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WORKING PAPER 34

AFTER THE PERSIAN GULF WAR

The Potential for Economic Reconstruction and Development in the Persian Gulf Region

By Mehran Nakhjavani

March 1991

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PREFACE

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EXECUTIVE SUMMARY

There have been various attempts within the Arab world to promote a measure of economic integration, of which only the Gulf Cooperation Council has been a modest success. Trade within the Arab world has never exceeded five per cent of the total volume, and even this figure has only been possible because of the need for energy-deficit countries to import oil from nearby sources. The oil trade will continue, and the emerging political alliance between Egypt, Syria and the Gulf may be translated into more defence-related trade and aid.

On the other hand, the political fall-out for countries which supported Iraq, such as Jordan and the Palestinians may be translated into a loss of their traditional Gulf markets for food products. Three non-Arab countries, namely Iran, Turkey and Israel have trading links, but these are unlikely to grow and show signs of shrinking considerably, with the possible exception of Turkish involvement in the Kuwaiti reconstruction business.

There have been two main themes in the literature dealing with economic integration, both of which have suffered from a surfeit of political idealism. The first deals with the notion of Arab (and more recently, of Islamic) economic integration, although heterogeneity of economic management, resource base and political ideology have been too great for such schemes to become reality. The second major theme in the literature discusses the possibilities of trade and economic development acting as a political inducement for warring countries to reconcile their differences.

The classic case of such a "peace bribe," namely the Israeli-Egyptian treaties, signally failed to meet expectations and resulted in a "cold peace" underwritten by large volumes of OECD aid. A third strand in the literature is a variant of the latter, which rejects the grand vision and favours a sectoral approach to peaceful co-existence, beginning with cooperation on such critical issues as water management.

The current thinking on post-war economic problems in the region defines two distinctive issues, namely the immediate reconstruction process and the longer-term economic relationships

which would be conducive to promoting regional stability. In the former category, there is a widespread assumption that the Kuwaiti government-in-exile will fund its own reconstruction with its financial reserves, while the Iraqi economy will be left largely to its own devices.

In the latter category, the method has yet to be defined that will ensure a more equitable distribution of oil wealth within the region. Arab states in the Gulf appear anxious to tie their aid tightly to Arab members of the coalition, especially to Egypt and Syria. There appears to be no desire to help rebuild Iraq, and demands for Iraqi reparations are growing. However, as the post-war financial climate is unlikely to yield significant surpluses of oil revenue, major financial flows from outside the region will be necessary if Iraq is to be rebuilt.

There are only a limited number of sources for reconstruction finance. Aid flows from Iraq's principal OECD creditors -- Japan and France -- are one possibility, although this would be in the form of tied bilateral aid only, and would presumably be heavily hedged with political conditions. The World Bank and the IMF could provide some initial project and programme funding. It is conceivable that foreign private investment could be attracted to rebuild parts of the oil sector.

Beyond these sources, there are various options for new facilities aimed at the longer term possibilities of economic development, including the establishment of a special IMF fund, the creation of a new regional development bank or a new UN agency tied to the region. There is also the possibility that no international initiative will be possible, in which case there is a need for a "middle power" initiative in order to offer some hope to the Iraqi people.

CONDENSÉ

Le monde arabe a fait diverses tentatives pour promouvoir une certaine intégration économique en son sein, et seul le Conseil de coopération dans le Golfe a connu un certain succès, modeste disons-le. Le commerce entre pays arabes n'a jamais dépassé 5 p. 100 du total de tous leurs échanges, et même ces maigres résultats ont été possibles seulement parce que des pays à faibles réserves énergétiques ont dû importer du pétrole de nations voisines. Le commerce du pétrole va continuer, et la nouvelle alliance politique en train de prendre forme entre l'Égypte, la Syrie et le Golfe donnera sans doute lieu à encore plus d'échanges et d'aide à caractère militaire. D'un autre côté, les intervenants ayant fait campagne dans le camp irakien, tels que la Jordanie et les Palestiniens, perdront probablement leurs marchés traditionnels du Golfe pour l'exportation de leurs denrées alimentaires. Trois pays non arabes, à savoir l'Iran, la Turquie et Israël, entretiennent des relations commerciales avec les pays arabes, mais celles-ci risquent peu de croître; elles diminuent sensiblement, sauf dans le cas de la Turquie qui aurait de bonnes chances de participer à la reconstruction du Koweit.

Les documents parus sur l'intégration économique ont abordé deux principaux thèmes, et dans chaque cas, les auteurs ont versé dans un idéalisme politique excessif. Le premier fait valoir la notion d'intégration économique arabe (et plus récemment, islamique), même si l'hétérogénéité des systèmes de gestion économique, des ressources naturelles et des idéologies politiques a été trop marquée pour autoriser la concrétisation d'un tel objectif. Sous le deuxième grand thème, les experts s'interrogent sur la possibilité d'utiliser le développement commercial et économique pour inciter les pays belligérants à régler leurs différends politiques. Le cas classique d'une telle «démarche de paix», à savoir les traités israélo-égyptiens, ne s'est manifestement pas soldé par les résultats escomptés, et il en est découlé une «paix froide» étayée par une aide massive de l'OCDE. Un troisième courant de pensée présente une variante du deuxième; il rejette la grande vision d'intégration et préconise plutôt l'édification sectorielle de la co-existence pacifique, en commençant par la coopération dans des dossiers aussi vitaux que celui de la gestion des eaux.

À l'heure actuelle, les analystes des problèmes économiques de l'après-guerre dans la région définissent deux questions bien distinctes : le processus immédiat de reconstruction, et les rapports économiques qui, à long terme, favoriseront la stabilité là-bas. À ce dernier égard, beaucoup sont d'avis que le gouvernement koweitien en exil financera lui-même la reconstruction du pays avec ses réserves de fonds, tandis que l'Irak sera en grande partie laissé à lui-même. Dans ce contexte, il reste encore à trouver une façon de garantir une répartition plus équitable des pétro-richesses dans la région. Les États arabes du Golfe semblent résolus à réserver leur aide aux membres arabes de la coalition, notamment à l'Égypte et à la Syrie. Personne ne donne l'impression de vouloir aider à reconstruire l'Irak, et de plus en plus, on réclame des réparations de la part de ce pays. Cependant, comme il risque peu d'y avoir de forts excédents de recettes provenant du pétrole, vu la conjoncture financière de l'après-guerre, il faudra trouver de gros investissements en dehors de la région pour reconstruire l'Irak.

Les sources de fonds pour la reconstruction ne foisonnent pas. Le Japon et la France, principaux créanciers de l'Irak au sein de l'OCDE, pourraient lui prêter assistance, mais ce ne serait probablement que sous la forme d'une aide bilatérale liée, laquelle s'assortirait probablement de conditions politiques rigoureuses. La Banque mondiale et le FMI pourraient fournir des fonds pour amorcer des projets et programmes. Il est concevable de penser que des investisseurs privés étrangers puissent s'intéresser à la reconstruction de certains éléments du secteur pétrolier. En dehors de ces sources, il y a lieu d'envisager de nouvelles structures dont l'objet serait de favoriser le développement économique à long terme; citons ici la création d'une caisse spéciale du FMI, la mise sur pied d'une nouvelle banque régionale de développement, ou d'un nouvel organe de l'ONU qui se consacrerait à l'essor du Golfe. Les initiatives internationales risquent aussi d'être impossibles, auquel cas l'intervention d'une «puissance moyenne» serait nécessaire pour donner espoir au peuple irakien.

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1. The Recent History of Cooperation in the Arab World

The notion that more trade within the region is desirable arises from, but is not limited to, the pan-Arabist political imperative. Just as the political fragmentation of the Arab world, when interpreted as a colonial legacy, became a target for the Nasserist cry of "Arab unity," so the need for economic integration and cooperation between Arab countries became a major theme of the revolutions in Egypt, Syria, Iraq and Libya. In other Arab countries the rhetoric of Arab economic integration appealed to conservative regimes as a sop to more radical elements calling for outright political union and, for poorer states, as a coded request for more Arab aid.

Thus, the creation of the United Arab Republic, which linked Egypt with Syria in 1958, included a series of economic agreements which sought to promote complementarity in the development planning process in both countries. The birth and eventual failure of the union was primarily politically motivated, and the economic aspects of the union remained largely undrafted.

The Arab League has also been more active in the political sphere than in its economic organs. Nevertheless, three institutions operating under the aegis of the League have had a significant economic impact. The Abu Dhabi-based Arab Monetary Fund (AMF) was created in 1976 on the IMF model and has provided short-term balance of payments support without IMF-style conditionality. Although it was instrumental in helping Morocco through a foreign exchange crisis in the late 1970s, it faced significant defaults from Sudan in the mid-1980s, followed by a fraud scandal and has been unable to raise fresh capital in recent years.

The Arab Fund for Economic and Social Development (AFESD) was established in 1974 under the aegis of the League, with the lion's share of the capital paid in by the oil exporting states. Based in Kuwait, AFESD has on average provided less than ten per cent of Arab aid but has an important role in coordinating policies between the various Arab aid agencies. The Damascus-based Arab Boycott Office was created in the 1950s in order to enforce a boycott of companies doing business with Israel. Although unsuccessful in its official aim to cripple the Israeli economy, especially with the introduction of counter-boycott

legislation in the United States after 1974, the Office has in specific instances demonstrated the power of the combined Arab market. It successfully kept Coca Cola and Ford out of the Arab world for two decades, and continues to act as a disincentive to Japanese-Israeli trade. In the financial markets, institutions perceived to have Jewish connections, such as Salomon Brothers, have been unable to participate in the often lucrative Arab bond and loan markets.

As Britain prepared to pull out of the Persian Gulf in the early 1970s, there was an attempt at a union of the former Trucial States with Qatar and Bahrain which foundered on the petty jealousies between the ruling families and the unequal oil endowment of the putative members of the union. The Iranian Revolution a decade later provided the political incentive for the creation of the Gulf Cooperation Council in 1980. Significantly excluding Iraq and the Yemens, the GCC's dominant member is Saudi Arabia, and it includes Kuwait, Bahrain, Qatar, the UAE and Oman. The GCC has succeeded in introducing a number of joint economic agreements in areas where all other intra-Arab groups have failed. GCC citizens have rights of residence, employment, property ownership and business incorporation throughout the six states -- a significant prerogative in a region which has highly restrictive immigration regulations. GCC members also grant each other's citizens privileged access to public sector contracts, agricultural and industrial subsidies. A common GCC tariff is applied -- although an increasing number of loopholes have been allowed which still afford a degree of protection to local industries from competition in member states. In its attempts to deepen the union, the GCC has failed to negotiate even the most elementary form of monetary union, despite the essentially homogenous structure of its members' economies.

In the late 1980s, two similar economic groupings were created in the Arab world. In North Africa, where the notion of Maghreb unity has a long political pedigree and where Libya in earlier years announced a series of quixotic merger attempts -- first with Egypt, then with Algeria and Morocco -- a political rapprochement between Algeria and Morocco prepared the ground for the Arab Maghreb Union in 1989. This links Mauritania, Morocco, Algeria, Tunisia and Libya, and it is still too young to be judged on its economic achievements. In the same year Egypt, Jordan, Iraq and North Yemen formed the Arab Cooperation Council, which was enlarged in 1990 with the addition of South Yemen after the merger of the Aden and

San'a governments. The ACC was from the outset an essentially political grouping, and was greeted with considerable unease by Saudi Arabia. It saw the alignment of Jordan and Yemen as a threat because of the irredentist claims to Saudi territory by both countries. It regarded Iraq as so great a threat that it went to the extreme of signing a non-aggression pact with Baghdad in 1989. On the other hand, the inclusion of Egypt was welcomed as a potentially moderating influence on what was seen as Iraq's growing ambitions. The ACC held a number of higher level meetings which agreed to set up joint ventures between the four countries and accorded citizens preferential travel privileges, including the abolition of visa requirements.

2. Trade with and within the Arab World

Despite these various attempts to foster intra-Arab economic cooperation, the experience has not been encouraging. As an overall share of total Arab trade, intra-Arab trade has never exceeded five per cent, which reflects the structure of economies in the Arab world. The great bulk of exports from the region (excluding Israel and Turkey) is in the form of raw materials. Oil is the dominant traded commodity, but in non-oil producing countries phosphates and other minerals are also important, as are agricultural exports such as cotton, fruit and vegetables. Imports, on the other hand, tend to be processed and manufactured goods.

The only obvious overlap is in the food sector, where Arab exporters have a comparative advantage in neighbouring Arab markets. In the Gulf region, imports of fruit and vegetables have resulted in significant financial flows to farmers in Jordan, Syria, Lebanon, the Occupied Territories and Egypt as well as in eastern Turkey and southern Iran. However, not all the Gulf's fresh produce is imported from the immediate vicinity, which tends to supply the cheaper end of the market. High value items, including the unblemished vegetables demanded in Western-style supermarkets, as well as exotic fruits, are imported from as far away as New Zealand and Hawaii. Among the impediments to the regional produce trade have been the inefficiencies inherent in the road and sea transportation system serving the Gulf and the frequent bureaucratic obstacles created at border crossing points. Air-freighted produce, on the

other hand, has been handled in a far more effective manner, and is also subject to more rigorous quality control.

In the oil trade, intra-Arab trade is significant. However, the only Arab countries which are dependent on oil imports are Mauritania, Morocco, Sudan, Djibouti, Jordan and Lebanon. These have traditionally relied on concessionary terms for at least part of their imports, and the availability of this assistance, rather than basic economics, has determined the pattern of trade. Thus, Lebanon has relied on Saudi oil, rather than Syrian or Iraqi supplies, which are much closer. Jordan has been tied to the purchase of Iraqi oil by counter-trade agreements, even though this has implied a higher real cost to its economy. Morocco's traditionally poor political relations with Algeria and Libya have sent it to distant Saudi Arabia and Kuwait in search of its own oil imports. In the case of non-Arab importers, however, these political considerations do not apply. Turkey and Israel both rely on market pricing to buy the cheapest oil available to them, which means from the closest source, i.e. Iraq and Egypt respectively.

Examples of intra-Arab trade outside the oil sector are relatively rare and frequently used as paradigms of regional economic cooperation. Kuwaiti investments in the Tunisian chemical industry, including concessional aid and equity participation, has resulted in the development of phosphoric acid production there. The acid is then exported to two Kuwaiti joint ventures in China and Turkey. In the latter plant it is used as feedstock for the production of ammonium nitrate and diammonium phosphate. The Turkish plant imports its phosphoric acid feedstock from Kuwait itself. However, it is important to point out that a trade and investment network such as this one was based on business criteria rather than any notions of Arab or Islamic solidarity. The record of Kuwaiti investments elsewhere in the Arab world confirms the strong preference of the investors for a stable and conducive business environment. The fact that the example of the Tunisian chemical trade has not been repeated on a large scale throughout the region is itself indicative of the relatively unattractive business climate offered to foreign investors -- whether Arab or non-Arab -- by many countries in the Arab world.

In the case of the arms industry, there exists a strong case for regional cooperation, which has to a large extent not been translated into reality. Iraq (pre-1991) and Egypt are the

major Arab arms producers, although other countries have small arms and ammunition production capabilities. Yet the market for imported armaments is dominated by equipment from outside the region. The sole exception is the case of Egypt, which during the Iran-Iraq war parlayed arms supplies to Iraq into its eventual readmission to the Arab League. It was also able to score some success in selling air defence technology and armoured cars to Kuwait in response to the threat from Iran. Egypt's arms industry is its most successful industrial export, and has been partly financed by investment and assistance from Gulf States after the 1973 war.

Even when new export-oriented industries are established in Arab countries, both the target market and the source of raw materials have frequently been outside the region. Export-oriented textile industries in Morocco, Tunisia and Dubai (UAE) all use Far Eastern yarn, even though Egypt produces high-quality cotton. The target market in the case of Maghreb states is the European Community, and in the case of Dubai is the United States. In the financial services industry, the establishment of Arab banks and investment companies in the international syndicated loan and bond markets after the late 1970s was based on the practice of lending oil surpluses to non-Arab (mainly sovereign) borrowers. Even after the debt crisis of 1982, Arab banks with international pretensions looked to Europe and the US for business, rather than to neighbouring Arab countries. The only exception was the attempt of Bahrain after 1975 to set up an offshore banking market to service the undeveloped Saudi market. After a few years of growth, the Saudi restrictions on the activities of the Bahrain-based banks effectively shut down the market.

Between the Arab world and its two immediate Islamic neighbours, Iran and Turkey, the pattern of trade has changed radically during the past decade. Iran, the traditional market for the entrepôt trade in Kuwait and Dubai, has shrunk considerably in importance. After 1981, it was effectively lost to Kuwait because of the Iran-Iraq war, and there were no signs of a revival in Kuwaiti-Iranian trade after 1988.

Dubai has been a traditional supplier, which has thrived on the existence of import bottlenecks in Iran. These bottlenecks have been caused by foreign exchange shortages and

bureaucratic constraints for most of this century, and by port congestion during the import boom of 1973-1978. The ability of Dubai merchants to grant credit to third-tier Iranian importers and to ship cargo in *dhows* with access to Iranian fishing and smuggling ports gave them a strong advantage in this trade. During the 1980s, Dubai merchants developed considerable expertise as a counter-trade centre used by Iran as a destination for its non-oil exports. This extra dimension softened the blow of an overall drop in the volume of trade for Dubai's exporters after 1984.

Turkish trade with the Gulf, on the other hand, had been negligible for sixty years after the Ottoman collapse. Turkey's own severe economic crisis in the late 1970s resulted in a major shift in trade policy towards the Arab members of OPEC, and it experienced dramatic growth during the early 1980s on the back of food exports and construction contracts. The latter had cooled off by the end of the decade, although Turkish industrial exports have been finding increasing acceptance in the Gulf.

The Egyptian-Israeli trade relationship after the Camp David Agreements barely exceeded the volume of Egyptian oil exports to Israel together with some Israeli tourism to Egypt, despite all the hope and hyperbole. The reasons have been primarily political, with Egyptian suspicions of Israeli intentions magnified by the bickering over the return of the Taba strip and the desire by Cairo not to draw undue Arab attention to its relationship with Israel.

3. Post-war Prospects for Trade

The Arab world has been deeply split as a result of Iraq's invasion of Kuwait and its consequences, which precludes any immediate revival of the pan-Arabist political or economic imperative. On the other hand, there may be room for some restructuring of the relationships as a result of the war and its fall-out. The axis between Riyadh and Cairo is perhaps the most resilient element of this restructuring, with the likely involvement of Syria. Such an alliance certainly makes sense from a strategic and political perspective, as a way of keeping Iraqi and Iranian revanchism in check. As such, it will have economic consequences insofar as aid from

the GCC is likely to be channelled to Egypt and Syria, in return for military assistance and a security umbrella.

Beyond a simple troops-for-aid deal, there will be considerable encouragement of existing trade links, implying the use of Egyptian and Syrian expatriate labour to take the place of Yemenis, Jordanians and Palestinians who have left or been expelled from the Arabian Peninsula. Similarly, Syrian and Egyptian agricultural exports can expect preferential access (to the exclusion of Jordanian or Palestinian produce) to GCC markets. A grand scheme, such as the proposed Saudi-Sinai bridge across the Red Sea, may serve as a tangible testament to the relationship between Cairo and Riyadh. The existing Egyptian arms relationship will be strengthened by the placing of guaranteed long-term orders, and could be extended to allow for Egyptian supplies to Syria (paid for by the GCC). This latter arrangement has been discussed in the past, but may now become a realistic possibility because of the cessation of concessionary Soviet arms exports to the area. One constraint on Egypt's arms exports would be the extent to which a regional arms control formula (aimed at neutering Iraq) places restrictions on the accumulation of military hardware in the area.

The prospects for a revival in Iran's trade with Dubai and other countries of the region is limited by the increasing Iranian trade alignment towards the EC and Japan. This is based on Iran's willingness to borrow abroad again under the pragmatic Rafsanjani presidency, and the eagerness of German and Japanese banks to lend money to Tehran. (The latter is as much a reflection of Iran's relative credit rating as of the apparent concern of the Kuwaiti authorities to ensure that the reconstruction business is divided among the combatants in the coalition.) The availability of foreign currency financing suggests that Iran will be less dependent on the Dubai route after the war. Kuwait is unlikely to attempt any revival of its old entrepôt trade with Iran while easy profits are available from satisfying its own reconstruction needs.

Turkish trade with the Arab oil exporters has been highly dependent on oil revenues. During the early eighties, Turkish companies did a roaring business, especially in Libya, Iraq and Saudi Arabia. However the experience of Turkish exporters in countries experiencing payments difficulties -- such as Libya and Iraq -- was a bitter one, as Turkish claims were

given a low political priority by the debtors. In the absence of any imminent oil boom, this suggests that the Turks will have difficulties finding paying customers, outside Kuwait anyway.

The future for Palestinian and Jordanian exports to the Gulf is closely tied to the political manoeuvering undertaken by the PLO and the Jordanian government in the wake of Iraq's military collapse. Having supported the loser in the war and having burnt many bridges in their relationship with countries which had -- until August 1990 -- provided them with substantial economic aid, it is up to King Hussein and Chairman Arafat to make the first gesture of reconciliation. If this proves too humiliating a proposition for them to bear and still maintain their hold on power, there will be a potential for a major loss of economic viability, which has a tangential impact on the Israeli economy and its own negotiating posture.

4. Middle Eastern Cooperation: the Theory

With the division of the Middle East after the collapse of the Ottoman Empire, development policy was underpinned by the classic colonial theory that the mandated territories be able to generate an agricultural or mineral surplus in order to trade with the metropolitan economy. This resulted in relatively open economies, especially within the respective British and French spheres of influence, but with little incentive for the colonized countries to trade with each other. In the post-colonial period, the rejection of this approach has in many cases involved the introduction of dirigiste and statist systems, with national economies protected by high tariff and non-tariff barriers.

Any attempt at promoting cooperation has been, by definition, a matter of legislating an extra layer of bureaucratic control in the form of special licenses and permits to do business between the cooperating countries. In a centralized system of economic management such as this, the provision of foreign aid must, by definition, reinforce the state's administrative control of the economy. A case in point is various attempts by the US and the World Bank to channel financial aid to small private sector industrialists and farmers in North Africa. Without exception, the loans are delivered to clients by the existing state controlled subsidized banking

system. This in turn encourages greater public sector leverage over the affairs of the private sector.

There have been many proposals for encouraging Arab economic integration. These can be divided between the messianic, which rely upon a pan-Arabist sense of self-reliance, and the prosaic, which deal with historical realities. The latter has been consumed with the modalities of delivering aid from donor states to recipients in a coordinated and efficient manner. It argues that such aid offers benefits to the donors as well as to the recipients because it eventually reduces overall Arab dependence on Western industrialised countries, as well as providing tangible political benefits. The literature dealing with this subject is extensive, and follows much of the same reasoning as other discussions of South-South cooperation.

In the Egyptian context, the theory was given political expression by President Sadat's formulation that economic development could be achieved by marrying Egyptian human and natural resources with Arab capital and Western technology. However, this intellectual approach has a fundamental flaw in its application to the post-war situation in the Gulf in assuming that Arab oil producers in the Persian Gulf will remain as capital rich "low absorbers." This is not applicable in 1991 and beyond, given the great reduction in financial reserves, the needs for Kuwaiti reconstruction and the increasing sophistication of the industrial complex in the region, especially in petrochemicals.

A second theme in the literature deals with the notion that the promise of economic development will be a sufficient incentive to induce warring neighbours to adopt policies of peaceful co-existence. The theory has a long pedigree, and was formally proposed during the Second World War by the Jewish Agency, which argued that a combination of active state intervention in the Arab hinterland, the example of Jewish agricultural and industrial development in Palestine and foreign aid for capital projects would keep the Middle East peaceful and make it prosperous. Since that time, various schemes for Arab-Israeli cooperation have been offered, and considerable theoretical work done in Israeli academic circles.

The Camp David peace agreements between Israel and Egypt offered the first opportunity for a practical application of this theory. However, despite the solid economic basis underlying Egyptian-Israeli relations, namely Israel's dependence on Egyptian oil and the massive foreign aid from the OECD offered to both countries, the trade relationship foundered on the political relationship.

The idea of a "peace bribe" suffers from two conceptual difficulties in its application to the region. The first problem is that it assumes that pragmatic economic considerations will influence the political posturing, which in the Middle Eastern context appears to be putting the cart before the horse. The second problem lies in the authorship of the idea which makes it unacceptable to countries which have not yet formally signed peace treaties with Israel.

However, there is an outgrowth of the grand theory which is limited to a sectoral approach. By focussing on, say, the serious problems facing all countries in the region in managing their water resources, it has been argued that some cooperation can be achieved which will also build confidence between mutually hostile neighbours. Nevertheless, even this limited approach faces a serious political hurdle. Water resources have already become so touchy an issue in the Turkish-Syrian-Iraqi and Lebanese-Israeli-Jordanian relationships that it is difficult to conceive of technical talks between the parties taking place without all the political grandstanding that marks their diplomatic relations.

5. Current Thinking on Gulf Cooperation

There now appears to be a widespread consensus which divides post-war economic considerations into two clear issues. One deals with the physical reconstruction of war-damage, which is concentrated in Kuwait and Iraq. The second looks at the prospects for wealth redistribution and long term stability, based on equitable and sustained economic growth throughout the Middle East. There are differences of approach on both issues, although on the question of Kuwait's reconstruction there is near unanimity.

In this case, the driving force is clearly the government-in-exile, which has made its position quite clear from the outset. Since the original Iraqi invasion, plans have been made, first from a project office in Washington headed by Kuwait's Executive Director at the World Bank, Mr Fawzi Sultan, and then from Dhahran in Saudi Arabia, where the Kuwait Emergency and Recovery Programme is headed by Mr. Ibrahim Majid al-Shaheen. Contracts for the restoration of essential services in the first ninety days of liberation have already been granted to some 170 companies, with an initial value of $500-700 million. Letters of intent in excess of $5 billion have been granted to the US Army Corps of Engineers and US engineering and construction concerns including Bechtel, Fluor Corporation, Halliburton, Baker Hughes and M.W. Kellogg.

The amiri government is aiming for a brick-by-brick reconstruction of the *status quo ante* and it has the financial resources to bring this about. The lone dissenting voice comes from Kuwait's expatriate democratic opposition, which has argued for the need to re-order economic priorities so that the reconstructed economy should not be dependent upon foreign labour, and that its foreign investment portfolio should be less concentrated on the oil industry and more geared toward development projects in the Arab and Islamic world.

The reconstruction of Iraq is viewed in a very different light. The current posture of the coalition in pushing for the mutually exclusive demands for Iraqi reparations and the maintenance of UN sanctions reflects hard line Kuwaiti and Saudi thinking. However, even the Kuwaitis, who have understandably adopted the harshest tone, have suggested that a change in Iraq's leadership would allow for things to be looked at in a different light. Clearly, the twin demands are not tenable for long and must be regarded as a tactic aimed at maintaining maximum pressure on Baghdad. The aims of the coalition in this respect vary somewhat. The lowest common denominator is Iraq's acceptance and implementation of the US ceasefire conditions, which include several ambiguities such as the return of an unquantifiable number of Kuwaiti detainees and the duration of the coalition's occupation of southern Iraq.

The fact that Iraq is in any case unable to export oil without extensive repairs to its infrastructure and explicit bilateral agreements from at least one of the three hostile parties

through which its oil exports must transit (i.e. Turkey, Syria and Saudi Arabia) indicates that the maintenance of UN sanctions has little practical significance. For as long as the political alignment of the coalition remains intact, therefore, intense economic pressure can still be brought to bear on Baghdad even if, as a gesture of goodwill to the Iraqi people and to promote harmony within the Security Council, UN sanctions are formally lifted.

With the ambiguities inherent in the ceasefire conditions, it is conceivable that lifting the sanctions would await a formal ceasefire, which would suggest an interval of perhaps three to six months. During this period, some coalition members will be hoping for the removal of Saddam Hussein's regime within Iraq and its replacement by a more amenable government. However, there are political dangers involved in making an explicit link between the imposition of sanctions and a change of government in Baghdad. The credibility of the UN system is put at risk, the "Dunkirk spirit" within Iraq is further bolstered, the domestic political legitimacy of any successor Iraqi regime is open to question, and there is a good chance that a coup attempt will fail (as have numerous earlier attempts) and merely strengthen Saddam Hussein's grip.

There is an argument for allowing Saddam Hussein to remain in power because of his ability to at least keep the country united. Given his military incapacity, he no longer poses a threat to his neighbours and could continue on as a US bogeyman and Arab gadfly, a role so ably created by Libya's Mu'ammar Qadhafi.

The economic implications for Iraq are bleak regardless of the survivability of Saddam Hussein. The damage to the Iraqi economy is substantial. In order to resume oil exports, very heavy investment (perhaps of the order of $1-5 billion) is required to repair production and export facilities. This order of financial liquidity is not available to the Iraqi government. Even if it were, and pre-war production and export levels were achieved at prices in the range of $18-20 per barrel, this would provide Iraq with revenue of $12-14 billion per annum. Its pre-war civilian imports amounted to $10 billion per annum, and its debt servicing requirements (to the OECD only) exceed $3 billion per annum. Clearly, there is nothing available in the oil revenue pot to finance reconstruction, let alone attempt reparations.

There also appears to be a broad consensus that post-war economic arrangements will follow on from the security arrangements in the region. This is another way of saying that aid donors will tie their financial contributions and trade to those countries with which they have a security relationship. This notion has been given most consideration within the GCC. The GCC Supreme Council met in Doha at the end of December and agreed in principle to a $10-15 billion fund (not fully paid-in) for "Arab and Muslim states." The fund was further discussed at the mid-February meeting in Cairo of foreign ministers of the GCC, Egypt, Syria and Morocco. However, statements by GCC officials indicate that there is an intent to find new ways of disbursing the aid. The GCC is very sensitive to the jibe that its own wealth was squandered while foreign aid programmes have been inadequate (an accusation which is not supported by the facts) as well as to accusations that it was somehow responsible for misspending by aid recipients.

There have also been comments suggesting that aid will no longer be channelled through international institutions as this has resulted in its provenance being obscured and gratitude from the recipients not properly acknowledged. There is an irony in the GCC's commitment to intra-Arab aid. In its 15 July 1990 complaint to the Arab League at the start of the Kuwaiti crisis, the Iraqi government suggested that an Organization of Arab Petroleum Exporting Countries (OAPEC) oil price of $25 per barrel be set, allowing for every $1 per barrel sold at a price higher than this level to be accumulated in an Arab League development fund at the rate of $5 billion per annum.

The US official position, as spelt out by President Bush and Secretary Baker in various statements during the month of February, is to acknowledge the need for a broad and multilateral programme of reconstruction and development and the need for Iraq to be included in this overall process, while leaving the funding and modalities of this effort largely to the countries of the region, namely the GCC. At the same time, US policy is keeping to the hard line which makes the continuation of sanctions and the expectation of reparations conditional on a change of heart (or head) in Baghdad. This post-war version of "linkage" is the subject of increasingly strident and hawkish sentiment within Congress.

The Washington Institute for Near East Policy argues that the US must take a far more activist role in the region, make clear its aims and motives, and act decisively. This suggests a policy of explicitly tying aid to political aims along the lines of the GCC's thinking. At the Foreign Policy Research Institute in Philadelphia, a more cynical view is heard, suggesting that the whole notion of regional cooperation is a non-starter. According to this argument, the GCC will not commit itself to any "peace bribes" vis-à-vis Iraq (or Israel for that matter) unless there is strong Western financial support available. That support would have to come from Germany and Japan, who are unlikely to join in unless the US is also specifically committed. The US in turn, will not commit itself without Israel being assured a place at the table, while Israeli participation, particularly in the context of Soviet Jewish immigration, will ensure that potential Gulf donors withdraw from the process. Even if the Israeli component of this chain is removed, the US still has domestic political and budgetary problems in committing taxpayers' dollars to any reconstruction effort which includes Iraq.

A more idealistic vision still finds a home at the Carter Center in Atlanta, where concern is expressed that long-term issues such as Palestinian and Jordanian economic viability are being ignored. An important contribution to the debate is their argument that Western participation in the reconstruction and development process need not be limited to financial aid. There is a need for technical assistance on a massive scale, for food aid, and the perennial problem of fresh water.

The Washington-based Joyce Starr Associates have been active in this regard, promoting the concept of a "Water Summit." The water issue is a favourite theme of Turkish foreign policy, and the Summit has been endorsed by President Ozal. For the Turks, there is a big pay off arising from their control of the headwaters of the Euphrates and Tigris rivers, and their desire to depoliticize and commercialize the issue. Since 1988, they have been indicating their interest in building water pipelines to supply the Gulf with fresh water, without any apparent interest from the other side.

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There has been some sustained thinking on the subject of reconstruction within the European Community. The Commission has suggested a G24-style cooperative approach to assess and possibly finance Gulf reconstruction, and the European Bank for Reconstruction and Development (EBRD) has been approached informally in this regard although it has been stated explicitly that the establishment of a new bank is not being considered. The Commission has taken a divergent view from the US on the matter of aid for Syria and the Palestinians, which it continues to balance against its aid to Israel. The Commission is proposing an economic accord with Iran, the resumption of relations with Libya and the establishment of an office in Riyadh, none of which are designed to please the US.

Among EC members, the Italian government has taken a lead in suggesting a Mediterranean version of the Helsinki process, to deal with everything from Polisario to Kurdistan at an international peace conference. The president of the Italian state oil company, ENI, has proposed a scheme where oil producers sell part of their oil reserves in the ground to oil companies and consumer countries. This has the benefit of financing reconstruction, promoting oil market stability, and saving on the cost of exploration and development of expensive new fields. Other EC members have tended to echo the US line, as has been the case in the UK, or to present modifications, as in France and Belgium, which have adopted a softer line on the sanctions and reparations issue.

6. Vehicles and Instruments, Ways and Means

The economic backdrop for the region in the post-war period is varied. Only two states have access to liquid reserves in excess of two years' imports. These are Kuwait, with an estimated $80 billion in accessible foreign assets and the emirate of Abu Dhabi, with an estimated $30 billion. Kuwait's cash will be used almost exclusively to reconstruct itself and pay for security from the coalition and its successors. Abu Dhabi is a possible source of aid, especially in view of its traditionally close relationship with Yemen.

Saudi Arabia has spent or committed $48 billion on the costs of the war and has run down its liquid reserves to well below the comfort zone. At the end of 1990, it is estimated to have had $50 billion in foreign assets, of which only $10 billion is accessible (the remainder

comprising foreign aid to the likes of Iraq and oil industry investments in the West). In mid-February, the Saudi government took the unprecedented step of raising a $3.5 billion syndicated loan, arranged by J.P. Morgan. The loan was contracted at relatively unattractive terms [three years at 0.5% over the London interbank offered rate (LIBOR)] and was clearly a last resort to shore up the Kingdom's balance of payments after the heavy reserve drawdown associated with the war. After the war, the need to reduce production in order to allow room for Kuwait (and eventually Iraq) back into the market and the inevitable softening of prices will restrict the Saudis' room for financial manoeuvre. Qatar, Oman and Bahrain have limited resources, with Qatar the most well-off.

For reasons of the internal dynamics of the GCC, it is inconceivable that Abu Dhabi and Qatar be accorded leading roles in the financing of any GCC aid schemes. The rate at which the GCC will be able to disburse aid will to a large extent be determined by the availability of finance to its senior partner, Saudi Arabia. The latter would be extremely reluctant to see its leading role usurped by the likes of Abu Dhabi. The implication is that the GCC is not likely to be a ready source of cash, except for within the context of a security umbrella led by Egypt.

The simplest method for disbursing aid is bilaterally, under the rubric of what is classified as Official Development Assistance (ODA), trade credits and export guarantees. Aid disbursed in this manner can be given a multilateral umbrella in the form of a coordinating group, such as the Gulf Financial Crisis Coordinating Group (GCFCG). This represents the twenty-six countries which financed the war, and which recently received a US request to provide $4-5 billion to help countries hit by the war.

The GCFCG has received a total of $14.3 billion in pledges ($10.3 billion of which is for Egypt, Jordan and Turkey) and has disbursed $6.7 billion (of which $4.3 billion went to the three, in the approximate ratio of 40% for Turkey and Egypt and 20% for Jordan). Japan's contribution to GCFCG has been $2.1 billion, of which $400 million has been disbursed. EC members and the Commission had pledged $2.1 billion by the end of January. The Commission itself has pledged $690 million for Egypt, Turkey and Jordan, of which 80% was to have

been disbursed by the end of February. Canada's contribution to GCFCG is C$77.5 million, of which approximately C$46 million will have been disbursed by the end of March. One third of Canada's aid was pledged to Jordan.

There are, however, two serious problems to this bilateral approach. First of all, potential donors in the Gulf are making it quite clear at the moment that aid for Iraq is out of the question. This is a political posture, which could well be expected to mellow if there is a new regime in Baghdad amenable to negotiation, but the deep sense of popular resentment of and desire for vengeance against Iraq should not be underestimated. However, even in the best case, the maximum degree of magnanimity that could be expected from Kuwait and Saudi Arabia would be to forgive old debts and -- perhaps -- to forgo reparations.

The second problem relates to the role of Germany and Japan. In neither case is there much enthusiasm for rebuilding Iraq. In the case of Germany, there is now considerable popular angst over the evidence of chemical weapon and missile technology sales to Iraq by German companies. Japan has apparently abandoned commerce in the Arab Gulf in favour of Iran. War fears pulled most Japanese employees out of Bahrain and Saudi Arabia, causing considerable resentment from their hosts. The Ministry of International Trade and Industry (MITI) has been indicating to Japanese exporters that it would be unwise to take a high profile in the bidding for reconstruction contracts, lest Japan be accused of avoiding the war and cashing in on the peace. Even if there were interest from Germany and Japan, it is clearly not in US interest to allow bilateral German and Japanese trade credits to tie up the Iraqi market for the foreseeable future.

However, Iraq's principal trade creditors in the OECD are France and Japan. In the latter case, there is some $3.5 billion worth of unguaranteed corporate debt outstanding to leading Japanese trading companies, which makes these companies particularly keen to eventually resume trade with Iraq, if only to recover their debts. With a total of $25 billion in debts outstanding to OECD creditors (about half of which are covered by official export guarantees), the same argument can be made in macro terms, but the Japanese and French are

perhaps most vulnerable to the temptation of resuming trade as soon as possible. Such trade would presumably be hedged with political conditions.

Another method for disbursing reconstruction aid is through a special IMF or World Bank lending window. This has the advantage of being relatively quick to get off the ground, while being multilateral and "non-American." Such special funds have been created in response to such issues as the famine in Sub-Saharan Africa, and they require donor countries to pledge assistance. Disbursement is not necessarily on a concessional basis, and follows the standard procedures set by each institution. Such a facility is therefore best suited to distribute aid when there is a broad consensus that the recipients are needy, and where technical rather than political conditions are set for the allocation and disbursement of funds.

This is not necessarily the case in the Middle East, and there are two other problems with this approach. The first is conditionality, which the IMF has already been obliged to stretch for Egypt but which it will be hard pressed to drop when dealing with the subsidy-riddled and debt-ridden Iraqi economy. Another aspect of conditionality is that according to World Bank classifications, Israel is already "too wealthy" to receive new loans, which means that any notion of a "peace bribe" could not use the World Bank umbrella. The second problem is political and relates to the widespread unpopularity of IMF "cures" as they have been applied in Morocco, Algeria, Tunisia, Egypt and Jordan. In all cases, the economic dislocation associated with the restructuring has added grist to the Islamic fundamentalists' mill.

In response to the problems caused by the Arab-Israeli war of 1948, the UN created a new agency, United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA). Creating a similar agency for reconstructing Iraq is not a proposal being touted by anyone of significance as a response to the present war, and the principal objection to it is the unsatisfactory nature of all sources of UN funding. However, if there is political will to provide finance by the international community and other vehicles are deemed unsuitable, then a UN/UNDP type umbrella has political advantages when compared with the IMF connection. There are no conditionality problems. The Soviet Union and China would by definition be

included, although as these countries are unlikely to provide any of the agency's financing, their inclusion in its management and direction may not be welcome by the main donors.

The creation of such an agency might also go some way to reinserting the UN system into the region, allowing Iraq to accept aid without negative domestic political fall-out, and of repairing any long-term damage caused by the propagandist argument heard in many Arab countries that the "UN is a US tool."

A regional development bank or fund has been referred to by Secretary Baker and various European leaders as being a good way of directing funds for the reconstruction of war damage and for promoting the general aims of equitable economic development throughout the region. However, there is a nuanced variation between the European Commission, which is talking of a fund and the US and Italy, where the word bank is used. In neither case does it appear that any serious thought has been given to this notion, apart from the general idea that funding has to come from the region. The principal advantage of a bank is that it enables the paid-in capital to be leveraged by debt raised from the international capital market, and is therefore an efficient conduit for aid.

There are three other advantages, all of which are of an essentially political nature. One is the necessarily high profile that such a bank (or fund) adopts. As an identifiable institution, it can represent in a tangible way the desire of the international community to facilitate a better life for the population of the Middle East. This symbolic role has important political implications, especially in Iraq and other "losers" of the war such as Jordan, the Occupied Territories and Yemen. An essential element of this flagship function is the availability of a large pool of Arab professionals in the development business to staff the bank.

Another political advantage for a bank or fund lies in its ability to combine the advantages of multilateralism with political conditionality. For the US, there is an advantage in keeping German and Japanese aid within multilateral constraints. For the GCC states, the same advantage as is derived by pooling their aid for the benefits of their security partners (e.g. Egypt and Syria) can be gained via a bank. The issue of a bank's political conditionality

is not, in theory, new. The EBRD attaches political conditions on its activities (namely the existence of democratic and open market reforms), so that in principle there can be no objection to the use of political conditions on a Middle Eastern development bank. This fact, in turn, yields the other political advantage of a regional bank, namely that it would be possible to allow for the inclusion, at an appropriate time, of Israel into the bank's activities.

Nevertheless, the politics of such an institution are extremely delicate, and the problems are legion: it takes ages to set one up (*vide* the EBRD), it can only lend at commercial rates, which would be inappropriate for Iraq in the immediate aftermath of war and for the "have-not" Arabs in general, at whom this whole process is presumably aimed. The political bickering over where the bank should be headquartered and who should head it is, on past experience, likely to result in considerable delay and ill feeling. The GCC itself is talking in terms of a fund, or a fund of funds, which would ensure that existing ODA budgets are directed on the basis of very narrow political conditionality, but which would be free from the constraints imposed by the inclusion of OECD funding.

Some thought needs to be given to the rather pessimistic scenario that no international initiative of any kind will be organized in order to deal with the specific issue of Iraqi reconstruction. This could be the result of a number of developments. However unlikely it may seem in the first flush of a military victory, the post-war climate could yet turn against the US as a result of a deadlocked peace process and terrorist attacks in the area, which might in turn cause it to tilt away from the any interest in the Gulf area (*vide* its reaction to the attacks on its Marines in Beirut in 1983).

Another possibility would be a prolonged period of anarchy within Iraq, when outside aid would be dissipated by the existence of uprisings undertaken by Kurds or Shi'as. A third possibility is that Iraq survives as an impoverished pariah state under a brutal and uncompromising regime in Baghdad. In any case, the effect of such a failure would be broadly comparable with the situation in Vietnam after the war, and there will be a strong reason for a "middle power" initiative to fill the vacuum.

A pooled approach by Canada, the Nordic countries, European neutrals, Australia and perhaps some EC members with the possible addition of non-aligned donors such as India and Brazil offers the advantage of denying conservatives in the Soviet Union the ability to present themselves as the only friends of the oppressed. The volume of aid required to defuse this threat is relatively small, because the Soviets themselves are in no position to offer any more than moral support. The very existence of tangible reconstruction assistance by the middle powers would effectively neutralise the impact of any Soviet posturing in the region, which in turn would go some way towards reassuring US policymakers that there is no credible resurgence of Soviet power in the region, and therefore no need to switch back into a "Cold War" mode.

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