Economic Policy and State Intervention
(Richards and Waterbury CHs #2,3,7,8,9)

1. Recovery Since 1800
2. Growth Policies
3. Why the Middle East Chose Import Substitution
4. MENA vs. Asia
5. Reform
Disparity in Middle East and N. Africa

Not just oil

Source: Abed, George T., “Unfulfilled Promise” Finance and Development, 40(1), 2003
Why no convergence?

- governance problems
  - property rights, policy mistakes, colonial rule
1. From 1800 onwards: Uneven Recovery

A. 1800-1913: Slow growth
B. 1913-1950: Industrialization
C. 1950-1970: Separate paths
A. 1800: Low point

- Population decline since Middle Ages
- Cultivated area (Why?)
  - Stagnated technological progress
    - (Ali finds no Egyptian foreign language speaker)
- International trade
- Human Capital

Causes? Government breakdown, Deterioration of terms of trade (ToT)
A. 1800-1913: Engine of Growth

• International trade:

  – Exports: Crops (cotton, sugar, silk, opium, tobacco)

  – Imports: Textiles, cotton and sugar (Turkey, Iran), coffee and tea.
    • No capital goods imported! (except in Egypt)
A. 1800-1913: Factors of Recovery

• Communications (industrial revolution):
  – Steam navigation, railways, telegraph.

• Trade reform:
  – Increased competition, lower tariffs
  Technological transfer, investment (foreign traders)

• Government reforms:
  – Modernized legal system to allow commercial loans and contracts.
  – Agricultural and commercial codes reformed.
A. 1800-1913: Uneven development

- Egypt: (most developed) Export oriented
  - Population increased, rise in income per capita.
  - Agricultural development: \( \uparrow \) Cultivated area, irrigation, market oriented.
  - Communications: railroads, ports, dams and canals (Aswan dam, Suez Canal) allowed transportation and agriculture to expand
  - Education: technical and secondary schools, publishing.
  - BUT Lack of manufacturing industry:
    - Political pressure (low tariffs, British rule), low human capital.
A. 1805-1849: Muhammad Ali

• Push for modernization and industrialization:
  – State control of agriculture and trade: State monopolies
    • Control over growers: oversee crops (cotton, sugar), buy directly from growers.
    • Control over trade: Sell directly to foreign buyers
  – State-owned Industry:
    • High tariffs and quotas to protect industry
      self-perpetuating lobby, unresponsive to technological change
    • Technical schools to develop human capital

• Breakdown of the system:
  – Foreign pressure (British empire), own imbalances.
    • Lower tariffs, end of trade monopolies
      the problem with the self-perpetuating lobby

  “Infant industry” argument.

\[
\begin{align*}
1. \text{Agricultural exports suffer} \\
2. \text{Consumers suffer from import prices.} \\
3. \text{Manufacturers' lobby for tariffs} \\
4. \text{Govt. resist lowering tariffs.}
\end{align*}
\]
A. Monopolies, State Revenue and Tarriffs

- [Monopoly Derivation & Graph]
- How much can govt. extract from monopoly?
- How much consumer surplus is lost?
- 3 reasons developing countries have more monopolies [back to Adam Smith]:
  - Why do monopolies lobby harder for tarrifs?
  - Why are state monopolies and tarrifs self-sustaining?
A. 1800-1913: Uneven development

- Turkey: (development from 1840s)
  - Wars: Less integration in international trade, less industrialization.
  - Intellectual progress similar to Egypt.
  - Less integrated in foreign trade.

- Iran: (Slowest development)
  - Less development of communications
  - Little change in agriculture (not market oriented)
  - Little intellectual interaction with other countries
B. 1913-1950: Industrialization

• Deterioration of Terms of trade after WWI.
• Disruption of imports due to Wars.
  – WWII:
    • Egypt: Trade with Europe interrupted.
    • Iran: British and Soviet occupation. Economic disruption.
    • Turkey: Neutral. Trade with both sides.

• Push for industrialization
  • Iran, Turkey: Government sponsored (Import Substitution industrialization (ISI)).
  • Egypt: Capital privately owned, more open to trade.
A. Import substitution & industrialization

• Key elements:
  – Directed investment: Government directs investment to certain target industries.
  – Protection from imports: High tariffs or low quotas on close substitutes.

• Mixed Results:
  • Rapid growth of protected industries.
  • Lack of competitiveness.
  • Increase in Government debt (unfavorable ToT, little domestic savings).
  – Faster industrialization in Turkey and Iran.
A. 1922-1952: Slowdown in Egypt

- Slow increase in cultivable land
- Deterioration of Terms of Trade (fall of cotton prices)
- Acceleration of Population Growth (From 13 to 26m)
- 1930-1950: Moderate Industrialization
  - Fiscal independence, end of tariff restrictions, shortage of capital goods
  - Local entrepreneurial and capitalist class (Education improvements, “Egyptianization” measures)
- Overall decline in standard of living
C. 1913-1950: Growth & Industrialization

- Iran grew faster, Turkey overtook Egypt.

<table>
<thead>
<tr>
<th></th>
<th>IRAN</th>
<th>EGYPT</th>
<th>TURKEY</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1925</td>
<td>1950</td>
<td>1925</td>
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<tr>
<td>Population (millions)</td>
<td>12.5</td>
<td>19.3</td>
<td>14</td>
</tr>
<tr>
<td>Imports (millions of dollars)</td>
<td>88</td>
<td>191</td>
<td>250</td>
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<tr>
<td>Railways (Km)</td>
<td>250</td>
<td>3,180</td>
<td>4,555</td>
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<tr>
<td>Automobiles</td>
<td>4,450</td>
<td>38,300</td>
<td>17,740</td>
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<tr>
<td>Students in schools</td>
<td>74,000</td>
<td>743,000</td>
<td>635,000</td>
</tr>
<tr>
<td>Energy consumption</td>
<td>-</td>
<td>4.51</td>
<td>-</td>
</tr>
</tbody>
</table>
C. 1950-1970: Separate paths

• Egypt: Slow growth (4%)
  – 1952 Nasser revolution:
    • Factors: Unequal distribution of land, decline in standard of living.
    • Successful land reform, crop intensification.
    • Industrialization (nationalization of industries, ISI)
    • Moderate social development (Education, health)
  – Wars (Israel, Yemen): Hike in military spending (20% GNP).

• Modest development, high government debt
C. 1950-1970: Separate paths

• Turkey: Fast growth (6.4%)
  • Marshall Plan aid.
  • Government and private investment (entrepreneurial class).
  • Skilled labor force, expansion of middle class.
  • Migration to Europe: Remittances, skill transfer.

• Iran: Fastest growth (9.6%)
  • Mix of public and private investment.
  • Expansion of entrepreneurial and salaried middle class.
  • Large contribution of oil revenues in late 1960s.
  – Richest of the three countries at the end of the period.
### 3. 1950-1970: Separate paths

<table>
<thead>
<tr>
<th>1972</th>
<th>IRAN</th>
<th>EGYPT</th>
<th>TURKEY</th>
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</thead>
<tbody>
<tr>
<td>Population (millions)</td>
<td>31.2</td>
<td>34.8</td>
<td>37</td>
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<tr>
<td>Per capita GNP ($)</td>
<td>490</td>
<td>240</td>
<td>370</td>
</tr>
<tr>
<td>Imports (millions of dollars)</td>
<td>2,410</td>
<td>899</td>
<td>1,508</td>
</tr>
<tr>
<td>Railways (Km)</td>
<td>4,944</td>
<td>5,500</td>
<td>8,133</td>
</tr>
<tr>
<td>Automobiles (thousands)</td>
<td>481</td>
<td>206</td>
<td>372</td>
</tr>
<tr>
<td>Students in schools (thousands)</td>
<td>4,820</td>
<td>5,708</td>
<td>6,720</td>
</tr>
<tr>
<td>Energy consumption (coal Kg)</td>
<td>490</td>
<td>240</td>
<td>370</td>
</tr>
</tbody>
</table>
2. Growth Policies
\((R&W\ pp.\ 21-44)\)

Colonial period ends
- Independent states can set development policies.
- Big governments.

The Choices:
\(A.\) Export oriented, \(B.\) Import substitution, or \(C.\) Mineral export

A. **The export-oriented strategy:** (Asian examples)
- exploit comparative advantage in low skill manufacturing (or agriculture)
  {comparative advantage diagram}
- progress to higher skill manufacturing through education
- guarantee property rights to attract foreign investment
  - note on human rights
- liberalize financial and labor markets to facilitate transfer of capital and labor to their most productive uses
Growth Policies (cont.)

B. Import Substitution
- Substitute imports with local manufacturing (or agriculture) by raising tariffs, manipulating exchange rates and directing capital
- mobilize capital through taxation and direct investment centrally
- frequently implemented with 5 year plans inspired by Soviet model
- requires “picking winners” among potential exporters
- lose gains from trade, which is restricted by tariffs and duties
- dynamic logic {comparative advantage diagram again}

C. Mineral export strategy
- Works fine till you run out
- Transfers (necessary to preserve political stability) undermine incentives to establish manufacturing or accumulate human capital
3. Why The Middle East Chose Import Substitution in 1950s

- Why not agricultural exports?
  - Colonial legacy – bad memories
  - OECD food production subsidies depress prices
- Risky export markets
- Self-sufficiency in food
- Soviet example and influence
- Wages supported by oil prices
- Feared loss of state control over capital and labor markets
- Loss of minority entrepreneurs during independence
- Stated political ideology hardly mattered at all.
Import Substitution - Examples

- Turkey (from 1920s)
  - aspired to be a “Western Nation”
- Rest of region (from 1950s)
- Result: Monopolies in favored industries never manage to export successfully and are never competitive with imports in prices or quality.
- Abandoned either with increase in oil prices in late 1970s or with collapse in oil prices in mid 1980s (which reduces local demand for manufactures).
4. MENA vs. Asia

Chart 2: Declining fortunes

In terms of real GDP per capita, MENA has lost ground compared with other developing countries.¹

Source: IMF, World Economic Outlook database and staff calculations.
¹GDP weights in purchasing power parity terms are used for all aggregates except Asia8, which is a simple average.
²Asia8: Hong Kong S.A.R., Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, and Thailand.
³MENA–Oil countries are Algeria, Bahrain, the Islamic Republic of Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Sudan, and Yemen.

Source: Abed, George T., 2003
Chart 3

No magnet

MENA has failed to attract sufficient net foreign direct investment compared with its economic size.

(billion dollars)


Source: Abed, George T., 2003
Chart 4

On the sidelines

MENA’s share of world exports fell by more than half between 1980 and 2000.

Export shares (percent of total world exports)

Developing countries

Asia

MENA-Non-oil

MENA

Export share indices (1985=100)

Asia

Developing countries

MENA-Non-oil

MENA-Oil


¹MENA–Oil countries are Algeria, Bahrain, Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Sudan, and Yemen.

Source: Abed, George T., 2003
Chart 6

Voice of the people

With some exceptions, government accountability remains low, and other governance indicators lag, in the MENA region.

(Percent)¹

Voice and accountability

Government effectiveness

Rule of law

Political stability

Regulatory quality

Control of corruption


¹Each entry indicates percent of countries worldwide that rate below selected country or region for each governance indicator. Higher score for any indicator shows better governance outcome. Aggregates are simple averages.

Source: Abed, George T., 2003
5. Reform

- Economic collapse and fall of Soviet Union vs. Western and Asian examples
- Dependence on foreign investment
- Decline in oil prices in late 1980s

- Successful transition to export-orientation and flexible markets: Turkey, Israel, Lebanon
  - Jordan, Algeria, Tunisia?
Reform (cont.)

Problems with reducing state intervention in capital and labor markets,
- reducing food subsidies is unpopular
- expanding tax base,
- expanding property rights
- import-substitution created vested interests
- state monopolies created vested interests

• Problems for next class: Education
Demographics (R&W Ch. 4; Weil Ch. 4)
Disparity in MENA