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Brach, Juliane; Loewe, Markus

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Getting Off Lightly? The Impact of the International Financial Crisis on the Middle East and North Africa

Juliane Brach and Markus Loewe

The international financial crisis has hit the Middle East and North Africa (MENA), like other developing regions, unexpectedly, during a long phase of above-average growth. In contrast to other parts of the world, however, most MENA developing countries will be able to get off lightly if the crisis does not last for too long. In Turkey and Israel, the region's more industrialized countries, different initial conditions apply and the situation is not comparable to the Arab MENA countries. This is why both these countries are not included in the analysis below.

Analysis:

- As is the case for other world regions, the crisis is impacting the MENA region mainly through two indirect effects: (i) a decline in the export of goods and services and (ii) a reduction in remittances sent back home by migrant workers abroad. The more direct effects on the region's financial markets matter to a much lesser extent. However, the Gulf countries in particular are also suffering from the wealth effect: substantial losses of capital invested abroad.
- The non-oil-exporting countries of the region are not very vulnerable to the effects of the financial crisis, partly because they are only weakly integrated into international trade and capital markets.
- The energy exporters are being hit harder, especially because the oil price has fallen steeply. However, as long as the price does not continue to fall, most energy exporters will be able to survive the crisis for some time because they have been able to accumulate considerable financial reserves during the boom years.
- Dubai, Iraq, Iran and Yemen are the countries within the MENA region that have been most affected by the financial crisis. They do not have sufficient financial reserves to finance the gap between public spending and income from the sales of oil and gas.
- Most countries in the region will probably be able to weather the financial crisis relatively well because of their comparatively limited openness towards global markets.
- Nevertheless, the governments should use the financial crisis as an opportunity to implement market-oriented reforms and to find solutions to their structural problems. These countries urgently need to improve their productivity and competitiveness in order to reduce their dependency on a limited number of export products and to create employment for a rapidly growing labor force.

Keywords: global financial crisis, Middle East and North Africa, crude oil and energy prices, Arab countries

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1. The Global Financial Crisis

The global financial crisis has hit the MENA region—like most other developing regions—during a long period of above-average economic growth. Between 2003 and 2008, the region's gross domestic product (GDP) grew by almost 6 percent per year on average. This boom was due to a historically unique coincidence of three favorable economic conditions for the developing countries: easy and cheap access to capital, increasing commodity prices, and huge flows of remittances. The global financial crisis has reversed all of these conditions, bringing about dramatic consequences for many developing countries. The MENA region, however, might be lucky and “get off lightly” if the crisis does not last too long.

The catalyst for the financial crisis was the so-called *sub-prime crisis* in the United States. For many years, US banks had been selling barely secured mortgages to clients, even those with a rather questionable financial standing. Finally, at the end of 2005, real estate prices began to stagnate and the first borrowers defaulted on their repayments. The rating agencies downgraded several mortgage banks, and as early as mid-2007 several institutes were insolvent. Their creditors also found themselves in difficulty, and faith in the US banking system eroded rapidly. Both domestic and foreign investors shifted their capital to less risky assets or withdrew it completely, meaning that the banks could no longer refinance themselves. When Lehman Brothers filed for bankruptcy in September 2008, interbank lending collapsed globally.

At the beginning, it seemed as if the crisis would only affect the USA and perhaps Europe. By the fall of 2008 it had become clear, however, that developing countries would not be able to avoid the downward spiral. Four channels of contagion can be differentiated:

- *The Wealth Effect:* State and private players lost parts of their savings invested in industrialized and emerging economies.
- *The Financial Effect:* In order to restore their liquidity and avoid additional risks, investors from all over the world withdrew their capital from developing countries and canceled new investments. Furthermore, liquidity bottlenecks arose because banks worldwide limited the extension of new credit.
- *The Real Economic Effect:* Owing to the cooling down of the global economy, the demand for goods exported by developing countries has been

shrinking, thus causing their external revenues to plummet.

- *The Transfer Effect:* Likewise, developing countries' revenues from transfers such as remittances and development assistance have been decreasing as well.

2. The Specifics of the MENA Region

The financial crisis struck the MENA region later and less vehemently than, for example, Latin America or East Asia. This fact is mainly due to three specific features of the region: First, most countries in the region are only weakly integrated into global trade and capital markets. Their reluctance to open their economies limited MENA countries' growth rates during the boom, but now, during the time of crisis, is limiting the leverage of financial and real economic effects. Second, the MENA region possesses the largest crude oil and natural gas reserves worldwide. Also, some of the region's countries had the opportunity to accumulate substantial financial reserves during the boom. Third, the region receives not only relatively large but also particularly stable flows of development aid—namely, from Europe and the United States.

3. The Effects of the Crisis on the MENA Countries

Like other world regions, MENA has been affected by the financial crisis through its real economic and transfer effects rather than its financial effect. In contrast to other developing countries, however, the wealth effect is also playing a noticeable role.

The importance of the four effects varies considerably within the region:

- *The energy exporters with large proven reserves and smaller populations* (Abu Dhabi, Algeria, Qatar, Kuwait, Libya, Oman, and Saudi Arabia) are feeling the real economic as well as the wealth effects. However, their oil and gas reserves are extremely large (especially in relation to the size of their populations) and their production costs low. These countries are able to finance their government spending with the energy export revenues despite the currently low oil price. The considerable capital reserves that were accumulated during the past boom years could help to smoothen any arising financial gaps.

- *Energy exporters with limited reserves or large populations* (Bahrain, Dubai, Iraq, Iran, and Yemen) are more vulnerable to the real economic effect of the crisis and also, partially, to the other three effects: Bahrain and Dubai are particularly suffering from the wealth and financial effects, while Iraq and Yemen have mainly been hit by the transfer effect. Within the MENA region, these countries are the most severely affected by the financial crisis because they are unable to keep their level of public spending at the current oil price without dissolving part of their financial reserves or even contracting debts. In particular, Iraq, Iran, and Yemen were not able to accumulate a significant amount of reserves during the boom.
- *The energy-importing countries* (Jordan, Lebanon, Morocco, the Palestinian Territories (PTs), and Tunisia) are suffering from a stagnation or decline in foreign direct investment (FDI) as well as declining revenues from industrial exports, tourism, and remittances. At the same time, however, these countries are benefiting from low-price energy and food imports. As a result, with the exception of Tunisia and perhaps Morocco, the positive effects of the crisis might compensate for the negative effects—at least on the macroeconomic level.
- *The net energy exporters* Egypt and Syria are special cases since they export and import almost an equal amount of energy. The impact of the financial crisis will therefore most probably be modest in both countries.

3.1. The Wealth Effect

The wealth effect is being felt by some MENA countries much more than by any other part of the world. Before the crisis, only few other countries had achieved similar levels of foreign assets. For example, foreign assets in Bahrain in 2007, measured in relation to GDP, excluding currency reserves, were equal to 13 times its GDP. Kuwait, Libya, Saudi Arabia, Algeria, Oman, the United Arab Emirates (UAE), Jordan, and Egypt also ranked very high on a global scale with regard to this criterion. The total sum that UAE sovereign funds had invested abroad by the end of 2007 was more than 300 percent of the country's GDP. Similarly, the sovereign funds of Kuwait, Libya, Saudi Arabia and Algeria had foreign assets that were equal to 142, 86, 64 and 34 percent of GDP, respectively. In contrast, the foreign assets of Jordan, Lebanon, the PTs and Tunisia were almost exclusively owned by private investors.

Different estimates suggest that at least 30 percent of these assets have been lost during the financial crisis. This means that the Arab sovereign funds and Arab private investors have lost approximately US\$500 billion and US\$300–500 billion, respectively. However, these losses are very unevenly distributed across the MENA region. The sovereign funds of Kuwait, Dubai and some others states have invested large shares of their capital into emerging market stocks and bonds. As a consequence, they have experienced particularly large losses. At the same time, the sovereign funds of Algeria, Iran, Libya, and Saudi Arabia have followed a much more conservative investment strategy and have therefore fared much better. Severe losses have particularly been recorded among private investors from Lebanon, Jordan, and the PTs. Syria, Tunisia, and Morocco have not suffered large losses, simply because they do not hold significant amounts of foreign assets.

And yet, none of these countries is severely vulnerable to the wealth effect of the crisis. The losses have predominantly occurred in countries and among stakeholders that are quite able to absorb them. Moreover, the wealth effect mainly concerns capital that has not been not invested into the national production process. Finally, there is quite a good chance that the losses can be recouped through future stock market gains.

3.2. The Financial Effect

Most MENA countries were initially affected by the financial crisis at a relatively late point in time and only to a limited extent. Even before the crisis the MENA region was not able to attract much investment from outside the region, and some evidence suggests that, with some exceptions such as Dubai, only limited sums of these investments have been withdrawn from the region. The stock markets in the region crashed just like those anywhere else, but the sales that led to the crash in the region were largely made by investors from within the region itself.

On average, MENA stock market indices have fallen by more than 50 percent from their peak in mid-2008, whereby between US\$200 billion and US\$600 billion have been lost. The losses have been particularly high in the oil-producing countries (with the exception of Iran), and Dubai has, by far, been hit the worst. The Egyptian stock market index has indeed also dropped by 54 percent from the level it had reached in January 2008. However, it had previously enjoyed a particularly sharp rise during 2007.

The stock markets in Jordan, Morocco and Lebanon have been less affected, and the Tunisian stock market even bucked the international trend by growing by 11 percent during 2008.

The property markets of the MENA region have reacted in different ways. In some countries they have remained largely unaffected and, as in Oman, have only slowed down their dramatic growth. In Lebanon real estate prices are stagnating. Kuwait and Morocco are suffering a noticeable setback. Jordan and Syria are also both expecting a slowdown in the next months. In the last few years, the return of guest workers from the Gulf, the influx of more than a million Iraqi refugees, plus land speculation have resulted in overinvestment in property in these two countries. Once again, Dubai has been hit more than any other MENA country. Property prices have fallen on average by approximately 50 percent and building projects worth US\$582 billion have been put on hold. A large percentage of migrant workers in the building sector have been laid off. By February 2009, as many as 17 percent of all inhabitants had left the country, something which will probably cause the demand for residential property and real estate prices to sink further.

In stark contrast to most other countries, the banking systems of the MENA region have never been seriously threatened by the crisis. This is mainly due to the fact that MENA's financial systems were and still are comparatively isolated from global markets. Most of them are still heavily regulated and some are still dominated by state-owned banks. In addition, most banks have easy access to domestic sources of finance. For example, in 2007 the deposits of the Egyptian banks exceeded their lending volume by more than 80 percent. Since then both dimensions, unaffected by the crisis, have continued to grow.

FDI has never been as important for the MENA region as it is in other developing regions (cf. Brach 2008a). Any decrease in FDI flows is therefore much less dramatic than for other parts of the world. This is even true for Egypt, where inward FDI flows shrank by 44 percent during the second half of 2008, mainly because Gulf investors were freezing planned investments.

MENA countries are even less exposed to declines in other forms of investment because they constitute the only group of developing countries with a net outflow of interbank, intergovernmental, and portfolio investments. Any reduction in these categories of capital flows would therefore reduce the outflow of financial resources from the MENA region rather than the inflow.

In contrast, the fact that some MENA countries have been assigned significantly higher levels of risk by some of the leading international rating agencies is worrying. Higher risk ratings not only discourage potential investors but also raise the costs of borrowing for both companies and governments. Most countries in the region have been able to improve or at least stabilize their rating since the beginning of 2009. The ratings of Yemen, Morocco, and the UAE, however, have further worsened. In the case of the UAE, this is probably due to the particularly precarious situation in Dubai, which is currently overshadowing the much less troubled situation in Abu Dhabi and the five smaller emirates.

The development of the exchange rates of MENA currencies in relation to the dollar and the euro provides additional evidence for the notion that the financial effect of the global crisis has hit the MENA countries much less than most other parts of the world. Hardly any of the fixed, official rates have been revised, even during the most turbulent periods of the crisis. Only the Jordanian dinar has been appreciated once, in April 2008. The floating exchange rates of Egypt, Algeria, Morocco and Tunisia fell sharply during the second half of 2008, but they have all recovered almost completely since then.

3.3. The Real Economic Effect

The real economic effect has had a much greater significance for the MENA region than the wealth or the financial effect. The energy exporters have been particularly affected, mainly because of the decline of the world market prices for oil and gas. Global demand for energy has only fallen by approximately 2 percent since the beginning of the crisis. Nevertheless, the price of oil has fallen by almost two-thirds from its all-time high in summer 2008 to little more than US\$50 per barrel. As a result, some of the energy-exporting countries in the region have experienced a 25 percent reduction in their GDP due to losses in their export revenues. Libya and most of the Gulf countries have sufficient financial reserves to cope with this loss of income for a limited period of time. Even with the low current oil price, they remain able to finance their public expenditure from the proceeds of energy exports.

The situation is more problematic for Dubai, Iraq, Iran, Yemen, and Oman. These countries have to contract debts if they want to maintain their current level of public spending. According to IMF estimations, Oman, Iran, and Iraq need an oil price of

US\$77, US\$90 and US\$110, respectively, in order to finance their government budgets from their export income.

At the same time, the energy-importing countries in the region (Jordan, the PTs, Morocco, Tunisia, and Lebanon) are benefiting from the low energy prices. They suffered badly from the high world market prices for energy during 2007 and 2008—not least because they heavily subsidize the prices of petrol, fuel, gas, and electricity. Jordan, for example, at that time spent more than a third of its GDP on oil imports. These countries are now able to save 5–10 percent of their GDP because they can import oil at a much lower price than in 2007.

Egypt, too, is benefiting rather than suffering from the decline in world energy prices although it is a net exporter of energy. It exports large quantities of natural gas on the basis of long-term contracts that were fixed well before the crisis. At the same time, Egypt depends on the import of oil and is therefore profiting from the current low price. Conversely, Egypt and the energy-importing MENA countries will have to bear losses in their income from the export of services (especially tourism and transport) and manufactured goods.

The revenues from tourism are expected to decline. Consumers in higher-income countries have become much more prudent and economic in their spending because it is still unclear what additional effects the crisis might have in the future. Dubai, Morocco and Tunisia will probably suffer the most. In comparison to last year, Tunisia is seeing 25 percent fewer reservations. The number of travelers to Egypt has also fallen—by approximately 30 percent between January 2008 and January 2009—but this might also be at least partly due to the Gaza conflict early this year keeping tourists from a holiday in Sharm-al-Sheikh or elsewhere on the Sinai. Jordan and Syria, however, are not as exposed to the global decline in tourism. These countries mainly attract cultural and religious rather than recreational tourists; the former generally face fewer budget constraints and can afford to travel even in economically difficult times. For the same reason and due to an improved overall situation in the war-driven countries Iraq, Lebanon and Gaza Strip, tourism in Jordan and Syria is currently increasing, despite the economic crisis.

While Egypt is not suffering from a heavy decline in tourism either, it is having to cope with large losses in the transport sector. Since the beginning of the financial crisis it has experienced a 25 percent drop in its revenues from the fees levied on ships for

the use of the Suez Canal—equivalent to approximately 1 percent of GDP.

In general, the volume of goods exported from the MENA region, excluding fuel, is small and very much concentrated on a few countries. Only Tunisia and Jordan have non-energy exports worth more than 20 percent of their GDP. Because 45 percent of its exports are directed towards the EU, Tunisia is the MENA country that has been hit hardest by the global decline in the demand for manufactured goods. In particular, Tunisia's turnover of textiles (-13 percent), automobile parts (-17 percent), leather goods (-20 percent), and olive oil (-38 percent) has been afflicted. Morocco and Syria have also seen a slight reduction in their leather exports. In addition, Morocco is expecting a 5–10 percent drop in revenues from agricultural products as well as a 78 percent decrease in the export of phosphate. Egypt's manufacturing exports, which grew by more than 50 percent during 2008, will also decrease again in 2009, by an estimated 25 percent. Jordan's exports, on the other hand, have hardly been affected by the crisis at all.

3.4. The Transfer Effect

Iraq, Yemen, and Egypt are anticipating a particular decline in the volume of remittances because a considerable number of their nationals are working in the rich oil-exporting Gulf countries and regularly sending money back home to their countries of origin. In Jordan and Lebanon, these remittances equal more than 20 percent of GDP; in Egypt, Yemen, and Tunisia they represent between 5 and 6 percent of GDP. If the oil price remains as low as it is now and the economic situation in the host countries worsens, a large number of the migrant workers might lose their jobs. Even those workers who stay will probably become more cautious about keeping their savings to themselves rather than transferring them to their relatives at home. In this case, remittances will decrease as they have often done during previous crises. It is estimated that 30,000 migrant workers have already returned back to Egypt. If, as predicted, some 5–10 percent of all migrant workers lose their jobs abroad, Egypt would lose revenues worth approximately 0.2–0.5 percent of its GDP. Remittances from the Gulf to Jordan, the PTs, and Lebanon are less likely to decline because migrant workers from these countries are employed primarily in the education and health sectors or in public administration rather than in the crisis-worn oil or construction sectors.

Morocco and Tunisia also receive significant remittances, most of which originate from migrant workers in Europe. These workers are also at risk of losing their jobs as a consequence of the financial crisis. However, the total number of workers returning back from Europe to their countries of origin in the Maghreb will most probably remain small.

In general, the level of development assistance provided by Europe, the US and other donor countries is likely to decrease significantly because a lack of public support in times of crisis. The MENA countries, however, will probably not be affected much by any reduction in development aid because the support they receive is motivated by political and stability considerations rather than humanitarian motives. In fact, it is hard to imagine that the volume of development cooperation with strategically important countries such as Jordan or Egypt would be reduced for mere budgetary reasons. At the very most, Yemen might face a limited reduction in the financial support it receives, which in any case only amounts to 1.5 percent of its GDP.

4. The Reactions of the MENA Countries to Date

Most MENA countries have taken immediate measures to deal with the financial crisis. With respect to the nature, volume, and main goals of these measures, two groups of countries can be differentiated.

As a first step, Egypt, Jordan, Qatar, Kuwait, and the UAE have concentrated on state guarantees or guarantee funds in order to secure private bank deposits and to prevent the collapse of national banking institutes. Other MENA countries have focused instead on the real economic effect of the crisis and imposed emergency programs to cope with any possible drop in domestic demand. Morocco and Lebanon, for example, have established publicly funded credit schemes to safeguard the easy and cheap access of small and medium-sized entrepreneurs (SMEs) to credit. In addition, Morocco has set up a fund to reimburse some of the costs of advertisements for Moroccan leather, textile, and electrical export products. The Lebanese government is planning to accelerate the realization of already approved infrastructure projects in order to create additional employment. Moreover, it has raised the salaries of public sector employees. The Tunisian government has made €10million available to support the tourism industry. Saudi Arabia has announced an infrastructure investment plan and has provided US\$3 billion for interest-free loans to the needy. Kuwait has also

established a fund to assist private enterprises when necessary, but has at the same time announced cuts in public expenditure on social services and infrastructure. Moreover, many countries have lowered their key interest rates in order to ensure that the economy is sufficiently capitalized.

Despite the sharp drop in the oil price, the Organization of the Petroleum Exporting Countries (OPEC), to which the most important oil exporters in the MENA region belong, has cut oil production only very moderately. The production cut agreed upon by OPEC members in October 2008 was smaller than expected, and a second reduction of crude oil production originally decided upon in December 2008 was canceled altogether in March 2009. Saudi Arabia, in particular, has championed a low oil price as a contribution of oil-exporting countries to reviving the world economy. It has therefore opposed any further cuts in production quotas. According to the International Energy Authority (IEA), a low oil price—remaining at the current level for the whole of 2009—would have the same effect as if a US\$3 billion stimulus package were to be adopted by the industrialized countries. The low oil price is relieving not only the industrialized and emerging economies but also the financial problems of the oil-importing developing countries and is therefore improving the chances of a rapid global economic recovery.

Most oil-exporting nations are, for their part, able to temporarily cope with the low oil price until it rises again, likely in 2011 or 2012. Within the MENA region, only Iraq, Yemen, and Iran do not have sufficient reserves to do so. The same is true, however, of several oil-exporting countries outside the MENA region, such as Russia and Venezuela. That OPEC has decided to support a low oil price against their interests is probably a result of Saudi Arabia's opinion leadership and its otherwise tense relations to these countries.

5. Prospects and Recommendations

In contrast to other developing countries, most MENA states will be able to weather the global financial crisis without suffering any major damage. Almost all of them will continue to grow at positive though somewhat lower rates than before (for example, Saudi Arabia at 1 percent in 2009, Bahrain and Syria at almost 3 percent, Egypt and Lebanon at approximately 4 percent and Qatar at even 8 percent). Some countries will even benefit from the crisis through a reduction of their inflation rates from

abnormally high to much more acceptable levels (for example, from 24 to 14 percent in Egypt, from 15 to 8 percent in Syria, and from 7 to 3 percent in Tunisia).

The energy exporters can expect the demand for energy to soon exceed their production capacity again. This will most certainly also push the oil price above its current level. Moreover, international stock market prices are expected to recover, so that some of the losses in foreign assets will be compensated. Thus, even if the oil price should temporarily slip under the critical mark of US\$50 again, the consequences will not be devastating for the majority of oil exporters in the MENA region, since most of them possess sufficient financial reserves and benefit from sound fundamental macroeconomic data. Nevertheless, they should take the current crisis as a further occasion to cut unnecessary government expenditure and to consider strategies for diversifying the range of their export goods.

Iran is the main exception in this regard. It had accumulated quite substantial financial reserves by 2004, but had already used up the bulk of these well before the crisis started in order to finance several programs for the poor established by President Ahmadinejad. In addition, unlike Dubai, Iraq, or Yemen, Iran faces difficulties in borrowing on the international financial markets because of the effects of the US embargo. The government can neither increase taxes nor increase the printing of money in order to contain its budget deficit because there have already been numerous protests by the Iranian people against both strategies and because inflation and unemployment already stand at 30 percent and 20 percent, respectively. The government will probably have to restrict imports, as it already did twice in the 1980s and the 1990s. Whatever happens, the country is going to be further politically destabilized by the crisis and could even suffer from some loss of influence within the region if the crisis lasts longer than expected.

Similarly, Dubai could also suffer from a decline in importance, since it is currently unable to cope with its liquidity problems without the substantial support of its sister emirate Abu Dhabi. This might increase the pressure on Dubai to accept a UAE under the single leadership of Abu Dhabi, replacing the joint leadership of Abu Dhabi and Dubai.

Finally, the low oil price also constitutes a problem for Yemen. The country's national budget deficit has already grown to 9 percent of its GDP, and its foreign debt amounts to 28 percent of its GDP. In contrast, Egypt, Syria, and most of the energy importers in the MENA region will be able to master

the global crisis quite well. The low energy prices have provided them with an extra financial buffer which is allowing them to withstand for some time the effects of losses in export revenues without having to accrue new debt.

In the short term, these countries should react to the crisis by ensuring that companies and households alike have easy access to market-price credit. In addition, they should support unemployed and impoverished households by, for example, establishing or extending public works (cash-for-works) programs. Their medium- to long-term priority, however, should be to continue their search for solutions to their structural problems. First, they should phase out food and energy subsidies before the prices of these commodities rise again. To compensate for this step, the countries could build up a basic social protection system (for example, a cash-for-education program), which would allow them to react quickly and flexibly with additional financial assistance for the needy in the event of external shocks, like the current financial crisis, in the future. Second, energy importers should—like energy exporters—improve their ability to innovate in order to reduce their dependence on a limited number of export goods and to make better use of greater integration in world markets, especially in the technology sector (cf. Brach 2008b).

One dilemma is that many MENA countries have coped well with the financial crisis partially because so far they have hardly opened themselves to world markets. This encourages internal opponents to reform and provides them with new arguments against market-oriented reforms. Thus, structural adjustment reforms could become even more difficult to implement than before the crisis. Nevertheless, they are essential to eliminating the dependency of MENA countries on just a few export goods, to strengthening their competitiveness in global markets, to creating jobs for a rapidly growing labor force, and to coming to grips with the rapidly growing public spending of the governments.

■ The Authors

Dr. Juliane Brach is an assistant research professor in the Department of Economics at the University of Copenhagen, a member of the academic staff of the GIGA Institute of Middle East Studies, and leader of the institute's "Innovation and Growth" research team. Her main areas of research are the economic development and growth of the MENA region, innovation and technology adoption in developing countries, technology transfer within global value chains, and EU-Arab relations.

E-Mail: brach@giga-hamburg.de, Website: <http://staff.giga-hamburg.de/brach>.

Dr. Markus Loewe is a senior economist at the German Development Institute/Deutsches Institut für Entwicklungspolitik (DIE). He is currently working in Department 2 (Competitiveness and Social Development) on a research project on the scope of industrial policies in nine low- and middle-income countries in periods of financial crisis. In addition, he is preparing for a project on how households and enterprises in developing countries are coping with the financial crisis. He previously researched social policies, poverty reduction and the implementation of the Millennium Development Goals in the Arab world as well as the strategies used by developing countries to fight corruption and improve their investment climate.

E-mail: markus.loewe@die-gdi.de. Website: <http://www.die-gdi.de>.

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