

Politics as growth stimulant

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MANAMA, Bahrain What does a tiny nation set on an archipelago off the coast of Saudi Arabia have to do with the home of the Liberty Bell? More than you might think, at least when it comes to one big question in economics.

Economists have struggled for years to solve the chicken-and-egg problem of politics and growth. Does economic openness lead to political freedoms, or vice versa? Would a government's decline into dictatorship pull an economy down with it, or does it happen the other way around?

The question lay mostly unanswered until Dani Rodrik, a professor of international political economy at Harvard University, brought a wealth of data and some high-quality statistical techniques to bear in the late 1990s. Looking at a broad range of countries, he found that democratic institutions could render economies more stable and resilient, as well as leading to higher incomes.

Perhaps democracies fared better than authoritarian regimes, but what would happen if such a regime decided to become a democracy? Would its economic performance also improve?

Today, the world is receiving answers in two forms. One is the paper Rodrik and Romain Wacziarg of Stanford University are presenting Saturday morning at the American Economic Association's annual meeting in Philadelphia. The other is coming from countries like Bahrain.

Since he succeeded his father as king of Bahrain in 1999, Sheik Hamad bin Isa al-Khalifa and his deputies have steadily moved the country in the direction of an open, democratic system under the rule of a constitutional monarchy. In 2002, the nation held its first parliamentary elections in three decades.

Democratization has already helped to bring Bahrain one economic prize from abroad: a free trade agreement signed with the United States in September. Clearly, if Washington decides to reward democratization with access to the world's biggest export market, then the chicken-and-egg dilemma will be one step closer to solution. Yet the fuel Bahrain's political reforms have added to its own economic engines may be just as important.

In the past, the revenue gained from sales of oil and Bahrain's flourishing Islamic banking industry were often salted away overseas, said Tim Young, director of strategy at BDO Jawab Habib, a consulting firm in Bahrain. "If the cash is going elsewhere," he said, "then there's something fundamentally wrong with your economy." But that is changing. Private investment in Bahrain has more than doubled in inflation-adjusted terms since 1999, far outpacing the overall growth of the economy. Alongside gradual democratization, the government of Bahrain has been improving transparency and the evenhandedness of enforcement in the legal system, particularly where companies are concerned.

"Small-business men are saying, 'There's enough room, there's enough predictability in the market, that if I invest with my brothers, my peers, then I can trust the system and we'll get a return,'" Young said. "That fundamentally, is a measure of political reform. Another good measure, ironically, is family businesses finding exits. If I can sell a business, then again, we've got predictability."

The changes in Bahrain, both political and institutional, are exactly the sort that Rodrik and Wacziarg highlight in their new paper. "What we do is a comprehensive statistical analysis looking at what happens in the short run when countries become more

democratic," Rodrik said. Even in places riven by conflict and deep ethnic divisions, he said, "There's more of a tendency for democratization to be associated with boosts in growth in the short run than declines in growth."

If that short run began in 2002 for Bahrain, it may take a little while longer to pay off. "In two years you cannot evaluate the democratic system and see the impact," said Yousif Abdulla Humood, director of economic planning in Bahrain's Ministry of Finance and National Economy. "This is a long-term process."

Humood said that the country's legal services needed further overhaul, as did its basic infrastructure. More laws to protect intellectual property and open up the insurance industry are in the legislative pipeline, he added. Young said the most crucial changes would come in the labor market, especially insofar as they encouraged Bahrainis to move from the public to the private sector.

"We're trying to liberalize the economy as much as we can to be more attractive for the local and the foreign investors," Humood said. "Now we see more investors coming to the country, but still there is more" to be done, he said

Bahrain also has some way to go along its road to political reform. In September, the government arrested Abdul-Hadi al-Khawajah, the vice president of the Bahrain Center for Human Rights and a critic of the country's economic policies. The arrest, which came just two weeks after the free trade agreement, brought a pointed statement of concern from the U.S. State Department. Two months later, Hamad released Khawajah, along with other activists.

Nonetheless, Bahrain has advanced much further toward democracy than many of its neighbors in the Gulf. And because of its diverse population - a mix of expatriates, migrant workers and locals - Rodrik said Bahrain might profit markedly from the process. "Do you achieve greater stability and coherence in policy making if you exclude a vast majority of your population," he asked, "or if you incorporate them in your decision making so that they become a constructive force?"

As for the old chicken-and-egg problem, the task in Bahrain may be not so much to solve it as to manage its implications.

"There are many things going in parallel," Humood, the economic official, said. "The political reforms, when you want them to be accepted and work well, you need to build the other things as well: economic growth, prosperity and income for the people. If this happens, then yes, they will be supportive of the political reforms. If you fail in the other things, then the reforms will mean nothing."

