Middle East Economic Trends and Forecasts

by Lauren Rossman

The following report summarizes assessments of various Middle East economic experts in order to provide an overview forecast of prospects for the Middle East for 1998. This is not a thorough assessment of Middle East economies, but rather a composite picture of near-term forecasts for the region.

Because of the great diversity of regional economies, it is difficult to generalize trends across the entire region. There are, however, several longstanding issues which will continue to influence all of the Middle Eastern economies in the near term:

- **Oil dependence**—Most countries in the region remain particularly vulnerable to adverse developments in the international oil market. Until the oil-producing states diversify their exports, their economic stability can only be uncertain. In addition, the economies of non-oil producing countries (or the minor producers), particularly Egypt, Jordan, Lebanon, Yemen, and Syria are also affected by this dependence because a large share of their foreign exchange earnings are derived from the GCC countries in the form of workers’ remittances.

- **Overspending**—Many countries in the region have fallen into the trap of importing too much and running up high debts. This is soaking up funds that would have otherwise gone to investment by the private sector.

- **Massive subsidizations**—Governments continue to heavily subsidize key sectors of the economy, draining revenues and distorting the market.

- **Poor education levels**—The low level of education in many Middle Eastern countries continues to hinder the industrialization of their economies.

Although future challenges will depend on multiple factors like prospects for Arab-Israeli peace, opportunities for closer integration with the EU, the economic outlook in industrial countries, and the evolution of world oil prices, there are several solutions to the aforementioned problems.

In particular, Middle East countries will need to intensify privatization programs to revitalize their manufacturing sectors, and limit government operations to the provision of public goods. Governments need to scale back regulations and remove distortions in markets to improve the efficiency of resource allocation via the private sector. And finally, in many regional countries there is a need for greater diversification of the non-oil export base to reduce vulnerability to oil-price fluctuations.¹

It is important to note that many of the above problems do not affect Israel's economy. Israel has a market economy and a higher rate of privatization and foreign investment than its Arab neighbors. Additionally, Israel has a larger industrial sector than the other Middle Eastern countries. Of course, Israel has its own economic problems, largely derived from the impact of poor government policies.

Additionally, in the past year both the Jordanian and Egyptian economies have been booming. Jordan's market orientation is beginning to rival Israel's, and Cairo has attracted considerable foreign investment with its privatization program, suggesting similar Egyptian competitiveness.

**Egypt**

The pace of economic change should quicken in the next two years as the government meets its obligations under the October 1996 International Monetary Fund (IMF) program. President Mubarak is now personally behind economic reform and integrating Egypt into the global economy. Economic policy will aim to maintain macroeconomic stability, which in turn will allow structural reform of the domestic economy.

Privatization remains the crucial test of the government's commitment to economic reform. Under the IMF agreement, the government is committed to privatizing one-third of 314 public-sector enterprises by the end of June 1997 and another third in 1997-98. This goal seems a bit optimistic. The government will begin to face the problem of finding buyers for the "lemons"—less attractive firms with large work forces and major debts. One well-placed economist said that, "60 to 80 percent of the companies left for sale are junk. And the government is running out of companies that can be easily disposed of on the stock market." In addition, there are still too few incentives to privatize and attention must be paid to whether control of the companies is not simply being transferred from one public-sector entity to another.

The government has promised to drop the standard maximum tariff rate to 40 percent, remove all non-tariff barriers, and streamline the import quality-control system. The removal of bureaucratic restrictions is now recognized as a prerequisite for attracting large-scale foreign direct investment. The government's priority is to pass a new investment incentives law. The economic reform schedule is quite ambitious and only some of these laws are likely to be passed in 1997. Those that prove politically sensitive may well be shelved until at least 1998. Nevertheless, according to one World Bank official, "If the pace of reforms is sustained, we envisage a higher trajectory of growth, from 4-5 percent now to perhaps 6-7 percent in two or three years." Further, exports are expected to increase from $4.7 billion in 1996 to $5.4 billion in 1998.

The deficit is projected to remain below 3 percent of the GDP over the next two years, due to improvements in public-sector management and debt restructuring. Exchange-rate stability will remain a policy priority and the pound will probably track the dollar, backed up by ample foreign exchange reserves. The deflationary effects of a stable currency, continuing fiscal and monetary discipline, and trade liberalization will keep inflation below 8 percent, down from 15 percent in 1995.

Given the country's macroeconomic stability, accelerated structural reform, and the high profile it has enjoyed in the wake of the Middle East and North Africa economic conference in November 1996, a sizeable increase in foreign capital inflows is expected in 1997 and 1998. Good prospects for a continuation of the tourism boom this year and next will contribute to strong growth in the services sector. According to Mamdouh el-Beltagui, Egypt's minister of tourism, "There is a real boom. We almost reached 4 million visitors in 1996 and the 1994-95 season saw our income from tourism increase by 31 percent to $3.09 billion."

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2 This summary is drawn in part from Economist Intelligence Unit (EIU), Country Report—Egypt, no. 1 (1997).
4 "Fateful Test as the Final Hurdle Nears," MEED, October 4, 1996.
In January 1997, Standard and Poor's accorded Egypt a "BBB" investment-grade rating which will open the way for a substantial increase in foreign investment. About $800 million in foreign direct investment is predicted for 1997, up from $50 million in 1995-96. In addition, experts say $1.3 billion in foreign portfolio investment is expected for 1997, an increase from $600 million in 1995-96. Foreign creditors now group Egypt among donor-friendly debtor countries. Finally, in 1996 alone the stock market doubled in size with an increase from 25,000 to 1 million investors.

Nevertheless, the massive public sector, including over 6 million civil servants, will remain a major drag on the economy. Unemployment is at about 9.4 percent. With a shortage of skilled labor and 2.5 million Egyptians working abroad in Saudi Arabia and other Gulf countries, industrialization is still slow to take hold.

Workers remittances should hold steady at around $4 billion annually, while official transfers for aid and development will remain high (the United States is unlikely to cut aid substantially while the peace process remains incomplete). Egypt will also begin to benefit from $6 billion in EU grants attached to the Euro-Med partnership program.

Iraq

The oil sales made possible by UN Security Council Resolution 986 will be a shot in the arm for the Iraqi economy, but will fall short of sparking a general economic recovery. Iraq's Ba'athist regime engages in extensive central planning and management of industrial production and foreign trade while leaving some small-scale industry and services, as well as most agriculture, to private enterprise. Historically, the economy has been dominated by the oil sector. Unfortunately, since the Gulf War, very few hard figures have actually come out of Iraq and few experts know Iraq's true economic situation.

Comprehensive UN sanctions against Iraq will remain in force into the indefinite future until Iraq complies fully and unconditionally with all relevant UN resolutions. Under Resolution 986, Iraq's oil shipments are calculated on the basis of revenue, not volume, with a limit of $2 billion in exports over six months. If oil prices were to climb to $22/b, the volume of exports would be limited to 500,000 b/day. On the basis of current production averaging 735,000 b/d, and a forecast average oil price of $18.5/b in 1997, however, the additional quantity is likely to take total Iraqi production to around 1.3 million b/d. (This figure of 735,000 b/d refers to non-986 oil exports, domestic consumption, and other production needs.) The increase in Iraqi production will greatly boost GDP but will not produce sustained or comprehensive rehabilitation of the economy.

As long as overall sanctions remain in force, the dinar will remain weak with the price of foods and other essentials outside the rationing system continuing to rise. The government will almost certainly try to control inflation and stabilize the dinar, as well as the exchange rate, in the short term. But over the 1997-98 period, depreciation against the dollar is expected to continue. Though trading opportunities—and thus a rise in foreign demand—will increase with the economic upturn brought about by 986, a rise in the availability of foreign exchange will be severely limited, thus protracting the weak dinar.

The inflation rate is expected to remain above 200 percent but as shortages are curbed and food prices begin to drop, the inflation rate should decline. Iraq's economic future will be hostage to action on its massive accumulated external debt, which is currently estimated at around $100 billion. (At least $35 billion of this debt is owed to Gulf Arab states.) Yet with 986 sales, the government will gain substantial revenue and the budget deficit will drop markedly.

9 CIA, World Fact Book 1996.
10 This summary is drawn in part from EIU, Country Report—Iraq, no. 4 (1996).
11 Ibid.
Israel

Based on the first year of the Netanyahu government, economic policy is likely to continue its uncertain course into 1997-98. Tough, effective measures aimed at addressing fiscal and monetary imbalances will only be taken if they do not involve political risk to the government—an unlikely prospect. The central bank will keep its cautious policy of allowing only gradual interest rate reductions, in an attempt to allow the exchange rate to fall without triggering an investment flight from shekels into foreign currency. A correction in the shekel’s valuation could happen at any time, though, and the necessary adjustment in the exchange rate is likely to be at least 10 to 15 percent depending on the central bank’s intervention.

Experts predict the economy will continue to slow with GDP growing only by about 2.5 percent. Private consumption, the largest contributor to GDP, is expected to grow by less than 3 percent, restricting overall growth to similarly low levels in 1998. High interest rates, fewer new immigrants, and the decline in the property sector all helped to slow GDP growth in 1996.

There are political as well as economic reasons for this slump in consumer confidence. The expansion of private consumption from 1991 to 1995 was due in part to the influx of Soviet immigrants, while the slowdown in 1996 can in part be attributed to a deteriorating political environment which helped dampen demand. Key sectors of the economy, in particular tourism and trade, will continue to face difficulties in 1997-98. Low-income groups, including new immigrants, are most likely to be affected by the economic slowdown. This could have political consequences, placing strains on the current coalition with Shas and Yisrael Ba’Aliya.

In the short term, there is little prospect of meaningful fiscal adjustment. Thus, the central bank will feel obliged to keep interest rates high which will maintain upward pressure on the exchange rate. In 1998, whatever the government’s makeup, there should be opportunity for some fiscal discipline, and the central bank also plans to set a 1998 inflation target in the hopes of reducing a near 10 percent inflation rate.

Import growth will fall to around 5 percent in 1998. In terms of volume, imports of goods and services should rise by about 3 percent. Exports should respond positively to the slack in domestic demand and the depreciation of the currency, rising about 8 or 9 percent. In 1996 exports were approximately $20.3 billion and are expected to increase to $25.9 billion in 1998.

In a recent interview with the Financial Times, Prime Minister Netanyahu stated that he wants Israel to attract more foreign investment. According to Netanyahu, the central bank recently reported that capital inflows in the past three years totalled more than $14 billion. However, very little of that was actually foreign direct investment; rather it was comprised of loans, bank deposits, and equity. Netanyahu says that investors have primarily opted for electronics and high-tech industries because, as well as being innovative sectors of the Israeli economy, they are the least susceptible to the vagaries of the peace process.

Government policy is not helping the economic situation, and in general, Israel’s economic miracle of 1986-94 is over. Economic growth has slowed and will continue to slow.

Jordan

Jordan’s economic prospects for the coming year continue to be tied to regional political developments and strong government policies. In 1989, Jordan began implementing an economic reform program interrupted by the Gulf crisis but then resumed in 1992. According to most economists, the program has been progressing positively, making huge strides toward reform that bode well for the future.

The economic consequences of the Hebron agreement and Resolution 986 should give a gradual boost to Jordan’s economy over 1997-98. As well as improving direct market access, the Hebron agreement should facilitate the use of

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12 This summary is drawn in part from EIU, Country Report—Israel, no. 4 (1996).
15 This summary is drawn in part from EIU, Country Report—Jordan, no. 1 (1997).
Israel as a gateway to the European market. With 986, Jordan should see an increased demand for food and medicines from Iraq. Iraq is also expected to look to the Jordanian pharmaceutical industry for more of its medicinal and health supply needs, and this additional trade could be worth as much as $100 million. In addition, because al-Basrah remains closed and Umm Qasr does not have the capacity to handle an extra $800 million of foodstuffs (as 986 provides for), a sizable amount of this extra volume will go through Aqaba, using Jordanian services and transport.

With support from the World Trade Organization set to drop after 1998 when Jordan’s foreign debt repayments begin, the government is expected to pass additional financial reforms. According to one Jordanian government official, "The speed with which the government has moved this year is amazing. The difficult stage is over—most of the coming reforms will make people’s lives easier."16

Jordan’s minister of finance has estimated GDP growth at 5.2 percent for 1996—this despite growing peace process difficulties and Amman’s attempts to keep inflation on a tight leash. Experts estimate, however, that 1997 GDP growth will slow to 4.6 percent. Beyond mid-1998, the fate of the peace process and overall prospects for the sanctions regime against Iraq again add uncertainty. Assuming there is neither a collapse in the peace process nor an early end to sanctions, experts expect GDP growth in 1998 to rebound to 5.1 percent. Although the peace process has affected Jordan’s economic situation, many positive movements can also be linked to the strong government reform policies.

Jordanian heavy industry, especially in the mineral fertilizer subsector, is expected to push merchandise exports up from $1.9 billion in 1996 to around $2.2 billion in 1998. At the same time, the liberalization of foreign trade has had the tendency to make imports cheaper as duty has been taken off or reduced. Mindful of both the upcoming election year and the August 1996 unrest in the south, the government will be tempted to allow people to enjoy these new consumption opportunities. As a result, imports should grow to $4.6 billion in 1997 and $4.8 billion in 1998.

Remittances should also increase as more Jordanians find work in the Gulf, while earnings increases in other areas—notably tourism—aid the services account. In the tourism sector, the number of visitors increased from 739,000 in 1995 to 786,000 in the first eight months of 1996.17

Palestinian Authority

The Palestinian economy is in a deepening state of crisis unlikely to be alleviated in the coming months.18 Despite an easing of Israel’s security closures, income from remittances and export revenues remains low, and the prospect of renewed closures in response to terrorism or violence will continue to deter private investment.

The loss of employment in Israel and the decline in trade flows have led to a serious decline in living standards in the West Bank and Gaza Strip. According to the UN special coordinator in the occupied territories, real GNP per capita fell by 23 percent between 1992 and 1996. Though unemployment has declined in recent months, in mid-1997 it still hovers around 20 percent for both the West Bank and Gaza, with some sources giving an even higher figure. In the short- to medium-term, relief will only come through a relaxation of Israeli closures and substantial private investment.

In addition to the lack of free movement of goods in and out of the PA resulting from the closures, the PA’s miserable economic policies are hurting the struggling economy. According to Khaled Abdel Shafi, an economist who works with the UN Development Programme to the Palestinians, the PA is not respecting the principle of free competition: "It has set up its own agencies, or monopolies, to import strategic goods from Israel.” In Gaza, these monopolies are dominated by Arafat’s old friend, Abu Hussein. This type of “cronyism” remains all too common in the PA agencies, while the companies run by the PA, says Abdel Shafi, “are the ones who get around the

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17 Jordan Times, September 21, 1996.
18 This summary is drawn in part from EIU, Country Report—The Occupied Territories, no. 4 (1996).
closures. They are the ones who pass the high prices on to the consumer.” At least, according to the IMF, “the PA plans to dismantle these import monopolies (notably on petroleum products, cement, tobacco, and some electronic products) by the end of 1998.”

The PA’s immediate fiscal problems are to be met by pledges from European donors to cover the anticipated $112 million budget deficit, but the likelihood of political violence and resulting interruptions to economic activity will most likely increase this deficit in the coming year. By pledging more than $800 million toward investment projects, donors have demonstrated the importance they attach to the PA’s public investment program, but they are likely to show some signs of fatigue over funding a Palestinian-Israeli peace process if it remains at its present impasse. Unless the political log jam is resolved and closures lifted on a long-term basis, further contraction is expected throughout 1997 and into 1998.

**Saudi Arabia**

Saudi Arabia continues to ride the wave of unexpectedly high oil prices, but deep structural problems remain and will likely drag the Saudi economy down in the next few years. It appears likely that Crown Prince Abdullah will succeed to the throne when King Fahd dies, or sooner if the king chooses to step down voluntarily. This change could mean a significant shift in Saudi economic policy, which currently seems in danger of stagnating.

Progress on sensitive reforms is especially slow. This reflects in part the fact that technocrats, who are more tentative about their authority than the princes, tend to be in charge of these ministries. Without active direction or approval from the king, they are unlikely to implement policy, and as a result, plans for further privatizing state enterprises, increasing foreign access to the country’s equity markets, and reducing government subsidies will likely remain on the drawing board. Moreover, the recent rise in oil prices is reducing the urgency to proceed with reform programs.

The 1997 budget announced no new initiatives and if King Fahd is in full control this time next year, a similarly cautious but unambitious approach to fiscal policy is anticipated. However, contrary to some reports, analysts have recently noted that the government is moving to open up to the private sector. Liberalization of the economy is also likely to be brought closer by Saudi Arabia’s attempts to join the World Trade Organization.

In 1996, the first sustained rise in oil prices came since their sharp drop in 1986. The price of Saudi Arabia’s benchmark crude, Arab Light, increased to an average of $20/b, up from $16.73/b in 1995. The rise in oil prices is the major factor helping to ease the imbalances in Saudi Arabia’s internal and external accounts. The petroleum sector continues to account for approximately 35 percent of GDP and 90 percent of exports, and there remains a consensus that, in the words of one expert, “the government remains too dependent on fickle oil prices.”

But the expected oil price decline is likely to curb both government and private spending. Real import growth is forecast to slow as a result of a lag from the surge in oil prices. Thus in 1998, a combination of cautious fiscal policy and lower oil prices is expected to lead to only modest real GDP growth of 1.5 percent, down from 5 percent in 1996.

Inflation is just 1 percent while unemployment is unofficially estimated at 15 percent. According to the International Monetary Fund, the main challenge now confronting Saudi policymakers is increasing employment opportunities for the kingdom’s rapidly growing youth population. More than half of Saudi Arabia’s 6 to 8 million citizens are believed to be under twenty-one years old.

**Syria**

Syria’s economy is likely to continue stagnating as the oil- (and foreign grant-) induced boom

20 This summary is drawn in part from EIU, *Country Report—Saudi Arabia*, no. 4 (1996).
26 Allen, “Riyadh’s Fiscal Severity.”
of the early 1990s peters out. Syria’s economy is saddled with a large number of poorly performing public sector firms and low industrial productivity, and the government’s economic policy in the coming year is expected to be unimaginative. Underlying the regime’s policies will be the central objective of avoiding social upheaval, and thus a large part of the Syrian economy will remain centrally planned well into 1998.

The government will likely place emphasis on minor changes to make the public sector more efficient and expand the role of the private sector without undermining government control over the economy. Any wholesale changes within the public sector—reducing the size of the army or the civil bureaucracy—and the inevitable loss of jobs this would entail is unlikely in 1998.

In the oil and gas sector, the government may be more imaginative. Currently, production is around 600,000 b/d of crude oil and is set to stagnate or even fall in the next few years unless exploration picks up. This means the government must attract foreign companies with the necessary expertise. The development of gasfields will also be a focus of future economic policy.

With the expected drop in oil prices, Syrian oil exports are predicted to fall slightly from $2.7 billion in 1996 to a little less than $2.6 billion in 1998. However, this should be offset by a predicted increase in non-oil exports, such as cotton and olives, from $1.8 billion in 1996 to $2.1 billion in 1998.

Agriculture, which accounts for almost 30 percent of Syria’s GDP, is a top priority. The focus will likely be on increasing production, particularly of cotton and cereals. Production of raw cotton is forecast to rise from 570,000 tons in 1996 to 635,000 tons in 1997 and to 700,000 tons by the year 2000. Real GDP reached 6 percent in 1996, and should slow to 5.4 percent in 1997 and 5.3 percent in 1998, resuming the decline from the mid-1990s.

Inflation will continue to trouble Syria, but an expected decline in the world price of non-oil commodities should help push the inflation rate down from around 20 percent in 1996 to 16 percent in 1998. However, as the more than 60 percent of the population under the age of twenty moves into the labor force over the next few years, unemployment is likely to rise sharply.

Syria is not expecting tourism earnings to increase in the coming year unless the political situation in the region improves, nor is it anticipating substantial funds from Gulf governments. Therefore the deficit is expected to widen in 1997-98.

Lauren Rossman is a senior research assistant at The Washington Institute. Adam Frey and Megan Fisher also contributed to this report.

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27 This summary is drawn in part from EIU, Country Report—Syria, no. 4 (1996).
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