EXECUTIVE SUMMARY

STRENGTHENING MENA'S TRADE AND INVESTMENT LINKS WITH CHINA AND INDIA

1. China and India's spectacular economic rise over the last two decades has accelerated their trade with Africa, Latin America, and the Middle East and North Africa (MENA). Their demands for oil, gas, and other natural resources have been driving new relationships with MENA countries based not only on energy but on trade, investment, and political ties. Indeed, Dubai has become the new Silk Road—the intersection where people, capital, and ideas meet—and Beijing, Shanghai, Hong Kong, Mumbai, Riyadh, and Cairo are the new centers.

2. The report's main messages are as follows:

- MENA is becoming a region of winners from the oil windfall—and of non-oil producers on the sidelines. Rising demand for energy from China and India has greatly contributed to the increase in oil price and is likely to sustain the oil boom in the future.
- The winners in the Gulf are laying big bets on economic diversification and knowledge enterprises—bets they might win, but with lots of risk along the way. Dutch disease effects of the oil boom may threaten the sustainability of the current expansion.
- The non-oil producers on the sidelines, especially in the Maghreb, are finding it difficult to compete with China and India in both third and domestic markets. The lack of competitive manufacturing industries and services, the insufficient attention given in the past to building technological capabilities and promoting openness and entrepreneurship are constraining their ability to respond to competition. They need to accelerate productivity to tackle unemployment, especially among youth.
- Both groups of MENA countries need to foster a culture of growth to overcome the complacency instilled by oil windfalls and government subsidies. To do this, they might look to China and India as models of pro-growth strategies.
- The growth of China and India offers new market opportunities for the countries in MENA. Besides energy, potential opportunities—for fertilizers, petrochemicals, crude materials, agricultural products, and a number of manufactured goods where MENA has strong comparative advantages—remain unexploited.

The MENA region is booming, but sustaining growth is an issue

3. The MENA region is enjoying strong economic growth for the fifth year in a row, almost 6 percent, driven by high oil prices, acceleration in market-oriented reforms, and deeper integration in the region and with the rest of the world. The rise in oil prices from about $25 in 2002 to almost $140 in mid-2008 has brought an unprecedented windfall to the resource-rich countries. With a large part of the oil revenues invested abroad, particularly through sovereign wealth funds, net financial outflows have tripled since 2002. The region has also experienced a record increase in foreign direct investment (FDI) flows, accounting for more than 4.7 percent of world FDI inflows in 2006, up from an average of 1.8 percent in 2000–04. Oil-producing nations have intensified their efforts to diversify the economy. In the six resource-rich countries of the Gulf Cooperation Council (GCC), the non-oil sector now accounts for a remarkable 60–70 percent of GDP and a massive program of infrastructure and social spending in underway.

4. The oil boom has improved the region's terms of trade with China and India: MENA's export prices to China and India doubled in 2004–06, while import prices rose by 25–30 percent. But the benefits are not distributed evenly. Oil producers have profited. The nonoil-producing countries are indirectly benefiting from the oil windfall through a surge of intraregional foreign investments in real estate and land, an exceptional increase in tourism and a rise in immigrant remittances. The region as a whole worries about the sustainability of this growth, as investments in non-tradable goods affect the competitiveness of exports. Many labor-abundant, nonoil-producing countries struggle with the rise in inflation caused by high food and property prices and growing fiscal deficits due to large energy subsidies. And they face the challenge of providing employment for a labor force that is growing at 4 percent a year, the highest in the world. Unemployment of 13 percent of the labor force, despite recent declines, falls disproportionately on the region's youth. Expanding trade with the fast-growing Asian countries may provide growth and employment opportunities.

MENA countries are looking East

5. While exports to China and India still represent a small share of MENA's total exports (6.4 and 8.2 percent respectively in 2006), their rate of growth has been impressive—41.1 percent for China and 37.5 percent for India over 2004–06. Some 60 percent of these exports are represented by fuels, followed by chemical and resource-based products, fertilizers, iron, and aluminum. Interestingly, Saudi Arabia has displaced South Korea as the leading supplier of petrochemical products to China's textile industry. More than half of China and India's energy imports come from MENA, and this share is expected to increase. Equally impressive has been the increase in MENA's imports from China and India: they now represent 8.5 and 4.5 percent respectively of MENA's imports. They are diversified, including rice and other agriculture commodities, machinery, electronics, telecommunication goods, and manufactured goods. Qatar, the Emirates, and other Gulf countries have specialized in re-exporting, confirming their role as regional hubs.

6. The volume of financial flows has traditionally been very small. Official figures suggest that in 2005, China received 0.2 percent of its FDI inflows from MENA, India around 1.5 percent. But anecdotal evidence indicates that these flows are growing rapidly. Private and institutional Gulf investors are making strategic investments in Asia and holding a diversified portfolio of assets, with emphasis on equity and equity-like instruments. And Asian companies have invested heavily in the downstream oil industry, while opening their industries to participation from the Gulf. MENA attracts 2 percent of Chinese FDI, mostly to the oil-rich countries; and it has received 5 percent of Indian cumulative FDI since 2000. The energy sector is the main recipient, and oil-rich countries are the main destination. But FDI from China and India is also rising in construction, tourism, telecommunications, software and engineering services, readymade garments, chemical products, and food.

Competing with China and India's non-oil exports has proved difficult in third markets…

7 Over the last decade most countries in MENA have seen their global market share of non-oil exports stagnate or fall. Moreover, while China's share of the EU market has risen dramatically, the importance of the EU as a market for the non-oil exports of MENA countries has declined, and significantly so for some countries. China and India have displaced some non-oil exports on third markets, with China a much fiercer competitor than India, especially in electronics, textiles, and apparel. Labor-abundant MENA countries, perhaps because they could count on privileged access to EU markets (and to some US markets), have been less severely affected than GCC countries by competition with the Asian countries. Exports from GCC countries that competed with China and India have been deeply affected, with some vanishing.

…and in domestic markets

8. Imports from China and India have lowered consumer prices but increased competition for domestic producers in labor-abundant countries. Pressures have been stronger in labor-intensive industries, including textiles, leather, and furniture. Skilled-labor and technology-intensive manufacturing was less affected, but it is a small share of domestic production. For GCC countries Chinese and Indian products appear to be more complementary, and the competition with domestically produced goods is more moderate. Interestingly, imports from China and India have grown strongly despite above-average import protection, particularly in Morocco and Tunisia. There have been some import surges, and their impact on domestic producers needs to be analyzed.

9. MENA countries are participating very little in global production networks. Intraindustry trade is low and only reaches 20–25 percent of manufacturing trade in some MENA countries (Tunisia, Egypt), very far from the 70 percent for China and other East Asian countries. Indicators of component trade are comparatively low, and are reflected in the limited technology content of MENA's imports and exports. This poor integration prevents MENA countries from benefiting from the knowledge spillovers that usually occur within production networks. Limited FDI in manufacturing and the small size of many MENA economies may explain these outcomes. There are signs, however, of MENA's increasing integration with Chinese and Indian production networks for goods destined for the European Union and the United States, particularly in the textile and power-generating machinery sectors. The major impediment to further integration with China and India may be the large distance, which results in very high transaction costs for trade.

Opportunities to export to China and India remain unexploited

10. In response to global competition in their main market (the EU), many MENA countries have started diversifying into new markets and, to a lesser extent, into new products. While this will provide a base for stronger growth in the future, many opportunities to export remain unexploited. In particular, less than 10 percent of potential opportunities in the Chinese and Indian markets have been exploited. Many MENA products with strong comparative advantages, doing well in international markets, have underperformed in China (fertilizers, vegetables, crude materials). Even in India a third of products with high comparative advantages show lackluster growth, among them wood, aluminum, chemicals, and yarns. Indeed, less than 10 percent of the potential opportunities in the Chinese and Indian markets have been exploited. Why? In part because of trade policy and logistical constraints between MENA countries. And in part because of the substantial trade barriers facing non-oil exports in Asian markets, notably in India.

China and India's investment in MENA's merchandise sectors is small

11. Contrary to other regions, there appears to be little complementarity between trade in non-oil products and investment between MENA and the Asian countries. Outside energy, China and India invest mainly in services and very little in manufacturing. Most of their FDI goes to resource-rich countries with higher GDPs. Chinese and Indian firms are also looking to export goods and services to third markets, using MENA countries as a warehouse platform, rather than a production place.

12. Overall, China and India have not established strong links with domestic firms in MENA or added to their 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. What's missing in MENA? High-quality skills, a supplier network that permits specialization and competitive costs, and a suitable physical, scientific, and institutional infrastructure.

Why non-oil exports are weak

13. Reforms have been slow and not deep enough to result in the type of structural transformation and export diversification that has occurred elsewhere. High tariff and non-tariff protection still bias the allocation of resources within sectors towards exports. In earlier studies, high trade protection has been identified as a key constraint to export diversification in the region. The vast majority of MENA countries also perform poorly in trade logistics, below their income peers. By contrast, both China and India perform better than their income peers in trade logistics, which lowers their transactions costs, including those with MENA countries.

14. Preferential agreements with the EU have not helped MENA countries withstand competition from China and India. They have partially helped maintaining a market in Europe, but the EU rules of origin may currently impede MENA's further export growth. They are strict, requiring a double transformation in qualifying countries. As a result, most of the inputs MENA producers use for exports to the EU comes from Europe. Preferential agreements have thus locked MENA producers into production structures that shelter them from competition and handcuff their ability to source inputs from other locations. The business environment has improved everywhere in MENA, including the institutional and regulatory regime for FDI. But foreign investors lament a lack of skills most. MENA countries score well below the Asian countries on "people and skills availability." Investment in human capital is needed to improve the quality of skills of the labor force and the absorption capacity of domestic economies, the keys to technology transfers and knowledge spillovers.

15. Finally, MENA's non-oil exports to China and India are small, partially because access to Chinese and Indian markets is limited. Petroleum can enter China duty-free and is subject to a 10 percent duty in India. But non-fuel shipments to these two markets face substantial trade barriers, especially in India. The two Asian countries have opened significantly over the past decade, but simple averages of most-favored-nation duties continue at about 10 percent in China and more than 18 percent in India.

Is MENA taking advantage of the opportunities in services?

16. China and India are major players in the services trade, and their services exports have grown at a faster pace than in MENA. Overall, MENA countries remain small players, although a few—Morocco, Egypt, Lebanon, and Tunisia—rank among the 30 largest net exporters of services in the world. The region is also emerging as a strong tourist destination, with Saudi Arabia and Egypt leading the way. Located on the fastest growing Asia-Europe trade route, the region aims at becoming a hub for services facilitating the transit of goods and people. Tunisia and the Gulf countries are achieving global standards in medical services. And Dubai and Qatar, with their "knowledge cities," hope to become global centers of excellence in the knowledge business.

17. However, MENA countries maintain behind-the-border barriers to services trade and are minimally exposed to foreign competition (including from India and China). Most countries in the region have only made GATS commitments on fewer than half of the services sectors. Air, road, and maritime transportation could become leading sectors, if reforms are undertaken. The case is strong for further regional trade integration in services. Most global law firms serve their MENA clients through their offices in Europe, mainly because of the high segmentation of the MENA market. Harmonizing standards and regulatory requirements could help regional firms reach a critical size for exports. The region has already tapped the Chinese and Indian worker pools in some sectors, but labor movements and technology transfers remain sensitive, and trade linkages and leakages could be further explored.

What will the continuing growth of China and India imply for MENA?

18. Our analysis shows that China and India will account for more than 50 percent of the incremental demand for oil in the next 10 years or so. The region as a whole is expected to benefit from an acceleration of growth in China and India, but most of the gains will accrue through improvements in the terms of trade, associated with higher world prices for energy products and some agricultural products. The gains are even larger if China and India improve the quality and variety of their exports, but they will be unevenly distributed. Oil-producing countries are the likely winners. Stiffer competition in third and domestic markets is likely to result in a decline of manufactured exports from nonoil-producing countries, challenging their growth prospects. Exports of resource-based and agricultural products, however, would increase. Large declines are expected in MENA for machinery, equipment, electronics, textile and garments, and other manufactured goods. So, all MENA countries will face increasing pressure to adjust their domestic and trade policies in order to increase their competitiveness and cushion the effects on their non-energy sectors.

19. The challenge for the region's labor-abundant countries is to generate jobs through faster productivity growth in all sectors. How did China and India do this? In both countries, significant political and institutional shifts appear to have preceded and accompanied sustained, growth-oriented policy changes—shifts that MENA countries have barely begun. Institutional changes gave entrepreneurs the confidence to invest. In China embracing growth as a political goal was manifest in specific reforms to liberalize entry and in the way public officials were compensated. In India a pro-growth strategy became part of the electoral mandate of all parties. In both countries, institutional changes were accompanied by dramatic and broad reforms in trade, competition, finance, and governance. The specific reforms in MENA countries may not be the same as those in China and India, two very large countries. But those reforms should be comprehensive enough to demonstrate a commitment to a growth strategy.

How MENA's oil-producing countries can respond

20. How should MENA's oil producers manage their higher revenues to minimize macroeconomic distortions and maximize long-run welfare? The benefits of the resource boom can be large, but will not follow automatically, for poorly handled resources can easily become a resource curse. These countries need to maintain macroeconomic stability and to design policies to guard against negative terms of trade shocks. They also need to share these gains widely across the economy—raising the competitiveness of other sectors and preventing de-industrialization.

21. *Cooperating with China and India.* Because of China and India's dependence on oil and gas, the Middle East is in a unique position to develop mutually beneficial cooperation—not only in energy but in downstream activities and in other trade and investment areas, including services. MENA oil producers have to weigh the tradeoffs, including those between investing their oil wealth in downstream petroleum activities or in other activities removed from petroleum.

22. *Embarking on grand schemes.* Leapfrogging to sophisticated manufacturing and knowledge enterprises may be a big gamble. Many investment banks have come to Dubai, but they will not stay without substantially more activity. Air traffic between Asia and Europe will be less likely to require the services of Middle East airports (with the advent of bigger jetliners with longer ranges). But in Dubai, where the economic diversification is already very advanced, the gamble may be worthwhile.

23. *Investing in people and knowledge.* The long-term viability of a modern services economy depends on a sophisticated workforce that wants to live in the region. 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 in other cities and countries has taken place in social and political settings very different from those in Jeddah or Qatar.

24. *Investing in the region.* Oil-producing countries have invested massively in the region, fostering regional integration. However, by investing their capital surpluses in non-tradable goods such as real estate and land, they have exported the Dutch disease effect of oil wealth. Given the need to create jobs in nonoil-producing countries, this will have to change. A great opportunity could be to invest in regional public goods, energy networks, infrastructures, and education. Oil-producing countries will face a new challenge to exercise the financial and economic leadership that could lead to a truly integrated region.

How MENA's nonoil-producing countries can respond

25. *Exploit proximity.* For labor-abundant, nonoil-producing countries, China and India amplify existing competitive challenges and pose threats to their manufacturing and possibly services sectors. While it seems unlikely that MENA countries will ever specialize in manufacturing, they can focus on niche products where they enjoy strong comparative advantages. What is needed is a switch to new products and new markets, avoiding reliance on productions where Indian and Chinese firms have tremendous economies of scale. For example, a winning strategy in the garment sector depends on the ability to exploit the proximity to the European Union. Being closer to markets allows producers to keep inventory costs and risks low and specialize in time- and fashion-sensitive products.

26. *Create a more equitable business environment.* While each country will have to choose its own menu of reform, the lesson from China and India is that growth accelerates when the overall climate for investment and innovation is favorable, ranging from the size of the domestic market to the entrepreneurial energy of a country's citizens, from the regulatory environment to the credibility of government promises. A recent World Bank report calls for a more equitable business environment, with rules and institutions that limit the room for discretion to sustain productivity and growth (World Bank, 2008c). Such a strategy is particularly important for MENA countries to withstand competition from China and India. Within this context, this report focuses on the importance of trade policies, including further tariff reforms to reduce the trade diversion from preferential agreements, to ensure that firms have access to competitively priced imports, and to improve trade logistics. To be effective, reduced protection must be accompanied by other structural reforms, including measures to improve the flexibility of labor markets, to ensure effective competition policy, and to support labor adjustments. To become more attractive to global FDI, countries need to reduce the complexity of their overlapping trade agreements. They also need to reduce the administrative costs of obtaining access to neighboring markets by removing licensing requirements and reducing the costs of complying with rules of origin. And they need to improve the backbone services critical for competitiveness.

27. *Invest in competitive services.* Competing internationally, including with China and India, requires exploiting the region's major assets—the reputation of service providers and the skills and technical knowledge in sectors. Maintaining and improving the quality of services, rather than going for the lower end of the market, is likely to be beneficial. This will take further investment in education and training, better regulation of the professions, and higher domestic standards to meet international norms. Giving priority to sectors where cultural and geographical factors are essential to the delivery of service would also help. Opening could be unilateral—but it could also be traded for further access to foreign markets. All three levels of trade negotiation instruments (bilateral, multilateral, and regional) could be pursued in traditional markets, such as the EU. While multilateral negotiations would also benefit China and India, the request-offer process at the WTO is mostly bilateral. MENA countries thus have a strong interest in participating in the Doha round, so that their

requests for opening sectors of comparative advantage prevail over those by China and India. With regional trade agreements proliferating in the world and services and investment provisions becoming more sophisticated, MENA countries could revise the level of cooperation in services within the region and with major trading partners.

28. *Negotiate with China and India.* Access to trade and service markets in India and China remains difficult. Reciprocal agreements to lower tariffs on imports of specific products should be pursued. Strengthening specific infrastructure to develop elements of deep integration with China and India (air links) could foster the integration into global value chains. Promoting learning about the two countries and their languages would also help. On services, there is a strong incentive to negotiate agreements with China and India to preserve market shares, to reinforce the security and predictability of services trade transactions, and to gain broader access to markets. A question remains, however. Is it in the interest of MENA countries to allow broader access to their markets by Chinese and Indian service providers? The answer depends on the type of commitments on both sides—and on careful analysis of the costs and benefits of bilateral opening.

CONCLUSIONS

29. The future may well bring new opportunities and faster growth to MENA countries, but the challenges are great. For MENA oil-producing countries, faster growth in China and India will increase revenues from oil and the difficult choices associated with their management. For the labor-abundant, nonoil-producing countries, competition with China and India will spotlight the need for policy measures to increase productivity. This may require the broader institutional changes seen in China and India—and may thus take some time. But the horizon for creating much needed employment is shorter, suggesting the importance of a pragmatic reform agenda that can accelerate productivity, trade, and investment in the region.