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WHY DOES INSTITUTIONAL DEVELOPMENT MATTER FOR MENA'S MANUFACTURING SECTOR?

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1. BACKGROUND:

The manufacturing sector is the largest contributor to the Gross Domestic Product (GDP) in the Middle East and North Africa (MENA) region when measured in terms of the percentage of firms operating in the economy as shown in Figure 1. However, recent facts collected by the World Bank show that the MENA region has generally realized lower annual economic growth rates compared to most other developing regions in the world. Given that trade in manufactured products comprises the bulk of international trade, and the fact that international trade has proved helpful in increasing economic growth, developing areas have found it beneficial to restructure and improve their manufacturing sectors. This is especially challenging for MENA region given that many countries in this region are continuing to go through politico-economic changes in their institutions following the so-called 'Arab Spring' that began in 2011, raising questions about the role of institutions in improving the growth and business environment of MENA's manufacturing sector. Institutions (economic, financial, legal and political) are indeed defined as a set of institutional arrangements that organize and coordinate economic and non-economic activities through setting and managing rules and regulations. Institutions affect the performance of manufacturing sector because they affect basically the allocation of resources through the accumulation of physical and human capital (Arayssi and Fakih, 2015). Thus, well developed institutions provide a suitable environment for companies to boom and continue to prosper as the economy grows in the future. They aim at efficiently allocating resources in the market among different sectors.

MENA REGION HAS GENERALLY REALIZED LOWER ANNUAL ECONOMIC GROWTH RATES COMPARED TO MOST OTHER DEVELOPING REGIONS IN THE WORLD.

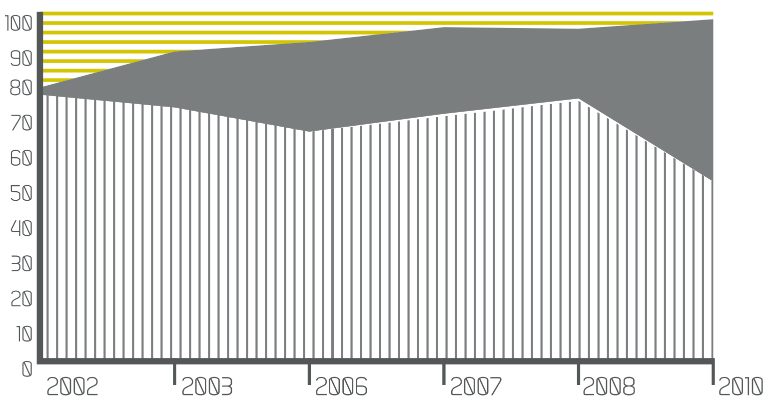

Figure 1: Percent of firms operating in the MENA economy.
Source: World Bank's Enterprise Surveys.

OTHER SECTORS
SERVICES
MANUFACTURING

2. MENA MANUFACTURING'S WEAKNESSES AND KEY INSTITUTIONAL CHALLENGES

The value added of the manufacturing sector in the MENA region (measured as a percentage of GDP) has slightly decreased from 12.2% in 1990 to 10.8% in 2007 to 9.8% in 2009 according to the World Bank Development Indicators database. Additionally, one can assess the size of the manufacturing sector by looking at the percentage of exports of manufactured products to the total merchandise exports; the MENA region manufactured 24.5% of their total merchandise exports in 2009. For example, exports from Tunisia and Morocco are manufactured products and are greatly concentrated in the EU market, whereas Mauritania's exports are primarily destined to BRIC (Brazil, Russia, India, China) countries, mainly China, which receives more than 40% of the country's exports (mostly iron ore). Lebanon and Djibouti's exports, on the other hand, mostly target other MENA markets.

MANUFACTURED GOODS EXPORTS IN THE REGION HAVE TARGETED LESS THE EUROPEAN UNION, AND MORE THE MENA AND THE BRIC REGIONS.

Over the last decade, manufactured goods exports in the region have targeted less the European Union, and more the MENA and the BRIC regions. Briefly, export activities of the manufacturing sector could eventually lead to higher industrial growth rates, as exporters respond to the demand from foreign markets (Bernard and Jensen, 1999; Fakih and Ghazalian, 2014). The corresponding country-level statistics reveal significant variations between MENA countries, particularly, oil-rich and other MENA countries. For example, manufactured products represent 1.6% of total merchandise exports for Algeria and 8.1% for Saudi Arabia; in contrast, these percentages were 43.8% for Egypt and 72.5% for Lebanon. These important deficiencies in some MENA countries have added to a lower contribution of the manufacturing sector to the growth and development in the region.

The economic environment prevailing embodies key challenges that hinder the improvement of the industrial sector. MENA infrastructure is characterized by weak facilities for manufacturing firms. For example, power outages in MENA's manufacturing sector are one of the major problems impeding firms' progress in the MENA region. For example, around 38% of firms own private generators leading to an increased cost of operation and to a reduced capacity to compete in the international trade. Looking more closely at business constraints facing manufacturing firms in Table 1, we notice that the MENA industrial sector appears to score lower grades through various indicators of international competiveness compared to other developing countries (Ahmed, 2010; O'Sullivan et al., 2011). Looking at this table, it is interesting to observe that MENA manufacturing firms have the highest figures identifying corruption as a major constraint facing the operations and the development of their business compared to other economic regions. Interestingly, MENA manufacturing firms show the highest figures identifying access/cost of finance as a major constraint in business development. This fact, accompanied by a large informal sector and a low number of registered companies, underlines the need for a major regulatory overhaul of this sector. This reform includes labor and safety regulations, credit availability, access to stock exchanges in an effort to reduce financing costs and provide long-term financing funds. Investments in job training are still low; this is especially important in MENA since the percentage of firms identifying labor as a major constraint is the highest in the world. For instance, the figures show that only 23.3% of manufacturing firms have offered formal training to their employees compared, for example, to 30.83% and 56.94% in Africa and East Asia and the Pacific, respectively.

	AFR	EAP	ECA	LCR	MNA	SAR
% OF FIRMS IDENTIFYING CORRUPTION AS A MAJOR CONSTRAINT	32.18	23.47	32.31	49.99	51.9	41.34
% OF FIRMS BELIEVING THE COURT SYSTEM IS FAIR, IMPARTIAL AND UNCORRUPTED	44.68	W.78	37.37	25.86	40.31	24.98
% OF FIRMS IDENTIFYING COMPETITORS IN THE INFORMAL SECTOR AS A MAJOR CONSTRAINT	34.22	16.99	29.76	41.89	52.46	16.2
% OF FIRMS FORMALLY REGISTERED WHEN STARTED OPERATIONS IN THE COUNTRY	81.54	71.26	96.26	90.57	53.37	90.69
% OF FIRMS IDENTIFYING ACCESS/COST OF FINANCE AS A MAJOR CONSTRAINT	47.6	17.83	26.88	28.21	35.2	23.12
% OF FIRMS WITH ISO CERTIFICATION OWNERSHIP	14.62	34.5	29.44	22.09	18.45	19.31
% OF FIRMS OFFERING FORMAL TRAINING (MANUF. ONLY)	30.83	56.94	44.69	51.38	23.3	18.84
% OF FIRMS IDENTIFYING LABOR REGULATIONS AS A MAJOR CONSTRAINT	8.98	11.9	14.68	25.37	24.04	11.62
% OF FIRMS IDENTIFYING LABOR SKILL LEVEL AS A MAJOR CONSTRAINT	18.9	19.66	25.31	34.14	36.5	16.17

Table 1. Business constraints facing manufacturing companies, by geo-economic region (averages, –2002 2010)
Source: World Bank's Enterprise Surveys. Notes: AFR=Africa; EAP=East Asia and the Pacific; ECA=Europe and Central Asia; LCR=Latin America and the Caribbean; MNA=Middle East and North Africa; SAR=South Asia.

FINANCIAL DEVELOPMENT EXISTS IN THE FUTURE. FOR INSTANCE, MORE FAVORABLE RULES THAT WOULD INCREASE THE RELATIVE DEVELOPMENT OF STOCK MARKETS OF THE MENA COUNTRIES CAN CONTRIBUTE TO A LARGER PERCENT OF INDUSTRIAL COMPANIES LISTING ON THESE EXCHANGES.

Looking at the composition of firms in Table 2, we observe that only half of the industrial companies are SMEs, 28% are publicly listed on stock exchanges, 32% are joint-stock (issuing stocks in the stock market) companies, and around 7% of the FDI flows into these firms. SMEs are especially important in supporting innovation and employment, and specifically make up the backbone of the industrial sector. Only half of the SMEs in the past decade sought banks or other loans, while 42% relied on their personal resources (Al-Yahya and Airey, 2013). Other financial variables show that the ratio of financial industry to GDP is less than 10%, and that adults with public credit registry (the number of individuals and firms listed in a public credit registry with current information on repayment history, unpaid debts, or credit outstanding, source: World Bank) in manufacturing companies represent a miniscule minority (around 2%). Both financial variables are uniformly low in the industry and cluster around the average values; therefore, much room for financial development exists in the future. For instance, more favorable rules that would increase the relative development of stock markets of the MENA countries can contribute to a larger percent of industrial companies listing on these exchanges.

The average rank out of 100 for rule of law is about 58%; this places the industry at better than half-way with respect to this measure. The public governance variables show that, rule of law needs to be crafted to support further legal protection of rights that would be consistent with economic growth. When it comes to the democratic environment, the data reveals that MENA region is mostly governed by undemocratic regimes with an average of -6.3. This figure clearly shows that the political environment is not conducive to economic inclusion, including opening new industrial firms, as this negative value indicates less open systems in the MENA region. It should be noted that this indicator ranges from –10 to 10 with higher values representing more democratic regimes.

	AVERAGE
SMALL AND MEDIUM FIRMS (SMES)	49.7%
PUBLICLY LISTED FIRMS	28.1%
JOINT-STOCK FIRMS	32.2%
INFLOWS FOREIGN DIRECT INVESTMENT (FDI)	7.1%
TELEPHONE LINES PER 100 PEOPLE	21.1
RATIO OF THE FINANCIAL INDUSTRY TO GDP	8.2%
PUBLIC CREDIT REGISTRY COVERAGE OF ADULTS	2.2%
RULE OF LAW (RANK OUT OF 100)	57.8
INDEX OF DEMOCRACY AND LIMITS OF EXECUTIVE POWER (RANGE -10 (WORST REGIME) TO +10 (BEST REGIME))	-6.3

Table 2. Stylized facts on MENA manufacturing sector and politico-economic environment
Source: Orbis and Bureau Van Dijk, 2010.

3. WELL-DEVELOPED INSTITUTIONS ARE ESSENTIAL FOR IMPROVING THE ECONOMIC ROLE OF MANUFACTURING SECTOR

Such macroeconomic indicators of quality of infrastructure, when lagging behind, are shown to become hurdles to manufacturing firms; therefore, their importance in increasing economic growth cannot be overstated. These observations also underline the role of national financial development levels in promoting economic growth where financial development is a necessary pre-condition for economic growth of the manufacturing sector. This seems to suggest that enforcing the rule of law and public governance mechanisms play an effective role in supporting economic growth. In sum, the results of all socio-economic, financial inclusion and public governance indicators are all weak; therefore they are not enhancing the growth of the manufacturing sector.

Our analysis of the MENA manufacturing sector presented above points out the direction in which governments and business should be moving with the task of developing this sector in MENA countries. The focus should be multifaceted on first liberalizing financial markets, and second enhancing the role of institutions to re-enforce the SMEs and the role of private equity firms, through venture capital and buyouts, in financing SMEs in the region. Institutions in the MENA economies should improve SMEs' ability to attract foreign investments; these reforms would then help to lift the industrial sector up, thus positively affecting the economic growth in the region.

In this context, governments should act as important catalysts in providing the proper institutions for manufacturing firms to flourish. Through passing rules that facilitate and speed up licensing and registration, access to credit, guarantee property and intellectual rights and create oversight agencies that ensure fairness and safety of business practices in this sector, governments can promote the SMEs in manufacturing.

INSTITUTIONS IN THE MENA ECONOMIES SHOULD IMPROVE SMES' ABILITY TO ATTRACT FOREIGN INVESTMENTS

The economic role of institutions has grown rapidly in recent decades due to the growth of emerging markets, the integration of the global economy, rising incomes and reduced transportation and communication costs. There is ample evidence that institutions form key ingredients to sustainable economic growth through manufacturing sectors. However, well developed institutions do not come without pre-conditions, which are lacking in the MENA region. For example, foreign investments in manufacturing sector are attracted by hospitable business conditions. These include political and macroeconomic stability, foreign exchange convertibility, freedom to transfer profits outside the country, transparency of incentives and speed of establishing new entities. This requires sound and integrated economic policies and regulatory framework, and efficient supporting institutions to enforce the relevant laws and regulations. This also necessitates well-developed organizations that facilitate the competitiveness of manufacturing sector in the international trade. This will help in increasing job creation rate and reducing the unemployment rates.

4. POLICY IMPLICATIONS: ENFORCING THE ROLE OF INSTITUTIONS

Institutional (financial, governance, legal) development is a necessary pre-condition for enhancing the capacity, quality and the competiveness of the manufacturing sector. Reforms aiming at improving the efficiency of the financial institutions and the enactment and enforcement of labor and corporate laws usually need to persist over a prolonged period of time to have a strong effect on the growth of the MENA manufacturing sector. Policymakers should also pursue efforts to undertake financial reorganizations that improve the safety, competitiveness, efficacy and the transparency of the financial system. This is important because countries without sufficiently developed financial markets, like the MENA region, cannot fully benefit from FDI. Therefore, in the current stage of financial development, the industrial sector witnesses less importance of the FDI as a vehicle for cross-border knowledge transfer in MENA companies. This conclusion is aligned with the general idea where FDI helps facilitate employment of youth and uses entrepreneurial talent to benefit economic growth. Finally, it is worth noting that the MENA region has the potential for innovation and entrepreneurship that can provide the lacking skilled labor (see Table 1 above) to the industrial sector to be more developed. For instance, half of the MENA population is under the age of 25 years, which makes it the second youngest population in the world behind the Sub-Saharan Africa (Farzaneh, 2011).

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