

CHAPTER 5. DIRECTIONS FOR THE FUTURE

Will further acceleration of the Chinese and Indian economies drive growth in the rest of the world, or will China and India simply overtake countries that fail to make competitive adjustments? The MENA region as a whole is expected to gain from higher growth in China and India, but manufacturing exporters may see sizable losses, particularly in the European Union and other markets. With unemployment already high in the region, these losses may be especially difficult. The challenge for the region's labor-abundant countries will thus be to generate jobs through increased productivity growth in all sectors of the economy. In both China and India significant political and institutional shifts appear to have preceded and accompanied sustained, growth-oriented policy changes—shifts that have barely begun for MENA countries.

IMPACT OF CHINA AND INDIA'S GROWTH ON MENA COUNTRIES

5.1 The World Economic Forum that took place in May 2008 proclaimed that China and India will become the dominant manufacturing and services powerhouses, while GCC countries are likely to support their growth through energy and capital. Chapters 1 and 2 found that MENA's increasing integration with China and India has brought many benefits, including higher consumer welfare and large oil revenues. However, competition with China and India has negatively affected the non-oil exports of all MENA countries and is becoming fiercer. Competitive pressures for producers have multiplied, particularly in the unskilled labor-intensive industries.

5.2 What will the future bring to the resource poor, labor-abundant countries of MENA? How will the welfare of all MENA citizens be impacted by these events? The literature offers a number of approaches to analyze these questions (box 5.1). In this chapter we use a general equilibrium model to simulate the potential impact on MENA's output, prices, and exports of changes in China and India's growth, as well as improvements in the quality and variety of their exports up to 2020. This model is a special version of the Global Trade Analysis Project (GTAP) model (documented in Ianchovichina 2004).⁶⁶ We construct a baseline for 2005–20 using current World Bank growth and macroeconomic projections; we then consider the impact of a further acceleration of growth in China and India (two percentage points per year higher than the projected rate). Finally, a special scenario in which the quality and variety of exports from China and India improve as they grow is then examined (see Annex V for further details on the model).

⁶⁶ A general equilibrium model ensures consistency while including important industry details: each region's exports of particular goods equal total imports of these goods into other regions (less shipping costs), global investment equals the sum of regional savings, regional output determines regional income, global supply and demand for individual goods balance, and demand for a factor equals its supply in each country or region. These accounting relationships and the behavioral links in the model constrain the outcomes in important ways not found in partial equilibrium analyses—increased exports from one country must be accommodated by increased imports by other countries, and broad-based increases in productivity that raise competitiveness also raise factor prices and help offset the original increase in competitiveness.

Box 5.1: Methodological approaches

Several approaches can be used to address questions about China and India's growth and its impact on trade and growth of other countries. The first approach, favored by the U.K. Department for International Development (DfID 2005) and Jenkins and Edwards (2006), focuses mainly on the bilateral trade links. However, strong spillover effects are likely when countries compete in the same third markets, even when there is no direct bilateral trade between them.

A second approach—favored by Lall and Weiss (2004), Goldstein and others (2006), and Stevens and Kennan (2006)—considers global markets and compares the trade patterns of China with those of their countries of interest. This approach argues that countries whose exports are similar to China's exports are likely to suffer losses as China grows, while countries whose exports match China's imports are likely to receive a boost. Although informative, this approach ignores the two-way trade prevalent in trade in manufactures and services and the possibility of gains from this trade even when net trade patterns are similar.

A third approach uses case studies of particular sectors to analyze developments in particular industries or markets. Yusuf, Nabeshima, and Perkins (in Winters and Yusuf 2007), drawing on the new economic geography, argue that manufacturing production and exports will remain central to development in both countries. Although services will be important to India, they will not create a completely new development model, and China's appetite for primary imports seems bound to continue growing. The combination of these characteristics will favor certain mid- and high-tech sectors, including autos, electronics, and domestic appliances and eventually pharmaceuticals and engineering. With rapid growth of skilled labor China could become a major force in some sophisticated sectors, but competing demand for skills in public service, general management, and education could delay its emergence as a technological leader for some time. The importance of exports in future development implies the continuation of low-skilled, labor-intensive manufacturing, but this is most likely to take place inland, where large numbers of farm workers could be trained for industrial work. India has had success with textiles and clothing exports and is a growing force in pharmaceuticals, steel, and electronics, and therefore will increasingly become an important competitor.

A fourth approach examines the trade links between China and India and their trading partners and the policy responses needed to best adapt to the growth of the emerging giants. Box 1.2 discussed earlier studies of China and India's impact on the economies of Latin America and Africa. Abdel-Khalik and Korayem (2007) focus on the links between China and MENA, noting the very rapid growth of energy trade. The implications of policy reforms in China, especially the massive reforms associated with China's accession to the World Trade Organization, are analyzed with particular reference to their impact on MENA countries.

Dimaranan, Ianchovichina, and Martin (in Winters and Yusuf 2007) discuss the global impact of accelerated growth in China and India during 2004–20 using scenarios based on the World Bank's baseline projections. The analytical exercise in this chapter is similar to their study, and in fact updates their main results. They find three broad effects of the accelerated growth of China and India: other countries' exports face fiercer competition from China and India, China and India's imports from these countries become cheaper, and other countries benefit from aggregate demand growth as real incomes increase in response to efficiency improvements. The balance of these forces varies by country, but since most countries import a substantial amount of goods from China and India, most countries gain overall, except some in Southeast Asia, the rest of South Asia, and the European Union. The rise in energy prices causes energy consumption, already heavily taxed in the European Union, to drop further. Chinese exports to other markets grow, while exports from other countries—especially manufactured products—fall. MENA as a whole increases exports to China and India across the board but loses market share in the European Union and other markets. MENA appears to have an opportunity to strengthen trade ties with China and India, but without policy measures to boost competitiveness by 2020 overall exports from MENA decline 1.5 percent from the baseline. The message: many MENA countries must boost their competitiveness.

5.3 The model includes eight low- and middle-income MENA countries, most of them labor-abundant countries—Algeria, Egypt, Iran, Jordan, Lebanon, Morocco, Syria, and Tunisia—plus a composite energy-rich MENA region (referred to as “other MENA”) that includes the GCC countries, plus Iraq, Libya, and Yemen. The model incorporates some of India's major reforms, such as the liberalization of nonagricultural tariffs, the introduction of free trade zones (with zero tariffs on intermediate inputs used to produce exports), and improvements in infrastructure that supports trade.

5.4 The starting hypotheses included in the baseline projection of world economic output to 2020 are as follows: China's output growing at 6.6 percent annually, India's at 5.5 percent, and MENA's at 3–5 percent, closer to historical trends (table A5.1 in Annex V). Next, the implications of higher-than-projected growth in India (1.9 percentages higher a year) and China (2.1 percentages higher a year) are examined: output in 2020 is 39.9 percent higher in China and 33.7 percent higher in India than under the

baseline scenario.⁶⁷ Finally, following recent empirical evidence (see, in particular, Hummels and Klenow 2005) we add the hypothesis that economic growth increases both the quality and the variety of goods exported by the growing economy and we then analyze the implications of this hypothesis.⁶⁸

Impact of higher growth in China and India on welfare, terms of trade, and exports

5.5 The effect of Chinese and Indian higher growth on real incomes (welfare), terms of trade, and exports is described in table A5.2 in Annex V. MENA is likely to benefit substantially from increased growth in China and India. Real incomes in MENA could rise \$24 billion (1.5 percent) a year at 2004 prices. The gains for other countries are generally relatively small: income gains are largest for commodity producers, particularly MENA oil exporters, but also for some high-income, industrialized countries. Countries in the European Union and Japan experience no net gains or losses because they are commodity-poor and because other terms-of-trade gains are offset by regulatory and trade distortions.

5.6 Improved welfare in MENA as a whole is generally not associated with increased export volumes. Oil-exporting countries experience large welfare increases thanks to higher energy prices and are thus able to increase consumption at any given volume of exports, reducing their ability to export. Given MENA's sizable exports of energy products and the larger increase in energy prices than in prices of other goods, it is unsurprising that the region as a whole benefits from the strongest terms-of-trade gains. The welfare gain of the oil exporters in MENA is exceeded only by the welfare gains of China and India. However, exporters of manufactures suffer from increased competition and lower prices for their products.

5.7 Since the world price effect in table 5.1 is an important determinant of the welfare changes in the region, it is useful to understand the contributing factors. These include effects on three separate groups of goods and services—manufacturing and services, energy, and agricultural products. For manufacturing and services, a decline in their relative price is expected. Energy supply is different from other resources in that it is fixed. As energy demand rises with an increase in incomes, energy prices are pushed up relative to factor prices. In our model the effect is muted, but not completely offset, by the assumed increase in the productivity of energy production. For agricultural goods several influences on prices compete in the long run.⁶⁹ The increase in world prices of key agricultural products appears to result from the transfer of resources out of labor-intensive agriculture, which is associated with the rise in physical and human capital in China and India. The effect of this complex movement of prices on the welfare of the region is straightforward. Many MENA countries are net food importers and therefore suffer from increased food prices; however, the energy exporters in the region benefit from higher energy prices and lower prices for imported manufactures.

⁶⁷ Predicted growth is assumed to be associated with the same percentage increases in capital and human capital (or, equivalently, continued high savings and investment) in China and India.

⁶⁸ In all simulations the trade balances as shares of GDP were held constant for China and India to avoid welfare changes due to increases or decreases in financial inflows from abroad when growth rates in these countries shift substantially. The macroeconomic closure of the simulation model assumes constant employment and perfectly mobile skilled and unskilled labor between sectors but not between regions.

⁶⁹ First is the technological change effect described above for manufacturing and services, which tends to lower prices. Second is a fixed factor, land, in agricultural production, which tends to raise prices, just as with energy products. Third is the Engel effect—that demand for agricultural products, and particularly basic foods, tends to rise more slowly than income. Fourth is that growth tends to reduce agricultural output and raise agricultural prices when it is associated with increases in the capital-labor ratio. The decline in world prices of agricultural products is a consequence of the assumed neutrality of technical change in this experiment. Output of all goods increases uniformly, but the demand for food grows less than proportionately because the demand for these goods generally has low income elasticities. This result is not preordained. For example, in the baseline simulations used to project the model to 2020, the prices of agricultural goods rose, rather than fell, but in the growth experiment reported by Dimaranan, Ianchovichina, and Martin (in Winters and Yusuf 2007) the prices of agricultural products fell because the stocks of capital and human capital remained constant.

Table 5.1: Implications of higher growth in China and India for world commodity prices

Commodity	Higher growth assumption	Higher growth and improved quality of exports assumption
	Percent	Percent
Rice	1.05	1.71
Wheat	3.16	3.4
Grains	2.58	2.85
Vegetables and fruits	2.08	2.25
Oils and fats	-0.21	-0.7
Sugar	-0.67	-1.29
Plant-based fibers	3.41	3.55
Others crops	1.24	1.15
Livestock and meat	-0.27	-0.8
Dairy	-0.78	-1.44
Other processed foods	-0.82	-1.4
Energy	5.52	4.89
Textiles	-1.15	-1.1
Wearing apparel	-1.9	-0.97
Leather	-1.36	-1.11
Wood products	-1.54	-2.03
Minerals	-1.42	-1.31
Chemicals	-1.17	-1.59
Metals	-1.89	-1.87
Vehicles	-1.76	-2.46
Machinery and equipment	-2.28	-2.22
Electronics	-2.66	-2.71
Other manufactures	-3.63	-1.12
Trade and transport	-1.37	-1.7
Communications	-2.13	-2.42
Other services	-1.66	-2.24
All	-1.24	-1.45

Source: Authors' simulations with GTAP-DD (Ianchovichina 2004).

Impact on welfare and trade of accelerated growth and improved quality and variety of exports

5.8 What happens when China and India improve the variety and quality of their exports moving into more sophisticated and technologically advanced products? The result is a significant welfare gain to the world economy (table A5.2 in Annex V). In this case the volume of exports from China grows 61 percent and from India 69 percent, with positive terms-of-trade effects in almost all countries.⁷⁰ Most countries benefit because they can import higher volumes from China and India at lower effective prices and because they enjoy greater Chinese and Indian demand for their exports. The biggest beneficiaries are, of course, China and India, whose estimated welfare gains increase for both by around 31 percent. The volume of trade between China and India increases more than either's trade with the rest of the world, deepening the trade links between the two Asian giants.

5.9 Real incomes in MENA could rise \$29 billion a year (at 2004 prices), \$5 billion more than in the case where China and India's growth is not accompanied by changes in types and quality of exports. However, some countries in MENA (Algeria, Jordan, Tunisia, and a few others) will experience higher

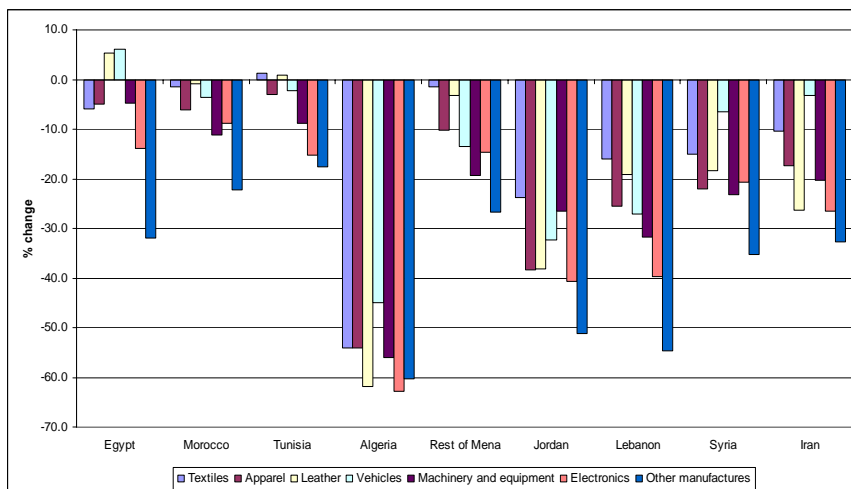
⁷⁰ In the model with product-quality-augmenting technical change, since the price of relevance to the importer is the effective price, which may fall when quality and variety increase, and the price relevant to the producer is the actual price, which rises when quality and variety increase, it is possible for the terms of trade to improve for both importers and exporters.

net export losses. The impact of increased opportunities to export to Asia is dominated by the negative effect of the increase in third-market export competition and increased domestic demand from the terms-of-trade improvement. MENA is likely to play a smaller role in exporting manufactured goods and services as a result of higher growth in China and India. But the boost to China's and India's manufacturing industries has positive spillover effects through increased demand for intermediate inputs, including minerals, energy, and farm-based natural resources. Indeed, exports of energy increase the most, followed by farm products and minerals.

MENA experiences net export losses

5.10 The aggregate results hide differences at the country level. But exports of manufactures will be hit hard in all countries (figure 5.1)—and even harder for some industries in some countries (figure 5.2). Improved growth of exports from China implies an expansion of its textile industry at the expense of the textile industry in all MENA countries except Egypt and Tunisia. The projected growth of China's apparel industry will also lead to a sharp contraction of apparel production elsewhere, including in all MENA countries. Similarly, large declines are expected for machinery and equipment, electronics, and other manufactures. But other industries will flourish, including energy, metals, and agriculture products such as vegetables and fruits.

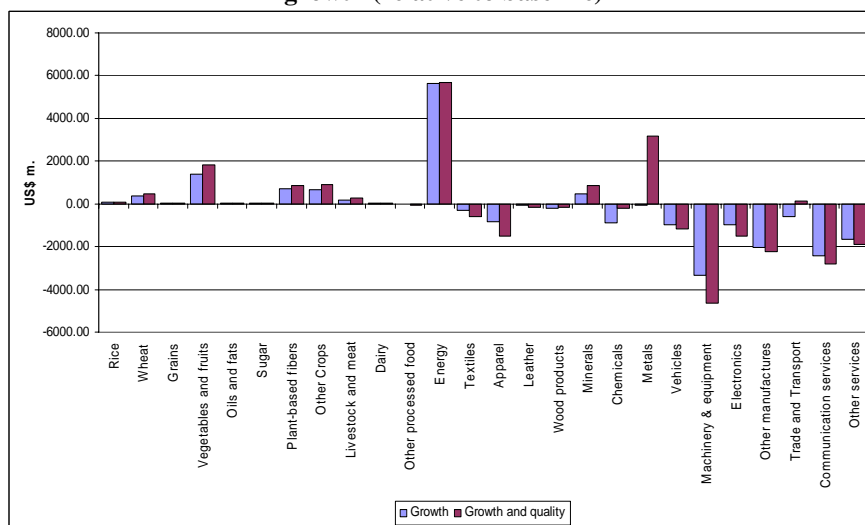
Figure 5.1: Change in manufactured exports due to high growth in China and India



Source: Authors' simulations with GTAP-DD (Ianchovichina 2004).

5.11 The expansion of the energy sector and the contraction of manufacturing and services are signs of the Dutch disease effect. Typically, the increase in the price of natural resources raises the possibility that the expansion of the natural resource sector will de-industrialize (or de-agriculturalize) the economy by attracting resources away from the lagging nonoil-production sectors and raising the prices of non-tradables in the economy (thus further lowering the competitiveness of the lagging sector). In principle, however, the resource boom may allow for governmental expenditures in the lagging sector that raise

Figure 5.2: Changes in export volumes under different assumptions of growth (relative to baseline)



Source: Authors' simulations with GTAP-DD (Ianchovichina 2004).

its competitiveness, through measures such as technological improvement. All MENA countries will face more pressure to adjust their domestic and trade policies in order to increase competitiveness and cushion the effects of rising oil prices and revenues on their non-energy sectors. The challenges will be great because the few export sectors enjoying dynamic export growth are capital intensity, creating fewer jobs. When improvements in product quality and variety are taken into account, new opportunities to increase exports of certain crops, vegetables and fruits, minerals, metals, and trade and transport services are amplified, but so are the losses of manufacturing sectors (figures 5.1 and 5.2).

MEETING THE CHALLENGE OF COMPETITION WITH CHINA AND INDIA

5.12 The acceleration of growth and exports in China and India challenges MENA producers to aggressively increase their productivity—especially to ensure employment growth. Productivity improvements have significantly lagged among MENA non-oil producers. Tunisia, the fastest growing of the non-oil producers in the 1990s, saw total factor productivity in the whole economy increase by approximately 1.8 percent per year from 1990–2000. Total factor productivity grew in Egypt by 1.6 percent from 1991–2000 and by 1.1 percent from 2001–06. Jordan, Morocco, and Algeria had no or negative TFP growth over the 1990–2000 period (Bosworth and Collins 2003). These rates fall well below those in China.⁷¹ And even countries that have experienced more rapid productivity growth have seen employment lagging.⁷² But how important is productivity growth in both oil- and nonoil-producing MENA countries, particularly in a global economy in which China and India have emerged as export powerhouses? And is there any lesson that MENA countries can learn from the growth experience of China and India? These questions are discussed in the next sections.⁷³

Addressing obstacles to investment and productivity improvement in labor-abundant, nonoil-producing MENA countries

5.13 Growth and innovation require capital; the freedom of innovative entrepreneurs to enter new markets and the ability to move capital away from unsuccessful efforts; and investor expectations of minimally predictable government policies that refrain from opportunistic expropriation of successful entrepreneurs. The Indian and Chinese productivity revolutions entailed major changes in the 1980s and 1990s that affected all of these. India shifted away from state-led economic development to significantly (if still partially) open markets, and increased internal competition. China liberalized agricultural markets and private investment and then adopted a very open trade regime, encouraging both internal and external competition where there had been none. China spent massively on public infrastructure, and much of it has improved the productivity of private investment. India's inability to grow even faster is due in part to its lack of investment in roads and power.

⁷¹ Islam, Dai, and Sakamoto (2006) review estimates of TFP growth for the first 15 years of reform (1979–94) that range from 2.6 to 3.8 percent per year. In their own analysis, taking into account changes in the quality of labor and capital composition (both of which push estimates of productivity growth downwards), they estimate TFP growth for the entire period, 1978–2002 to range from 2.95 to 4.06 percent per year. These estimates at least match Egyptian TFP growth in the 1980s and are twice or three times as fast as Egyptian TFP changes after 1990. The slower rate of TFP growth in Egypt helps to explain the Yeats and Ng (2000) finding that the international competitiveness of many MENA countries appeared to decline in the 1990s—precisely when productivity exhibited striking increases in China and India.

⁷² Some evidence suggests that in Tunisia (1997–2001) and Morocco (1999–2003) productivity growth and employment growth moved inversely (Nabli 2007). Productivity increases have been associated with job losses in the United States as well, though the underlying reasons are likely different. In particular, Resheff (2007) found that technological change in the United States did not directly cause a bias toward skilled workers but that it shifted production to (non-skill-intensive) services and away from (skill-intensive) manufacturing, while leading to a tremendous increase in the productivity of unskilled workers in the service sector, allowing employers to use fewer of them. In MENA countries so few unskilled workers are employed in manufacturing that this employment-reducing substitution effect is unlikely to be important.

⁷³ Answers to this final question are provided in the recent World Bank (2008). The aim of this chapter is limited to the discussion of MENA's relationship with China and India.

5.14 Only recently, and then only in some countries and in some policy areas, has MENA seen changes in a similar direction. Overall, though, persistent governance concerns, low public spending on infrastructure, limitations on private provision of infrastructure services (such as telecommunications), and difficulties in finance and entry regulations such as those related to the acquisition of land have not been offset by significant changes in other areas of the investment or competitive climate. These issues are particularly important for the labor-abundant, nonoil-producing countries, while a separate set of issues concern the oil-producing countries.

5.15 *Finance.* Labor-abundant, nonoil-producing MENA countries' ability to finance investment depends heavily on local financial systems, particularly the efficiency with which banks collect savings and channel them to productive private enterprises. At first glance, finance does not appear to be an issue in nonoil-producing MENA countries: credit to the private sector as a fraction of GDP is higher in Tunisia, Jordan, Morocco, Egypt, and Lebanon than in East Asia (Keefer 2007b). Capital is abundant in the region, in both traditional banking and Islamic financial institutions.

5.16 However, other indicators offer a less optimistic outlook. Firm-level data indicate that businesses in China are both more likely to use bank credit and less likely to rank access to credit as a major obstacle to growth. Investor protection and credit information are key institutional ingredients in a well functioning financial system—and both are substantially worse in labor-abundant MENA countries than in the best performers. No labor-abundant MENA countries have private registries that provide credit information. The borrowers covered in public registries range from a high of 13.7 percent of all adults in Tunisia to 0.8 percent in Jordan. Neither China nor India is a stellar performer in this area, but both at least match the best performers in the MENA nonoil-producing group: India's private registries cover 10.8 percent of adults, and China's public registry covers 49.2 percent. Similarly, the investor protection index is 5.0 for Egypt and Lebanon, 4.3 for Jordan, 3.3 for Tunisia, and 3.0 for Morocco; it is 9.7 for the top performer, New Zealand. Again, China (5.0) and India (6.0) at least match the top performer among the nonoil-producing MENA countries.⁷⁴

5.17 How can lending to the private sector in nonoil-producing MENA countries be so high without institutions that reduce credit risk? Keefer (2007b) suggests that the main reason is the extraordinary concentration of lending among a few borrowers and state-owned lending institutions. Although the situation may have changed recently due to financial sector reforms, 2006 data from the Central Bank of Egypt show that 565 borrowers (approximately 0.2 percent of total borrowers) receive more than 50 percent of total credits issued by Egyptian banks to the private sector (World Bank 2006).

5.18 *Entry regulations.* The ease of entry into new markets and activities is a key determinant of investment flows and productivity-enhancing innovation. Entry barriers come in many forms, some observable, some not. Two particular obstacles to new entrants stand out: barriers to land ownership and barriers to trade. Barriers to land have two main effects. First, most economic activities are difficult to undertake without physical premises. Second, in countries with weak credit markets collateral demands of banks tend to be high, and forms of collateral other than property are disfavored. In both cases barriers to land can reflect official efforts to bar entry to potential competitors of favored incumbents. Firm-level surveys indicate that businesses in MENA countries are more likely to report that access to land is a major or severe obstacle: 26 percent of medium-size firms in Egypt and 42 percent in Morocco (among oil-producers, 35 percent of medium-size firms in Algeria and 38 percent in Syria), compared with only 12 percent in China. Difficulties of land access are generally due to the extent of state ownership of commercially attractive property and to inadequacies in land registration institutions that obstruct land sales and rental markets.⁷⁵

⁷⁴ All comparisons in this paragraph are from the World Bank 2008a (www.doingbusiness.org).

⁷⁵ See Keefer 2007b, table 4, based on data from the World Bank Investment Climate Surveys (www.enterprisesurveys.org).

5.19 Chapter 2 has discussed barriers to trade in MENA. They vary by country, and overall the region has become more open in recent years. Nevertheless, estimates from Kee, Nicita, and Olarreaga (2006b) indicate high rates of trade restrictiveness among non-oil producers in MENA relative to East Asian comparators. They calculate an index of restrictiveness that was greater than 0.7 for Egypt and almost 0.5 for Morocco but only 0.24 for Malaysia, 0.18 for China, and 0.06 for Indonesia. Even if Egypt's 2004–06 trade reforms halved the country's trade barriers, they remain substantially higher than East Asian comparator countries.

5.20 *Governance.* The credibility of government promises and the degree to which government policies treat private investors equally and predictably are at the heart of governance issues in growth. In contrast to most industrialized countries, where entry barriers are uniformly low for all investors, and to China, where many officials can approve investments, large investments in nonoil-producing MENA countries must have formal or informal approval from high-level government officials. This is symptomatic of the governance problems that the countries confront: the lack of institutional or other guarantees against opportunistic changes in the rules of the game make it prudent that large investors have explicit understandings with high-level officials to provide insurance against adverse policy changes.

5.21 Aggregate indicators suggest a governance environment at least on par with fast-growers such as China and India. In the 2004 Worldwide Governance Indicators Egypt, Lebanon, Morocco, Jordan, and Tunisia averaged one point higher on rule of law and corruption scores than large East Asian countries.⁷⁶ About 30 percent of medium-size firms in China interviewed for the enterprise surveys that are the source of entry regulations discussed earlier viewed corruption as a major or severe obstacle to growth, compared with 50 percent in Egypt. Fewer than 10 percent of Jordanian and 15 percent of Moroccan respondents expressed this opinion, however. But even if the *de jure* environment becomes friendlier, entrepreneurs in some countries complain that connected individuals exploit new, informal privileges when reforms eliminate old advantages. Anecdotal evidence points to importers who previously relied on informal arrangements to avoid tariffs and who, post-liberalization, turn to similar arrangements to avoid paying value added taxes when trade regimes are liberalized. This is consistent with the conclusions of Esfahani (2007), who argues that government accountability to citizens is inversely related to the difficulty of doing business in the region.

5.22 *Infrastructure.* Public policy undermines infrastructure when public infrastructure is underfunded, when resources flow to projects with low rates of return, and when the regulation of infrastructure operations deters efficiency improvements and innovation. By contrast, governments committed to economic growth spend more on productivity-enhancing infrastructure. Such spending also signals to investors how seriously the government takes the growth agenda because the political benefits of productive public investment usually depend to a larger degree on a significant response by private investors than nonproductive investment does.

5.23 Agénor and others (2005) observe that public investment in MENA exhibits all three traits: underinvestment, low productivity, and inefficient regulation. For example, throughout the 1990s Egypt and Tunisia spent less than 2.5 percent of GDP on infrastructure and Jordan less than 1.8 percent. Though more than what India spent (1.5 percent of GDP), these spending levels were far less than what China spent (more than 7 percent of GDP in some years). Over 1990–2002, for example, China's increased its total road network by 50 percent, with half the increase achieved during 1990–95. Both India and China have liberalized key infrastructure sectors, particularly telecommunications, to a far greater degree than MENA non-oil producers.

⁷⁶ One point is almost one standard deviation. See Keefer 2007b, figure 5, based on information from Worldwide Governance Indicators (<http://info.worldbank.org/governance/wgi2007/>).

Attitudes and the investment climate in nonoil-producing MENA countries

5.24 Shortcomings in the investment climate are in part the result of government decision makers favoring some economic interests over others. However, government policies can also reflect the general preferences of citizens. If citizens are antagonistic to a growth-oriented policy environment, governments are less likely to implement growth-promoting reforms. There is evidence that attitudes in MENA substantially differ from those in China and, to a lesser extent, in India on a wide range of issues, from the value of leisure to the importance of religion to tolerance for the influence of free markets. Chinese respondents to cross-national surveys exhibit a stronger preference for work (and the income that work brings) and less suspicion of markets than respondents in MENA or India. To the extent that public policy toward private investment and markets reflects popular preferences, these attitudinal differences would point to a more investment-friendly climate in China.

5.25 The World Values Surveys (most of them undertaken in 2001 and 2002) are the best source of evidence on some of these issues.⁷⁷ One survey question concerns the value that respondents place on leisure. Some 49 percent of Chinese respondents rated leisure as very or rather important (only 7 percent rated it as very important), compared with 74 percent of Moroccans, 68 percent of Iranians, 64 percent of Saudis, 63 percent of Algerians, 57 percent of Jordanians, and 55 percent of Egyptians. Indian respondents, at 61 percent, were closer to the MENA respondents. More than 20 percent of respondents rated leisure as very important in all these countries except Egypt, where only 9 percent rated leisure as very important, and the closest to the Chinese respondents.

5.26 The relationship between religion and economic growth is much disputed. In countries where citizens regard religion as particularly important, citizens are more likely to tolerate slow growth if government policy on religion aligns with their preferences. McCleary and Barro (2006) find evidence that religious beliefs (such as belief in an afterlife) promote growth, while resources dedicated to religious activities slow growth. Religion is far more important in the MENA region than in China or India. In China only 9 percent of respondents to the most recent World Values Surveys regarded religion as very or rather important. India was, again, much higher, at 79 percent. But in all MENA countries more than 90 percent responded that religion was very important, and nearly 100 percent that it was very or rather important.⁷⁸

5.27 MENA countries differ substantially from China, though again, not from India, in the degree to which they believe others would take advantage of them rather than try to be fair. In China only 18 percent of respondents said that others would take advantage of them, compared with 70 percent that said others would be fair. This is all the more remarkable because respondents have maintained such attitudes even in the massive shift toward market-based economic relationships. By contrast, 64 percent of Moroccans, 55 percent of Indians, 50 percent of Egyptians, 49 percent of Algerians, 47 percent of Saudi Arabians, and only 23 percent of Iranians responded that others would take advantage of them. The absence of a belief in the fairness by others makes a shift toward market-based policies and away from government-guided economic relations appear much more risky to citizens.

5.28 Attitudes toward free markets and government oversight of the economy are more directly assessed by asking whether people or the government should take more responsibility for their welfare. But the question is ambiguous: it is unclear whether the question refers to “more responsibility, relative to the

⁷⁷ The World Values Survey (www.worldvaluessurvey.com) is a broad effort to interview nationally representative samples of the residents of countries throughout the world. It is conducted by a network of social scientists at universities around the world; to date they have surveyed more than 80 countries and conducted four waves of surveys since 1981.

⁷⁸ McCleary and Barro (2006) find, however, that Muslim countries are an outlier. They score high on religious beliefs and low on frequency of attendance, which suggests that Muslim countries should grow faster than average. In fact, they grow much more slowly than average. McCleary and Barro attribute this to mismeasurement: the frequency of attendance at religious services, as measured cross-nationally, significantly understates the actual time, effort, and resources devoted to religious activities in Muslim countries. The World Values Survey results provide an indication that this could indeed be the case.

responsibility they currently accept” or “who bears more responsibility for welfare.” Whichever the case, though, Chinese and MENA attitudes again differ widely. The share of respondents who assign the most responsibility to people was 15 percent in China and 16 percent in India. MENA respondents are uniformly lower, though not necessarily by much: responses range from 13 percent in Jordan to 5 percent in Egypt. At the other end of the spectrum, 14 percent of Chinese respondents assign the most responsibility to government, compared with 34 percent of Indian respondents, 30 percent of Moroccans, 28 percent of Jordanians, 22 percent of Algerians, and only 8 percent of Iranians, 6 percent of Saudi Arabians, and 18 percent of Egyptians.

5.29 Whether a product of the MENA economic and political environment, MENA respondents’ attitudes are less conducive to government policies to promote growth. More encouraging, however, is that Indian respondents are somewhat similar to their MENA counterparts and India is prospering despite attitudes that are significantly less friendly to markets than those in China. This reinforces the general lesson emphasized here: growth is driven by creation of policy environments that offset disadvantages over which the government has little control, such as citizen attitudes.

5.30 The political changes in India and China are important when considering assessments of Chinese reforms that emphasize pragmatism, including assessments by Chinese leaders themselves (box 5.2). Pragmatism is often taken to mean that the reforms were incremental. Although the approach was pragmatic, the shifts in the underlying policy—and political—environment were dramatic, going far beyond lifting some trade barriers or introducing one-stop shops to facilitate business registration, as helpful as such reforms are.

Box 5.2: Learning from institutional shifts and growth in China and India

China’s and India’s experiences show that a serious pro-growth agenda requires broad and deep economic and institutional reforms. As Keefer (2007a) argues, these countries experienced political and institutional shifts that suggest profound commitment from political leaders. One shift simply involved a change in attitudes toward private sector activity. Rodrik and Subramanian (2005) argue that Indian growth accelerated when Indian leaders began to see growth as a viable strategy for political survival. And in China reform began with leaders concerned about the growing income gap between China and the rest of East Asia who became convinced that centrally planned economic growth would not be enough to catch up. In both cases economic growth became the best response to actual and potential political challenges. However, attitude shifts about the political merits of growth were not sufficient to ensure growth. Entrepreneurs needed to be sure that commitments to the private sector were credible, and public officials needed to be convinced that growth-oriented policies were in their interest.

In India lack of credibility in the commitments toward the private sector was acute in the 1970s. Intraparty checks on Congress Party leaders weakened, and the government of Indira Gandhi nationalized the banks and began to rule using emergency powers. In 1977, however, India took a significant step toward mitigating one-party or one-individual rule. The Congress Party lost the elections, and India shifted from a near one-party state to a multiparty democracy. Multiparty democracy increased checks and balances on government and reduced chances of investor abuse by political actors. Along with these changes, India began to dismantle a strict licensing regime that severely restricted the scope for private sector entry and competition.

China’s evolution was more stark. After Mao Zedong’s death the leaders of the Communist Party had to transform the party from a noninstitutionalized entity that placed few constraints on the top leadership to one in which 60 million party members could feel confident in the promises made to them by the leadership. Deng Xiaoping made deliberate decisions to institutionalize the party, with greater intraparty transparency regarding leadership decisions and greater transparency and credibility in leaders’ treatment of party members. This permitted leaders to make credible promises to party members that would not have been possible before. One such promise—now enshrined in the performance objectives expected of governors and mayors—was bonuses and promotions for officials who encouraged economic growth in their jurisdictions. China went from being a country where career advancement of public officials depended on personal ties and the suppression of private economic initiative to one in which it depended more reliably on economic growth and the growth of private sector activity. The key lesson from China is that institutional change is crucial if policy reforms are to trigger growth. In the Chinese case institutionalization meant that leaders tied their own hands in the decisions they could make regarding the 60 million Communist Party members. This meant, for example, that leaders could not as easily give bonuses and promotions to close supporters who had failed to produce growth, at the expense of non-supporters who had. However, without these restraints on leader discretion, leaders could not have persuaded party officials to be at the forefront of the growth initiative—either authorizing investments themselves or supporting private investors who sought to set up shop in their jurisdictions.

The response of oil-producing MENA countries to the rise of China and India

5.31 The emergence of China and India as economic powers raises at least two sets of issues for MENA's oil producers. One is well known: how should MENA oil producers manage the increased revenues from the higher commodity demand triggered by China and India to minimize macroeconomic distortions and maximize long-run welfare? In particular, to what degree do oil producers avoid domestic consumption booms that come at the expense of high inflation and that place too little weight on future citizen welfare? These are standard questions, widely addressed elsewhere.⁷⁹ The focus here is thus on the second question: how can MENA's oil producers best utilize their oil revenue to spur productivity growth in the region and in their own countries?

5.32 *Investing in downstream activities.* A few MENA oil exporters have decided to participate in downstream petroleum activities located in major consumer countries, for reasons that range from the geopolitical (gaining the support of these countries for their proposals in international arenas), to technical capacity, to a diversification hedge against future depletion of their oil resources. Properly weighing the tradeoffs that the pursuit of these objectives entails is a key challenge for MENA's oil producers. For example, investments in distribution facilities are fixed and vulnerable to expropriation by consumer countries, particularly when oil prices rise. Oil-producing countries also need to weigh the tradeoff between investing their oil wealth in downstream petroleum sector activities or in other activities further removed from petroleum. One tradeoff is between comparative advantage (these countries know the oil sector better than other potential sectors) and diversification against a low-oil future. A world in which MENA's oil producers run low on oil is one in which oil, in general, is likely to be in much shorter supply. While returns to oil are likely to be high in that environment, the returns to downstream petroleum activities could fall, as consumers shift out of oil into other energy sources.

5.33 *Investing in big projects.* Most of the unprecedented oil wealth associated with the current boom in oil prices has gone to portfolio investments, as in the past. However, a larger share than in the past has gone to direct investments. Oil producers' direct investments in their own countries seem to have aimed directly at jumping straight from producing a commodity to creating an environment for sophisticated manufacturing and service enterprises. Dubai has established Media Cities wired for high-speed data transmission and has made well known and large investments to position itself as a gateway between East and West, between Europe and Asia. These have included not only the airport and logistics facilities famously associated with the emirate, but also more recent efforts to attract the largest Western financial institutions to set up shop. The King Abdullah Economic City in Saudi Arabia veers from the services model and retains a strong link with the kingdom's petroleum focus, but huge port and substantial manufacturing enterprises in the city, ranging from petrochemicals to pharmaceuticals, constitute a leap forward in scale and sophistication for the region. These efforts are a significant gamble. Investment banks have come to Dubai but will not stay without a substantial increase in activity. Traffic between Asia and Europe will be less likely to require the services of airports in the Middle East in the future (for example, with advent of bigger jetliners with greater ranges). But especially in places such as Dubai where the economic diversification is already very advanced, gambles may be worthwhile.

5.34 *Investing in people.* A greater challenge is to integrate the citizens of oil-producing countries into the 21st century enterprises being created. The long-term viability of these endeavors depends on a sophisticated workforce that wants to live in the region. Again, sizable investments in universities can generate local human capital capable of driving these large and sophisticated enterprises. But the agglomeration of talent and human capital characteristic of similar sectors in other cities and countries (finance in London and New York, pharmaceuticals in Switzerland, world-class universities in

⁷⁹ For a classic discussion, see Gelb 1988.

Massachusetts and California) has taken place in settings with large communities of scientists and cities with social and political characteristics much different than those in Jeddah or Qatar.⁸⁰

5.35 *Investing in the region.* Oil-producing countries' investments in their own countries look much different from their investments in nonoil-producing countries. Foreign direct investment is believed to be one of the main channels through which countries gain the advantages of foreign expertise, market access, and entrepreneurial skill.⁸¹ However, much of the foreign direct investment into nonoil-producing MENA countries has been in real estate and tourism (Noland and Pack 2007). Investments in land simply raise the cost of doing business in nonoil-producing countries, making operations more difficult for local producers. Such investments, then, "export" the Dutch disease from oil-producing countries to nonoil-producing countries. This effect is added to that of the steady rise of immigrant remittances from the migrant workers that are employed in the Gulf countries.

5.36 The lack of greater direct investment from oil-producing to nonoil-producing MENA countries in productive areas is particularly surprising because cultural and other affinities play a significant role in foreign investment flows. Bottazzi, Da Rin, and Hellman (2007) find strong evidence that trust in the citizens of other countries is important in the investment decisions of venture capitalists in Europe.⁸² One immediate implication of these results for MENA is that venture capital—and, most likely, foreign direct investment—should flow more easily within the region than from outside the region. The World Values Survey may provide an explanation for this, based on replies to the question do "citizens believe that others can be trusted"? The six MENA countries with results from the World Values Survey exhibit an average score of 31.5, compared with 42.8 for 18 larger Organization for Economic Co-operation and Development countries that have data and contain most of the world's financial centers (a difference of more than half of a standard deviation). By contrast, proximity and affinity did matter in China, and in fact a large share of foreign direct investment into China is from expatriate Chinese and from countries located close to China (Japan and Taiwan, for example).

5.37 Oil producers in the region have less technical expertise to share with the non-oil producers. They have the capacity to partner with foreign enterprises that do have such expertise, thereby catalyzing foreign direct investment that carries promising productivity advantages. The great, and so far unrealized, contribution that oil producers can make to the region's productivity growth is to use their capital and their greater ability to build bonds of affinity and to reduce "country risk" when it comes to investments in the region.

5.38 *Investing in Islamic financial institutions.* Islamic finance has grown dramatically in importance, but has not favored affinity-based investment as expected. The Islamic Development Bank in Jeddah and Western financial institutions has developed a multitude of sharia-compliant financial instruments. One estimate of deposits at Islamic banks puts the figure at \$300 billion, while the IMF puts the assets of all Islamic financial institutions at \$400 billion (Noland and Pack 2007). Current efforts to make some countries (particularly in the United Arab Emirates) into regional financial centers are another potential step toward more direct investment in neighboring, nonoil-producing countries. Unfortunately, despite these efforts, the substantial amount of capital they entail, and the natural advantages of investment between countries that share a cultural affinity, there is no evidence that this affinity is playing a role in

⁸⁰ Glaeser and Ponzetto (2008) point to the significant interplay between technology, ideas production, and goods production in determining which cities succeed and fail.

⁸¹ Portfolio investments by foreigners, distinct from foreign direct investment, can eventually drive up direct investment, but portfolio investments begin by simply raising the value of the assets of existing entrepreneurs. This potentially raises returns to capital for all investors, but the market response to this higher return depends on whether financial markets are adept at turning new capital into productive investments and on whether product markets themselves are open. If financial markets are not fluid or other barriers to entry are high, as is the case in the nonoil-producing MENA countries, portfolio investment does not spur new direct investment or productivity growth.

⁸² That is, because the French trust the Spanish more than the British trust the Spanish, venture capitalists in France are more likely to invest in companies in Spain than are venture capitalists in the United Kingdom. Moreover, venture capital firms in both France and the United Kingdom are more likely to invest in Spain if they have a Spanish partner.

actual investment decisions. The clearest indication: Islamic financial institutions have as great or greater propensity to channel capital into the markets as non-Islamic countries compared with conventional financial institutions. The reason for this may simply be related to the investment climate in the nonoil-producing countries. Ties of affinity between the investor and target countries are not expected to overcome conditions in the target countries that substantially lower expected investment returns.

CONCLUSIONS

5.39 China and India have created new opportunities and challenges for all countries. This chapter has shown that an acceleration in their growth would result in further improvements in MENA's terms-of-trade and overall welfare. These gains are larger when the likely improvements in the quality and variety of exports from China and India are factored in. Oil-producing countries are the likely winners. By contrast, increased competition in third and domestic markets is likely to result in a decline of manufactured exports from nonoil-producing countries, challenging their growth prospects. All MENA countries, but particularly the labor-abundant non-oil producers, will face pressures to adjust their domestic and trade policies to increase competitiveness and cushion the effects on their non-energy sectors.

5.40 The most important lesson from China and India is the need to undertake a broad shift in policy and institutions toward a pro-growth environment. In both countries institutional changes gave entrepreneurs who had no personal relationship with political leaders the confidence to invest. In China embracing growth as a key political goal was manifested not only in specific reforms to liberalize entry but also in the way all Chinese public officials were compensated. In India the political imperative of pursuing fast growth increased when it became evident that this is what voters expected.

5.41 In the end, the main burden for increasing employment-generating investment in the nonoil-producing MENA countries falls to the nonoil-producing countries themselves. Through actions and reforms across a broad range of policy areas, they must demonstrate to foreign investors, and to their own domestic investors, that they are serious about growth. The specific reforms are not those that China or India undertook, but as in China and India they should be comprehensive enough to demonstrate commitment to a pro-growth strategy despite persistent disadvantages, such as small market sizes, about which they can do little.

5.42 Given the need for broad and deep reform, MENA countries have to choose which reforms to emphasize. While the specifics of Chinese and Indian reform do not offer strong guidance here, analysts and domestic entrepreneurs concur on the importance of financial sector reform, on the systematic removal of barriers to entry (such as those imposed by difficult access to land and continued high tariffs in many countries), and on a more reliable governance. Reforms of governance may require the broader institutional changes seen in China and India—and therefore may take more time. The horizon for financial and regulatory reforms is much shorter, suggesting a feasible, even pragmatic, reform agenda that can accelerate investment and productivity increases in the region.