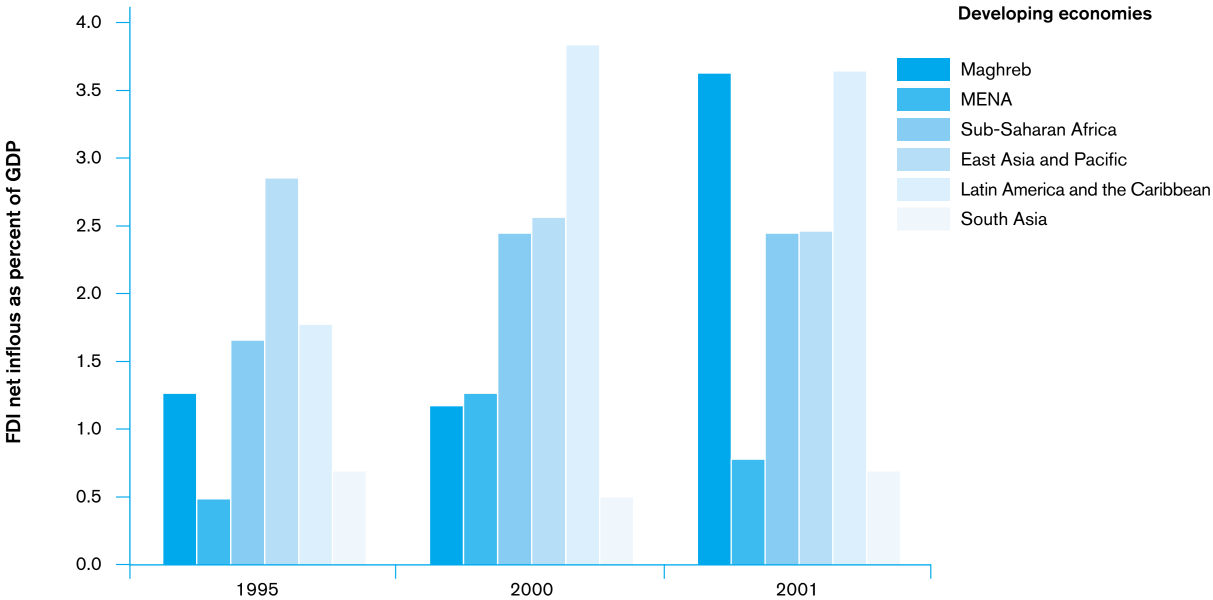
Deterrents to Private Investment in North Africa

Theodore Ahlers
Director, Maghreb Department
Middle East and North Africa Region
The World Bank

There are two fundamental pillars to a successful development strategy in a globalised world. Firstly, countries need to have a good investment climate, in order to will encourage private firms to make investments, create jobs, and produce increasing added value. And secondly, countries need to empower and invest in the poorer populations, through health, education, and social protection, so that they may participate in the development decisions being taken, and which affect their livelihoods.
I will focus here on what drives private investment in an increasingly globalised world, namely the ability to maintain competitiveness – to find untapped markets, to invent products, to adopt new technologies, and to respond to changes in market conditions at home and abroad.
While there are many features of a climate that is conducive to private investment, I will limit my discussion to the three features that I believe are particularly important in the case of North Africa.
The first of these features that is important for creating a climate in which private investment can be competitive is the management of the exchange rate. Countries that have been successful in maintaining competitiveness of exports have achieved this by avoiding exchange rate overvaluation. Overvaluation is damaging to competitiveness, and therefore damaging to private investment, because it artificially alters the price ratio between tradable products and non-tradable products, thus weakening the ability of the producers of tradable goods to compete with either imported goods or with other countries' exports.
What has been the experience of the North African region with respect to exchange rate management? In a recent study, we examined this issue by looking at the degree of exchange rate misalignment in the region. For North Africa, the results are mixed. During the late 1970s and early 1980s, exchange rate misalignment was a significant problem in some of the economies of North Africa. For example, between 1975 and 1984, overvaluation averaged eighty-two percent in Algeria and thirty-six percent in Morocco, which compares to average levels of misalignment of twenty percent in Latin America, twenty-nine percent in non-CFA Africa, ten percent in South East Asia, and forty-three in South Asia.
Since the mid 1980s, however, some countries have been more successful in their control of exchange rate misalignment than others. Between 1985 and 1994, Algeria's exchange rate was overvalued by an average of twenty-eight percent, but between 1995 and 1999, that figure was reduced to an average of only five percent. Morocco and Tunisia, on the other hand, have both experienced significant overvaluation of their exchange rates, averaging sixteen to seventeen percent for both countries over the 1995 to 1999 period.
This continued overvaluation that has prevailed in certain North African economies can be traced in part to their reliance on fixed or managed exchange rate regimes. Prior to the late 1980s and early 1990s, most economies in North Africa opted for a fixed exchange rate regime as the most effective strategy for combating high inflation. This adoption of fixed exchange rates, either *de facto* or *de jure*, was successful in contributing to macroeconomic stability. However, once the immediate threat that inflation may run out of control had been averted, only Algeria and Tunisia shifted their policies to a more flexible exchange rate arrangement, while Egypt, Libya, and Morocco maintained fixed regimes. Recently, of course, Egypt has adopted a floating exchange rate regime.
A central piece of evidence has emerged from the battery of empirical investigations looking into the subject: exchange rates are overwhelmingly more likely to become overvalued under fixed systems than under more flexible ones, which for North Africa has resulted in a substantial loss of competitiveness.
A second valuable feature for private investment which I think is particularly important for the North African economies is the health of the financial sector. An efficient financial sector, which is able to mobilise resources and allocate them efficiently to productive uses, is essential to the development of a competitive private sector. In North Africa, however, the financial sector serves as a major deterrent to that private sector development.
Throughout North Africa, a principal deterrent to firms for investing and expanding is the lack of access to credit at competitive interest rates. Moroccan manufacturing firms are overwhelmingly financed from owner equity and retained earnings, and lending interest

GRAPHIC 10 **Foreign Direct Investment into the Maghreb (International Comparison)**



* Maghreb countries included in analysis are Morocco, Algeria, Tunisia and Mauritania.
Source: Banco Mundial, World Development Indicators.

rates are double what businesses pay for credit in Thailand and China. The situation reflects inefficiency and lack of competition in the banking industry.

In Algeria, a random sample of firms found that only eleven percent of working capital financing needs was financed by bank credit. The large banks are still state-owned, and banking remains bureaucratic, non-business-friendly, and poorly equipped. Private and foreign banks and other financial institutions are still weak and only play a minor role in financing enterprises. And in addition, export financing facilities are extremely limited.[1]

In Egypt, the financial system suffers from both inefficiency and lack of competitiveness. The four state-owned banks continue to dominate the field and the banking system still suffers from a low level of technology and poor financial innovation. Credit is granted overwhelmingly to big corporations, leaving small businesses with little access to formal credit. A 1997 survey of small and medium enterprises, which represent over ninety-eight of firms in Egypt, found that total banking sector loans to SMEs only accounted for about five to six percent of loans extended.[2]

Even in Tunisia, access to credit by SMEs is limited. According to a survey in 2000, fifty-three percent of firms finance more than fifty percent of their investment from their own funds. Some of the major reasons for this low level of financial system funding are the collateral requirements for lending, which though applied equally to large and small firms, have a more deterring impact on small firms, accounting standards, and capitalisation and financing plans.[3]

The examples discussed above present the case for urgent and much needed reform of the financial sectors in North Africa.

Finally, a third vital element in a successful climate for private investment, and one which in my mind is of highest importance for the North Africa region, is related to the overall governance framework. Governance is a highly implicative expression. It encompasses how well the public are made aware of laws and regulations, as well as the general clarity of laws, how consistently and fairly laws are applied, how well the systems function in making public agencies accountable for their behaviour, and the degree to which the population are able to participate in government decisions.

The Middle East and North Africa Region of the World Bank recently launched a report on governance in the region. In North African countries the governance challenges that are particularly relevant derive from weaknesses in inclusiveness and public accountability. Inclusiveness reflects the notion that everyone who has a stake in governance processes and wishes to participate in them can do so on an equal basis with all others. Accountability draws on the principle of proper representation, which means that those selected to act in the name of the population are credited for their successes as well as answerable for their failures.

Limited public accountability in North Africa has resulted in private invest-

[1] The World Bank, «A Medium-term Growth Strategy for Algeria: Fostering Private Sector Development with Economic Stability. Middle East and North Africa Region Policy Note. The World Bank», January 2003.

[2] The World Bank, «Egypt: Action Plan for Improving the Business Environment, Civil Service and Business Linkages. A Joint Report of the Government of Egypt and the World Bank», June 2000.

[3] The World Bank, «Tunisia: Private Sector Assessment Update - Meeting the Challenge of Globalisation. Private and Financial Sector Development Report. Middle East and North Africa Region. The World Bank», December 14th 2000.

ment being hindered by a bureaucratic environment that is cumbersome and inefficient. An example of this can be seen in the level of bureaucracy and red tape that is necessary to go through in order to set up a business. In Morocco in 1999, firms needed an average of ten different permits to initiate their activity, and half of all firms surveyed maintained full-time employees just to deal with the bureaucracy. In Algeria, entrepreneurs report an impenetrable degree of bureaucracy and red tape, with cumbersome and unclear regulations, and endless delays in obtaining clearances and authorisations.

But the second governance issue that affects private sector investment is the lack of inclusiveness, which emanates from a lack of fair and consistent application of regulations and policies. The form in which this lack of consistency occurs varies between the different countries. In Algeria, businesses have identified the unfair access to public contracts as significantly deterring their activities. In Egypt, on the other hand, businesses have consistently identified informal competition as a major constraint to their activities. As some firms escape both duties and taxes, the ability for formal activities to be in a position to compete is undermined. This is also a prevalent situation in Morocco, where firms cite unfair competition emanating from firms evading taxes and having undeclared workers.

Smaller firms are often the most disadvantaged in North Africa, both as a result of the lack of inclusiveness and by the inefficient regulatory environment. While larger firms can alleviate some of the administrative obstacles to carrying out business by providing the required services internally, smaller ones have neither the organisational capacity nor the resources to cope with such extras. And more directly, evidence relating to business perceptions suggests that large private businesses and individuals throughout the Middle East and North Africa Region play a disproportionately large

INVESTMENTS IN THE MAGHREB. CHALLENGES FOR THE FUTURE

To achieve economic growth in the Maghreb, the current stagnation of investments must be overcome. Foreign investment has shown a decline in comparison with other regions: whereas, during the first half of the 1990s, 1.2% of the total of all world investment was destined to the countries of North Africa, during the second half of the decade, this figure fell to only 0.7%. Among the reasons that can be identified are the lack of definition in exchange rate policy, the deficiencies in the operation of the financial system and the lack of a general framework of good governance. The direction that solutions must take points towards a concentration of resources not only in the financial sphere but also in the retention of human capital.

The exceptional status occupied by agriculture must be reviewed within the free trade agreements. The finalisation of the free trade zone that is envisaged for 2010 might herald an about-turn in the current situation, in that the value of exports from the EU into the countries on the southern shores of the Mediterranean amounts to 6,000 million euros, while imports amount to only 4,000 million euros. The extension of the liberalisation to include agricultural products should represent not only the competitiveness of Euro-Mediterranean products on a world scale but also the just growth in welfare. It is necessary to foster the mastery of the South over its own development, by means of the export of high-quality agricultural products, without allowing the disappearance of trade barriers to lead to a proliferation of unsuitable crops or losses for the small farmer. The liberalisation of agriculture, under the terms contemplated in the Euro-Mediterranean Partnership, will entail a significant boost for the economy of North Africa and an important factor for the stability of Europe due to its mitigating effect on migrations.

The liberalisation of the energy markets in the EU offers new investment opportunities for both shores of the Mediterranean. The energy sector is at once a lynchpin of the economy of the Maghreb – especially for Algeria where hydrocarbons represent 41% of GDP – and at the same time one of the main strategic economic interests of Northern countries. The Algerian economy has undertaken a series of fundamental reforms affecting mines, electricity and gas distribution, and the hydrocarbons, with the resulting creation of employment, the granting of numerous licences and the influx of foreign capital. In the future, however, it will be necessary to make exports compatible with self-sufficiency and the expansion of the local market and supply.

A united Maghreb could become a prime-ranking actor in Mediterranean relations. The United States government desires to secure the countries of the Maghreb as allies against terrorism through the recourse of tightening bilateral links at various levels (the setting up of the free trade agreement with Morocco is a paradigmatic case). This could prove detrimental to Euro-Mediterranean relations if these fail in the medium term to reach proper common grounds of economic, and even social and cultural, integration. Common referents must be developed between the societies of Europe and the Maghreb in order to make this possible. At the same time, a decided stimulus must be undertaken for South/South relations: in the economic field, intra-Maghreb commercial exchanges have remained unchanged at extremely low levels, around 4-5%.

The extended Europe and the new policy of neighbourliness will instil some vigour into the economy of the Maghreb. The initiative of the Commission for a new community, the *Wider Europe*, may act as the catalysing influence for a true economic and social integration. The alternative is that the South will drift further way economically and socially, with destabilising consequences for the entire region. The extension of the EU and Euro-Mediterranean relations must stop being seen as opposing processes, for with the new system of balances, the Mediterranean has much to gain here: an enlarged market – the area making up the Wider Europe could comprise 20% of the world economy by 2020 –, with opportunities for the commercialisation of new products in the future Member States and a new framework of relationships, in which the experience of the Maghreb could weigh significantly in the balance.

Conclusions of the *North Africa Business & Development Forum*, jointly organised by the European Institute of the Mediterranean and the Barcelona Chamber of Commerce, (September 2003).

http://www.iemed.org/activitats/2003/nabd/cnabdpresentacio.htm role in manipulating the systems for personal gain. This may range from the persistent awarding of large public sector contracts to effecting actual change in laws and regulations to lower costs or increase profitability. Such state capture of government regulations discourages the development of small enterprises, since they are less able to afford to buy decisions. At the same time, it has also deterred new investors, including those from abroad, from entering the economies, as the rules of the game are both unclear and biased.

Private investment is driven by many factors, but there are three preconditions that are fundamental issues the countries of North Africa will need to address if they are to successfully promote a stronger private investment response:

- A flexible exchange rate in line with fundamental levels
- A financial system geared to business development
- A governance system that ensures a business and investment-friendly climate effectively regulated to promote competition.