



# POLICY BRIEF ECONOMIC DIVERSIFICATION IN THE MENA REGION



Task Force 1  
**TRADE, INVESTMENT AND GROWTH**

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# موجز السياسة التنوع الاقتصادي في منطقة الشرق الأوسط وشمال أفريقيا

فريق العمل الأول  
التجارة والاستثمار والنمو



المؤلفون

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## ABSTRACT

The Middle East and North Africa (MENA) region consists of a heterogeneous group of countries ranging from high-income countries in the Arabian Gulf to middle-income and least developed countries. A dominant concern in the MENA region is the high dependence on oil and gas among high-income countries and on traditional agriculture among the least developed ones. The region is characterized by volatile economic growth owing to the changes in international commodity prices. This necessitates the adoption of economic diversification policies outside resource-based sectors. G20 policymakers should support MENA countries to leverage the global value chain in technology sectors in order to facilitate access to foreign markets. Policymakers should also provide technical developmental support for the region's entrepreneurship ecosystem and improve the business competitiveness indicators of MENA countries.

تتألف منطقة الشرق الأوسط وشمال أفريقيا من مجموعة غير متجانسة من البلدان. فمنها بلدان ذات دخل مرتفع في الخليج العربي، وبلدان متوسطة الدخل، وبلدان أخرى أقل نموًا. ومن الشواغل الرئيسية في منطقة الشرق الأوسط وشمال أفريقيا اعتمادها الكبير على النفط والغاز في البلدان ذات الدخل المرتفع، واعتمادها على الزراعة التقليدية في البلدان الأقل نموًا. ويحثُّ النمو الاقتصادي المتقلِّب في المنطقة بسبب التغيُّرات في أسعار السلع الدولية، اعتماد سياسات التنويع الاقتصادي خارج القطاعات القائمة على الموارد. فينبغي لصانعي السياسات في مجموعة العشرين دعم بلدان منطقة الشرق الأوسط وشمال أفريقيا للاستفادة من سلسلة القيمة العالمية (GVC) في قطاعات التكنولوجيا لتسهيل الوصول إلى الأسواق الأجنبية. كما ينبغي لهم تقديم الدعم الفني لتطوير بيئة ريادة الأعمال في المنطقة. إضافة إلى ذلك، ينبغي أن تتناول السياسات تحسين مؤشرات القدرة التنافسية للشركات في دول منطقة الشرق الأوسط وشمال أفريقيا.



## CHALLENGE

The Middle East and North Africa (MENA) region is characterized by an excessive reliance on raw materials exports for foreign exchange earnings as well as a dependence on foreign markets as a source of industrial and food produce. These dependencies have given rise to two main challenges: growth volatility and high unemployment levels, especially among the youth. The economic and social effects of recent crises signify the magnitude of the challenges facing the region and the need to diversify away from commodity-based sectors, and thereby promote private sector development.

Economic diversification is the pursuit to transform an economy that relies on a single commodity as its main source of income into one with multiple sources of income across primary, secondary, and tertiary sectors. It seeks to accelerate productivity and create employment opportunities. The main objective here is to achieve sustainable economic growth by building resilience to the fluctuations in economic conditions, given the volatility of commodity prices in the international market. Therefore, it is imperative for both developed and developing countries to design policies that induce greater economic diversification.

To diversify their economies, MENA countries must promote the development of the non-resource sector; this entails producing a larger variety of goods with higher value added and better integration within the global value chains (GVCs). It also involves more complex forms of production. Providing the foundations for structural transformation is essential, should MENA countries seek greater resilience and sustainability. However, structural transformation is a double-edge sword—while it sets the foundation for sustained economic growth, it also weakens environmental quality, unless deliberate actions are taken to ensure environmental sustainability during the transformation process (United Nations Conference on Trade and Development [UNCTAD], 2012).

The dominance of a single-energy system unavoidably leads to extreme environmental burden and, therefore, risk (Li 2005). Successful sustainable development in the MENA region may be achieved through the diversification of energy systems—such as by adopting renewable energy—if the adverse effect of each energy system is adequately small and well within the tolerance limits of the environment.

## CHALLENGE

The route to economic diversification would depend not only on comparative advantages, but also on economic reforms, the availability of human resources, sound institutions, and macroeconomic stability. In this regard, internal and external drivers, including export competitiveness, productivity of employees, market structure, trade liberalization policies, and the dynamics of the global market, would be key determinants of successful economic diversification.

Given its strategic position as a bridge between the global north and south, and as a substantial source of the world's energy, the MENA region plays a significant role in the global economy. If the G20 supports economic diversification in the region, it would not only improve regional resilience to external shocks, but also bring global economic benefits. Better integration with the global economy, through exports of higher quality and diversity of products, would accelerate diversification, create more jobs for the region's youth, and achieve political stability.



# PROPOSAL

## **MENA Economic Structure and Trade**

The MENA region's gross domestic product (GDP) is approximately \$3.6 trillion, measured at purchasing power parity exchange rates, and represents 4.3% of the global GDP. Its share of global trade increased from 3.5% in 1990 to 4.8% in 2017, and has remained stable since. In 2017, the MENA region's total trade in goods as a percentage of GDP, which is an indicator of openness, was 75.9%, indicating a relatively open regional economy compared with 48% for developing countries and 60% for advanced economies (Saidi and Prasad 2018). The region also represents approximately 7% of the world's population; it has 60% of the world's oil reserves<sup>1</sup> and 45% of the world's natural gas reserves.

The oil-rich countries within the MENA region have long enjoyed petroleum revenues, and continue to depend on oil to generate economic growth as well as to finance the growth of their social and physical infrastructure. Non-oil-rich MENA countries, however, rely on agriculture and tourism, and face numerous challenges to economic growth (World Bank 2019).

Dadush et al. (2016) establish five areas that represent key obstacles to the region's economic progress: deficiency in diversification efforts, dominance of public enterprises, insufficient entrepreneurship, gap in human capital innovation, dysfunctional job market, and imperfect financial development. Further, the ratio of domestic private sector bank credit to GDP in MENA countries is low—about 44% in 2014—compared with East and Pacific Asia (122%) and Europe and Central Asia (99%).

## **Role of Trade in Accelerating Structural Transformation**

Despite the numerous challenges to trade, Teignier (2018) contends that trade did help accelerate the transition out of the agricultural sector in Britain and the structural transformation in South Korea. The author confirms that international trade in the agricultural sector is beneficial to the economy, while a protectionist policy reduces overall welfare and de-accelerates real income growth. Fajgelbaum and Redding (2018) provide another example of Argentina in the late nineteenth century, where structural transformation from agricultural to non-agricultural development was central to Argentina's rapid export-led economic development.

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1. See <https://www.investopedia.com/terms/o/oil-reserves.asp/>.

The reduction in internal transportation costs is important in enabling interior regions to expand trade and in the process of structural transformation. In the Belt and Road Forum for International Cooperation 2017, the Chinese President Xi Jinping highlighted different promising areas of interaction among countries; these include political coordination, interconnection of infrastructure, free trade and free movement of capital, and strengthening of ties among peoples. The aim of the Belt and Road Initiative is to facilitate access to foreign markets and therefore, increase the trade turnover between China, Europe, and Africa, with goods transported through Central Asia and neighboring regions (Silin et al. 2018).

It is established that balanced trade liberalization can accelerate economic growth and benefit all trading partners. In the past two decades, MENA countries have implemented some structural reform to improve macroeconomic performance. However, there has been no real success in tackling deep-rooted structural problems; issues of governance and institutional reform have not been addressed either. Thus, there is a need for more action, including a reassessment of the role of the state in the economy and the creation of an efficient regulatory environment, reforming financial and labor markets, and improving transparency.

It is not conflicting interests but mutual interests that could be enhanced once countries realize the benefits of trade to their economies. The Gulf Cooperation Council (GCC), together with active trading MENA countries, can accelerate trade and investment opportunities through G20 support. This would lead to structural transformation in each economy. In light of the forces that are currently re-shaping international business, MENA countries must intensify their efforts to scale the value chain and diversify toward medium and high technology sectors as well as digital services.

### **Trade Agreements and Global Value Chain Integration**

Giovannetti and Marvasi (2019) examine the GVC relationships among MENA countries and between MENA countries and other regions. They also explore trade opportunities in intermediate goods and services in global trade networks. They argue that there exists significant regional heterogeneity, where some countries operate as inward hubs, while others operate as outward hubs. Thus, myriad benefits exist in accelerating trade in the region; greater GVC integration is also needed for more potential opportunities.

The MENA–OECD initiative in governance and competitiveness for development was established at the request of MENA countries in 2005. This initiative aims to facilitate

co-operation between the two regions and thus, promote the policies of sustainable and inclusive growth. The Gravity Model predicts countries' trade flows as a function of their economic size and distance; Ferragina, Giovannetti, and Pascore (2005) show that the trade volume between MENA countries and the EU could be 3.5 to 4 times higher than the current volume. Under the two major preferential agreements currently in force—"Pan-Arab Free Trade Area" and "Agadir Agreement"—most tariffs in the region have been eliminated. Nevertheless, their implementation is lacking owing to poor logistics, lack of transparency, and complicated customs clearance.

Although the MENA region has witnessed some progress in diversification over the last decade, agriculture continues to remain underexplored. Most countries in the region are experiencing a decline in the percentage of agricultural value added in their total GDP, while the shares of the industry and the services sectors have been increasing. For example, the share of agricultural value added in the total GDP of developing MENA countries was 9.3% in 2017, according to the World Bank development indicators. In addition, manufacturing plays a meager role in GCC countries, accounting for less than 14% of the GDP (UNCTAD 2018). This clearly indicates that manufacturing opportunities in the MENA region remain under-exploited, which is impeding structural transformation.

Despite globalization-led trade in value added, transitioning to high-income levels for most developing countries, including those in the MENA region, has been hindered by the middle-income trap. The increasing share of medium- and high-tech manufacturing value added in the total manufacturing value added in GCC countries has not yet translated into higher export quality. However, in Morocco and Tunisia, progress in structural transformation between 1990 and 2016 has improved the quality of exports, indicating better integration into global trade. Thus, GVC participation may have differentiated implications for structural change in manufacturing in different countries.

Meanwhile, MENA countries have not shown significant integration into the GVC, which would deepen technological and overall productivity. While the COVID-19 pandemic and its dramatic disruption of supply chains are likely to enhance the momentum for inward-looking policies, the key role of productivity and competitiveness in determining the location of firms' activity and patterns of global trade would remain prominent. To reap the full potential of GVCs in the MENA region, a number of bottlenecks in logistics, human resources development, and information infrastructure must be addressed.



### **Human Development, Technology Transfer, and Digital Technologies**

Demographics have become a critical challenge for productivity growth in many advanced economies; thus, MENA countries should take greater advantage of their youth by improving the education system, providing appropriate incentives for skills development and innovation, and developing the information infrastructure. Efforts to open economic potential should further be supported by the G20 through actions such as reducing barriers to knowledge and technology transfers in trade and investment policies and regulations, encouraging cooperation at the institutional level for capacity building, and allocating resources for technology and innovation-related projects.

It is essential to expand the scope of destination activities through foreign direct investment (FDI), beyond the limited subset of oil and gas and petrochemical sectors, to high value-added products and services in electronics and electrical equipment, green energy, pharmaceuticals, and banking and insurance services. FDI will facilitate the participation of the MENA region in GVCs, providing the economies with access to knowledge and skills essential for building innovation capacities and high value-added manufacturing.

Digital technologies, driven by the so-called “Fourth Industrial Revolution,” will augment the capacity of an economy to absorb knowledge, acquire skills, transfer technology, and diffuse innovation. In particular, the MENA region must target high value-added technology transfers, which would help in knowledge dissemination and innovation diffusion in emerging non-energy sectors. Sustaining growth requires developing such new sectors that can steer the economy and provide alternative sources of revenues as oil and gas industry revenues dwindle.

Thus, various legal measures ought to be enacted to increase the propensity of multinational enterprises (MNEs) to commit to FDI. The key propositions cited by MNEs contemplating entry in targeted economic activities in the non-oil sector include (1) suspending the nationalization of the labor force for a stipulated and long period, (2) permitting arbitration of all FDI disputes to be resolved through (a) foreign arbitral tribunals, (b) with the “choice of law” in terms of the commercial and intellectual property law that prevails in the country in which the arbitral tribunal is situated, and (3) rather than having a “negative list” that delimits spheres of economic activity to foreign investors, the countries should institute a “positive list,” excising as much bureaucratic red tape as feasible in a deregulated business environment characterized by transparency (Standard-Trade Markets 2017).

### **Role of Start-Ups' Financial and Regulatory Support in Economic Transformation in the MENA Region**

Over the last four decades, the MENA region has suffered from tunnel vision, where it has focused on conventional economic objectives such as crude oil production, traditional agriculture, and heavy industry production. The governments in the region should better realize the power of start-ups and their notable role in economic transformation. Any entrepreneur establishing a business or launching a new product or service into the market is forced to deal with challenging business environments; this includes regulatory and funding issues. MENA region entrepreneurs are no exception; most start-ups fail in the region because of difficult business environment and weak regional business maturity.

Some of the challenges include, but are not limited to, inflexible and outdated legislations, time-consuming and bureaucratic registration processes, unavailability of specialized funds, and an extremely cautious banking industry. Absence of mentorship to help scale start-ups and effectively employ skills and talents is another challenge. Overall, these challenges force many regional talents to migrate to more business-mature regions, such as Europe and the US.

To support the region's entrepreneurship ecosystem, which especially struggles to access capital, governments must reform their regulatory environments and financial systems. This would promote investments in start-ups, and eventually, help build a foundation for sustainable transformation of the region's economy. A comprehensive understanding of start-ups, especially the technology and knowledge-based ones, is required from each government in the MENA region.

We propose the establishment of a business-oriented and politically independent regional body—"MENA Start-ups Evolution Council"—in one of the MENA countries. This council should be supported by all MENA countries and partially financed by the regional governments through foreign direct investors. The council's main responsibilities and activities shall include, but would not be limited to, promoting a start-up culture within the MENA region, reducing or removing national and cross-border regulations, securing regional start-ups funds, evaluating start-ups' business ideas and plans, and providing financial support to select start-ups that have passed the evaluation and selection criteria.

A healthy entrepreneurial ecosystem within the MENA region can not only motivate people to start businesses, resulting in the creation of jobs, but also encourage equity investors to finance small and medium-sized entrepreneurship. Such an environment will also enable regional venture capital firms to extend their services to entrepreneurs, covering structuring costs, and even supporting initial public offering whenever applicable. It would spur significant economic activities to compensate for the shrinking of traditional economic sectors as well as help the region meet unexpected global challenges and volatility in commodity prices.

### **Input–Output Framework to Help Design and Evaluate Diversification Paths**

Many of the highlighted issues can be addressed within the input–output framework, along with enhanced GVC integration, introduction of new technologies, boosting the share of the private sector, upscaling the traditional sectors to higher value-added production, and the support of the service sector for sustainable growth. These adjustments are structural, and the application of new modeling approaches can help identify the most efficient transformation paths. A suitable diversification path would deliver substantial support to economic growth and job creation, and would also mitigate environmental impacts.

A significant advantage of the input–output framework is its ability to provide high sectoral granularity. The adjustments to economic structure, final demand, or government policies can be measured and analyzed with respect to individual sectors by considering the major differences in overall economic impacts. Policymakers may be interested in the effects of various policies on industrial value added, household income, jobs created, and environmental costs owing to the envisaged changes in the economic structure. This would, in turn, help them shift their attention to the most promising adjustments and channel funds for sectoral changes with the highest impact.

The input–output table (IOT) represents a basic structure of the economy; it provides a useful quantification of linkages and interdependencies across sectors. It enables flexible analysis of policy decisions and assessment of public expenditure effects. At the same time, a set of well-documented approaches are available for projecting an IOT over a given time horizon to incorporate long-term structural changes (Havrlant 2020). Having such a model for any MENA economy would facilitate viable transformation plans and allow for the assessment of progress along the transformation path.

The typical reasons that underlie structural adjustments in the economy, which can be well-addressed through an IOT, correspond to pressing MENA issues. These issues include (1) technological changes, including the introduction of more efficient methods of production and improvements in human capital, (2) significant increases in demand for particular types of goods or services, implying a rise in supply that encourages economies of scale and changing input–output proportions, and (3) adjustments in the use of imported and domestically produced inputs, goods, and services that can precipitate the emergence or disappearance of entire industries.

These changes are part of any diversification path in the MENA region. Employing quantitative input–output analyses supports more informed decision-making by policymakers. The IOT-based simulation can provide an overview of the forward and backward linkages, and thus, estimate the targets for economic diversification. This includes increasing the contribution of the private sector to the GDP and assessing the subsidies impact on the economy. Overall, the input–output approach constitutes a useful framework for designing a suitable economic diversification path and assessing the progress made toward a more diverse and sustainable economy.

### Policy Recommendations

- Together, G20 and MENA policymakers must enhance trade cooperation and GVC integration in technology sectors that are currently re-shaping international business. They must create new transport paths to facilitate access to foreign markets. This would ultimately enhance global economic growth.
- MENA policymakers should focus their efforts on how to effectively execute bilateral and regional trade agreements; they must engage in economic and legal reforms to improve business competitiveness indicators in the MENA region, thereby expanding trade and attracting FDI.
- MENA policymakers must improve their own educational systems to provide information technology labor force for the future and thus, target high valued-added technology transfer in order to stimulate innovation in emergent non-commodity-based sectors.
- MENA countries must improve regional business climates by transforming the cross-border clearance ecosystem through transparent, efficient, digital, and innovative procedures, supported by state-of-art logistics infrastructure, airports, seaports, and railroad systems.

- The G20 should reaffirm its commitment to achieve inclusive growth by providing technical support in establishing a MENA Start-ups Evolution Council in order to create an enabling entrepreneurship ecosystem within the region. This initiative would accelerate structural transformation in MENA countries, and eventually expand trade and investment potential with the G20 economies.
- MENA countries may explore the use of the input-output framework to identify diversification strategies that are most suited to each country in delivering substantial economic growth and job creation.

**Disclaimer**

This policy brief was developed and written by the authors and has undergone a peer review process. The views and opinions expressed in this policy brief are those of the authors and do not necessarily reflect the official policy or position of the authors' organizations or the T20 Secretariat.



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