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NATURAL RESOURCE ABUNDANCE, GROWTH & DIVERSIFICATION IN MENA: THE EFFECTS OF NATURAL RESOURCES & THE ROLE OF POLICIES

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Introduction: The Middle East and North Africa (MENA) region is one of the richest in the world in terms of natural resources. It holds more than 60 percent of the world's proven oil reserves, mostly located in the Gulf region, and nearly half of global gas reserves. Not surprisingly, oil represents close to 85 percent of the merchandise exports of the region, making it highly susceptible to fluctuations in international prices. A long strand of economic literature suggests that such dependence may hurt a country's growth prospects and job creation by reducing the scope for economic diversification.

A forthcoming WB publication[2] investigates how MENA can overcome this challenge and encourage greater economic diversification. The study examines the pattern of structural transformation in MENA and explores the role of natural resources and macroeconomic policies in driving the current (limited) diversification outcomes. The authors explore analytical questions, such as: (i) the impact of the real exchange rate on manufacturing and tradable services competitiveness in MENA; (ii) the role of fiscal policy in supporting diversification; (iii) how "weak links" (input sectors with low productivity) play a critical role in explaining the concentration of economic activities, in addition to the classical Dutch disease effect; and (iv) the impact of macroeconomic factors on the drive for regional integration. The main findings are summarized in this Quick Note.

Economic Performance in MENA: MENA countries set for themselves three interrelated policy shift goals in the 1990s: a shift from economies dominated by the public sector to economies led by the private sector; a move from closed economies to more globally integrated ones; and a transition from oil-dominated to more diversified economies.

As a result, economic performance in MENA showed some progress starting from the late 2000s, featuring higher growth rates, less growth volatility, and increased market shares for exports than in the past, despite competition from fast growing countries and exporters such as China and India. Nonetheless, with the exception of Oman, MENA countries have failed to climb the economic ladder and remain in either the lower-middle- or in the upper-middle-income group. An analysis of the correlates of this overall disappointing performance shows that at the macro level MENA countries have been unable to maintain depreciated (undervalued) real exchange rates for long periods. Such undervaluation has proved important elsewhere to offset the market failures and poor institutional environment that severely hit the dynamic non-resource-intensive traded sectors.

In addition, the volatility of the real effective exchange rate in MENA has been greater than in comparable groups of countries, contributing to the lack of development of new activities outside the resource sectors and to short-lived export spells. Furthermore, despite some progress toward reducing tariffs on industry, MENA countries have

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[2] Diop, Marotta and DeMelo: "Natural Resource Abundance, Growth and Diversification in MENA: the effects of natural resources and the role of policies", Directions in Development (2012)

fared poorly in most indicators describing the domestic microeconomic environment, underlining the impression of an environment in which trade is not facilitated and of an unfinished reform agenda. Improved domestic regulatory policies along with improved public sector governance reflected in better values for key indicators would help MENA achieve greater integration into the world economy.

Services sectors in resource-rich MENA countries are subject to a Dutch disease-type effect: The traditional negative effect of Dutch disease on the development of tradable manufacturing sectors is well documented. What this new study finds is those Dutch disease related phenomenons also have an impact on the services sector, since the former has become increasingly tradable.

Services sectors in resource-rich MENA countries have been declining as a share of gross domestic product (GDP) and of non-mining GDP as per capita incomes increase. This negative relationship between the share of services in GDP and income per capita is contrary to global patterns and is linked to the large rents generated by natural resources in these countries. A large number of services sectors can now be moved offshore or provided by temporary movement of service providers, implying that countries need to be competitive to maintain domestic production. Rents from natural resources inflate wages and nontradable prices, thereby appreciating the real exchange rate and discouraging domestic provision of tradable services.

The study highlights that the negative effect of rents is compounded by the negative impact of policy and regulatory restrictions on entry, and of business conduct on the development of services sectors. These restrictions create rents captured by "protected incumbents" or increase the real cost of producing services—in both cases inflating the price of services. Resource-rich countries need to reduce these restrictions, build strong human capital, and improve their institutions to create an enabling environment for diversification in the long run. Meanwhile, they offer formidable export diversification opportunities to resource-poor MENA, provided that these countries reduce their own regulatory restrictions to investments in exporting service industries, improve their backbone services (such as telecom), and proactively engage resource rich countries in reducing barriers to labor mobility within the region.

MENA and Global Patterns of Diversification: There are systematic differences between the patterns of diversification in MENA and the rest of the world. The relationship between economic diversification and income per capita is non-monotonic: at early stages of development, countries typically diversify as income increases and new economic opportunities emerge, but at later stages the production bundle becomes more concentrated as income rises. This empirical regularity does not fit the observed pattern of development and diversification in MENA countries. At their early stages of development, production becomes more concentrated as income rises, and then less concentrated after reaching a certain income-per-capita threshold.

The correlates of these different patterns of diversification are varied, starting from the role of relative endowments in natural resources and then investigating the role of Dutch disease associated with a strong appreciation of the real exchange rate in contrast with the role of weak links in the economy. The weak link argument is recent—it shows that complementarities in production and linkages among sectors can lead to either multiplier or weak link effects. When the links are weak, low productivity in one sector can reduce productivity throughout the economy, depending on the degree of substitutability among inputs.

In a setup with low substitutability, weak links will result in a less diversified production bundle as downstream sectors are hurt by higher input prices and factor prices[3]. The study econometrically tests the relevance of the Dutch disease versus weak links in explaining MENA's peculiar pattern of diversification. It was found that weak links contribute to a more concentrated production bundle than Dutch disease. Moreover, after

[3] Examples of sectors that can be considered weak links are the energy production or oil refining industries whose products are broadly used by others sectors as intermediate inputs, and which have a non-negligible, nontradable component. Energy is required by almost every sector, and while oil is highly tradable, energy production can be highly nontradable. Low levels of productivity in energy production will imply higher costs for users of energy and might constrain diversification into new sectors as their expected profitability falls. Thus, the presence of weak links may lead to higher levels of concentration.

controlling for these two variables[4], the differences in development patterns between MENA and the rest of the world become smaller. This result has some interesting policy implications, at least in terms of the timing of industrial policy reforms. Policies aimed at diversifying the production process should first try to address the region's weak links. Otherwise resources may be wasted in trying to diversify into sectors that are not economically viable. Although more research is needed in this area, this chapter suggests that if governments first address the existing weak links in their economies, diversification may naturally follow. If addressing weak links may sometimes seem like a daunting task requiring large infrastructure investments with a long term objective, it is important to note that one characteristic of weak links is that they are non-traded goods. If there is an easily imported substitute, then the low productivity of the domestic input sector is no longer a drag on growth. Thus, when restrictive trade policies limit the tradability of input sectors, liberalization may be sufficient to address those weak links.

Fiscal Policy and Diversification in MENA: From a historical perspective, fiscal policy has not contributed significantly to diversification in MENA, because it has been more oriented toward food and fuel subsidies (consumption) rather than toward public goods such as infrastructure (investment). Even at that, fiscal policy has not been well targeted and has been particularly ineffective at promoting redistribution. Fiscal policy in resource-rich countries of MENA has also suffered from a lack of transparency and accountability. The most recent oil boom in the Gulf Cooperation Council (GCC) countries has led to an impressive buildup of sovereign wealth funds, which have helped mitigate deficits and cushion these countries through crises, but transparency on the governance of these funds has been limited. Nevertheless, over a longer period, the three regions in MENA—the GCC oil exporters, the Maghreb countries in the northwest of Africa, and the Mashreq countries located in the Middle East—have all improved their overall fiscal management, although they have all neglected infrastructure investments.

The long-term challenge for the MENA region is to ensure that fiscal policy is used to promote growth and diversification. The GCC countries will need to implement policy reforms to accelerate non-oil growth and create employment opportunities for a rapidly increasing labor force in a sustained fashion.

For oil importers in the Mashreq and Maghreb, fiscal management must ensure that the pressing demands on the state from the citizenry must be accommodated without jeopardizing longer-term macroeconomic stability.

Reorientation of public expenditure away from subsidies that do not go to the poor and towards both conditional cash transfers and effective public investment programs must be encouraged. Through fiscal policy targeted toward infrastructure, MENA countries can help lay the foundation for successful diversification.

Incentives for Regional Integration among Resource-rich and Resource-poor MENA Countries: The authors of the study emphasize the different characteristics of regional partners in terms of their resource endowments and consider wealth distribution effects within the region. A recent theoretical model developed by Venables shows that the proximity of resource-rich and resource-poor countries creates an opportunity, through regional integration to even up wealth distribution among these countries. Preferential trade liberalization is typically more beneficial than unilateral nondiscriminatory most-favored-nation trade liberalization for the resource poor country, because the country gains access to the rents in the resource-rich country. This would imply that integration between resource-rich labor-importing and resource-poor labor-abundant countries might be beneficial only for the resource-poor countries in MENA. The study tests the extent to which economic diversification has been achieved at the expense of trade diversion and, consequently, at the expense of broader economic efficiency. Results suggest that significant trade creation is associated with regional integration within MENA, with no evidence of trade diversion in resource-poor countries. But there is evidence of trade diversion in both labor-abundant and labor-importing resource-rich countries. Hence, while further intraregional trade integration is an important avenue for

[4] Dutch disease (proxied by percentage changes of the real exchange rate) and Weak Link (proxied by the probability of observing productivity in a sector lower than a certain threshold-mean productivity minus 2xstandard deviation- in a given country and year)

enhancing diversification of resource-poor MENA countries, resource-rich countries have no strong incentive for further preferential regional integration from a purely economic standpoint, and this may explain their relative reluctance to engage in this type of scheme.

Conclusions: Several policy recommendations emerge from the report. Policy makers should strive to avoid real exchange rate overvaluation through consistent fiscal policies, flexible exchange rates, and adequate product and factor market regulations. Reforms to strengthen the competition and efficiency of upstream input activities are crucial for improving the performance of downstream activities and diversification. Consistent and transparent fiscal policy is essential to reduce instability, build the fiscal space needed to invest in core infrastructure and human capital, and create a favorable environment for diversification. Finally, it is worth considering that while regional trade integration leads to greater diversification and welfare gains for the resource-poor countries, the resource-rich countries need to go beyond trade to derive benefits from regional integration since trade preferences tend to generate net income losses for them.

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