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High-level Segment of Heads of State and Government – In the wake of the global economic crisis: New opportunities for economic growth with social equity

Note by the UNCTAD secretariat

I. "Why did no one see it coming?" and other questions

1. The global economy, including the Arab region, has witnessed momentous changes since the financial crisis erupted in 2008. Conventional ideas about the workings of the economy have come into question and popular movements have called governments to task for failing to deliver on the development aspirations of peoples and tolerating growing social and economic inequities. The push for reform has been mirrored by vocal calls for a fresh economic direction to alleviate poverty, generate more and better jobs, improve social protection, ensure access to basic services and commodities at affordable prices and establish a more equitable distribution of national income in general.

2. Departing from "business as usual" is not confined to developing countries, but has become a pressing need in even the most developed economies. In Europe especially, the global financial and economic crisis, which erupted in 2008, exposed the frailty of certain economic policy strategies and the vulnerability of sovereign governments if they are left prey to market sentiment. The trend of a "lost decade" in these countries and generations denied employment opportunities highlights the urgent need for new economic thinking that puts greater emphasis on inclusive and sustainable growth.

3. For policymakers worldwide, this is an opportune moment to renew the social contract between the State and citizens and to reconsider the results of finance-led globalization. Internationally and nationally, neglected public institutions need to be rebuilt with popular assent. The policy challenge, for all countries, is to take advantage of the opportunities offered by political transformation, to assess the lessons of past failures and to identify feasible alternative paths to inclusive and sustainable development.

4. The present issues note highlights some of the key policy questions that such a reassessment poses, with a strong focus on the Arab context and the major political and economic transformations underway since early 2011 in the region. However, we do not favour an approach that would treat the Arab countries as culturally or otherwise exceptional or, as some analyses do, simply take them as an extreme example of a more ubiquitous "resource curse". Instead, the movement that began in the region should be regarded as part of a broader policy debate about the impacts of financial and trade liberalization and the missing role of the State as guarantor of social equity and development for all. Indeed, in Arab countries, as in many other developing and developed economies, the crucial role of the government has been maligned or neglected in the enthusiasm for market fundamentalism that has dominated policy discussions in the past decades.

5. As social discontent, political turmoil and constitutional change spread through the Arab region in 2011, the economic dimensions of the transformation underway often received secondary attention. Yet the economic fallout from prolonged unrest and uncertainty has been felt throughout the whole region. No country has been spared having to respond to the growing wave of social and political demands. In some cases, prolonged violent confrontation has delayed the elaboration of a coherent social reform agenda. But in other, more stable countries, oil revenues are being allocated to greater social expenditures. In countries where democratic transformation has moved forward more peacefully, painful recessionary conditions and economic uncertainty naturally make citizens and entrepreneurs wary of prolonged turmoil and can threaten further advance. So far, the economic outcomes of the past year's uprisings represent a mixed bag of sharp blows to the real economy, belated official recognition of profound social grievances and the first green shoots of a critical stock-taking of the lessons, and failures, of the past.

6. Beyond the immediate economic impact and its continued interplay with social movement, several questions seem evident in any appraisal of the economic policy implications of these challenges. Alongside the overriding political and human rights dimensions, what role did socio-economic governance failures play in the build-up to the Arab uprisings? In turn, were prevailing economic policy frameworks incapable of delivering sustained growth *and* development because they entailed *too much* liberalization, or was the problem not enough, *or poorly managed*, liberalization? In these new circumstances, what new approaches to development policy must be considered, or old ones revised, in a way that at once responds concretely to massive social discontent and demands and does not jeopardize the fragile growth gains of recent years?

7. While none of these questions has easy answers, many economic and development policy challenges that must be met in the Arab region today and in the coming years are similar to those that have arisen in the wake of the global financial and economic crisis. Much of the profession and most international institutions did not expect, much less prepare for, the recent waves of economic and social crises. Famously, Her Majesty Queen Elizabeth II asked an eminent economist from the London School of Economics, "Why did no one see it coming?" In the same vein, vocal protests from Wall Street to the streets of Athens and Tahrir Square ask for new thinking in the highest policymaking and intellectual circles. It is increasingly recognized that faith has been shaken in the economic policy prescriptions which helped to generate the crisis and that turned a blind eye to its build-up.

8. With this in mind, the centrality of socio-economic grievances to the upheaval in the region becomes evident. As elsewhere, economic and social inequalities were a necessary but not a sufficient condition for an Arab social movement to emerge. Only when the more general model that was applied in all these economies for many years began to reveal its weaknesses were conditions for the new social movement fulfilled. In defending the case

for enduring “market fundamentalism”, some narratives would reinterpret Arab economic policy failings as being primarily rooted in poor political and institutional governance, and not in the policy package itself. Governance challenges certainly persist, but UNCTAD maintains that many of these cannot be addressed separately from the misguided policies that gave rise to them.

II. Liberalization and employment in the Arab region: Reform or distortion?

9. Policy reforms in developing countries since the 1980s involved a reorientation of macroeconomic policies, with priority given to combating inflation, attracting foreign direct investment (FDI), and increasing openness to trade and capital flows. With market liberalization, the economic role of governments was reduced, and the goals of full employment and equitable income distribution lost their former pre-eminence. Large efficiency gains were anticipated as countries allocated resources in line with their “comparative advantage”.

10. However, liberal trade, capital and FDI policies in many Arab and other countries have not expanded national productive capacity to the levels that would have a tangible positive impact on employment. Success was too often measured in terms of the degree of trade openness and the quantity of trade and FDI, rather than their positive links to employment creation, income generation or the sustainability and inclusiveness of growth. Tighter fiscal budgets and the sale of public assets were welcomed as signs of unleashing private entrepreneurial capital, with scant attention paid to the social efficiency of management of public goods by private operators or their distributional consequences.

11. The *jobless* economic growth pattern in Arab countries in the last three decades was the outcome of, inter alia, a deliberate trade and financial liberalization process, sustained wage-compression and retreat of the State from the economy in a formula promoted around the world. In most countries in the region, the push for political change has been echoed by calls for new policy approaches that focus on the alleviation of poverty, more and better jobs, improved wages and social security, access to basic services and commodities at affordable prices, and a more equitable distribution of national income in general. These hitherto neglected goals will now have to become the main focus of economic policymaking to stave off further political unrest. But, in UNCTAD’s view, there are good economic reasons for revisiting the concept of the broken social contract between Arab citizens and States. The search for new pro-growth policies that uphold social equity rather than individual enrichment and that nurture, rather than squander, national economic resources has to be based on a new economic strategy.

12. As shown in the *Trade and Development Report 2010*, more than 20 years of policy reform have had a limited impact on strengthening the potential for rapid and sustainable growth in many developing countries. Indeed, they may even have reduced that potential by hindering crucial investments in physical and social infrastructure. Furthermore, when governments rapidly opened up to foreign capital, the investment they attracted was often capital-intensive and could not be integrated into domestic production networks. Typically, long recessionary episodes with high unemployment weakened the bargaining power of organized workers and lowered their share of national income. This encouraged further moves towards “labour market flexibility”, which aggravated wage compression and their negative effects on domestic demand growth. Even so, lower wages were often offset in export-dependent sectors by restrictive monetary policy which maintained high interest rates to attract foreign capital but lead to weakened competitiveness via real exchange rate appreciation. At the same time, this policy discouraged domestic investment by raising the cost of credit to prohibitive levels for domestic investors in fixed capital.

13. The challenges faced in the Arab World are thus symptomatic of a wider policy malaise and regressive social transformation agenda. In the last 20 years, while many Arab economies experienced an average annual real economic growth above 5 per cent, growth in productivity was less than half of that and negative in some cases. During the same period, the structure of the economy moved away from the agricultural and manufacturing sectors towards services and construction. The generally low wage share in GDP either stayed constant or declined over the same period. At the same time, unemployment rates remained at stubbornly high levels for almost all countries in the region. In a country such as Egypt, in the last seven years, even while productivity was steadily increasing, average real wages were declining, a stark indicator not only of a worsening income distribution but of a flawed economic policy approach.

III. Trade liberalization, regional integration and policy space

14. The lesson from ongoing research, including by UNCTAD, is that rapid trade liberalization has not automatically guaranteed that poverty can be reduced. The characteristics of the poor, their sources of income, the way they spend their limited income, and the way in which price changes pass, or fail to pass, to households, all influence the impact of trade driven growth on poverty reduction. Given the heterogeneity of the poor and the evolving situation of the international environment, where all countries try to improve their competitiveness, it is risky to count on trade liberalization to fight poverty. Perhaps the major lesson that is common to all Arab countries is that trade policies will not have a significant impact on poverty unless these policies are complemented by different macroeconomic policies and measures specifically targeting employment generation and income redistribution.

15. Most Arab countries have, since the 1990s, implemented trade liberalization policies and regional integration has also focused on trade liberalization. However, trade agreements and trade liberalization *per se* do not necessarily lead to increased trade among participating parties. There is a multitude of other factors that influence trade and explain the weakness of intra-Arab trade and the obvious failure of previous regional agreements to stimulate trade flows among the Arab countries. These factors range from economic and logistical factors to historical, institutional and political factors.

16. The weak intra-Arab trade is mainly the result of the similarity of production structures and the dominance of oil in Arab countries. Structural factors also played their role in impeding intra-Arab trade. Transport modes constitute a major barrier to the expansion of trade in the region. For example, although the Arab Maghreb Union member States have signed an agreement to simplify the movement of people and goods, there remain many cross-border barriers to trade, such as closure of roads, delays in border checks and visa restrictions to certain nationalities. A multitude of other non-tariff barriers are related to complicated and time-consuming customs procedures, complex and diverse foreign exchange and exchange rate controls, absence of regional clearing and payments arrangements and lack of effective dispute settlement mechanisms, as well as individual countries' trade commitments with other trading blocs. Other relevant factors include poor preparation of the agreements emanating from the low quality of bureaucracy, poor management and lack of market information.

17. At another level, UNCTAD's research has highlighted the tension between international economic integration and the autonomy available to nation States to pursue policies that effectively support their economic development – the concept of "policy space". Recent concern about the tension between international integration and national policy autonomy mainly relates to two factors: (a) the unsuccessful policy agenda for acceleration of economic development in many countries; and (b) the increased internationalization of

markets and the associated stronger impact of foreign factors on national development. Much of the debate on policy space has been confined to trade policy and concerned with how trade agreements, whether bilateral, regional or multilateral, can restrict the sovereignty of nation States to make their own policy decisions. However, as has been shown by the *Trade and Development Report* over the years, restricting other policy domains, including monetary and fiscal regimes, may be just as or even more important in the design of development strategies.

IV. Starting anew: Policy action is within reach for socially vulnerable developing countries

18. UNCTAD has consistently emphasized that, in most developing countries, employment growth critically depends on the expansion of aggregate demand and overall growth. The traditional argument that the price of labour relative to that of capital determines employment growth independent of overall growth cannot be maintained in most circumstances. Falling wages across the board lead to falling domestic demand and falling investment long before the expected positive effects of lower labour costs on the structure of production can materialize. The fact that domestic investment and domestic employment are closely correlated illustrates that point. Beyond the domestic problems to implement a concept of wage flexibility, the conventional wisdom about “export-led growth” has focused policymakers’ attention on lowering wages and unit labour costs to improve a country’s global competitive position. However, competitiveness is always a relative concept and cannot be applied to the global economy as a whole or to large groups of countries without consideration of retaliatory action of the trading partners.

19. Hence, a more sustainable macroeconomic strategy would rely on domestic investment and new capacity creation for absorbing surplus labour, which would be based on domestic demand with average real wages, as a rule, increasing in line with aggregate labour productivity increases. For all countries, the ability to achieve sustained growth of income and employment depends critically on how the gains in productivity are distributed within the economy. Only if consumers are systematically participating in the overall progress of the economy sustainable and stable investment and more and better employment can be expected. For countries facing severe social pressures, such strategic macroeconomic criteria are central to a successful recovery and a reconstruction strategy that will allow renewing the “social contract” between the state, employers and labour.

20. For a virtuous circle of investment, productivity growth, income growth and employment creation to occur, policies need to be oriented towards ensuring that the income gains from productivity growth are distributed appropriately between labour and capital. This means that, over time, the share of wages in national income should not decline; for developing countries, this includes incomes from self-employment in agriculture and non-agricultural informal activities. This is not enough, given the low level of the wage share in many countries. The social equity goal calls for complementary taxation and social policies of the government to avoid declines in relative and absolute real incomes of the lower income shares of the population and particular vulnerable groups of the population.

21. Overall, it is not greater wage flexibility that leads to faster employment growth, but rather a reorientation of macroeconomic policies including incomes and social policies. A full participation of wage earners will not only create additional jobs that produce additional value added, but will also allow for the emergence of profit differentials and an incentive structure that strengthens innovation, the dynamic forces in the economy and, thus, investment in productive capacity. Moreover, linking wage increases to productivity growth would tame cost push inflationary pressures and free central banks to pursue pro-

growth and employment-friendly monetary policy by stimulating domestic investment. UNCTAD has proposed in the *Trade and Development Report 2010* several labour–income policy instruments that could support such a broad macroeconomic reorientation.

22. FDI can play an important role in a fresh economic start, focusing on inclusive development, growth and social equity in Arab countries. However, for this to happen, governments and policymakers will have to undergo a conceptual shift in the way they perceive and use FDI. Previous policies had relied primarily on quantitative targets as a measurement of policy success rather than the quality of FDI and its positive socio-economic contribution on host countries. As a result of this perception, the spillover effects of FDI often remained quite limited as compared to the size and growth of the population.

23. For many Arab countries, bilateral investment treaties (BITs) have been the policy tool of choice to attract FDI. The main challenge is to strike a balance between the potential for such agreements to increase FDI flows and the ability of countries to pursue development-oriented FDI policies aiming at creating jobs, reducing poverty, transferring technology and boosting productive. This entails maintaining sufficient policy space in the agreements to give governments the flexibility to use such policies within the framework of the obligations established by the BITs.

24. For example, BITs can have implications on the policy space available to governments to regulate capital flows in cases of balance of payments difficulties or other economic problems. The free transfer of funds provision found in most of the BITs concluded by Arab countries gives foreign investors the right to transfer back to their home countries, without delay, funds, profits and returns related to an investment. This could limit developing countries' regulatory rights in ensuring investors' compliance with specific laws (e.g. laws on bankruptcy and payment of taxes prior to transfers) or in safeguarding flexibility to properly administers financial and monetary policies. Furthermore, BITs could also have implications on efforts to re-regulate financial systems through, for example, the recourse to capital controls for coping with volatile capital flows (see the *Trade and Development Report 2011*) and exceptionally large capital outflows during periods of political instability, similar to the unfolding events of the present time.

25. Arab countries have also concluded a number of regional investment agreements among themselves that aim at facilitating and encouraging intra-Arab investment flows; however, the regional investment framework in the Arab world remains at an early stage of development. The weak regulatory framework for investment among Arab countries could be one of the factors explaining why, despite other advantages, intra-Arab FDI flows remain strikingly below potential. There is a need to revise and consolidate existing Arab regional investment agreements with a view to better reflect the changing economic and social realities on the ground.

26. It is crucial from this perspective that new foreign investment policies and regulations reflect and adapt to the changing economic and social realities in Arab and developing economies without violating existing international investment commitments made at the bilateral, regional and multilateral levels. More specifically, FDI policies should aim at achieving strategic employment objectives and generating more equitable income distribution. They can play an important role in modernizing industrial productive capacity and revitalizing the huge potential of the agricultural sector in line with overarching national development strategies.

27. It remains incumbent on policymakers in the region and globally to consider how they can meet this multifaceted crisis with the macroeconomic and sectoral policy framework and instruments best adapted to the challenges they face.