5. Private Investment for Inclusive Growth in the Middle East and Central Asia

Between 2000 and 2017, annual private investment in Middle East and Central Asia countries averaged 15.6 percent of GDP, the second lowest worldwide after sub-Saharan Africa. Since the global financial crisis, investment ratios have declined markedly relative to peers. A more dynamic private sector, underpinned by robust private investment, is needed to foster greater job creation and boost inclusive growth. Increasing access to finance, investing in education and infrastructure, reducing the role of the state in the economy, and improving government effectiveness and governance would unlock private investment, laying the foundation for higher and more inclusive growth. These efforts would enable a transition from the current state-led economic growth model, which has inhibited private sector development, to more dynamic private-sector-led growth.

Boosting Private Investment Is Key to Achieving Higher and Inclusive Growth

The Middle East and Central Asia region needs higher and more inclusive growth to create jobs for a growing population and to enhance economic resilience, as discussed in Chapters 1–3 of this report.

Increasing investment—both public and private—would add to aggregate demand in the short run and lay the foundation for higher potential growth going forward, including by improving productivity. Public investment has an important role to play by providing the necessary infrastructure (for example, energy, transportation, communication) to unlock private investment, and by helping to build human capital (for example, investment in education and health).

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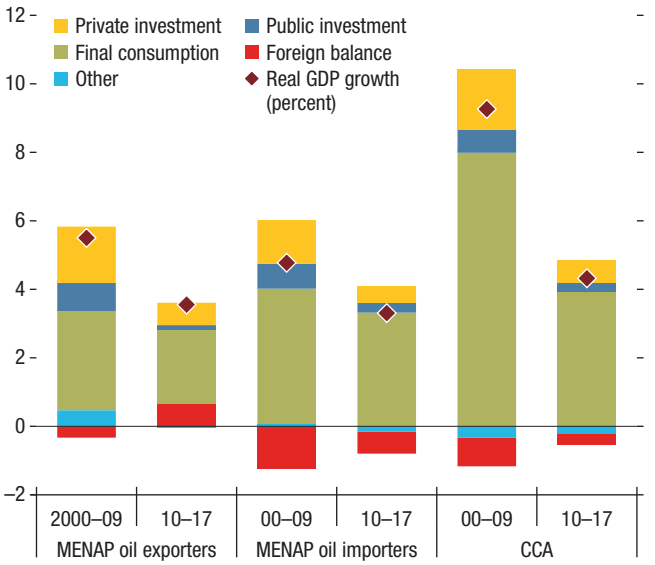
However, as shown in Chapter 4, limited fiscal resources means that increasing private sector investment will be key. In addition, private investment is critical to expand an economy's productive capacity and to boost productivity through the introduction of new techniques and processes.

Although many countries in the Middle East and Central Asia are taking steps to promote private sector development—including improving the business environment, strengthening governance, and pursuing productivity-enhancing reforms (see Chapters 1–3)—private investment is low relative to peers, and its contribution to growth has been declining (Figure 5.1). This chapter seeks to understand the main drivers of private investment in order to help guide policy and reform efforts to mitigate current impediments to private investment and unlock the region's growth potential.

Private Investment in Middle East and Central Asia Countries is Low

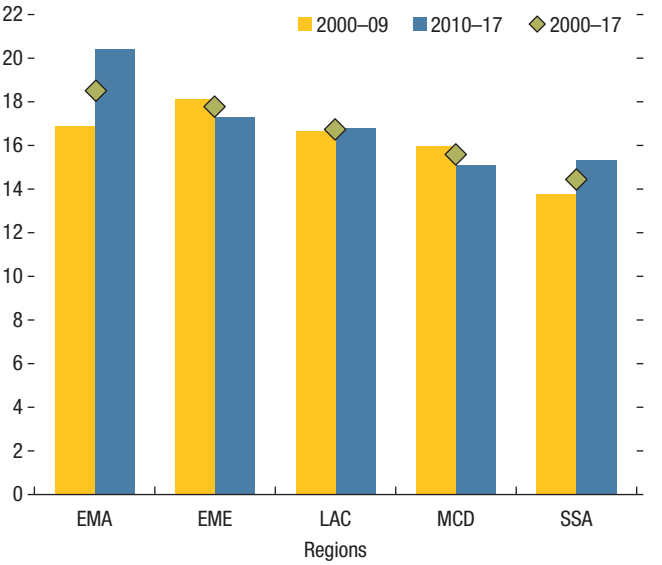
Between 2000 and 2017, annual private investment in Middle East and Central Asia countries averaged 15.6 percent of GDP, the second lowest worldwide after sub-Saharan Africa's 14.5 percent (Figure 5.2) (see Chapter 3 in the April 2018 *Regional Economic Outlook: Sub-Saharan Africa*). During the same period, private investment ratios in Latin America and the Caribbean and in emerging Europe were higher by about 1.2 and 2.3 percentage points, respectively. Emerging Asia has outperformed Middle East and Central Asia countries by almost 3 percentage points. Investment ratios are markedly low relative to peers for low-income countries and for high-income Gulf Cooperation Council (GCC) countries (Figure 5.3).

Figure 5.1. Decomposition of Real GDP Growth
(Simple averages, percentage points)



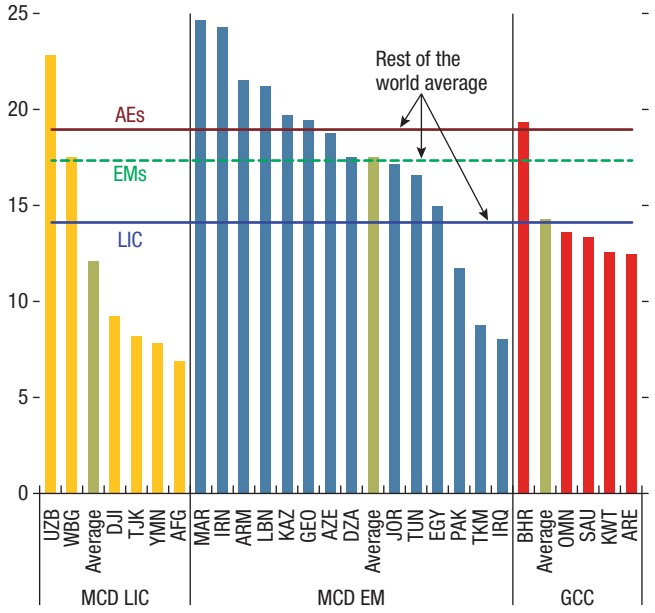
Sources: National authorities; IMF, *World Economic Outlook*; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; and MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

Figure 5.2. Private Investment Ratios
(Average, percent of GDP)



Sources: IMF, *World Economic Outlook*; national authorities; and IMF staff calculations.
Note: EMA = emerging Asia; EME = emerging Europe; LAC = Latin America and the Caribbean; MCD = Middle East and Central Asia; SSA = sub-Saharan Africa.

Figure 5.3. Private Investment by Income Level
(Average 2000–17, percent of GDP)



Sources: IMF, *World Economic Outlook*; national authorities; and IMF staff calculations.
Note: Qatar was excluded from the MCD Gulf Cooperation Council average due to data availability. AE = advanced economies; EM = emerging market economies; GCC = Gulf Cooperation Council; LIC = low-income countries; MCD = Middle East and Central Asia. Country abbreviations are International Organization for Standardization (ISO) country codes.

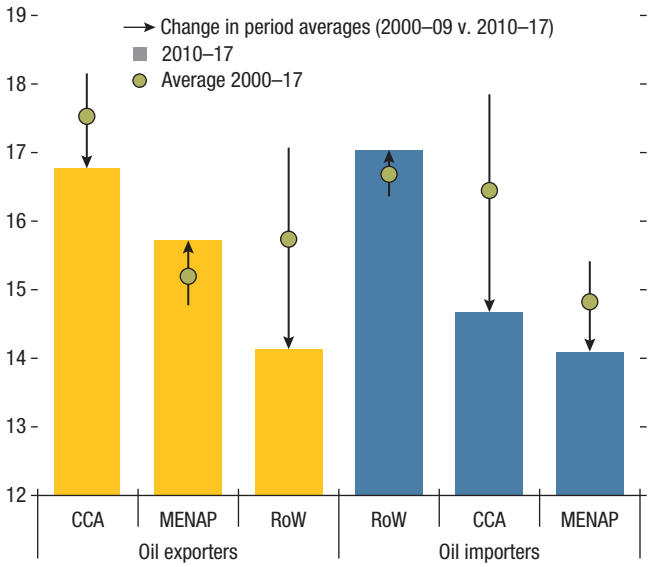
Private investment has also declined in the region since the global financial crisis, in line with emerging Europe. This is due to a combination of factors, including weak economic activity, firms' expectations of lower profitability, and tighter financial conditions, coupled with the sharp decline in oil prices over 2014–15.[1]

However, regional averages mask some notable differences across these countries (Figure 5.4):

- The ratio of private investment to GDP increased on aggregate in oil exporters in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region. However, this result is driven by Algeria, where the average investment ratio increased from 14 percent of GDP to 22 percent. This likely reflects large investments by state-owned enterprises (SOEs), which are difficult to disentangle from private investment in the data. Excluding

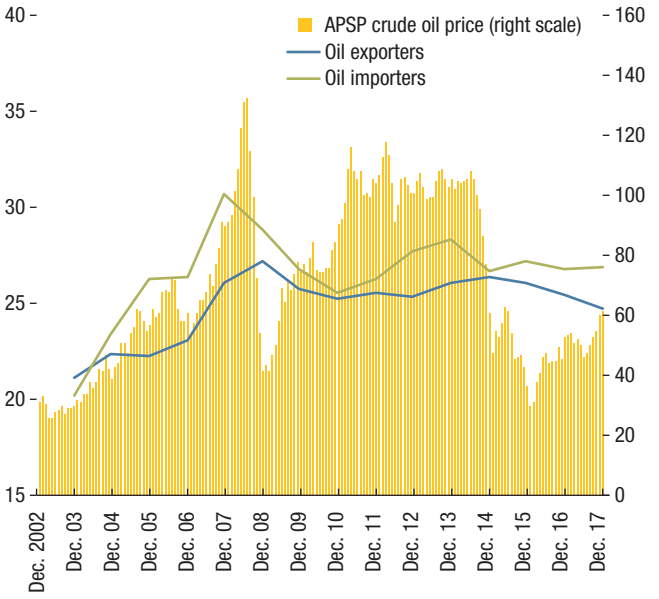
[1]See Chapter 4 of the April 2015 *World Economic Outlook* for a discussion of factors affecting investment in the wake of the global financial crisis. See IMF (2016a) for a discussion of investment trends in Middle East and North Africa oil exporters and importers.

Figure 5.4. Private Investment Ratios
(Average, percent of GDP)



Sources: IMF, *World Economic Outlook*; national authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; RoW = rest of the world.

Figure 5.5. Real Investment
(Percent of real GDP)



Source: IMF staff calculations.
Note: APSP = average price of spot prices.

Algeria, investment ratios stayed broadly stable, with modest gains in Iraq, Kuwait, and Oman offset by modest declines in Iran, Saudi Arabia, and the United Arab Emirates.

- Most MENAP oil importers have exhibited a decline in their private-investment-to-GDP ratio since 2008, particularly in Egypt. This trend can also be seen in Afghanistan and Pakistan since 2004. This indicates that political instability has not been conducive to attracting private investment.
- Within the Caucasus and Central Asia (CCA) region, investment ratios have declined since the global financial crisis, especially among oil importers. This was largely driven by a steady decline in Armenia, which more than offset a recent pickup in Georgia. Among oil exporters, while the private-investment-to-GDP ratio has increased, this has been partially offset by a slow decline in Kazakhstan.

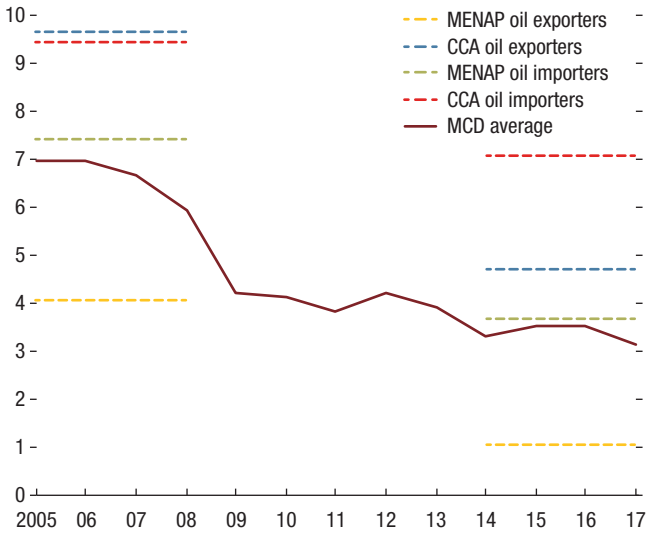
Investment Flows in the Region Driven by Commodity Cycles

The continued dominance of commodities in the region's economic model is also reflected in the relationship between investment—both public and private—and commodity prices, especially oil prices (Figure 5.5).

Higher oil prices tend to be associated with an expansion in public investment in oil-exporting countries, reflecting the strong procyclicality of capital expenditure. In parallel, oil prices indirectly affect the availability of resources for investment in oil-importing countries given spillovers through remittances, grants, and direct investments from oil exporters. These channels are more pronounced in the CCA, where transnational oil projects are prominent.[2]

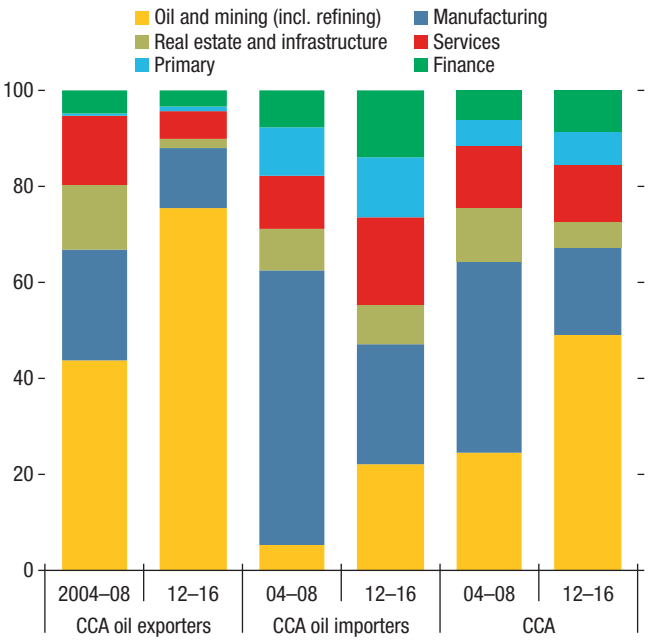
[2]Oil exporters such as Azerbaijan and Kazakhstan are among the top investors in Georgia and the Kyrgyz Republic, respectively. Large oil and gas projects, such as the construction of Turkmenistan-China gas pipeline, are spurring new FDI in oil importers, including the Kyrgyz Republic and Tajikistan.

Figure 5.6. Foreign Direct Investment Inflows
(Percent of GDP, simple averages; dotted line = period average)



Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MCD = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

Figure 5.7. Foreign Direct Investment Inflow Commitments
(Percent of FDI commitments, simple averages across countries and years)



Source: Broner and others (2018).
Note: CCA = Caucasus and Central Asia.

Foreign Direct Investment Inflows Concentrated in Commodity Sectors

Foreign direct investment (FDI) has been a key driver in the decline in private investment. In line with the overall trend in private investment, inflows of FDI have nearly halved since the global financial crisis (Figure 5.6). As FDI is heavily concentrated in the commodity sector, this likely reflects the decline in oil prices, with oil exporters in MENAP (especially Bahrain, Oman, Qatar, and Saudi Arabia) and CCA seeing the largest decline in the rate of FDI inflows.

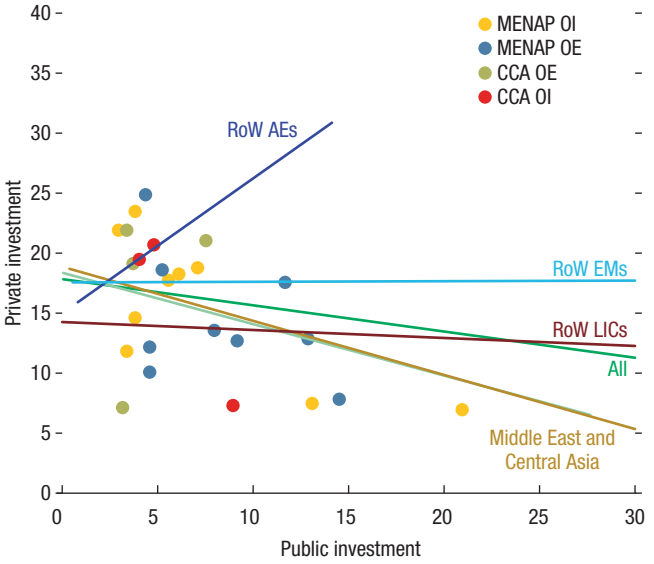
Although overall FDI flows have declined, they have also become more concentrated in the oil and mining sectors, with less of an impact on job creation given the capital-intensive nature of those sectors. The share of FDI flowing to these sectors in the Middle East and Central Asia increased from an average of 29 percent of inflows between 2004–08 to 40 percent of inflows between 2012–16. CCA countries accounted for most of this increase. In CCA oil importers, the share of FDI inflows to oil and mining sectors increased from an average of 5 to 22 percent of total inflows during the same period (Figure 5.7). In CCA oil exporters, the oil and mining sectors constituted more than 75 percent of total inflows during 2012–16. During the same period, the average share of inflows to the sector in MENAP oil exporters declined from already-elevated levels, while it remained flat in MENAP oil importers.

Large Public Sectors Impeding Private Sector Development

Although public investment can be an important complement to private investment, there are indications that it may be crowding out private investment in the MENAP and CCA regions (Figure 5.8). This crowding out is one indication that the large state sector is competing with—rather than complementing—the private sector for limited resources, including access to credit and talent.

Figure 5.8. Correlations between Public and Private Investment, 1995–2017

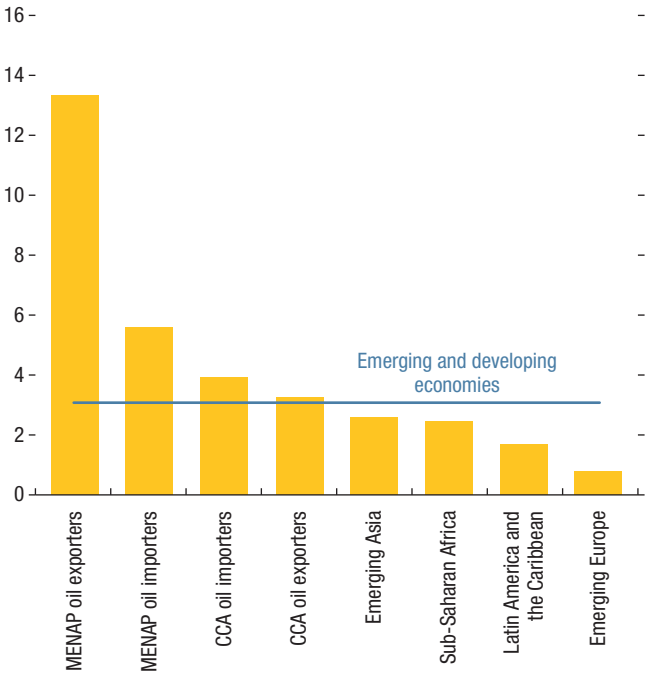
(Percent of GDP, dots show simple country averages across time periods, trendlines are linear fits of the observations in each group)



Sources: National authorities; and IMF staff calculations.
Note: AEs = advanced economies; CCA = Caucasus and Central Asia; EMs = emerging market economies; LICs = low-income countries; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers; and RoW = rest of the world.

Figure 5.9. Bank Credit to Public Nonfinancial Corporations

(Percent of total bank credit, simple averages)



Sources: IMF, International Financial Statistics; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; and MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

The larger share of credit being allocated to SOEs in the MENAP and CCA regions relative to other regions is also indicative that the state is heavily involved in the productive sector of the economy (Figure 5.9). This is most pronounced in MENAP oil exporters, where the ratio of SOE credit to total credit is several times the average of emerging market and developing economies.

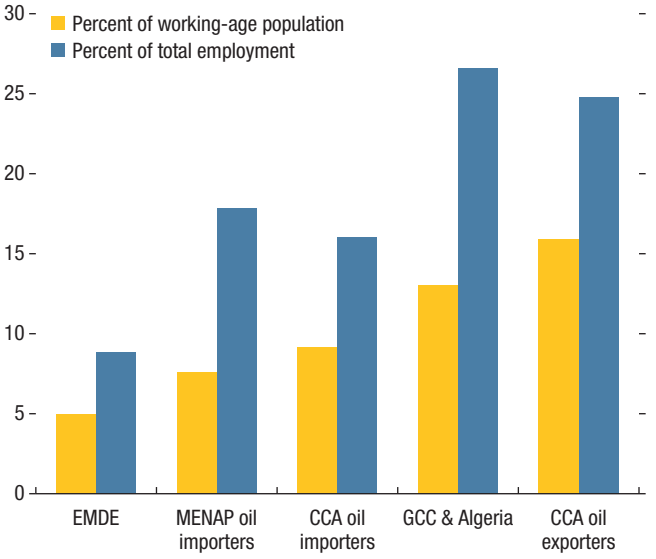
In addition, public sectors in the region are larger employers than in peers, exposing the private sector to competition for talent. The ratio of public employment to overall employment in CCA oil exporters is 2.7 times the average for emerging market and developing economies (Figure 5.10). Also, in several MENAP oil-exporting countries, large gaps exist between public and private sector compensation, effectively raising labor costs for the private sector (IMF 2016b). Particularly in the GCC, public wages are about two to three times higher than average private sector wages (Tamirisa and Duenwald 2018).

The Middle East and Central Asia region's natural resource endowments, with strong interlinkages across economies, coupled with the heavy role of the state in the productive sector, has deterred private investment in non-oil sectors. This has dampened the region's gains in productivity and job creation, limiting investment opportunities and leaving the government as an employer of last resort, in some cases.

Constraints in the Business Climate Holding Back the Private Sector

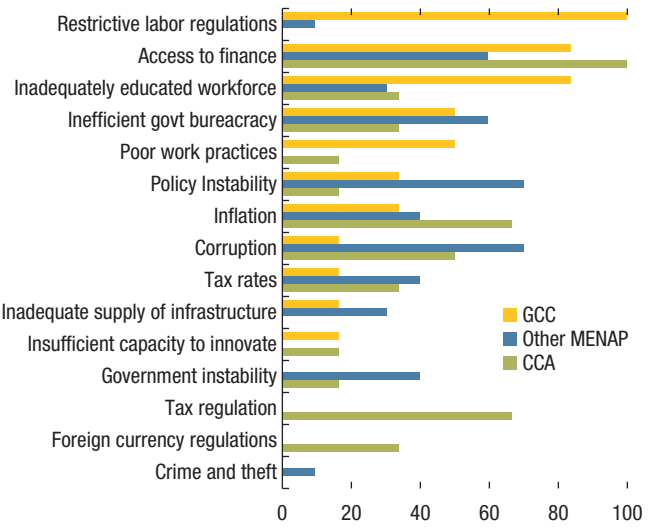
Ongoing weaknesses in the business environment also impede the private sector. In particular, access to finance and talent emerge as important impediments to doing business, as do issues related

Figure 5.10. Public Sector Employment



Sources: National authorities; national labor surveys; and International Labour Organization.
Note: CCA = Caucasus and Central Asia; EMDE = emerging and developing economies; GCC = Gulf Cooperation Council; and MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

Figure 5.11. Challenges to Doing Business
(Percent of countries identifying the constraint among top five)

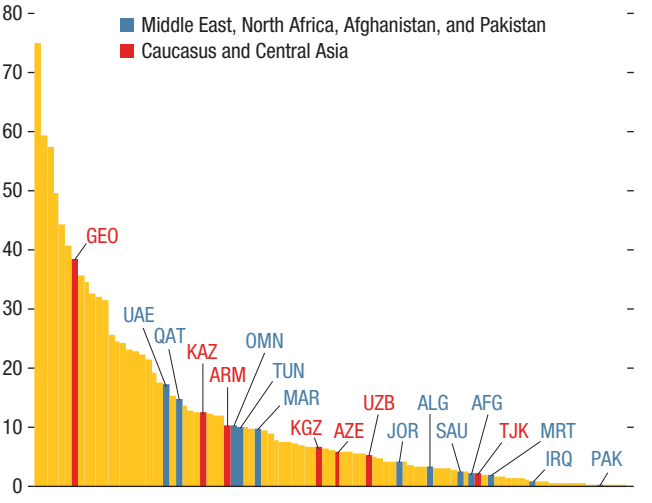


Source: World Economic Forum, *Global Competitiveness Report 2017–18*.
Note: CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

to government bureaucracy and regulations, also potentially linked to the heavy state presence in the economy (Figure 5.11).

New business entry remains a major challenge across the region, with the creation of new businesses lagging other emerging economies (Figure 5.12). Average business entry levels in MENAP trail other regions significantly, while the CCA is on par with sub-Saharan Africa and Latin America and the Caribbean, lagging only emerging market economies. Thanks to its structural reforms in the early 2000s, Georgia stands out among the regional countries, with twice as many new business entries as its closest follower, the United Arab Emirates. Iraq and Pakistan suffer from particularly low levels of business creation, with one business per 5,000 and 1,000 residents, respectively.[3]

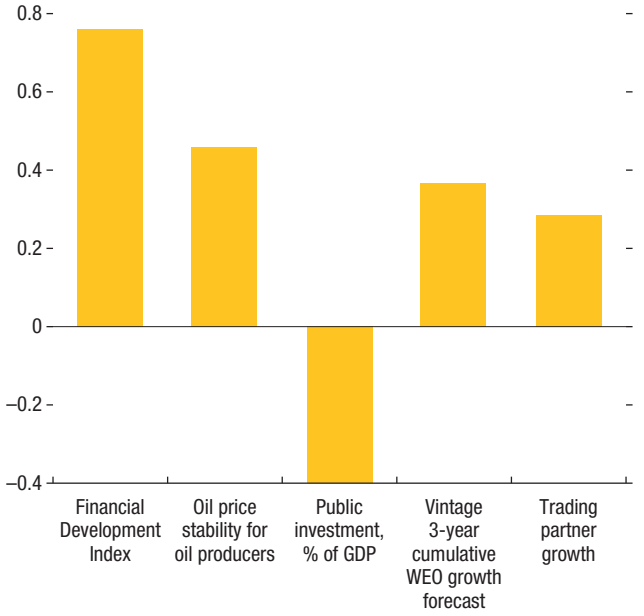
Figure 5.12. New Businesses in Emerging Market Economies
(Per 1,000 Residents, 2008–16 average)



Source: World Bank, *World Development Indicators 2018*.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

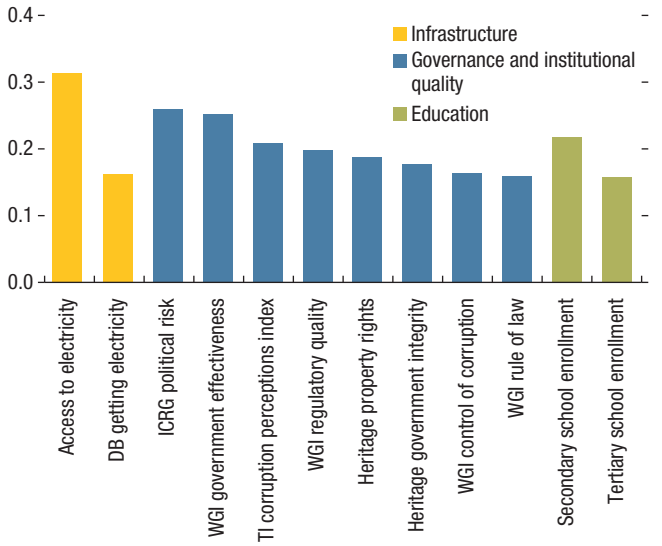
[3]However, low levels of business creation could be the result of the high levels of informality in some countries.

Figure 5.13. Economic Significance of Noninstitutional Drivers of Private Investment
(First-stage regression coefficient times 1 standard deviation)



Sources: IMF, *World Economic Outlook* (WEO); Svirydzenka (2016); and IMF staff calculations.

Figure 5.14. Explanatory Power of Institutional Variables
(R-squared statistics of individual second-stage regressions)



Sources: Heritage Foundation; ICRG; TI; World Bank, World Development Indicators and DB; WGI; and IMF staff calculations.
Note: DB = Doing Business; ICRG = International Country Risk Guide; WGI = World Governance Indicators; and TI = Transparency International.

Empirical Determinants of Private Investment

The empirical analysis of the determinants of private investment for emerging market and developing economies confirms that financial development, domestic growth prospects and trading partner growth, oil price volatility, and public investment are key determinants of private investment (Box 5.1; Figures 5.13 and 5.14). Overall, securing a one standard deviation change in any of the factors highlighted in Figure 5.13 would lead to a significant increase in private investment (all other factors being equal), and consequently boost overall growth.

As expected, better economic growth prospects lead to higher levels of private investment, as businesses invest more when they expect prosperity. Similarly, private investment is higher when countries' trading partners are experiencing stronger growth and thus providing more demand for companies' products.

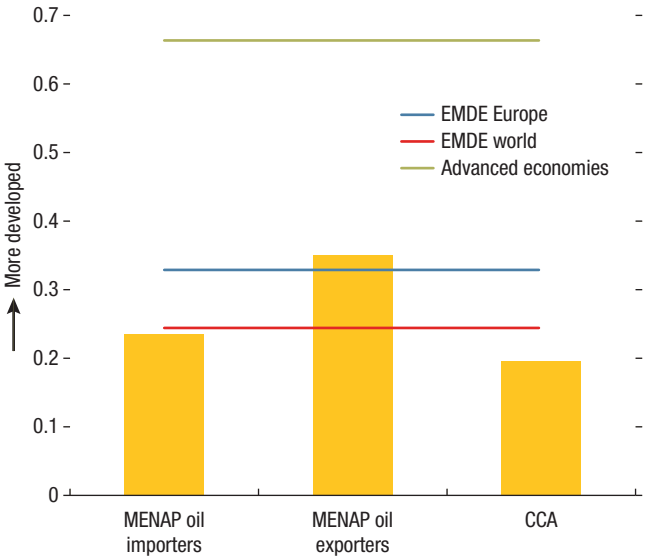
Oil producers attract higher levels of private investment when oil markets are stable (as measured by the volatility of oil prices). This again highlights their exposure to commodity cycles. Greater economic diversification would likely reduce this effect and lead to more stable investment levels.

The results seem to confirm that public investment can crowd out private investment. However, given the role that public investment can play in supporting business—by providing a skilled workforce, critical infrastructure, etc.—some level of public investment is necessary to enable private investment in the first place.

Institutional Factors Also Matter

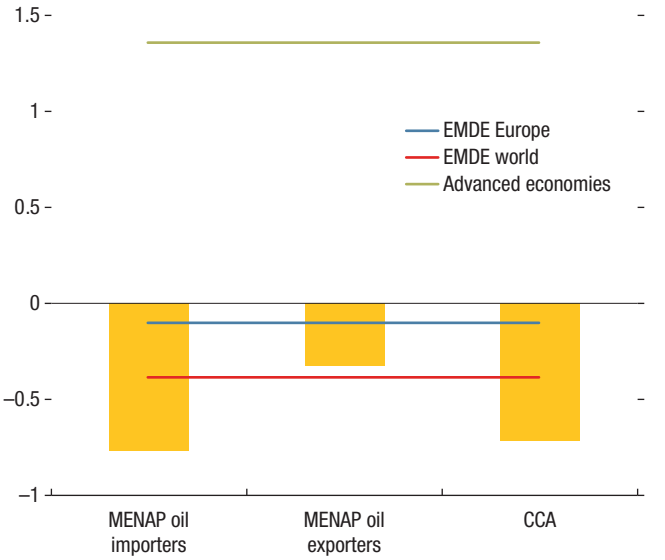
To assess the relevance of more institutional factors, this chapter takes the analysis a step further. Further results provide more insight into the supportive role of the public sector by confirming the importance of access to education

Figure 5.15 Financial Development
(Financial Development Index, 2015)



Source: Svirydzenka (2016); and IMF staff calculations.
Note: Index ranges from 0 to 1. CCA = Caucasus and Central Asia; EMDE = emerging and developing economies; and MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

Figure 5.16. Rule of Law
(From –2.5 (weak) to 2.5 (strong) governance performance, 2016)



Source: World Governance Indicators.
Note: CCA = Caucasus and Central Asia; EMDE = emerging and developing economies; and MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

(to boost human capital) and infrastructure in encouraging private investment (Figure 5.14).

These results also confirm the importance of a stable political environment, strong governance, government effectiveness and integrity, and the rule of law.

The Importance of Closing Key Gaps in the Quality of the Business Environment

Overall, the analysis underscores the importance of narrowing the gaps in some key areas between the Middle East and Central Asia and peers.

In particular, financial development in MENAP oil importers and CCA countries lags behind averages for emerging market and developing economies (Figure 5.15). Similarly, these countries have large gaps relative to emerging market and developing economies across a number of governance indicators, such as the rule of law (Figure 5.16). Closing these gaps would make an important contribution to securing more private investment and higher growth in these countries.

Better access to education is also needed across the entire region. Enrollment and educational attainment levels are weaker in MENAP at all levels of education relative to peers (see Chapter 4; see also Purfield and others 2018). Enhancing the focus of public investment on increasing access to quality education could play a significant role in boosting private investment and growth.

Finally, the quality of infrastructure varies significantly across the region (see Chapter 4). Thus, for some countries, important gains could be made by undertaking some well-designed infrastructure development.

Policy Recommendations

Promoting greater private investment is a high priority for the countries of the Middle East and Central Asia to raise and sustain higher growth to create jobs. Developing a dynamic private sector and attracting greater private investment will, in

turn, require supportive macroeconomic policies and structural and institutional reforms.

In particular, measures to increase access to finance across the region would play a key role in increasing private investment. These measures could include efforts to introduce and expand the coverage of credit bureaus, strengthen creditor rights in enforcement of collateral and the related operational quality of court (and out-of-court) systems, improve bankruptcy laws and proceedings, and strengthen banking systems (especially in the CCA) to enhance access to bank credit. Greater competition among banks could also be promoted by easing entry requirements and removing preferential treatment for publicly owned banks. In parallel, efforts to deepen domestic capital markets would expand the channels for the private sector to access capital, including equity capital as well as other private capital, such as venture capital. Strengthening insolvency and bankruptcy frameworks, as well as furthering the development of Fintech, would also help (Lukonga, forthcoming). Regulatory and supervisory frameworks would need to be strengthened to support sound financial development.

Well-targeted public spending on education (including orienting education and vocational training toward the skills needed in the private sector) and physical infrastructure are paramount for building human capital and enhancing competitiveness and productivity. This type of public investment would act as a strong complement to private investment. For most countries in the region facing fiscal constraints, this will entail reallocating spending from unproductive uses (for example, untargeted subsidies and high wage bills) toward investment. Embedding this into strong public investment management frameworks would ensure the quality of spending and efficient and sustainable use of resources (see Chapter 4).

Complementing these measures with efforts to improve government effectiveness—including by reducing bureaucracy, enhancing transparency and accountability to reduce perceptions of corruption, and strengthening the legal framework for businesses—would also support private investment. Promoting a competitive business environment by lowering barriers to entry and reducing the public footprint (for example, through state-owned enterprises) would reduce the dominance of the public sector and provide greater space for the private sector to flourish. These efforts would enable a shift from the current state-led economic growth model to more dynamic private-sector-led growth. This would support greater economic diversification in oil-exporting countries and ensure broad-based and inclusive growth across the region, enhancing countries' economic resilience.

Box 5.1. Determinants of Private Investment: An Empirical Examination

Two-stage regressions are estimated to empirically identify the determinants of private investment in the Middle East and Central Asia. In the first stage, a country fixed-effects panel regression is used to estimate the historical relationship between the private-investment-to-GDP ratio and a selection of macroeconomic variables for a sample of 140 emerging market and developing economies covering the period 1991–2015. Specifically, the following relationship is estimated[1]:

$$\left(\frac{I}{Y}\right)_{i.t} = \beta_0 + \beta_1 \left(\frac{I}{Y}\right)_{i.t-1} + BX_{i,t} + \gamma_t + \delta_i + \varepsilon_{i,t}.$$

The set of explanatory macroeconomic variables ($X_{i,t}$) includes public investment to GDP; GDP per capita; the cumulative three-year GDP forecast from the *World Economic Outlook* (made in the same year as the private investment in question); growth in the country's trading partners; an oil producer dummy; the inverse of the standard deviation of the daily oil price; interaction of the former two variables; and measures of financial development (see the Financial Development Index detailed in Svirydzenka 2016), capital account openness (the Chinn-Ito, 2006, indicator), and trade openness. The panel regression includes year and country fixed effects. Table 5.1.1 presents the regression results and Figure 5.13 in the main text summarizes the economic significance of variables with statistically significant coefficients.

Table 5.1.1. First-Stage Regression Results

Variables	Private Investment, % of GDP
Private investment, % of GDP, lagged	0.796***
	(0.0360)
Public investment, % of GDP	−0.0822**
	(0.0369)
GDP per capita, PPP, log, lagged	−2.255***
	(0.612)
Vintage 3-year cumulative WEO growth forecast	0.0437*
	(0.0233)
Trading partner growth	0.136**
	(0.0689)
Oil producer dummy *x* inverse of daily oil price standard deviation	2.990**
	(1.456)
Financial Development Index	5.772***
	(1.925)
Capital account openness	1.103
	(0.790)
Trade openness	0.484
	(0.792)
Constant	Yes
Country fixed effects	Yes
Year fixed effects	Yes
Observations	3,210
R-squared	0.676
Number of countries	140

Sources: Chinn and Ito (2006); IMF, *World Economic Outlook*; Sviryzdenka (2016); and IMF staff calculations.
Note: WEO = IMF, *World Economic Outlook*; PPP = purchasing power parity.
Standard errors in parentheses *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

[1]The panel regression includes year and country fixed effects and uses a clustered sandwich estimator to allow for correlation of standard errors over time for each country. It avoids the need to use instruments (as in Chapter 3 of the April 2018 *Regional Economic Outlook: Sub-Saharan Africa*) by selecting explanatory variables that are not directly driven by the dependent variable. In particular, the regression uses a lagged value of GDP per capita, and instead of contemporaneous same-country GDP growth, it includes contemporaneous trading partner growth and vintage *World Economic Outlook* growth projections to proxy for expectations of same-country economic growth when the private investment in question was made.

Box 5.1 *(continued)*

The first-stage regression does not include any institutional variables, which tend to change very little over time in each individual country. The cross-country variation between them is captured in the first-stage regression by the country fixed effects. The importance of these factors is then assessed in a set of second-stage regressions, each of which relates the country dummies and various institutional and infrastructure variables (using averages of available values for 1991–2015). These include the overall scores and their components from the World Bank's Doing Business Indicators, the World Governance Indicators, the Economic Freedom Indices and their components from the Heritage Foundation and Fraser Institute, the World Economic Forum's Ease of Access to Loans Index, Transparency International's Corruption Perceptions Index, the International Country Risk Guide's Political Risk Index and its components, and the World Bank's series on access to electricity and secondary and tertiary school enrollment.

Each regression only relates the country dummies to one institutional variable at a time, since the latter are often strongly correlated. To compare the economic significance of the various institutional factors in explaining the cross-country differences in private investment, Figure 5.14 in the main text displays the highest of the *R*-squared coefficients of the individual regressions.

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