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Mobilising Investment for Development
in the MENA Region

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Investment Outlook in MENA region: Summary of facts from the discussions and presentations

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The picture of the investment scene in MENA that emerged from the exploratory meeting in Istanbul can be summed up as follows:

1. The region offers many opportunities to investors, both domestic and international; yet, its policymakers have not given due importance to investment as a driver of economic growth, nor has made serious efforts to create a truly business friendly climate and promote opportunities to those who move investment flows. Poor foreign direct investment (FDI) figures reflect poor integration into the global economy and the consequent marginalisation in terms of global economic activity.

2. Not only FDI levels are very low in many countries of the region, but also private domestic investment is limited. The domestic private sector in MENA countries is generally underdeveloped and is not well connected to the regional and global economy. Private investment in the region as a share of total investment is around 40-45 per cent – even lower than in Africa and particularly low when compared to the 75-80 per cent in Latin America and East Asia. The ratio of private investment to public investment is only two while the same ratio stands at over six for OECD countries and around five for East Asia countries.

3. The region has a very diverse group of countries: rich countries like Qatar and Saudi Arabia, and very poor countries like Yemen and Djibouti. It has countries with a lot of natural resources – primarily oil and gas. And it has countries like Tunisia or Jordan that do not have much in the way of natural resources. So when talking about the MENA region, one should bear in mind that there is substantial intra-regional variation. Some participants debated inconclusively whether there should be a two-track approach in the process treating each sub-region according to its particular circumstances.

4. Often the problem, it was stressed, is not the shortage of capital, particularly in the oil-rich GCC countries. One MENA participant indicated that in the aftermath of 11 September there has

been almost no capital outflow from the region as in the preceding years and that, according to one calculation, the amount of Arab capital available for investment was in the range of $2.3 trillion and most Arab financial institutions were looking for investment opportunities in the MENA region. Therefore, it was indicated several times that the government efforts should aim not only at FDI attraction but also mobilisation of domestic and intra-Arab capital for development.

5. The following key features concerning FDI in MENA region were elaborated by country presentations:

- FDI remains the dominant source of external financing for developing countries. Flows of FDI into the MENA region have not kept face with global FDI trends. Indeed, they have been lower than most other regions. The MENA region is only responsible for 0.9 percent of global flows of FDI and 4 percent of FDI flowing to the developing world. The situation is even worse in the oil-rich GCC, which received just 0.1 per cent or one-tenth of one per cent of global FDI and only 7.88 per cent of the region's total FDI inflows in 2002. This is a feeble performance for 5 percent of the globe's population. In a nutshell, the region has ignored FDI and FDI has ignored the MENA world.

- Most of the limited FDI flows go only to a handful of countries and specific sectors. More than 80 percent of FDI stock is concentrated in five countries – Saudi Arabia (34 percent), Egypt (22), Tunisia (14), Bahrain (7) and Morocco (7). The same five countries also have the highest average annual FDI flows. In terms of sector distribution, the bulk of the region's FDI is directed predominantly to petroleum-related and other natural resource activities. Some other countries such as Bahrain, Egypt, Morocco, Tunisia and Lebanon have witnessed FDI inflows into various sectors such as tourism, banking, telecommunications, manufacturing, and construction. Some of these non-hydrocarbon sector FDI flows were ushered by cross-border M&A, particularly of privatised firms.

- At the country level, the flows and stock of FDI remain a small part of the respective economies, both in terms of the gross fixed capital formation (5 percent on average – Bahrain 74, Kuwait 1.4 of FDI stock)) and the gross domestic product (14 on average – 3.9 UAE, Bahrain and Tunisia above 20).

- Although intra-Arab investment is likely to be understated in international FDI statistics, it comprises a significant proportion of FDI inflows – more than half of the total FDI inflows. In some cases intra-Arab investment is considered domestic investment. Private capital flows from the GCC to other MENA countries are a potentially significant source of future private investment. High net worth citizens of the GCC states have invested roughly $1.2 trillion (about 85 percent of their wealth) abroad, mostly in the United States. Also notable is the considerable amount of outward FDI flows and stock in the Arab world. Kuwait has a much higher outward FDI stock ($1.98bn) than inward FDI stock ($527 mn) as of 2000. Despite their familiarity with economic conditions in MENA and willingness to take a fresh look at investment opportunities at home, these elites have diverted only a trickle of their wealth back into the Arab world because they cannot find ways to invest it productively at home.

6. Business representatives identified the following areas as key in explaining the short supply of FDI in the Middle East and North Africa:

- **Conflict and regional instability**. Growth prospects are contingent on political factors. Many countries in the region have faced internal and external challenges that have

deterred FDI. Lebanon, Algeria, Kuwait and Libya for instance had periods of political instability over the past two decades that have discouraged investors. In the MENA region, the military intervention in Iraq represented the latest in a series of shocks in recent years. If the efforts to revitalise the peace process shift into high gear, it was argued that there would likely be a lot of "peace dividends" in the region including for investment prospects.

- **Unpredictable macroeconomic conditions and public policy choices** – including volatility from trade shocks; non-market driven exchange rate regimes; lagging integration and openness.

- **Weak institutions and high administrative barriers** – including an arbitrary and cumbersome judicial system; high entry costs for firms; delays in customs clearance. Until recently, many countries confined foreign investment to very few sectors; even then, allowable investment was capped at only 49 percent, preventing a majority ownership and requiring a venture with a local partner.

- **Inadequate infrastructure** – including insufficient access to electricity and water; low access to telecommunications; and low overall quality of infrastructure.

- **Underdeveloped financial sector** – including state ownership of banks and a shallow level of financial services and instruments. The Arab world's 12 stock markets are very small, with a total capitalization at the end of 2002 of around $200 bn. The banks do not provide financing to the most credit-worthy recipients they can find – most of their funds are loaned to the state and to elites who have political connections.

- **Inadequate availability of a skilled workforce and local partners** – the quality of public schools is inadequate, and research and development is insufficient.

- Another factor is the relatively **slow pace of privatisation**. FDI inflows for some countries have been closely linked to the pace and breadth of the privatisation process, and as the process has encountered delays and significant opposition in many countries, so too, have inflows of FDI been impeded.

- According to World Economic Forum, "with the exception of Egypt, Oman, Syria, and Tunisia, productivity growth in the Arab world has been negative." **Low productivity** in the Arab world does not stem from lack of natural resources or low domestic investment rates. There is plenty of capital. The problem is that financial markets in the Arab world do not channel capital into its most productive and efficient uses. Restrictions range from public sector monopolies and limitations on foreign majority equity ownership in particular sectors, to corruption and red tape throughout.

7. **Corruption** was repeatedly cited as one of the major impediments to domestic and international investment. It remains one of the Middle East's core problems. In many countries in the region, families and clans simultaneously control large segments of the private and public sectors. Several participants including the Lebanese Transparency Association raised the issue of whether Arab countries are now willing to attack this menace head on or if international organizations should play a leading role in the struggle. Clearly, local intellectuals and political leaders are aware of the issue. The real weakness is in the implementation of internationally recognized standards, including the strict punishment of

offenders. A system of checks and balances, linked to public access to information on the decision-making process, could eliminate the problem at its source.

8. The discussions focused on four specific areas viewed as critical for the creation of an integrated and dynamic economy in the region: (i) the need to remove distortions (subsidies, monopolies, protectionist measures) to increase productivity; (ii) the need to remove investment/trade barriers in order to increase intra-regional investment/trade; (iii) the need to increase R&D and innovation in the region; (iv) the need to develop the region's human capital. A **complex regulatory maze** survives in most countries; a web of regulations creates an environment of detailed interference in economic activity. Investors also care greatly about the reliability of the judiciary.

9. Business representatives outlined three factors that **investors look for** when deciding where to put their money. First, they look for an "enabling environment" that is welcoming, with no cumbersome regulations, well-defined ownership rights, the respect of contractual obligations, the rule of law and international accounting standards. Second, the economy should be dynamic, with sustainable growth, a level playing field, transparency and the free flow of timely and comprehensive information. Third, the country should have adequate infrastructure, including sufficient human resources. Foreign investors also look at whether local investors are investing. "You cannot delink domestic investment and foreign investment," BIAC representative underlined.

10. Another business participant told the audience that MENA countries cannot just do the minimum or use "standard recipes" to attract FDI. Because of the political uncertainty, "the region has to **over-compensate**." He added: "You need to do much more. It's not just economic reform; it's comprehensive reform - political, economic and social." Also important, he argued, is human resource development and regional integration.

11. One of the key challenges for oil-rich countries was how to mobilise investment for **achieving diversification.** The Saudi representative said that his country's foremost priority was to reduce dependence on revenue from hydrocarbons, diversify sources of income and create employment opportunities in other sectors.

12. Some MENA economies were compared with the traditional **"transition"** economies of Eastern Europe and the former Soviet Union as they also try to move from heavily state-dominated and closed economic systems to ones based on private initiative, market forces, and greater integration with the rest of the world. The previous model of public sector largesse financed by rents is no longer workable because the government cannot show the same largesse to a growing population with dwindling resources. Governments account for as much as 40-60% of gross domestic output and of employment in the MENA region. The big role of the state -- a sector that essentially has low productivity and with limited inherent potential for productivity gain – was viewed as a drag on growth in most economies in the region.

13. There was common agreement as the most important challenge facing MENA countries - **rapid population growth**, which stands at over 3 percent a year – the fastest rate of growth in the world. For this region, where almost sixty percent of the people are under the age of twenty-five, demography could be a "gift" (as it was a gift for East Asia) because if these young people find jobs and can produce, it would provide high returns because of low dependency ratios. But if they cannot find jobs, the demographic gift can turn into a "curse".

14. Creating **larger and more integrated markets**, facilitating cross-border, intra-MENA investment and allowing the free movement of businessmen and exchange of ideas carries economic, as well as political benefits. Despite their combined size of 370 million consumers, MENA markets are “small” because they do not constitute a free trade area and the individual economies and real per capita income are not big enough. MENA states have not only been slow to open up markets and create a transparent and liberal investment environment to outside investors, but intra-regional moves to reduce tariffs and create a regional free trade area have also been stalled by what is regarded as lack of political will, over-reliance on the oil and gas sector and protection of large public sector interests. It is of foremost importance for MENA development to strengthen regional co-operation. It was made clear that different regional associations and initiatives should be co-ordinated and where possible integrated.

15. Participants shared common view as to MENA’s **enormous potential**, as aptly characterised by the UN Arab Human Development Report, which needs to be effectively harnessed. After more than 20 years of rapid economic growth, falling oil prices in the mid-1980s and abrupt decline in investment and growth pushed many MENA governments to rethink their basic frameworks for economic management.

16. Beginning in 1985 they shifted at varying rates towards policies designed to achieve macroeconomic stability, a higher degree of integration with the world economy, and an expanded role for the private sector. Most MENA countries have made progress in the past decade. By and large, economic stability has been maintained and structural reforms have been implemented. Several regional integration initiatives have been launched. As a result, economic growth has resumed while poverty and inequality have remained low. But the challenges facing the region demand **greater policy effort** than has been achieved thus far.

17. What kind of economic reforms are needed? What are the prerequisites? How do we accomplish reform? Why have past reforms have failed? A number of initiatives in the trade and investment policy arena have already taken place in the region over the last decade. They include intra-regional bilateral and multilateral integration agreements, the Euro-Med agreements for many countries, and accession to the WTO for others; in addition to many unilateral trade reforms. These agreements and policies are certainly in need of harmonization in order to get the most benefits from them. But more importantly they do not need to be placed at the center of the new development strategies of MENA countries. Participants suggested the problems facing the region require a **massive rather than piecemeal approach** that emphasizes implementation.