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Why economic growth has been weak in Arab countries: the role of exogenous shocks, economic policy failure and institutional deficiencies

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Why Economic Growth Has Been Weak in Arab Countries:
The Role of Exogenous Shocks, Economic Policy Failure and
Institutional Deficiencies

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1 Poor Growth Performance

Few Arab countries have succeeded to catch up economically to advanced industrial countries since the early 1990s. Recent reports suggest that Arab countries have even underperformed by the standards of other developing countries (World Bank 2003; Abed 2003; Hoekman and Messerlin 2002). The income gap vis-à-vis the United States widened for eleven out of 15 Arab countries for which the change in per-capita income (in PPP terms) in 1992–2002 can be calculated on the basis of World Bank data (Table 1). This applies especially to important oil-exporting countries such as Saudi Arabia and Algeria.

Yet, the economic performance of Arab countries defies easy generalization. The development of per-capita income in resource-poor Jordan was similar to that in resource-rich Oman. Bahrain performed better than most other oil countries. Growth in Egypt was significantly higher than in Syria, even though both countries started from a similar initial income of about 10 percent of US income in 1992. Economic development differed remarkably between neighboring countries such as Algeria and Tunisia, or Lebanon and Syria. Tunisia belongs to the few countries that narrowed the income gap vis-à-vis the United States, whereas Algeria fell back significantly.

Table 1 – Catching Up and Falling Back: Arab Countries Compared to the United States, 2002 vis-à-vis 1992

	PCI ^a		PCI ^a
Sudan	1.10	Morocco	0.93
Tunisia	1.07	Syria	0.93
Egypt	1.05	Oman	0.90
Yemen	1.05	Jordan	0.88
		Algeria	0.86
Mauritania	0.99	Un. Arab. Em.	0.80
Lebanon	0.99	Kuwait	0.80
Bahrain	0.93	Saudi Arabia	0.74

^aRelative change in per-capita income (PCI according to PPP), calculated as follows:

$$\frac{PCI_{2002}^i}{PCI_{2002}^{US}} : \frac{PCI_{1992}^i}{PCI_{1992}^{US}};$$
figures below 1 (above 1) imply that country *i* caught up (fell back) relative to the United States.

Source: World Bank (2004).

Consequently, it is not only the poor economic performance of the group of Arab countries that needs to be explained, but also the divergence within this group. The widely held view that the major responsibility for low economic growth rests with the Arab countries themselves deserves special attention in this regard. Frequently mentioned domestic policy failures include the strong and interventionist role of the state, weak integration into international trade and insufficient attractiveness to foreign direct investment (FDI) (e.g., Abed 2003).

Before assessing the empirical relevance of domestic policy failure, we discuss whether exogenous factors beyond the control of Arab policymakers prevented higher economic growth (Section 2). Moreover, the finding in Section 3 that economic policy reforms along the lines of the so-called Washington Consensus (Williamson 1990) can only partly explain divergent growth patterns calls for an analysis of more deeply rooted bottlenecks to growth. This is why we turn to institutional deficiencies in Section 4. We conclude in Section 5 that oil-exporting Arab countries, in particular, are facing challenges that extend far beyond conventional stabilization and adjustment programs.

2 The Role of Exogenous Shocks

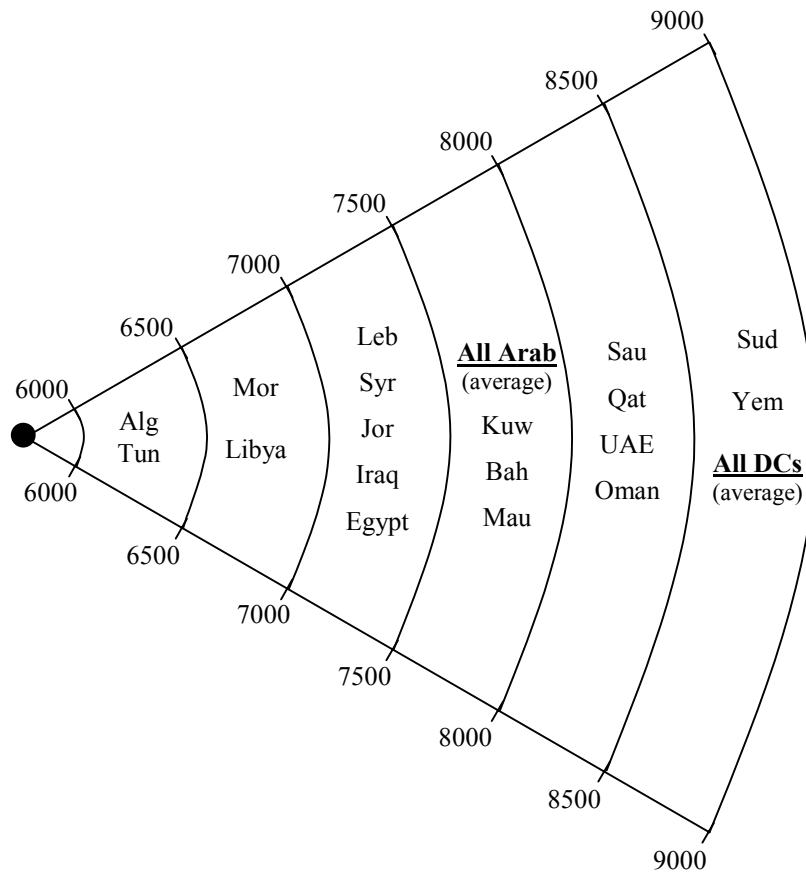
It cannot be denied that exogenous shocks have shaped the growth performance of some particular Arab countries. For example, it is difficult to conceive that Sudan would have ranked at the top in Table 1 without the discovery of oil in this country. On the other hand, growth in Jordan suffered from the embargo against neighboring Iraq. Nevertheless, exogenous factors can hardly explain divergent growth patterns across all Arab sample countries. In this section, we evaluate the role of three factors that may be considered exogenous in the sense that they escape the immediate control of Arab policymakers:¹ geographical distance from world economic centers, terms-of-trade shocks, and forced compliance with policy conditionality, along the lines of the Washington Consensus, attached to IMF and World Bank loans.

The hypothesis that distance from economic centers hinders growth at the periphery is firmly rooted in development economics (e.g., Fujita et al. 1999). However, neither the weak performance of Arab countries nor the growth differences within this group can be attributed to this factor. With few exceptions, Arab countries are not handicapped by large distance to world economic centers, compared to other developing countries (Figure 1). Moreover, the growth performance reported in Table 1 is not correlated in a statistically significant way with the average distance in kilometers between the capitals of Arab countries on the one hand and the capitals of Germany (as a proxy for the EU), Japan, and the United States on the other hand. Sudan and Yemen have narrowed the income gap to advanced industrial countries, even though these two Arab countries are located furthest away from world economic centers. Economic catching up of Tunisia might have been helped by its relatively favorable location, but the same advantage did not prevent Algeria from falling back considerably.

Likewise, terms-of-trade shocks do not provide a convincing explanation of the disappointing growth performance of Arab countries. This is not to ignore that oil-dependent Arab countries have witnessed more volatile terms of trade since the early 1990s than other developing countries. Terms-of-trade

¹ For a more detailed account of exogenous factors, see Nunnenkamp (2004a).

Figure 1 – Distance from World Economic Centers^a: Arab Countries Compared to All Developing Countries



^aAverage distance to Germany (representing the EU), Japan and the United States in kilometers.

Source: <http://www.maclester.edu/research/economics/page/haveman/trade.resources/data/gravity/dist.txt>;
<http://www.indo.com/distance/index.html>.

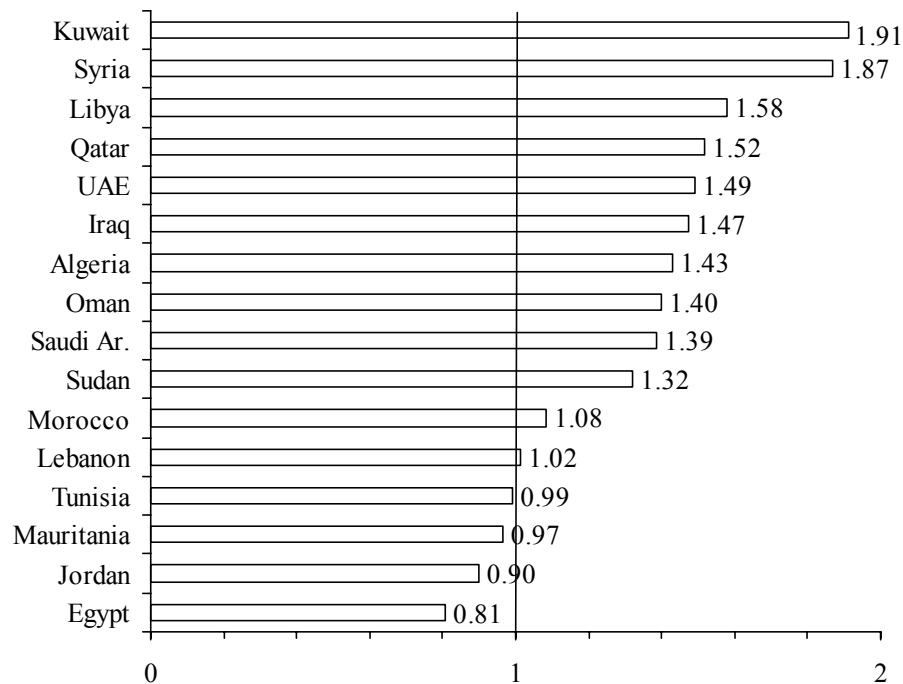
volatility is considered by Sala-i-Martin and Subramanian (2003) to be one of the mechanisms through which economic growth of oil-rich countries may be impaired.² In the cross-country regressions of these authors, higher volatility tends to be correlated negatively with growth. However, the terms of trade are not exogenous for influential oil producers such as Saudi Arabia. Furthermore, Figure 2 reveals terms-of-trade gains for twelve out of 16 Arab countries in the period 1992-2000. More surprisingly perhaps, two of the four exceptions, namely Egypt and Tunisia, performed relatively well in terms of growth. As a result, the correlation between changes in the terms of trade and growth performance remains insignificant across Arab countries.

Another factor beyond the control of developing countries has received much attention recently. Globalization critics attribute widening income gaps between advanced industrial countries and

² Sala-i-Martin and Subramanian (2003) do not find any direct impact of natural resources such as oil on economic growth. Two other indirect mechanisms are discussed by these authors, namely the impact through overvalued real exchange rates (Dutch disease) and institutional deficiencies. Overvaluation turns out to be never significant in the cross-country regressions. However, resource abundance in oil (and minerals) is shown to have a negative effect on growth by impairing institutional quality (see also Section 4 below).

developing economies to counterproductive policy recipes of the Washington Consensus.³ Arab policymakers, too, may be tempted to blame the IMF and the World Bank for having imposed growth-impairing policy conditionality in the context of conventional stabilization and structural adjustment programs. However, such claims are hardly justified, even though the Washington Consensus proved less effective than its proponents might have expected. As shown below, Arab countries have refrained from fully implementing the Washington Consensus. The leverage of the IMF and the World Bank remained fairly limited in the region. Few Arab countries relied extensively on IMF and World Bank financing and were, thus, subject to strict conditionality. Three of the five Arab countries which fell back most significantly did not draw at all on IMF and World Bank financing (Algeria and Jordan representing the exceptions). On the other hand, all countries which narrowed the income gap at least somewhat were clients of international financial institutions.

Figure 2 – Terms of Trade of Arab Countries: 2000 Compared to 1992^a



^aNet barter terms of trade in 2000 divided by net barter terms of trade in 1992. Vertical line divides terms-of-trade gains (>1) from terms-of-trade losses (<1).

Source: World Bank (2004).

In summary, it appears that exogenous factors contribute surprisingly little to the explanation of the weak growth performance of Arab countries. This suggests that major responsibility rests with domestic factors to which we turn next.

³ For a summary, see Williamson (1990) who also coined this term.

3 Insufficient Policy Reforms?

Confronted with the critique that the Washington Consensus leaves much to be desired, the IMF and the World Bank tend to insist that economic policy prescriptions were essentially correct and effective, and to blame their clients for having implemented policy reforms at best partially. The reform-mindedness of Arab countries is considered insufficient (World Bank 2003; Abed 2003). This view is assessed in the following by considering some policy-related variables that reflect major elements of the Washington Consensus. Macroeconomic stabilization efforts by Arab countries are captured by annual average rates of inflation and government consumption expenditure in percent of GDP. Investment in physical and human capital is proxied by gross fixed capital formation in percent of GDP and average years of schooling, respectively. The world market orientation of Arab countries is assessed by the shares of imports and exports in GDP. Finally, openness to FDI is measured by FDI inflows and inward FDI stocks, both related to the host country's GDP.

Table 2 – Policy-Related Variables in Arab Countries^a, 1980–1983 and 1999–2002^b (Median)

	1980–1983		1999–2002	
Inflation (percent)	9.2	(12.5)	1.5	(4.4)
Government consumption (percent of GDP)	18.1	(14.6)	19.5	(13.5)
Gross fixed capital formation (percent of GDP)	26.3	(22.0)	18.5	(20.3)
Years of schooling ^c	2.9	(3.4)	5.5	(5.1)
Imports (percent of GDP)	39.2	(35.7)	34.5	(40.1)
Exports (percent of GDP)	39.3	(24.9)	39.3	(30.5)
FDI inflows (percent of GDP)	1.0	(0.5)	1.4	(2.6)
Inward FDI stocks ^d (percent of GDP)	1.0	(4.9)	12.9	(30.0)

^aIn parentheses: median for other developing countries. The number of observations for Arab countries varies from 10 (FDI inflows) to 18 (inward FDI stocks). — ^bPeriod average, if not indicated otherwise. — ^c1980 and 2000, respectively. — ^d1980 and 2002, respectively.

Source: World Bank (2004); Barro and Lee (2002); UNCTAD (2003).

Table 2 shows how these variables have developed since the 1980s and offers a comparison between Arab countries and other developing countries. The evidence supports the view that policy reforms have remained fragmentary. In some respects, however, economic policies pursued by Arab countries were in accordance with the Washington Consensus:

- Compared to other developing countries, inflation in Arab countries was fairly low in the early 1980s already. Inflation was further reduced to a very low median in recent years. By contrast, government consumption, as a share of GDP, was higher in Arab countries than in other developing countries. Moreover, Arab countries failed to curtail government consumption. This tends to

support the critique of Hoekman and Messerlin (2002: 1) that “most of the governments in the Middle East and North Africa have made scant headway in reducing the interventionist role of the state in the economy.”⁴

- The evidence on factor accumulation is mixed as well. The share of gross fixed capital formation in GDP declined considerably in Arab countries. On the other hand, human capital formation, proxied by average years of schooling, improved more pronouncedly in Arab countries than in other developing countries. Nevertheless, Hoekman and Messerlin (2002: 23) reckon that education in the MENA region lags behind the rest of the world. Eken et al. (2003: 16) point out that education systems in some MENA countries remain ineffective, with high dropout and repetition rates offsetting high enrollment rates, even though government spending on education is relatively high.⁵
- Hoekman and Zarrouk (2000) acknowledge that virtually all Arab countries have dismantled tariff-related and quantitative import restrictions. Yet, these authors argue that the pace of integration into the world economy has been slow. In contrast to other developing countries, the shares of imports and exports in GDP did not increase for the group of Arab countries. This can be attributed, at least partly, to high transaction costs associated with international trade, resulting from inefficiencies in customs clearance procedures, administrative red tape, and deficient transportation and telecommunication services in many Arab countries (World Bank 2003: 95).⁶
- The rise in FDI indicates that Arab countries have followed the worldwide trend towards the liberalization of FDI regulations. Nevertheless, most Arab countries have remained substantially less attractive to FDI than other developing countries. This is consistent with Nabli and De Kleine (2000), who found FDI flows to Arab countries to be relatively small and concentrated in a limited number of sectors.⁷

Against this backdrop, it has been argued that especially the failure to develop closer links with the global economy through FDI as well as through trade in services and goods other than oil has prevented a more positive growth impact of reforms (Hoekman and Messerlin 2002). It has to be taken into account, however, that the group averages reported in Table 2 disguise considerable differences concerning the reform-mindedness of individual Arab countries. According to the World Bank (2003), the intensity, timeliness and sustainability of reforms varies remarkably across Arab countries, although even the frontrunners have not fully implemented the Washington Consensus.

A surprisingly ambiguous picture results when considering the World Bank’s account of reform-mindedness as a possible explanation of the growth differences reported in Table 1 above. For some Arab countries, there appears to be a clear link. This applies to Saudi Arabia, in particular, where reforms were delayed until 1999 and progressed only slowly in recent years. It also fits into the picture that, except for inflation, Saudi Arabia consistently ranked below the median for other developing countries with regard to the policy-related variables considered in Table 2. However, the income gap widened for several small member countries of the Gulf Cooperation Council (GCC), to an extent similar to that for Saudi Arabia, even though the World Bank comments favorably on successful diversification efforts by GCC members such as the United Arab Emirates. Furthermore, GCC economies are characterized by an open trade system and free movement of capital. Hence, the

⁴ For similar statements, see World Bank (2003), Abed (2003: 13) and Bennett (2003: 22). Gardner (2003: 20) argues that the large share of government employment impaired labor productivity growth in several Arab countries.

⁵ See also Gardner (2003: 20) on low returns on MENA countries’ investment in education.

⁶ For recent survey results on barriers to trade and investment in the MENA region, see Zarrouk (2002). According to Abed (2003: 14), “for the MENA region as a whole, overall trade restrictiveness (as measured by an index developed by IMF staff) is double the developing country average.”

⁷ Likewise, Hoekman and Messerlin (2002: 8) as well as Abed (2003: 12) point to the limited magnitude of FDI flows to the MENA region.

experience of these economies is in some conflict with the view that the poor growth performance of Arab countries is mainly due to insufficient openness.

Some other resource-rich countries are classified as “later, more gradual, sporadic reformers” by the World Bank. By contrast, some relatively resource-poor countries are considered “early, intensive and steady reformers.” The former include Algeria, Syria and Yemen. It is consistent with this classification that the growth of per-capita income was low in Algeria and Syria. On the other hand, the favorable growth performance of Yemen conflicts with the World Bank’s verdict on the country’s insufficient reform-mindedness. Similarly, Egypt succeeded to narrow the income gap, although the pace of reform is said to have been much slower and sporadic in Egypt compared to frontrunners such as Morocco and Tunisia. Egypt has made considerable progress in reducing inflation and government spending since the mid-1990s. Yet, economic growth in Egypt may prove difficult to sustain, considering the sharp decline in the investment ratio, relatively high import tariffs, and poor attractiveness to FDI in recent years.⁸

The relation between policy-related variables and economic growth is elusive for the subgroup of “early, intensive and steady reformers”, too. Tunisia’s favorable growth performance is in line with its relatively strong reform-mindedness. The generally positive assessment of Tunisia’s economic policies may be qualified in an important respect, however. According to data provided by WTO (2003), Tunisia (together with Morocco) continued to apply the highest import tariff rates in 2002 among Arab sample countries. The “series of wide-ranging reforms” (World Bank 2003: 97) notwithstanding, Morocco’s growth performance was not better than that of Syria which is classified as a gradual and sporadic reformer. Jordan undertook stabilization measures and structural reforms in the 1980s already. Reforms gathered momentum in the aftermath of the Gulf crisis in 1991/92. Nevertheless, Jordan’s growth performance was weaker than that of neighboring Syria and Lebanon.

In the case of Sudan, economic policy reforms are fairly unlikely to have contributed to its top position with regard to per-capita income growth. Sudan has attracted high FDI inflows since 1998. At the same time, the share of exports in GDP increased. However, these developments are mainly because of the discovery of oil. Weak internal factor accumulation points to persistent bottlenecks to sustainable growth. The investment ratio of less than 14 percent in 1999-2002 was far below the average of Arab countries. Average years of schooling in Sudan hardly exceeded two years in 2000. In the period under consideration, the long-lasting civil war undermined the incentives of investors and private households to accumulate physical and human capital.

The evidence for Arab countries indicates that the relation between policy-related variables and economic growth is blurred for several reasons. The fragmentary nature of economic policy reforms, often referred to by international financial institutions, provides just one possible explanation. Even wide-ranging reforms may fail to stimulate growth if, as in the case of Jordan, their effectiveness is undermined by negative country-specific shocks. On the other hand, positive shocks as in Sudan may offset, at least temporarily, internal bottlenecks to growth.

In addition, the effectiveness of specific reforms is not necessarily the same across countries. The widespread belief that economic growth in developing countries can be promoted by opening up towards FDI provides a case in point (Nunnenkamp 2004b; Mayer-Foulkes and Nunnenkamp 2005). Empirical studies suggest that positive growth effects of FDI are restricted to relatively advanced host countries. FDI is unlikely to induce catching-up processes if host countries lack a sufficient

⁸ For details, see World Bank (2004).

endowment of complementary factors of production, e.g., sufficiently qualified workers, and if FDI is located in economic enclaves with few linkages to local markets. Hence, it is questionable whether countries such as Sudan can derive sustainable benefits from the engagement of foreign investors in the oil industry.

Finally, economic policy reforms along the lines of the Washington Consensus may have had limited growth effects as more deeply rooted barriers to growth have been neglected in conventional stabilization and structural adjustment programs. In the recent growth literature, the institutional framework is regarded as a key factor for explaining international divergences in income levels and economic growth. According to Rodrik and Subramanian (2003), the primacy of institutions implies that narrowly defined economic policy reforms are bound to remain ineffective.⁹ This is why we turn to the question of institutional deficiencies in Arab countries in the subsequent section.

4 Institutional Deficiencies?

In order to identify institutional deficiencies that may have hindered economic growth in Arab countries, we refer to the widely used data presented by Kaufmann et al. (2003). This source comprises six indicators, all of which range from -2.5 to 2.5 (with higher values indicating better institutions): voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption. These factors are supposed to shape the incentive structure of economic agents. Hence, they are likely to affect policymaking, factor accumulation and, eventually, economic growth.

At a cursory look, the institutional underpinnings for sustainable economic growth do not appear to be less favorable in Arab countries than in other developing countries. Considering the average of all six institutional indicators, the median of 18 Arab countries is even slightly above the median of the control group (Table 3). It is only for voice and accountability that Arab countries lag significantly behind other developing countries.¹⁰ Surprisingly, better institutional conditions are shown for Arab countries with regard to the rule of law and control of corruption.¹¹

However, the comparison of the median of Arab countries with the median of the control group of other developing countries obscures that institutional development varies tremendously between Arab countries. All indicator values for the three Arab countries rated most unfavorably (bottom 3 in Table 3) are significantly negative, whereas most indicator values for the three best-rated Arab countries (top 3) are more than two points higher. Some Arab countries are characterized by serious institutional deficiencies in various dimensions. Iraq clearly represented the taillight with regard to institutional development in 2002. Likewise, Sudan belongs to the bottom 3 in all six institutional dimensions.

⁹ Likewise, Easterly and Levine (2002: 33) argue that “bad policies are only symptoms of longer-run institutional factors, and correcting the policies without correcting the institutions will bring little long-run benefit;” see also Acemoglu (2003).

¹⁰ This is consistent with the finding in the *Arab Human Development Report* that the region performs poorly when it comes to civil and political freedoms (UNDP 2002).

¹¹ A similar pattern results when drawing on the corruption index presented by Transparency International for the year 2004 (http://www.transparency.de/Tabellarisches_Ranking.542.98.html).

Syria belongs to the bottom 3 in still four dimensions. The top 3 typically consist of small Gulf states, except for voice and accountability that is most advanced in Jordan and Morocco.¹²

The comparison of institutional development in Arab countries with that in other developing countries has to be qualified in another respect. In most Arab countries, institutional development lags behind economic development. The per-capita income of GCC members, in particular, is clearly above average. Taking into account that the correlation between per-capita income and institutional development is strongly positive across countries, the United Arab Emirates, for example, should have similarly advanced institutions as Spain; Bahrain and Kuwait should have reached the institutional development of South Korea, and Saudi Arabia should have institutions at least as advanced as in Malaysia or Poland. Actually, however, all these Arab countries lag considerably behind the selected reference countries in other regions.

Table 3 – Institutional Development^a of Arab Countries, 2002

	Median of 18 Arab countries ^b		Top 3 (average)	Bottom 3 (average)
Voice and accountability	-0.79	(-0.05)	-0.33	-1.84
Political stability	-0.14	(-0.01)	0.92	-1.74
Government effectiveness	-0.11	(-0.41)	0.77	-1.21
Regulatory quality	-0.01	(-0.34)	0.85	-1.69
Rule of law	0.10	(-0.43)	0.90	-1.43
Control of corruption	-0.02	(-0.41)	1.09	-1.11
Average of six indicators	-0.07	(-0.26)	0.62	-1.43

^aIndicator values range from 2.5 to -2.5, with higher values corresponding to better institutional development. — ^bIn parentheses: median of other developing countries.

Source: Kaufmann et al. (2003).

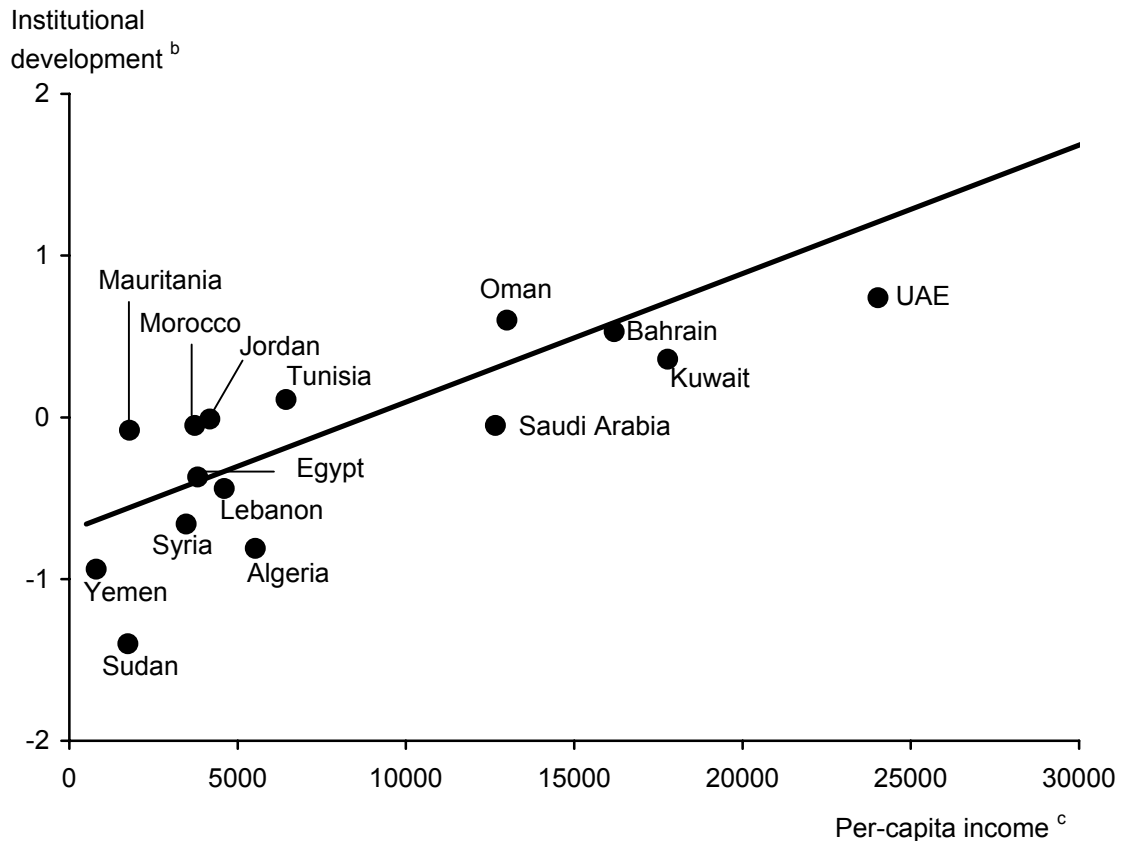
Figure 3 reveals the institutional development of 15 Arab countries when controlling for their per-capita income. The "normal pattern" results from a simple regression of the average of the six institutional indicators presented by Kaufmann et al. (2003) against per-capita income across all developing and industrialized countries. Most Arab countries fall below the regression line, which underscores that institutional development in the region is less advanced than the stage of economic development would have suggested.¹³ This applies especially to oil-rich countries. At the same time,

¹² Note that Tunisia no longer belongs to the top 3 when using data for 2002 presented by Kaufmann et al. (2003). Compared to 2000, Tunisia was downgraded in all institutional dimensions.

¹³ Iraq and Libya are not listed in Figure 3 for lack of comparable data on per-capita income. As mentioned before, institutional development is rated particularly poor in these two countries. Hence, it can be safely assumed that Iraq and Libya, too, fall below the "normal pattern".

Saudi Arabia, Kuwait, the United Arab Emirates and Algeria rank at the bottom of Table 1 with respect to economic growth in 1992-2002.

Figure 3 – Position of Arab Countries Relative to the Normal Pattern of Institutional Development^a, 2002



^aNormal pattern identified by regressing institutional development against per-capita income across all developing and industrialized countries.— ^bAverage of all six indicators mentioned in text; data for 2002. — ^cUS\$ in PPP for 2002.

Source: Kaufmann et al. (2003); World Bank (2004).

The latter finding supports the view that economic growth was hindered by insufficient institutional development. Furthermore, the institutional deficiencies observed for oil-exporting countries are consistent with the reasoning of Sala-i-Martin and Subramanian (2003) on the so-called natural resource curse. Accordingly, the abundance of some natural resources, including oil, encourages rent-seeking and corruption, and exerts a negative impact on economic growth via the deleterious impact on institutional development.¹⁴ This phenomenon renders it still more questionable that Sudan can sustain the process of catching up beyond the period 1992-2002. This country suffers from serious

¹⁴ See also World Bank (2003) and Eifert et al. (2003) on oil-related rents and the ensuing reorientation of economic incentives towards competition for access to oil revenues and away from productive activities.

institutional deficiencies even if its low per-capita income is taken into account (Figure 3). The discovery of oil may have induced a temporary growth spurt, despite the civil war in the country, but threatens to undermine institutional development in the future.

Viewed from an institutional perspective, Tunisia stands out among the Arab countries that caught up economically in 1992-2002. Tunisia's institutions are more advanced than its economic development would have suggested which, together with the country's favorable ranking with regard to various economic policy-related variables, may help sustain economic growth in the future.¹⁵ Other relatively resource-poor countries such as the early reformers Jordan and Morocco, too, tend to have better institutional conditions for future growth than most oil-exporting countries.¹⁶ The rather disappointing economic performance of these two countries in 1992-2002 indicates that better institutions are not necessarily associated with higher growth. Put differently, growth patterns may diverge, at least in the short to medium run, even though institutions are similarly advanced. However, this does not invalidate the primacy of institutions over narrowly defined economic policy reforms (Rodrik and Subramanian 2003).

5 Summary and Conclusions

Few Arab countries have succeeded since the early 1990s to narrow the income gap to advanced industrial countries. The growth performance of most Arab countries has been weak by developing country standards, too. We discuss three factors that may help explain the generally poor, though highly diverse growth record in the region: exogenous shocks, policy failure and institutional deficiencies.

Country-specific shocks played a role, notably for relatively high growth in Sudan and the poor performance of Jordan. On the whole, however, influences beyond the control of Arab policymakers contribute surprisingly little to the explanation of Arab growth patterns. The major responsibility for the poor growth record rests with the Arab countries themselves. As concerns economic policies, the region has partly fallen into line with the Washington Consensus. While some Arab countries undertook timely and fairly comprehensive reforms, most of them are still lagging behind other developing countries when it comes to trimming the interventionist role of the state and integrating themselves into the global division of labor through trade and FDI.

This invites the conclusion that deeper and broader economic policy reforms are required to promote sustainable growth. For example, the World Bank (2003: 2) argues that "the region now needs to deepen and accelerate its reforms".¹⁷ And indeed, delayed and at best partial reforms as in Saudi Arabia help explain why this country fell back considerably. Nevertheless, the evidence presented in this paper is in some conflict with the view, favored by Washington-based institutions, that a strict relationship exists between economic policy reforms and growth. The differences across Arab

¹⁵ This would require, however, that the aforementioned erosion of institutional development in Tunisia in recent years will be halted.

¹⁶ According to Figure 3, this also applies to Mauritania. However, it was only since 2000 that Mauritania's institutions have improved, especially with regard to political stability and control of corruption. These recent improvements shifted the country above the "normal pattern" in 2002.

¹⁷ Likewise, Abed (2003: 12), the Director of the IMF's Middle Eastern Department, concludes that a critical mass of reforms is needed to improve the growth performance.

countries in adhering to the Washington Consensus only partly explain the divergent growth patterns in the region.

The elusive relation between economic policy conditions and economic growth has important implications. It is for several reasons that conventional stabilization and structural adjustment programs proved less effective than widely expected. The effectiveness of specific reform measures depends on country-specific conditions. For instance, the advice given to almost all developing countries to lure foreign direct investors ignores that positive growth effects of FDI cannot be taken for granted (Nunnenkamp 2004b; Mayer-Foulkes and Nunnenkamp 2005). The enclave character of FDI in natural resource-related activities in some Arab countries is unlikely to spur per-capita income growth. Hence, rather than applying standard recipes to all Arab countries, country-specific conditions deserve closer attention when designing economic policy reforms.

Furthermore, it has to be taken into account that policy failure and an insufficient reform-mindedness are often only the symptoms of more deeply rooted bottlenecks to growth. Poorly developed institutions tend to distort the incentive structure of economic agents. For oil-exporting Arab countries, in particular, institutions required for sustainable growth are less advanced than the level of their per-capita income would suggest. The abundance of oil appears to be a curse, rather than a blessing. It encourages rent-seeking, while discouraging productive activities, and exerts a negative impact on economic growth via its deleterious impact on institutional development.

This implies that economic policy reforms along the lines of the Washington Consensus are not sufficient to improve the growth prospects of Arab countries. The challenge facing Arab policymakers, notably in countries such as Algeria, Saudi Arabia and Sudan, is not limited to narrowly defined economic policy measures but extends to institutional reforms. The crux is that institutional deficiencies are most difficult to tackle in resource-rich countries with strong vested interests. Yet, the natural resource curse can be overcome. The experience of countries like Mexico, having managed the transformation from an oil-dependent to a highly diversified economy with more advanced institutions, may offer important lessons to Arab countries.

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