result of administrative action alone; it emanates from the balance of power in society and the existence of strong bargaining structures that mediate state-society relationship. Such structures are mostly lacking in Arab RREs. A universal feature of these economies is the lack of an independent economic constituency that could demand and receive policy signals. With their high degree of overlap between businessmen and rulers it is unsurprising that Arab RREs lack an institutionalized framework for macroeconomic policy that is shaped by lobbying, bargaining and feedback from the private sector. Macroeconomic policy therefore operates in a relatively unconstrained domain. There is little also limited policy coordination. Macroeconomic challenges in each domain are dealt with separately.[22]

In the absence of resilient institutional structures it is natural for policy distortions to spill over from one macroeconomic domain to another. Selected illustrations from the region can be useful. Consider, first, the inter-dependence between fiscal and exchange rate policies. As global evidence suggests, fiscal policy is usually more pro-cyclical in countries with less flexible exchange rate arrangements, which underscores the importance of fiscal absorbers in the face of high revenue volatility and fixed exchange rate regimes. There is also a deep connection between financial development and the conduct of monetary policy. As this paper has argued, a weak financial infrastructure and underdeveloped debt markets in Arab RREs limit the scope and efficacy of monetary policy instruments for liquidity management. In particular, illiquid and underdeveloped secondary markets for government securities hinder the broad use of open market operations by central banks. Inflation is largely controlled through maintenance of high deposit ratios and reserve requirements. The cost of this is usually lower private sector credit. Another illustration of how distortions in one policy domain can have an economy-wide impact is provided by Algeria. Pervasive exchange controls in Algeria result in negative real interest rates on dinar assets, which, in turn, prevent the development of financial

[22] Coordination is sometimes absent even within a single policy domain. There is no institutional body in Algeria, for example, that oversees and assesses financial sector challenges as a whole.

markets and limit the scope and efficacy of monetary policy. There are just a few examples of policy spill-overs that need a more detailed treatment in future work.

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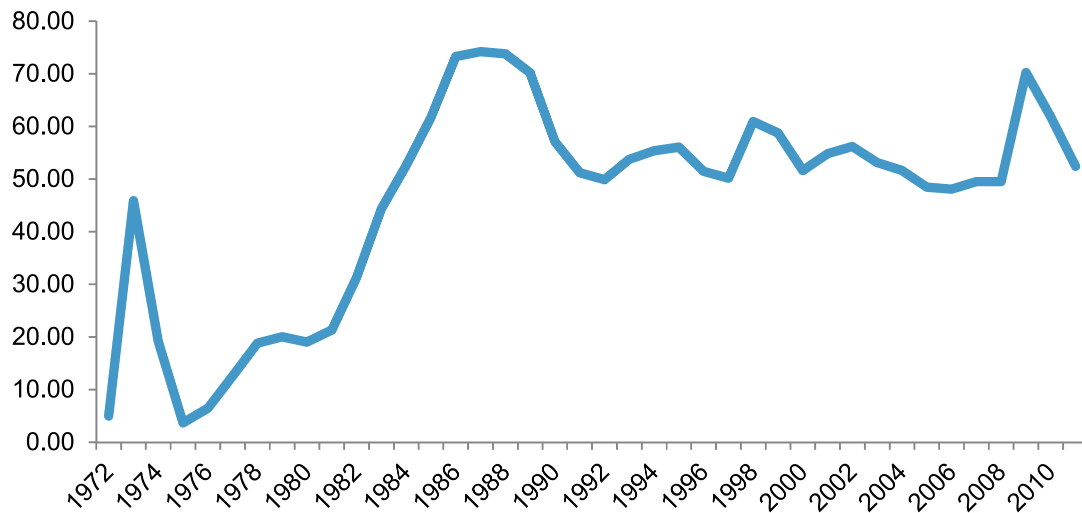
Figure 1: Credit to the Private Sector (% of GDP) in Saudi Arabia, 1974-2011



Source: Financial Structure Database, The World Bank.

Figure 2: Public Registry Coverage in Arab RREs, Average, 2004-2014

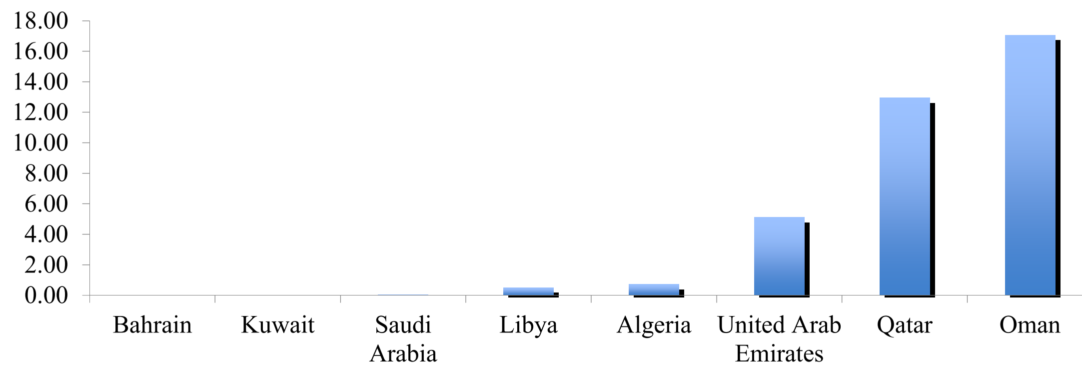
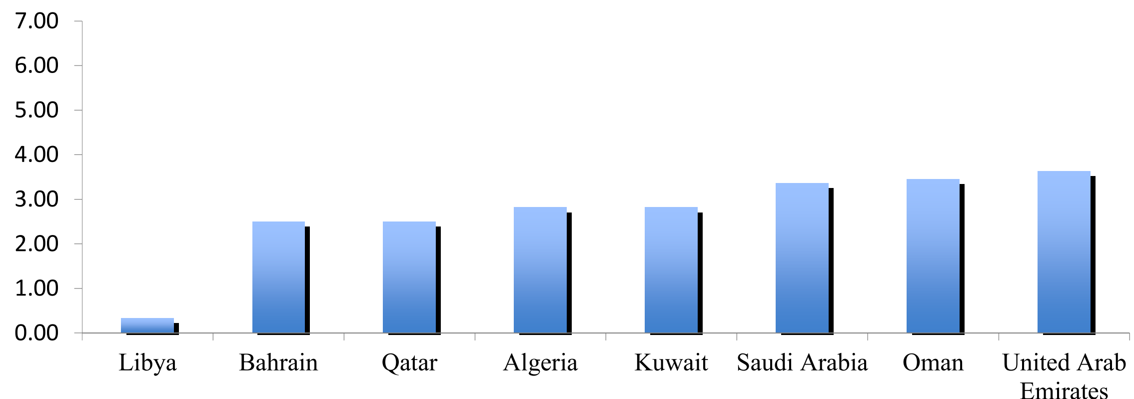


Figure 3: Strength of Legal Rights in Arab RREs, 2004-2014



Note: Averages for other regions are: sub-Saharan Africa: 5; South Asia: 5.3 and East Asia: 6.2.
Source: World Development Indicators 2014.