strategy+business

ISSUE 68 AUTUMN 2012

Staying on the Road to Growth

Even amid ongoing tensions, Middle East leaders must maintain their commitment to economic reform.

BY JOE SADDI, KARIM SABBAGH,

AND RICHARD SHEDIAC

REPRINT 00125

This article was originally published by Booz & Company.

Staying on the Road to Growth

Even amid ongoing tensions, Middle East leaders must maintain their commitment to economic reform.

by Joe Saddi, Karim Sabbagh, and Richard Shediac

The Middle East and North Africa (MENA) region is experiencing its greatest level of change in 50 years. Middle East governments are being challenged by their populations, often in unprecedented ways that have highlighted the tensions in some countries. Young people, many of whom face debilitating unemployment, are demanding that their voices be heard. Observers point to these and other factors as signs of even greater imminent change.

But this focus on immediate issues, however compelling, should not draw attention away from long-term trends and economic growth. Many Middle East countries have engaged in decades of economic reform. The perception that these systemic adjustments have not gone far enough in some cases, or not proceeded fast enough, is itself a cause of tension. Yet economic growth in the MENA region is genuine, is substantive, and has already had lasting effects. It would be unfortunate if Middle East government leaders, while pursuing appeasement measures and other short-term policies, regressed or relented on the systemic economic reforms that are needed for future growth and success.

The understandable inclination to focus exclusively on immediate issues could dissipate some of the positive economic momentum that many leaders of the Middle East have worked hard to sustain. For example, the Gulf Cooperation Council (GCC) countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) have deliberately set out to use their resource wealth to build modern, knowledge-based economies and move away from dependence on hydrocarbon revenues. Some of these GCC countries are increasingly active on the global stage. Their largest companies are becoming nimble, competitive multinational corporations, almost unrecognizable as the sluggish state-owned behemoths that they were a few years ago.

If the effect of the current regional upheaval is to slow the pace of economic growth and private-sector development, it could mean missing a chance for prosperity that may not come again. The costs would be paid later, and with interest. A slower pace of deregulation, which would prevent the setting up of new, efficient service providers, would lead to lower standards of living. Less effort invested in transforming government agencies and how they serve their communities, whether through healthcare or pensions, would lead to weaker social cohesion. Insufficient and inadequate investments in such vital social services as education and health will rob future generations of the ability to compete in the global economy.

A slowdown in systemic change could also prevent the region from exploiting its potential in global trade and investment. There is a shift toward increased Middle East trade with, and investment in, less-developed frontier economies across the developing world — so-called south–south flows. (See "The New Web of World Trade," by Joe Saddi, Karim Sabbagh, and Richard Shediac, *s+b,* Autumn 2011.) Through-

Illustration by Lars Leetaru

out the region, cross-border business is expected to experience massive growth. HSBC's February 2012 "Global Connections Trade Forecast" projected that regional trade could increase by 131 percent between 2012 and 2026, compared with an 86 percent global forecast. But much of that trade could be lost if governments retrench.

Moreover, without deep economic change, the MENA region will be unable to realize the benefits that come from having a young, energetic, and aspiring population. The current demographic bulge (in which more than half of the population is younger than 25) means that the Middle East needs to create millions of jobs just to stand still. Youthful populations can fuel prosperity, as China, India, and Brazil have all recently discovered. However, this prosperity depends on having a reinforcing virtuous circle in which economic growth, robust and relevant education, and creative opportunities come together. MENA governments have invested in education, but the results have been slow to appear. People in the region are more educated than ever before, but many are struggling to find suitable jobs, and that has been an ongoing source of unrest.

The last 18 months have been characterized by unexpected tests for government and business leaders in the Middle East. It may be tempting to appease the partisans of the "Arab Spring" with subsidies, or to slow down the pace of economic reforms. But if Middle East business and policy leaders are serious about continuing the region's economic momentum, they will have to resist these temptations. To do so, they will have to resolve five fundamental tensions: stability versus openness, social appeasement versus economic transformation, nationalization versus privatization, untargeted development (leading to exclusion and entitlement) versus inclusive development, and sovereignty versus regionalization. Resolving these paradoxes will take conscious attention to long-term goals, but in a way that has been developing in the region for 20 years. It's as if the leaders of the MENA countries have been developing their acumen all this time, just to prepare themselves for the challenges of the current moment.

Those places where the government demonstrates flexibility have coped best with the turbulence.

Stability vs. Openness

In the past, many people in the region seemed to fear that economic reforms might lead to instability. According to this view, too much openness to change could be dangerous to the social order. That reflexively cautious attitude, however, has now been proven incorrect. Societies have been evolving at a faster pace than their governing structures, in part thanks to technological advances. As it turns out, the more rigid a country, the more difficult it has been to assimilate social change. By contrast, those places where the government demonstrates flexibility are precisely those least affected by the Arab Spring; they have coped best with the recent turbulence.

Perhaps the most important manifestation of the tension between stability and openness is the way in which governments have engaged their younger citizens. Countries in the Middle East have had mechanisms for dialogue and consultation, but in the past these did not include all groups. Young people, in particular, were left out — even as their numbers swelled and they grew accustomed to new digital technologies that empowered them as communicators. It should thus come as no surprise that the region's youth have an appetite for community participation and a sense of economic frustration that their parents did not. This is not just a demographic shift; it has a cultural component.

The GCC countries are seeking long-term ways to manage this tension. Some of them have turned to "soft power," or the persuasiveness of ideas and culture. These countries have attracted first-rate universities, invested in basic R&D labs, promoted the arts, launched top television and communications companies, and started citizen engagement initiatives. Just consider the change in local media. Until recently, the Middle East was known for state broadcasters that lacked a diversity of viewpoints. Today, the GCC hosts at least two world-class international television networks (Al Jazeera and Al Arabiya). Both sources produce candid content about local and international affairs; they also break important news and broadcast a diversity of opinions.

At a variety of levels, soft power is a crucial tool for dealing with the tension of stability versus openness. In addition to allowing more diverse media, the most important measure that governments can take is increasing the available forms of civic engagement. Even on contentious issues, there are possibilities for dialogue. In 2011, for example, when Saudi Arabia set up a new government agency called the National Anti-Corruption Commission (known as *Nazaha,* Arabic for integrity), it did so with a public statement that opened discussion of this issue. The country also launched a national dialogue initiative in 2003 that led to the government's soliciting its population's views through an unprecedented series of elections and consultations. This approach seeks to give citizens a sense that reforms need their participation to succeed. In short, governments that hope to continue balancing stability and openness must find a way to build their own capacity, not just for listening to more people, but also for responding in ways that show that the most important concerns are being heard.

Appeasement vs. Transformation

The most dramatic policy swings have come from governments that try to move in two directions at once: promoting overall economic growth and reform on one hand, while using subsidies to mollify groups and special interests on the other. These efforts naturally tend to work at cross-purposes. Subsidies can often be more popular in the short term, because the gains from economic transformation may not be realized for years, and the social cost can be immediate. For this reason, Middle East governments — even when they have embraced the main planks of economic reform, have achieved some notable results, are convinced that further reform is necessary, and have been schooled in its details — are sometimes less than rigorous in the implementation of reform.

Contrary to many outsiders' perceptions, the last decade in the Middle East has been one of steady economic expansion. The compound annual real GDP growth rate from 2007 through 2010 was 6 percent in Egypt, 4.2 percent in Tunisia, 6.1 percent in Oman, 16.1 percent in Qatar, and 4.6 percent for the MENA region overall. In comparison, the worldwide economic growth rate was 1.8 percent for the same years. This growth is at least partially attributable to wide-ranging economic reform. Governments have promoted the private sector and trade, made it easier to do business, and created more jobs for women.

But today, many government leaders seem to be recoiling from this agenda. They are seeking refuge in methods of social appeasement — typically increasing subsidies and creating government jobs. Non-GCC states have increased their overall spending by one-third since 2010. In Egypt, subsidies currently account for 10 percent of GDP. The government will spend US$16 billion on energy subsidies in fiscal year 2012, which is 40 percent more than it spent in the previous fiscal year. Tunisia's transitional government has announced an employment plan that includes 20,000 new public-sector jobs. Since the Arab Spring, the GCC countries have announced that they will pour an estimated $150 billion (12.8 percent of the GCC's total GDP for 2011) into social welfare, incentive schemes, and higher public-sector wages.

The result is that in an era of high commodity prices, these countries are actually more vulnerable to external shocks. For example, Saudi Arabia's fiscal break-even price is around $70 per barrel of oil, up from around $50 per barrel in 2008. (The fiscal break-even price is the amount that the government must allocate to its own budget to avoid having to borrow.)

Increasing the size of the public sector would worsen the distortions that helped lead to the Arab Spring. A large public sector crowds out the private sector, removes the incentive for enterprise, and diminishes entrepreneurial dynamism and social mobility. There is also a ratchet effect. Short-term spending becomes a long-term commitment to those who have been rewarded, making the eventual cost of a correction very high.

Joe Saddi
joe.saddi@booz.com
is chairman of the board of Booz & Company and the firm's managing director for the Middle East.

Karim Sabbagh
karim.sabbagh@booz.com
is a senior partner with Booz & Company and the leader of the firm's communications, media, and technology practice in the Middle East. He is also chairman of the Ideation Center, Booz & Company's think tank in the Middle East.

Richard Shediac
richard.shediac@booz.com
is a senior partner with Booz & Company and the leader of the firm's public sector practice in the Middle East. He is also a member of Booz & Company's board of directors.

Also contributing to this article was Mounira Jamjoom, senior research specialist at the Booz & Company Ideation Center.

For another version of this article, with citations to background references, see Mounira Jamjoom, Karim Sabbagh, Joe Saddi, and Richard Shediac, "The Road to Growth in the Middle East," Booz & Company Ideation Center white paper, 2012: http://booz.co/roadtogrowth.

Nobody expects subsidies to disappear overnight. What is required, however, is a process to ensure that government spending is done in a manner that invests for economic transformation. That means replacing outright subsidies with targeted support to the genuinely needy — buttressed by social dialogue. It also means investing in programs that train job seekers in the skills the economy needs. For example, Saudi Arabia's Ministry of Labour contracted with the Tamer Group, a private company, to create an institute to attract Saudi nationals and train them in logistics and operations skills. The company typically finds jobs for about 20 percent of its trainees and provides certificates for another third. Another Saudi public–private partnership developed the Madinah Airport, which is critical for transporting pilgrims to this holy city. Constructed by a consortium that included TAV Airports, Air Rajhi Holdings, Saudi Oger, and other companies, the airport is credited with transferring private-sector skill and expertise into the public sector.

Governments can emulate this example by instituting more public–private partnerships to attract investors, and by promoting the transfer of skills from foreign firms to the local private sector.

Nationalization vs. Privatization

Privatization was one prominent area in which the Middle East was joining the global mainstream before the Arab Spring. Since 1990, some countries, including Egypt, Jordan, Morocco, and Tunisia, have sold off state enterprises and liberalized such sectors as telecommunications and transportation, hoping to eventually hand the reins of growth to private companies. In the GCC, privatization has helped the economy remain robust, and has promoted diversification away from hydrocarbons. Saudi Arabia transferred operation and maintenance of ports to the private sector in 1997; the Saudi Ports Authority owns the assets and retains a supervisory role.

This swing of the policy pendulum away from nationalization was bold. Nationalization had assisted state economic development. It had given a lift to newly independent economies, and often boosted national pride. But over time, state-dominated enterprises and economic institutions became sclerotic and hard to manage.

Privatization was one prominent area in which the Middle East was joining the global mainstream before the Arab Spring.

In the wake of the Arab Spring, governments may be tempted to swing the pendulum back toward nationalization. This trend may be encouraged by the popularity of state-owned enterprises, which fared relatively well during the economic downturn. The recent funneling of budget resources into the public sector is a warning that privatization could falter. One example is the Gulf housing market, where shortages are becoming acute for parts of the population. The best approach is for a mixture of public- and private-sector firms to build more dwellings for people of all incomes. Instead, state-owned firms, with easy access to funding, have pursued mammoth projects for affluent customers; these large-scale ventures have allowed them to overawe their private-sector competitors. Governments can avoid such public-sector dominance by using their existing national economic capabilities to nurture entrepreneurship, promote small-business creation, and foster the kind of privatization that works well.

Morocco, for example, has used its long-term commitment and openness to foreign direct investment to generate sustained economic momentum. In 1989, with the passage of a national privatization law, major state enterprises began to manage themselves along private-sector lines. Morocco is now a venue for large and innovative investment. In February 2012, Renault-Nissan opened a $1.3 billion automobile manufacturing plant in the Tangier Free Zone (a low-tariff port area dedicated to industrial development). The plant will be able to produce 400,000 cars per year and create 3,000 jobs. The facility has a carbon footprint of zero, a global first in the automotive sector.

Admittedly, the track record of privatization so far — the rate at which private enterprises participate in major economic activities — has varied by sector. The telecom industry generally performs well, and in the process enables citizens of the region to participate in the world economy. Jordan, which started bringing in private firms in 2001 and used an advanced regulatory regime, now has more mobile telephone subscribers than people. Its 2011 penetration rate of 120 percent compares to 2.5 percent in 1999, when the government had a monopoly. By contrast, the record in banking and finance is mixed. The GCC ratio of banking-sector assets in private hands ranges from 87 percent in Kuwait to 47.8 percent in the UAE (at the end of 2007).

Encouraging entrepreneurship among small companies is particularly important. The MENA region has a low level of enterprise creation (just 0.63 firms per 1,000 working-age people, according to the World Bank, less than half the rate of Latin America and the Caribbean), and many new companies are very small. Yet small firms have tremendous potential. In Morocco, microenterprises account for 65 percent of all private-sector employment; in Saudi Arabia, they account for 40 percent. In a region blighted by unemployment, governments should recognize that nurturing local businesses is a very powerful form of privatization. Counterintuitive though it may seem, one way to accomplish this is to use the buying power of large, state-owned companies. This technique, in which corporate giants deliberately foster smaller businesses along the value chain, has worked in South Korea, Singapore, and Taiwan. Large companies can also cut their import costs if they have more and better-quality local suppliers. Companies such as Saudi Aramco, the Saudi Basic Industries Corporation, and the Abu Dhabi Basic Industries Corporation are already taking this approach. They also provide training programs to groom skilled workers whom they then place with their suppliers. The same pattern is occurring in the telecommunications sector with regional operators such as Saudi Telecom, Etisalat, and Qtel.

Bringing educated women and properly skilled youth into the economy fuels growth, enterprise creation, and employment.

Exclusion vs. Inclusion

The Arab Spring has raised questions about the dominant development model in the Middle East. For decades, national development involved top-down, countrywide policies with legitimate goals, but these policies often had unfortunate effects. Food and fuel subsidies intended for the poor were sometimes shunted instead to middle-income groups, which then treated them as an entitlement. Governments at times paid more attention to the views of organized labor and the bureaucracy than to those of the young and unemployed.

As many government leaders have already realized, this untargeted development has led to a mismatch between demography and economic structure. Despite robust growth, MENA countries cannot provide enough jobs. The youth unemployment rate on average was more than 27 percent in 2011 — more than double the global rate of 12.6 percent. Meanwhile, universities in the region produce too many graduates whose training does not match the present or future needs of employers in the private sector. Many of these graduates will depend on the state for employment, housing, and subsidies.

Instead of continuing to support untargeted development, governments can encourage development that promotes the one social sector that can have the most positive long-term effect: the middle class. The best way to do this is through inclusion, particularly of those groups with the skills and ambitions to become entrepreneurs, and those who have thus far been omitted from the development equation. The most prominent and significant of these groups is women.

Economically excluded women are part of what Booz & Company calls the "third billion" — the first and second billions are the populations of China and India. (See "The Third Billion," by DeAnne Aguirre and Karim Sabbagh, *s+b,* Summer 2010.) These are the women who have the potential to become middle-class entrepreneurs, employees, and consumers, but whose economic lives have previously been stunted, underleveraged, or suppressed. As they enter the economic mainstream, they will have a huge impact around the world.

This will probably affect the Middle East dramatically, especially given its high levels of female education. For example, women in Kuwait, Qatar, and Saudi Arabia constitute 67 percent, 63 percent, and 57 percent, respectively, of university graduates. Yet in many countries, only a minority of women participate in the labor force, and comparatively few in the private sector.

Bringing educated women and properly skilled youth into the economy fuels growth, enterprise creation, and employment. Ultimately, that will provide the bedrock of stability that the MENA region has lacked: a sizable middle class.

Governments need other pro–middle class policies as well. Recently, Booz & Company surveyed about 1,450 members of the middle class in Egypt, Saudi Arabia, and Morocco; their highest-ranked aspirations were for stability and national economic development, and they showed considerable desire for better governance and education. These are exactly the qualities associated with a strong middle class, and working toward them should be the first priority of any government.

Sovereignty vs. Regionalization

Before the Arab Spring, there were repeated attempts to create regional alliances and trading blocs in the Middle East. These plans invoked the region's shared language and culture, the commonalities that run from Morocco to Oman and that are stronger than those found in Europe. Yet few of these bids to unify governance or economic structures came to fruition, in part because of the tendency to put national sovereignty above regional ties in all cases, even when regional ties were worthwhile. Unfortunately, this tendency could increase after the Arab Spring. Governments may see trade, monetary, and financial-sector integration as a further threat to sovereignty, rather than as a chance to stimulate commerce and enterprise. But that would be an error and a swing of the pendulum in the wrong direction.

Already, the region is one of the most fragmented in the world in terms of production and trade. There are only two significant long-lived economic alliances: the Greater Arab Free Trade Area (GAFTA) and the GCC. GAFTA, signed in 1997, now includes 18 countries (Algeria, Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, the Palestinian territories, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, the UAE, and Yemen). It was intended to catch up with other regional blocs, but has not yet done so — likely because of weak implementation mechanisms and a lack of trade complementarity among Arab states.

The GCC is a better model. Founded in 1981 by states with a common geography and other shared cultural features, it has focused on important, attainable projects, and brought them to completion. For example, it launched its own economic common market in 2008. In 2012, the bloc will finish a $2 billion project known as the GCC Interconnection Grid. The result will be a regional power network that can trade electricity, thereby ending the inefficiency of six national grids serving just 44 million people. Equally important has been the GCC's decision to allow labor mobility among its members. An agreement signed at the end of 2001 enables GCC passport holders to live and work throughout the six-member group. The result has been a small but noticeable movement of skilled labor among these countries.

Of course, the GCC has had challenges, as all integration schemes do. In 2009, Oman and the UAE opted to bow out of the bid for a monetary union, citing the need to put their economies in order first. But governments can learn from GCC successes. They can start by choosing projects wherein shared effort is a necessity rather than an aspiration. MENA countries may not yet have much to sell to one another, but they do share trade routes and infrastructure. As these develop, and as excluded groups join the workforce, the volume of cross-border commerce will rise.

Stable Policies, Stable Outcomes

There is an understandable temptation during crises to seek easy answers or to revert to old practices. Neither option is available in the Middle East today. Rather, what exists is promise and potential. Middle East countries have young, aspiring populations, of whom many are well educated. The middle class wants to be more productive. Millions of young women are ready to enter the workforce. Capable, global companies are willing to launch projects of national importance to train young workers.

For these elements to cohere, governments need to provide stable policies. They will have to remain on the long-term course that they began before the Arab Spring. The reforms of that time led to faster growth. Now, similar economic reforms and measures designed to harness the resources of youth, women, and the middle class can further transform the Middle East.

Reprint No. 00125

strategy+business magazine
is published by PwC Strategy& Inc.
To subscribe, visit strategy-business.com
or call 1-855-869-4862.

For more information about Strategy&,
visit www.strategyand.pwc.com

• strategy-business.com
• facebook.com/strategybusiness
• http://twitter.com/stratandbiz
101 Park Ave., 18th Floor, New York, NY 10178

pwc | strategy&
Formerly Booz & Company