CHAPTER 4. MENA'S INVESTMENT LINKS WITH CHINA AND INDIA

MENA countries are attracting more world FDI, fueled by intraregional foreign investment from the oil-rich countries and by investment from other emerging markets, with China and India progressively becoming more significant. And thanks to unprecedented current account surpluses, Gulf countries are investing billions abroad, seeking investments in alternative markets and currencies and looking more toward the East. Two-way investment between MENA and China and India shows the increasing importance of MENA oil-producing countries as international investors and suppliers of capital, including to China and India. China and India are investing more in MENA, particularly in oil-producing countries. But they are contributing very little to job creation or to the transfer and diffusion of technology.

MENA, CHINA, AND INDIA AS RECIPIENTS OF GLOBAL CAPITAL FLOWS

4.1 Capital flows to developing countries[34] reached a record $647 billion in 2006, with equity accounting for almost three-quarters. China alone received more than 20 percent of the total FDI inflows, with inflows of nearly $80 billion, and ranked among the world's top three recipients. India, at only 5 percent, attracted a much smaller share of FDI[35] but this share is increasing fast, thanks to rising investor confidence. Important improvements to the country's business environment allowed it to be considered, together with China, as one of the two most attractive global business locations by transnational companies in UNCTAD's World Investment Prospects Survey 2007–09. Portfolio investment surged in both China and India, reflecting greater confidence from international investors.[36] Four of the 10 largest initial public offerings (IPO) in 2006 were by Chinese companies, increasing China's share of portfolio equity flows to developing countries from 30 percent to 35 percent.

FDI flows to MENA rose considerably but are concentrated in a few countries and sectors

4.2 The MENA region experienced a sharp increase in FDI flows to a record $51.6 billion in 2006, accounting for 4.7 percent of world FDI, up from an average of only 1.8 percent in 2000–04. This astonishing growth in FDI is a reflection of the ample oil-generated foreign currency liquidity, combined with an improved business environment, cross-border mergers and acquisitions and increased outward orientation. Intraregional foreign investments from oil-exporting Gulf countries (notably Saudi Arabia and the United Arab Emirates) in energy, infrastructure, real estate, and tourism dominated but China and India played a progressively more significant role. Private equity firms were also prominent. In GCC countries, private equity rose to $10 billion in 2006, almost twice the amount of the previous year, and it is estimated at around $27 billion for 2007, the bulk in the resource-rich countries and in energy.

[34]The definition "developing countries" or "developing economies" refers to the sum of the six regions of the world that include low- and middle-income countries: Latin America and the Caribbean (LAC), East Europe and Central Asia (ECA), Middle East and North Africa (MENA), Sub-Saharan Africa, East Asia, and Pacific and South Asia. Capital flows represent the sum of private and official flows. Among private flows (debt + equity), the analysis here looks at equity flows—FDI and portfolio equity. Net capital flows are the sum of inflows minus outflows.

[35] UNCTAD has benchmarked India as an "under-performer" for FDI attraction in its *Inward FDI Index*.

[36] In 2006 China received about $43 million of net portfolio flows, up from $6.9 billion in 2000. India received $9.5 billion in 2006, up from $2.3 billion.

4.3 FDI flows to the region are concentrated in few countries: Saudi Arabia, Egypt, UAE, Tunisia, Bahrain, and Morocco. The bulk of the region's FDI is directed to petroleum-related and other natural resource activities. But Bahrain, Egypt, Morocco, Tunisia, and Lebanon have also attracted FDI to tourism, banking, telecommunications, manufacturing, and construction, partly through cross-border mergers and acquisitions. FDI averaged 17 percent of gross fixed investment in 2006 (more than four times the average share for 2000–03) and 3.8 percent of GDP (table 4.1). The trend has continued in 2007.

Table 4.1: Foreign direct investment in MENA

	1996–99	2000–03	2004	2005	2006
Share of gross fixed investment					
MENA (excluding Iraq)	4.3	4.3	4.5	7.2	17.0
GCC countries	3.5	2.7	4.2	4.4	14.7
Maghreb	4.5	6.8	5.2	9.7	12.8
Percentage of GDP					
MENA (excluding Iraq)	1.0	0.9	0.9	1.5	3.8
GCC countries	0.8	0.5	0.8	0.8	3.1
Maghreb	1.1	1.5	1.2	2.1	3.4

a. Estimates revised in May 2008
Source: MENA Economic Development Prospects 2007 and 2008.

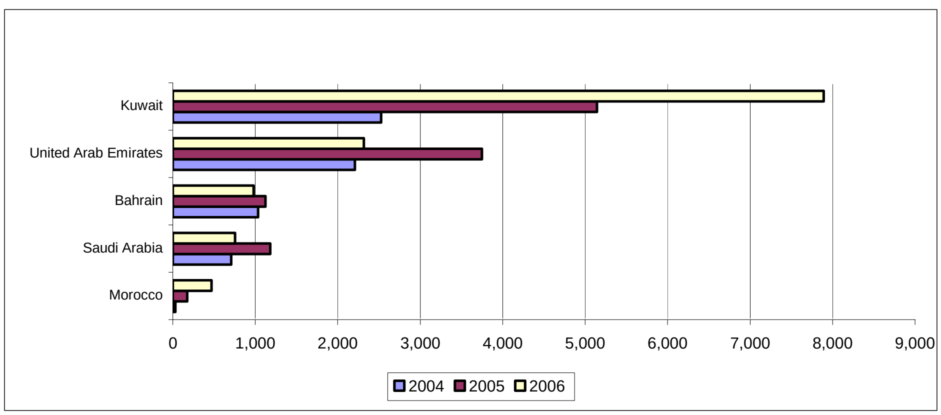
MENA, CHINA, AND INDIA AS INTERNATIONAL INVESTORS

4.4 Developing countries have become net exporters of capital in recent years and their outflows have closely matched the external financing gap of the advanced countries. Capital flows are channeled primarily through central bank reserves and sovereign wealth funds, mainly those of oil exporters in the MENA region. FDI has also been an important channel through which MENA countries invested capital overseas.

Gulf countries are looking toward the East

4.5 MENA's outward FDI made up 8 percent of all FDI outflows from developing countries in 2006 (up from 1 percent in 2000). Investments from resource-rich countries—with unprecedented current account surpluses—represented the major part of the investment from the region.[37] Kuwait and the UAE are the leading international investors (figure 4.1). Flows from other countries, such as Morocco, are also becoming important. If FDI flows are sizable, the stock of foreign assets[38] owned by MENA oil countries is astonishing.[39] Considering that Gulf countries have

Figure 4.1: FDI outflows in MENA: Top five countries (US$ million)



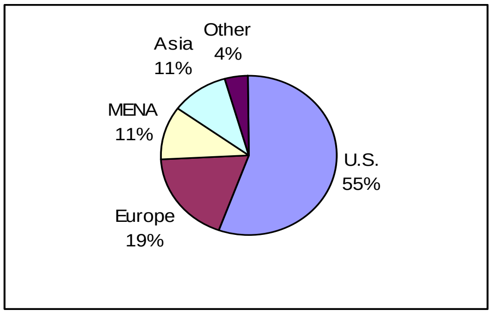
Source: UNCTAD World Investment Report 2007.

[37] Their share in 2006 is more than 90 percent of the total, up from 50 percent in 2000.
[38] Foreign assets (or international investment positions) are defined as "mainly financial claims over non-resident institutional units" by OECD.
[39] Determining the true size of GCC foreign assets is difficult because of the lack of comprehensive official data. Only four of the GCC countries publish incomplete information with the IMF's International Financial Statistics. A 2007 study by the Institute of International Finance (IIF) —based on IMF Balance of Payment data and several other sources —conservatively estimates the accumulated foreign assets of the GCC states at the end of 2006 at $1.6 trillion, or 225 percent of GDP, slightly more than China

invested an estimated 80 percent of their foreign assets offshore in 2006, it is not surprising that they are becoming an important source of capital for the rest of the world. Capital outflows from GCC countries were in fact estimated at $540 billion for 2002–06. The same estimates suggest that the influence of capital flows from GCC countries, as other oil exporters, will continue to be substantial, if current projections of high oil prices are maintained.[40]

4.6 The United States is still the main destination of GCC capital, followed by the EU (figure 4.2).[41] But Asia is becoming a more important destination: in the past five years GCC countries have invested 11 percent of total capital outflows in Asia. This has been driven in part by an extended period of low interest rates and low yields on US and European assets. That has made emerging market assets more attractive for investors globally and led Gulf investors to invest more heavily in domestic equities—as stock markets in the region have risen strongly—and to look more closely at Asia as an investment destination.

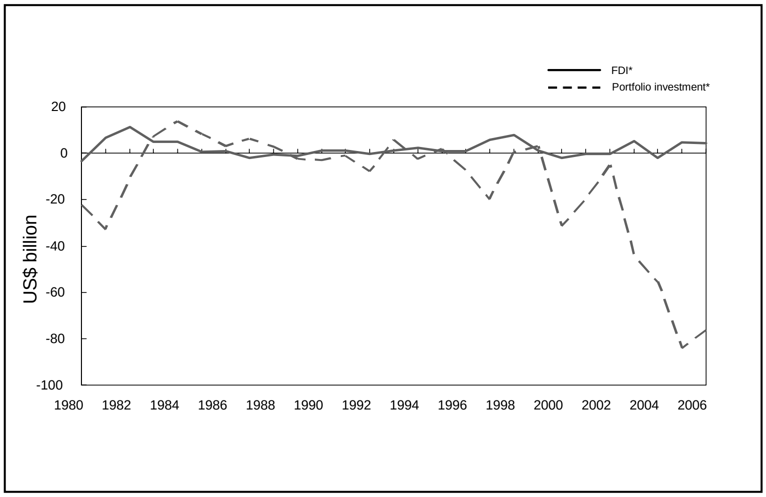
Figure 4.2: GCC estimated geographical distribution of capital outflows, 2002–06



Source: Institute for International Finance 2007, McKinsey 2007.

4.7 GCC countries have traditionally preferred portfolio investments to FDI, a reflection of the lack of manufacturing and industrial activity and expertise. This tendency has increased in recent years (figure 4.3). GCC countries have become increasingly more sophisticated in managing their reserves and in establishing large-scale sovereign wealth funds.

Figure 4.3: GCC net flows of portfolio greatly exceed net direct investment



*Negative numbers indicate a net outflow
Sources: Economist Intelligence Unit, staff calculations.

4.8 Net portfolio outflows are estimated[42] to be around $80 billion in 2006 (from almost zero during the early 1990s). Private and institutional Gulf investors are making "strategic" investment in Asia by holding a diversified portfolio of assets, emphasizing equity and equity-like investments. Nonoil-producing countries, by contrast, appear to invest more in FDI to complement their trade interests with the Asian countries. FDI remains a smaller share of GCC capital outflows in oil and oil-related sectors, infrastructures, tourism, and real estate.

($1.1 trillion) and Russia ($355 billion) combined. Corresponding estimates from the McKinsey Global Institute are around $1.6-$2.0 trillion. In addition, the rest of the resource-rich countries (with exclusion of Iraq) hold about $330 billion in foreign assets.

40 The McKinsey Global Institute published the results of its research on global energy demand. For the base case scenario of oil at $50 a barrel in 2006–12, the estimated total capital outflows from oil-exporting countries would reach $387 billion a year through 2012. The high case scenario of $70 a barrel suggests capital outflows as high as $628 billion a year through 2012. But even in the low case scenario of only $30 a barrel, the oil-exporting countries will have as much as $147 billion to invest each year to 2012. In all these alternative scenarios, the resulting amount of capital estimated to belong to GCC is considered to be an extraordinary infusion of capital into global financial markets, at a rate (for the base case) of more than $1 billion a day.

41 As estimated by IIF 2007.

42 The Economist 2007b.

Diversification appears to be a key driver of the GCC's recent behavior in capital markets

4.9 In the early 2000s GCC countries started to diversify away from US assets, partly because of political events in and after 2001, and partly because of financial considerations. While flows to the US have returned massively, the GCC are investing proportionally less in treasury bills, the safest type of investment available, and moving toward other types of government (or corporate) securities (table 4.2). This is a sign of a different strategy in managing oil surpluses with respect to past oil booms and a signal of their search for higher (expected) returns on investment. Further, they are seeking alternative markets and currencies. A report from the Economist Intelligence Unit that analyzes the rise of Gulf investment in Asia, argues how this aggressive and diversified strategy of Gulf investors coincided with the rise of China and India and their increasing integration into the global economy.

China and India are also diversifying their investment abroad

4.10 China and India hold huge foreign reserves, representing 70–80 percent of their total foreign assets holdings. China is by far the largest holder of foreign reserve assets in Asia,[43] and India's central bank is among the 10 largest foreign reserve holders in the world. As argued by Lane and Schmukler (2007), this rapid pace of reserve accumulation, well beyond a precautionary level, is costly.[44] China has started to invest some excess reserves into a more diversified portfolio of international financial assets and is slowly liberalizing its capital account regulations. As with GCC countries, China, India, and Asian central banks are diversifying their investments from mostly U.S. treasury bills into other U.S. government securities—a sign that investors are searching for higher yields. More important, China's government is starting to shift a part of its reserve assets to sovereign wealth funds, similar to those in oil-exporting nations. An example of China's new investment approach is the creation in 2007 of China Investment Corporation (CIC), with $200 billion of assets under management and a target of investing in more than 50 large enterprises around the world.[45] As all sovereign wealth funds, CIC can take more risk in the search for higher returns.

Table 4.2: Capital outflows from MENA oil-exporting countries, 2000-06 (US$ million)

	2000	2001	2002	2003	2004	2005	2006
US long-term securities	***14,713***	***4,991***	***-2,926***	***-2,752***	***20,228***	***6,684***	***24,225***
US treasury bills	3,482	865	-3,880	-6,645	*9,041*	2,063	4,548
US government bonds	477	1,151	1,959	1,472	4,353	1,810	7,037
US corporate bonds	1,565	1,186	304	1,809	349	1,022	4,666
Outward FDI							
United States[a]			1,138	393	713	1,508	10,271
Europe	152		833	133	-7,780	-213	
China	41		50	76	107	109	
India	5		20	24	57	50	184

Source: Bureau of Economic Analysis, China Ministry of Commerce, Mofcom and India Ministry of Industry and Trade (millions of dollars.)
Note: Net purchases (+) of U.S. long-term securities by MENA oil-exporting countries.
a. From Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and UAE. Data on FDI include Israel.

4.11 Despite its success in attracting FDI since the early 1990s, China has only recently emerged as an international investor,[46] starting to encourage its national firms to "go global" only in 2002. By the end of 2006, more than 5,000 domestic Chinese investment entities had established nearly 10,000 overseas

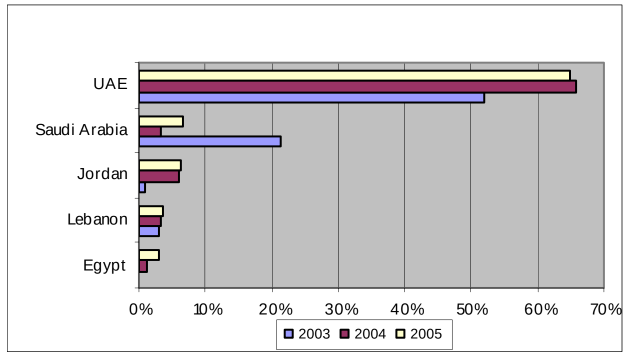
[43] China's central bank alone had $1.1 trillion in reserves at the end of 2006, equivalent to 80 percent of the assets of all 7,000 hedge funds around the world (McKinsey Global Institute (2007).
[44] For a discussion on the costs of reserve accumulations please refer to Lane and Schmukler (2007).
[45] CIC officially began operating in September 2007.
[46] Starting from nearly zero in the early 1980s, Chinese outward FDI exceeded $6 billion in 2006.

directed invested enterprises in most countries around the world.[47] India has been investing abroad since the 1970s. Until the 1990s outward investments by Indian companies were driven by India's political will to improve "south-south" cooperation and by the need to promote Indian exports in the form of Indian-made machinery, raw materials, know-how, and consultancy. In the 1990s a more favorable, private-sector-oriented approach emerged, and outward FDI started to be much more linked to the export success of Indian multinationals.

MENA AS INVESTOR IN CHINA AND INDIA

4.12 In 2005, China received 0.2 percent of its FDI inflows from MENA, India around 1.5 percent.[48] But these flows have been growing since 1999, particularly those from GCC countries, a sign of growing interest of the MENA oil-exporting countries in Asia. The top five MENA investors in China are the UAE, Saudi Arabia, Jordan, Lebanon, and Egypt (figure 4.4). The UAE accounts for more than 60 percent of the registered nonfinancial flows to China. Jordan, Egypt, Lebanon, and Morocco have steadily increased their financial investment over the last 10 years, even though the amounts are very small.

Figure 4.4: Top five MENA investors in China (percentage of MENA FDI flows to China)



Source: Ministry of Commerce of the People's Republic of China.

What determines MENA's investment in China?

4.13 To identify the determinants of MENA's FDI outflows to China, we estimated a country fixed effect model.[49] The dominant factors explaining FDI positions over time are bilateral investment agreements (when in force), trade openness, bilateral trade, and income growth (table 4.3). China's characteristics also account for part of the variation of MENA FDI outflows. Trade openness and market

[47] The accumulated outward FDI stock volume stood at $91 billion, with non-finance FDI accounting for 83 percent of it. See Chinese Statistical Bulletin 2007.

[48] India Department of Industrial Policy and Promotion, 2007.

[49] The adopted equation is: $\log(Fdi)_{it} = \beta_1 X_{it} + \beta_2 Z_t + \alpha_i + \varepsilon_{it}$ where index *i* indicates the origin country (all MENA countries except Israel and Malta) and *t* the year in the interval going from l996 to 2005. The matrix X_{it} includes explanatory variables. Source country characteristics include the log of GDP to control for country size, log of GDP per capita to control for income level, an index capturing the degree of capital control restrictions which goes from 0 to 13 (very restricted country), the share of imports and exports over GDP to control for trade openness, the log of market capitalization to control for the size of domestic financial sector, and an institutional quality index. As bilateral factors we include a dummy variable equal to one if a bilateral investment agreement has been either signed or entered in force with China and the log of energy (gas + oil) exports from a specific MENA country to China to see whether there is a correlation between bilateral FDI and bilateral trade. But when we include this variable, the underlying sample represents prevalently resource rich countries and the sample size drops considerably. Regressions not reported here show that bilateral energy trade is significant with a negative sign: it does not drive bilateral investment, but it is an important factor in the sense that the bigger energy exporters are not the ones investing more in China. This result is consistent with the negative sign on GDP per capita suggesting that among MENA countries the resource poor (which have also lower GDP per capita) are those investing more in China. The matrix Z_t contains the host country characteristics that could make China attractive as a destination country like the size of domestic financial market (market capitalization), the degree of trade openness, the GDP growth, and the index of capital control restrictions to measure how much policy factors on international finance affect bilateral FDI flows. The country fixed effects α_i account for all unobservable country-specific factors that don't vary over time interval considered (like culture, religion, physical proximity, and common legal origin).

potential are positive and significant variables. China's restrictions on capital have little (or no) importance in deterring investment. This is consistent with the hypothesis that FDI to China is motivated not by the need for capital injection,[50] but by the desire to participate in international networks.

4.14 MENA investors are driven to China mostly by the attractiveness of a large market and the low cost of production, as well as availability of labor and infrastructure. Bilateral investment agreements have the expected positive sign and are significant: they signal the attractiveness of the local market. It also appears that MENA's nonoil-producing countries invest proportionally more than oil-exporting countries.[51] Market capitalization has a positive sign indicating that countries with large domestic financial markets have a larger need to diversify assets holdings overseas.

Table 4.3: FDI outflows to China—estimation results

	(1)	(2)	(3)	(4)	(5)
Bilateral investment agreement with China (=1 if it is in force)	2.16 *(1.74)*	1.91** *(2.32)*	2.66* *(2.29)*	1.98 *(1.85)*	0.38 *(0.46)*
Log of GDP, US$ in current prices	–4.77*** *(–4.66)*	–3.04* *(–2.09)*	–5.25*** *(–4.78)*	–3.74** *(–2.71)*	–1.46 *(–0.98)*
Log of GDP per capita, US$ in current prices	–2.94 *(–0.70)*	–10.16* *(–2.26)*	–2.39 *(–0.81)*	–8.76 *(–1.19)*	–10.74* *(–2.15)*
Log market capitalization	1.56*** *(3.97)*	0.44 *(1.41)*	1.88*** *(4.68)*	0.91* *(2.01)*	
Total exports + total imports / GDP					4.77** *(2.89)*
Restrictions index	0.10 *(0.30)*	0.12 *(0.40)*	0.12 *(0.39)*	0.12 *(0.43)*	–0.16 *(–0.53)*
Log market capitalization of China	2.33* *(1.94)*				
China total exports + total imports to GDP		16.24** *(2.67)*			12.35* *(2.10)*
Restrictions index of China			2.13** *(3.06)*		
China GDP per capita at constant prices				8.40* *(1.55)*	
R2	0.52	0.52	0.55	0.51	0.51
Adjusted R2	0.38	0.37	0.41	0.36	0.35

Note: Figures in parentheses are t-statistics. Regressions include a constant term.
Significance of *** 0.01; ** 0.05; * 0.1.
Source: Staff calculations.

4.15 We do not have sectoral disaggregations of data on FDI, only anecdotal evidence, so it is very difficult to link our findings to specific sectors or to the type of global production network. Survey data on greenfield FDI from MENA countries to China and India during 2003–07, indicate that participating in industrial clusters and domestic market growth potential were the main motives behind their investment (table 4.4). The reliance on industry clusters leads to the hypothesis that FDI between MENA and China mostly complements trade patterns and that the investment is mostly in export-oriented sectors.

Table 4.4: Why MENA countries invest in China and India (percent)

Industry cluster/critical mass	33
Domestic market growth potential	28
Lower costs	11
Presence of supplies or joint venture partners	11
Proximity to markets or customers	11
Technology or innovation	6

Source: Staff calculations based on OCO Monitor data.

[50] China has a high saving rate of almost 40 percent of GDP.
[51] The coefficient for GDP per capita is instead positive when we run the same regression to explain investment in a developed market, such as the United States. The size of the host country's financial market is also important in this case. This confirms the idea that the GCC countries are investing more strategically in the US, also when the investment is direct (FDI).

Where are MENA countries investing?

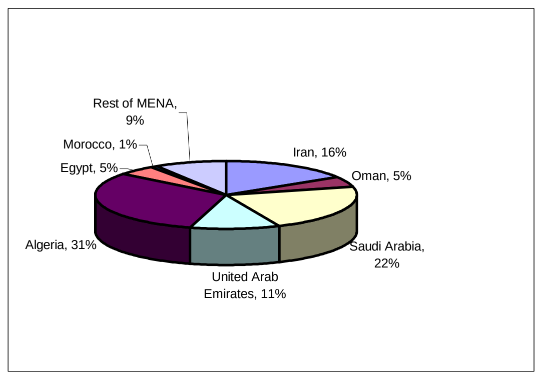
4.16 GCC countries are investing heavily in petrochemicals in China. Although China is the second largest producer of basic petrochemicals outside the US, Western Europe, and Japan, its rapid economic growth has outpaced its ability to produce enough basic petrochemicals. This is a big opportunity for foreign investors, and GCC countries are heavily engaged. The Chinese government allows foreign companies to be majority owners of most types of petrochemical companies,[52] an attractive feature for foreign investors. Added to this is the opportunity to deal directly with the two vertically integrated public enterprises created by the restructuring of the petrochemical industry in 1998: Sinopec and CNPC. The two companies are authorized to operate with foreign companies seeking partnerships with Chinese enterprises, allowing for fewer bureaucratic hurdles. China's desire to upgrade its chemical industry to world standards requires large capital investment, and this matches the profile of GCC investors. MENA's interests in India's downstream industry have also multiplied in recent years.[53]

4.17 GCC investors have also targeted strategic activities, particularly in services, banks, ICTs, and real estate.[54] In China the Kuwait Investment Authority applied in 2007 for the IPO of China's biggest mainland bank, the Industrial and Commercial Bank of China. GCC countries are using a diversified range of instruments to invest in China, including preferential credit. Saudi Arabia is one of the 18 foreign governments that provide concessional loans to China through Exim Bank China in key sectors. It is also stepping up efforts to forge closer business and cultural exchanges with both China and India. And it has had discussions to share technology through academic institutions in India (Indian Institute of Technology) and forge a longer term commitment between the two countries.

CHINA AND INDIA AS INVESTORS IN MENA

4.18 MENA attracts 2 percent of Chinese outward FDI, mostly to the oil-rich countries (figure 4.5).[55] MENA has attracted about 5 percent of Indian cumulative FDI flows since 2000 (figures 4.6 and 4.7). The energy sector is the main recipient, and oil-rich countries are the main destinations. Before 2000 developing countries were the main hosts of Indian FDI outflows, accounting for almost three-quarters of the cumulative flows from 1995 to 2000. Since then the percentage has decreased to less than 50 percent, reflecting a change in the investment strategies and

Figure 4.5: Cumulative FDI flows from China to MENA countries, 2003–06



Source: China Statistical Bulletin 2007.

[52] The exception is ethylene complexes, of which foreign investors can own no more than 50 percent.

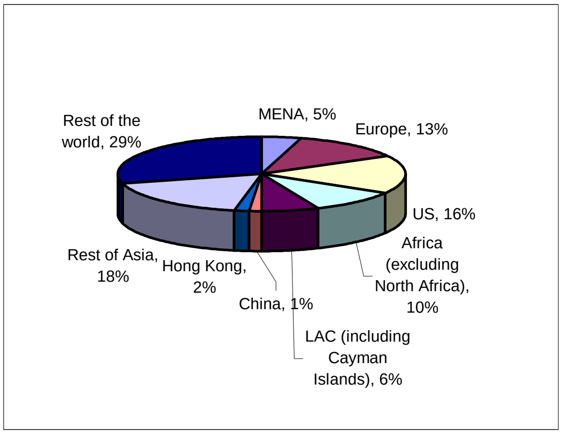
[53] Examples of MENA's recent investment in petrochemicals in China and India and in the oil downstream industry include: a) In July 2005, a new, $3.6 billion 160,000 barrels a day refinery and petrochemical plant complex was inaugurated in Fujian, China. The facility is a joint venture between Sinopec (50 percent), ExxonMobil (25 percent), and Saudi Aramco (25 percent). In 2007 China agreed to allow Aramco to open and manage 600 gas stations in Fujian; b) In 2007 Aramco was negotiating the construction of secondary refinery in Qingdao. The Qingdao plant is expected to handle high-sulphur ("sour") crude oil, given the dearth of such capacity worldwide; c) China has signed several deals for concessions to explore for and produce natural gas with Kuwait Petroleum Corporation; d) Gulf Finance House of Bahrain will be investing $650 million in completing the 2008 Energy City project in China. Examples of MENA's interests in India's downstream energy sector are as follows: a) State owned Indian Oil Corporation and Saudi Aramco are to build a new 6 million ton a year oil refinery in Punjab, India, as part of a venture that would eventually cost $2 billion. They have agreed to invest $125 million each as equity; b) Indian Oil Corporation and Aramco are partnering in a refining project in Orissa, with a building cost of $5.6 billion, to be online in 2011.60; c) In 2007 Gulf Finance House launched the Energy City project in India with an equity placement of $635 million. See Lee and Shalmon 2007.

[54] Global Investment House concluded in two investments in real estate in December 2007 in China and India, to develop both residential and retail space. In China it entered a joint venture with a Chinese real estate development and construction company.

[55] Chinese outward netflows FDI reached almost $18 billion in 2006, up 44 percent from the previous year. But more than four-fifths of these flows go through third countries, such as Hong Kong and Cayman Islands, complicating the interpretation of destinations.

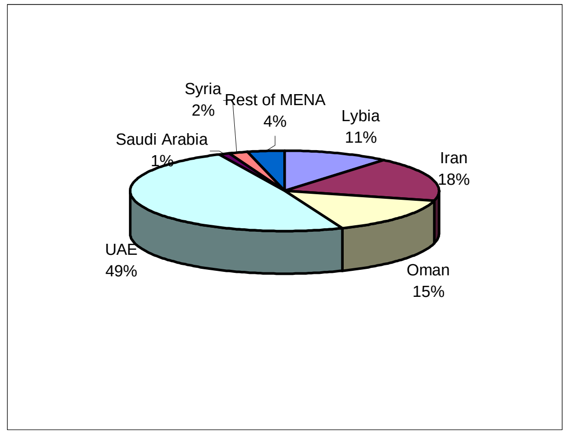
competitive advantages of firms, which became more oriented toward developed markets to gain access to new skills, technologies, and marketing capabilities.

Figure 4.6: Cumulative FDI flows from India by world regions, 2000–06



Source: Investment Division, Department of Economic Affairs, Ministry of Finance, India.

Figure 4.7: Cumulative FDI flows from India by destination country in MENA, 2000–06



Source: Investment Division, Department of Economic Affairs, Ministry of Finance, India.

China and India investment strategy in MENA: energy and downstream industry

4.19 Globally, China's interest in investing in the oil sector goes back to the early 1990s. The first outward FDI for China in the oil sector took place in 1992 when China National Petroleum Company took part in developing the North Twing Oilfield in Canada. These first investments were small low-risk projects such as rehabilitation of oil fields, field-development and provision of services. With time, China's investment has expanded to cover exploration as well as refining and building of infrastructure. In 1998, the Chinese government reorganized the three state owned oil companies—CNPC, Sinopec and CNOOC—into vertically integrated firms. Before the reorganization CNPC and Sinopec had been focusing on exploration and refining and distribution respectively. The purpose of the reorganization was to make the structure of China's main oil companies vertically integrated, and more competitive. Since then, the China's global search for oil has widened and now includes investments in more than 25 countries around the world. By 2004 the three Chinese oil companies had concluded 61 projects, and 41 of these projects were made by CNPC that has by far been the largest investor.

4.20 India's Government is pursuing a strategy of bilateral engagements with energy producing countries to benefit from each others strengths in areas of technology transfers, R&D, safety and training, as well as multilateral engagements such as the Asian Round Tables, International Energy Forum etc. Recently India has signed a memorandum of understanding with China for joint bidding of hydrocarbon blocks. The third India-GCC Business Conference in 2007 saw the adoption of the Mumbai Declaration to enhance economic engagement between the two sides in a number of areas, including energy (oil, gas, and power).

4.21 While increasing, FDI from China and India remain limited because most countries in MENA restrict foreign ownership. The petroleum sector in oil-exporting countries is dominated by national oil companies, and foreign investments in oil exploration and production are restricted. State-owned enterprises play a key role in setting the sector's objectives and priorities, the energy pricing policies, and the share of production allocated to domestic energy markets. The region's 11 national oil companies rank among the 35 largest oil and gas companies, with Saudi Arabia's Aramco and Iran's National Iran Oil Company ranking first and third. The openness of MENA countries to FDI has differed among MENA countries with equity investment the least popular (table 4.5).

Table 4.5: Restrictions on energy investment in MENA

Algeria	The 2005 hydrocarbons law allows foreign operators to act independently of Sonatrach. However, Sonatrach will have majority participation options on each newly discovered project.
Kuwait	Oil discovery or oil and gas production and upstream petroleum sector: only on buy-back contract arrangements, which do not involve production sharing, concessions.
Qatar	Commercial agencies and trading in real estate, public transportation, steel, cement, and fuel distribution. According to Law No.13/2000, foreign firms are allowed 100 percent ownership in agriculture, industry, health, education, and tourism sectors, as well as projects involved in the development and exploitation of natural resources or energy or mining, pending approval from the government.
Iran	The Iranian constitution prohibits production sharing agreements or outright concessions: only buy-back contracts.
Saudi Arabia	Exploration, drilling and production of oil, production of military equipment and uniform, production of explosives for civil purposes certain printing and publishing activities certain telecommunication services, land and air transportation, real estate investment, services involving fishing, distribution services including wholesale and retail trade and commercial agencies.
UAE	Foreign investors may not own more than 49 percent.

Source: US Commercial Guide 2006, IMF report 2007.

4.22 Given the limited possibility to buy equity in the MENA energy sector, Asian companies have focused on the downstream industry and on gas. On their side, both China and India are opening to investment from GCC countries in the downstream sector and in petrochemicals, seeking to benefit from their capital and experience. China and India represent important investment partners for GCC countries in the downstream sector, given their many competitive advantages: strategic location for crude supply and export, excellent infrastructure, experienced and competitive construction companies, and good fiscal regimes. Investment cooperation between China and MENA countries in the energy sector has increased significantly in recent years.[56]

CHINA AND INDIA INVESTMENTS OUTSIDE ENERGY

4.23 FDI from China and India in non-energy sectors is rising, particularly in Egypt, Morocco, and Algeria. However, most of the investment is directed toward the non-tradable sectors and very little toward export-oriented manufacturing. These sectoral trends in FDI have been considered a further example of the region being subject to the Dutch disease effect, which explains investment flows to non-tradable sectors with the low and declining competitiveness of the manufacturing sectors.[57] For India the major areas of operations include software services, engineering services, tourism, readymade garments, chemical products, agriculture, and allied activities.[58] China has targeted services (construction, tourism, and telecommunications).[59] Algeria's largest construction sites are virtually run by Chinese firms. In Tunisia Chinese firms are involved in the fertilizer industry, in Morocco in the fishing industry, and in

[56] Anecdotal evidence is as follows: In December 2007 China's Sinopec signed a deal to buy oil and gas from Iran and to develop Iran's Yadavaran oil field. (i) Sinopec has committed to buy 250 million tons of liquefied natural gas from Iran over 30 years. (ii) In 2004 the Government of Oman and Sinopec signed an oil-concession agreement that provides for oil and gas exploration and production in 2 blocks in the south of the country. Provisions of the agreement commit Sinopec to carry out geological and geophysical assessments. In addition to the investment in the oil sector, the company plans to expand cooperation to include petrochemicals, training, and exchange of expertise. (iii) In 2004 officials from Yemen and China established a number of energy agreements calling for mutual exploration of Yemeni oilfields by CNPC and the Yemeni National Oil Company, as well as increased cooperation for technological exchange between the two companies. (iv) In 2004 a joint oil venture, the Sino-Syrian Kawkab Oil Company, was founded to develop an old oil field in Northeast Syria. (v) In 2004 Aramco granted Sinopec a $300 million concession to explore and produce natural gas in Saudi Arabia.

[57] For more details please refer to World Bank 2008b

[58] A 2007 report by the Euro-Mediterranean Network of Investment Promotion Agencies (ANIMA) shows that in 2006 India invested more than $730 million in 17 projects in the MEDA region, mostly in chemicals and software, but also in banking and consulting services. China and India ranked as 15 and 19 in countries investing in MEDA in aggregate FDI flows in 2006, and they are among the top three investors, with Russia, in chemicals. MEDA countries include Algeria, Egypt, Israel, Jordan, Lebanon, Malta, Morocco, Palestinian Authority, Syria, and Tunisia (De Saint-Laurent and Henry 2007).

[59] De Saint-Laurent and Henry (2007) show 20 new projects (from more than $1 billion) initiated in 2006 by China in MEDA region countries, mostly in banking, cement, machinery, and telecommunications.[59]

Algeria and Egypt in telecommunications. In Iran more than 100 Chinese companies are engaged in infrastructure (building telephone networks, roads, subways, dams, and port facilities) and the auto industry (it is in Iran that the Chinese automaker Chery opened its first car factory abroad). Box 4.1 describes recent investment activities of China and India in Morocco, Algeria, and Egypt.

Box 4.1: China and India FDI in Morocco, Algeria, and Egypt

Morocco. Morocco is one of the countries that has actively promoted FDI from China and India. Agreements of "investment encouragement and reciprocal protection" were signed by Morocco with China and India in 1995 and 1999, respectively. Double Taxation Treaties were concluded with China in 2002 and India in 1998. Agreements between the General Confederation of Moroccan Enterprises (CGEM) and the Indian Confederation of Industries were signed in 2000 and with the China Council for the Promotion of International Trade in January 2001. Investment projects from China and India during 2000–07 ranged between $2.5 million and $32.3 million. Official data suggest that in 2006 at least 30 Chinese firms (wholly owned or with an ownership participation of at least 50 percent) were operating in Morocco. About 90 percent of them were in the maritime fishing industry. India has traditionally enjoyed a presence in the strategic sector of phosphates and in the textile sector (18 Indian textile firms are currently operating in Morocco). However, in recent years it has also started to invest in the IT sector and in transport. In 2006 Tata Consultancy Services (TCS) has made the biggest investment ever made in Morocco in the off-shoring industry. The Government of Morocco has an active industrial policy that has targeted sectors with high value added and intends to promote Morocco as a platform of offshoring for the francophone and hispanic markets. TCS committed to create 500 new jobs in the coming three years and to assure the professional training of workers. Interviews to firms and operators point to the following motivations of investment, per sector:

- *Phosphates and derivatives*: Morocco is a world leader in phosphates and phosphoric acid, and has significant industrial know-how. India has traditionally been the largest client. In 2002 the Moroccan phosphate group OCP in partnership with the Indian company Zuari acquired majority stakes in an Indian company to facilitate its expansion in the Indian market.
- *IT-offshoring*: Excellent incentive framework for FDI for offshoring (tax incentive, installation of parks dedicated to this activity, financial support with training program professional); availability of professional qualifications and geographical proximity with Europe.
- *Maritime fishing*: Large fishing resources and good partnerships with foreign investors.
- *Iron and steel industry*: High performing local firms and market potential.
- *Transport materials*: Good geographic and strategic position.

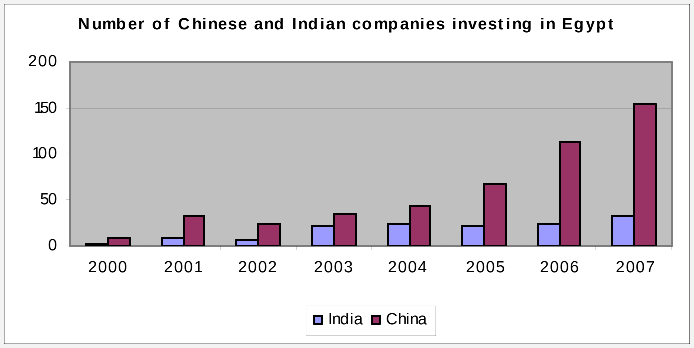
Chinese and Indian investors also face a number of constraints. Restrictions on visas constitute a major obstacle to Chinese investors and production costs are relatively high (for example, a number of Chinese entrepreneurs are reconsidering plans to invest in the "zone franche" of Tangier because the cost of production is considered too high).

Algeria. In 2002 Algeria signed an agreement with China for reciprocal encouragement and protection of investments. No similar agreement was signed with India. Algeria grants "national treatment" to all foreign investors including temporary tax exemption and access to the industrial land. The minimum threshold for consideration is 500 million Algerian Dinar ($5 million). The National Council of Investment has the authority to negotiate the nature and level of the advantages with foreign investors. For example, in the early 2000s Algeria granted substantial advantages (over a period of 10 years) to the Indian multinational firm ISPAT (steel business) to establish operations in two locations (Annaba and Tébessa). ISPAT committed to invest at least $140 million in Annaba and $30 million in Tébessa over a period of 10 years. The advantages received included: application of 5 percent customs duties only; exemption from payment of value added tax; exemption of corporate income tax and of tax on professional activity in proportion to the turnover carried out with export; consolidation to 2002 level of the nominal tariff applied to imported products that compete with ISPAT products. Data from the National Agency for Investment and Development, confirmed by the General Directorate for Investment in the Ministry of Industry and Investment Promotion, indicates the following projects from China and India during 2000–07:

- *China*: Industry (12 projects for $228 million), Public works (7 projects for $26 million), Services (2 projects for $133 million).
- *India*: Industry (4 projects for $254 million), Public works (1 project for $127 million).

Interviews to firms and operators suggest that this low amount of investment is due to the relatively low purchasing power of the population and severe constraints in the business climate, including slow bureaucratic procedures.

Egypt. Egypt is attracting more investment from India and China, with Chinese private enterprises leading the way. Most of the investment is in the industrial sector, closely linked to the trade patterns between the countries (the government of Egypt considers China the most important trading partner; only few years ago China was 50th in the ranking of trading partners). But investment in services is on the rise with great potential. Egypt has made remarkable progress in reducing red tape and facilitating entrepreneurship. The World Bank's *Doing Business 2008* study placed Egypt as the top global reformer. Moreover, with the largest talent base in MENA, it is home to an increasing number of outsourcing centers operated by multinationals.



Source: The General Authority for Free Zones and Investment.

Egypt is now one of the main destinations for Chinese greenfield FDI. In 2006 Egypt and China secured contracts for joint ventures worth $2.7 billion.[60] The two governments also signed 11 trade and business cooperation agreements, ranging from manufacturing to communications equipment to cooperation in hydrocarbons, followed by a broader initiative to simplify procedures between the two countries, a memorandum of understanding to build Egypt's first marble waste recycling plant using technology from China, and technological service centers targeting Egypt's building materials and textile industries.

Source: Oxford Business Group.

Analyzing greenfield investments

4.24 Data on greenfield investments from China and India in the MENA region between 2003 and 2007[61] reveal that the main activities of Chinese affiliates in MENA are in the manufacturing sector (table 4.6). Chinese exports to MENA are mostly in manufactures and machinery and transport products, and investment decisions are likely to complement the trade structure. By contrast, Indian FDI are in offshoring activities, such as business services, which represent 24 percent of the total, followed by manufacturing of products and sales, marketing, and support to customers. Indian firms have also been investing more in sophisticated sectors, such as banking and finance and software and IT services, which has been the main Indian industry investing successfully abroad, mostly motivated by exploitation of firm-specific advantages through an offshore-onshore model of service delivery.

Table 4.6: Main activities of foreign subsidiaries in MENA (percent)

Main activities	India	China
Business services and technical support	24	4
Manufacturing	23	46
Retail	11	
Sales, marketing, and support	17	14
Extraction	3	21
Research and development	4	4
Logistic	1	7
Construction	4	
Others		4

Source: Staff calculations based on OCO Monitor data.

[60] In June 2007, Tianjin Industry Design and Research Institute secured a cement production line contract worth $370 million (De Saint-Laurent and Henry 2007).

[61] Given the lack of official databases on FDI (by country and sector) we use a unique dataset produced by a private company, OCO Monitor, which reports data on greenfield investment projects or expansions of existing projects by China and India in MENA. The data refer to 239 projects between 2003 and 2007 and provide detailed information on the sectors of the investment, the activities of the subsidiaries, the amount invested and the number of jobs created (where the information is available). A survey on the motives for the investment is also available.

Main drivers of China and India investment in MENA

4.25 The main motive for investment appears to be access to domestic markets, explaining why most FDI goes to resource-rich countries with higher GDP, proxies for a bigger domestic market (table 4.7). A second motive is proximity to markets and customers, which has two interpretations. First, Chinese and Indian firms aspire to serve customers in the region, in particular in the service sector where proximity to the final customer is very important. Second, China and India are looking strategically to export goods and services to third markets, using MENA countries as platform to reach these markets thanks to their geographical and cultural proximity. The EU and African markets are both accessible from MENA. Cost minimization is not a major motivation for Chinese and Indian multinational firms in MENA. This is consistent with China and India being already a low-cost production base.

Table 4.7: Motives for Chinese and Indian FDI

Motive	**Percent**
Domestic market growth potential	27
Proximity to markets or customers	25
Finance incentives or taxes or funding	8
Infrastructure and logistics	8
Lower costs	6
Attractiveness and quality of life	6
ICT infrastructure	4
IPA or government support	4
Regulations or business climate	4
Skilled workforce availability	2
Natural resources	2
Industry cluster and critical mass	2

Source: OCO Monitor data.

China and India spillover effects of investment in the region

4.26 There is little evidence of job creation or technology and knowledge transfers to local affiliates so far. It appears that FDI to MENA is not creating jobs, since fewer than 45,000 jobs were created in the whole region during the four years of observations in the dataset. Added to the analysis of the main activities of the subsidiaries in MENA, this shows the absence of potential backward linkages or technology diffusion through research in the region (R&D accounts for only 4 percent of the total activities), probably due to the lack of local skills and capabilities. Indeed, the availability of skills explains only 2 percent of the investment. This is also shown in the migration rates within the region, and the GCC countries in particular. Of the migrants to GCC countries in the early 2000s, 60 percent came from Asia, most of them from India (36 percent). China did not have the same importance as a supplier of labor to the region, but this could be due to the lack of up-to-date data and the differences in business models between China and India.[62] The picture might be different in more recent years, as anecdotal evidence shows a rising share of Chinese workers in the GCC labor market (particularly in construction). "Labor service cooperation" between China and GCC countries is also on the rise (table 4.8).[63]

Table 4.8: Labor service cooperation with China (percentage increase over previous year)

	2003	2005
Bahrain	43	40
Kuwait	55	141
Oman	147	28
Saudi Arabia	18	4

Source: Staff calculations based on data from the Ministry of Commerce of the People's Republic of China.

Main constraints to positive spillover effects in the region

4.27 Empirical evidence shows that FDI can have positive effects on productivity and growth in host countries. The beneficial spillover effects are due to several interrelated factors, including improvements in productivity, technology transfers, and promotion of exports. However, the impact of FDI is larger when financial markets are well developed, few local barriers to entry exist, and human capital is ample

[62] China has until recently invested mostly through state-owned enterprises or firms with monopoly to secure strategic assets, with private firms requiring government approval to invest overseas. This strategy changed after 2002, when China started to encourage its national firms to "Go Global." In contrast, Indian multinationals have been present in the region for a longer time, even if not extensively in the amount of investment.

[63] Labor cooperation refers to wages and salaries, overtime pay, bonuses, and other remuneration received by Chinese contractors, firms, and employees from the employers during the reference period.

(Alfaro and others 2006). Other studies of foreign direct investment impact show that the spillover effects on the productivity of the rest of the economy, crucial for foreign direct investment to promote growth, come through direct links with foreign investors. Joint ventures are more likely to generate productivity spillovers, which occur mostly in companies that supply the new foreign direct investment entrant. However, in countries where financial markets are underdeveloped, other barriers to entry proliferate, and human capital is limited, the productivity effects of FDI appear to be small.[64]

4.28 MENA countries have made significant progress in reforming the regulatory environment for business and investment. They have all embarked on second generation reforms (for example, privatization, financial sector reforms, and business-entry regulatory reform). As a result, the attractiveness of their economic environment to foreign investors has increased substantially and the risk of investing in MENA has decreased (most of them present an "investment risk" index lower than China and India).[65] However, discriminatory screening and approval procedures for FDI still apply to most of the countries, and formal and non-formal barriers are still in place.

4.29 There is room for more spillovers associated with investment from China and India. MENA countries may want to adopt measures to maximize the potential benefits from the incoming investment. In particular, MENA countries need to accelerate trade reforms and increase the outward orientation of the economy to attract larger flows to the export sector. For instance, by integrating more into regional and global production chains, MENA countries would be more likely to encourage those linkages of foreign affiliates with domestic firms that are currently missing. The institutional and regulatory regime for FDI needs improvement to create an investment environment conducive to private sector growth.

Investing in skills is key

Table 4.9: Global services location index, 2007

Rank	Country	Financial attractiveness	People and skills availability	Business environment	Total score
1	India	3.22	2.34	1.44	7.00
2	China	2.93	2.25	1.38	6.56
13	Egypt	3.22	1.14	1.25	5.61
14	Jordan	3.09	0.98	1.54	5.60
26	Tunisia	3.03	0.90	1.50	5.43
36	Morocco	2.92	0.90	1.33	5.14

Note: The weight distribution for the three categories is 40:30:30. Financial attractiveness is rated on a scale of 0 to 4, and the two other categories are on a scale of 0 to 3.
Source: Kearney (2007).

4.30 Improving the quality of skills available and the absorption capacity of the domestic economy is key to ensure technology transfer and knowledge spillover. Table 4.9 shows the index of "Global services location," which indicates the attractiveness of a number of MENA countries, China, and India for off-shoring services. MENA countries are increasing their visibility as remote locations. Egypt and Jordan are among the top 20 countries in the Global Services Location Index 2007, and Tunisia and Morocco are moving up, reflecting interest in locations that can serve francophone markets. The indicators of financial attractiveness and business environment are not very distant from China and India's. In fact, in a few countries they are actually higher than China and India's. But MENA countries fare well below the Asian countries in the "people and skills availability" indicator. This represents a constraint to potential positive spillovers from foreign investment.

4.31 Investment in human capital is critical to channel knowledge and expertise from foreign investors into the host country. A highly educated domestic labor force has been an important factor behind the rapid growth of the Asian countries, which invested substantially in skills. Most MENA countries, by contrast, still lack a labor force with a proper mix of skills. This is true both for oil and non-oil producers. MENA countries need to further engage with the global economy also through knowledge. They need to invest more in providing quality higher education, establishing skills institutions to promote technical

[64] Some studies finds a much stronger link between trade openness and export diversification than between foreign direct investment and diversification (Noland and Pack 2007).
[65] For more details, please refer to Annex IV.

knowledge, and promoting linkages between firms (domestic and foreign) and knowledge institutions by creating active networks to successfully channel knowledge transfer.

CONCLUSIONS

4.32 The MENA region is enjoying an economic boom thanks to the rise in oil prices, increased integration in the world economy, and implementation of reforms that improved the investment climate. Some countries in the region are emerging as international investors. Gulf countries are investing billions abroad thanks to unprecedented current account surpluses. They are increasingly seeking to invest in alternate markets and currencies, looking more toward the East. The region is also attracting an increasing share of the world FDI, partly due to an increase in intraregional foreign investment from the resource-rich countries, attracting capital from other developing countries including China and India. However, most of the investment is concentrated in a few countries and sectors, exacerbating the Dutch disease effect in the region.

4.33 Two-way investment flows between MENA and China and India are still small, but they are increasing fast, involving not only the oil-rich countries but also the rest of the region. The two Asian countries have welcomed investment from MENA's oil-rich countries in their downstream energy industry offering strategic locations for crude supply and export, excellent infrastructures, experienced and competitive construction companies, and excellent fiscal regimes. Oil-exporting countries could attract sizable FDI into their energy sectors—but this is not happening because they limit the equity participation of foreigners. More than capital, countries in MENA need FDI primarily as a source of knowledge, technology, management know-how, and networking.

4.34 While FDI in industry and service has increased, MENA countries have failed to attract significant high-quality, export-oriented FDI, particularly from China and India. In a global world, trade and investment tend to be complementary, and global investors need free trade and free foreign exchange regimes to maximize the economies of scale generated by multicountry production centers. To attract FDI from multinational corporations, MENA needs to lower the costs of setting up business, dealing with bureaucracy, paying taxes, exporting and importing, and hiring and firing workers. It also needs to improve the supply of skills, infrastructures, and legal and judicial systems.

4.35 The benefits of FDI do not come automatically. Multinational corporations aim to increase their profitability in an international context, and host governments, to foster development. Host governments should develop policies that are friendly to investors and that maximize the contribution of FDI to development. China and India have not yet established strong links with domestic firms in MENA or added to production capacity. Nor do they contribute much to job creation or to the transfer and diffusion of technology. This is due partly to their investment strategies and the business models for implementing them—but also to constraints in the region that might prevent FDI from generating positive spillovers. These constraints include high-quality skills, a supplier network that permits specialization and competitive costs, and a suitable physical, scientific, and institutional infrastructure.