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Background Report on Private
Sector Development in Latin
America, the Post-Communist
Countries of Europe and Asia,
the Middle East and North Africa

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Abstract¹

After a long period in which state-led development was the dominant economic paradigm, since the 1980s private sector development has been the focus for economic policy makers. It is probably no coincidence that economic growth, stagnant for a few decades in much of the developing world, took off in the 1990s after this policy shift, and has generally remained high (in spite of a wave of crises and recessions in the late 1990s and early 2000s). Privatization has made a great deal of progress in the developing world, particularly in Latin America, though the Middle East and North Africa (MENA) have lagged somewhat. One of the main lessons for privatization policy makers in MENA countries from the experience in other regions is that merely transferring assets from the state to the private sector is not enough to ensure improved social welfare; competition and the institutional environment are also very important. With respect to the latter, much attention has focused in recent years on improvements in the business environment, which are necessary to spur entrepreneurship and encouragement movement from the informal economy into the formal sector. In this area the post-communist countries have been leaders; while Latin America and the MENA region have also seen significant improvement, they still lag behind the new European Union member states as well as some of the post-Soviet states (although the MENA region performs very well with respect to the protection of property rights). The area where the MENA region needs improvement most drastically is in the financial sector. Although rich in savings, it performs very poorly in these countries with respect to the provision of credit to the private sector (particularly small and medium-sized enterprises), largely due to the insufficient level of competition in the sector. We conclude with some speculation regarding possible scenarios for development between now and 2030.

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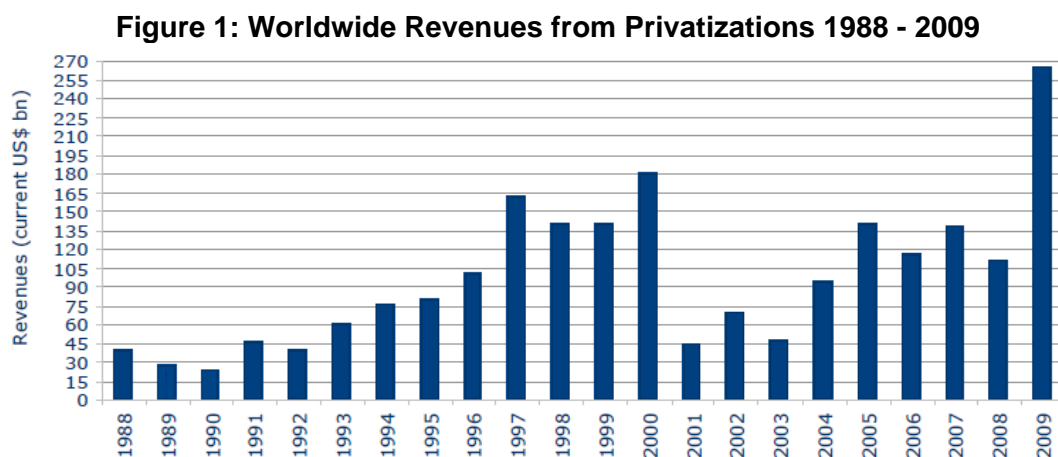


1. Introduction

A period of roughly 50 years from the 1930s to the 1970s saw a great expansion in the role of state ownership in economies around the world, regardless of whether we look at socialist or capitalist countries or at rich or developing countries. The Middle East and North Africa were no exceptions, with socialist policies implemented in Israel as well as countries where variants of Arab socialism prevailed, such as Egypt, Syria, Iraq and Libya. In the 1980s, this trend began to reverse, with the drive to roll back the state under Reagan and Thatcher in the West and the introduction of Deng Xiaoping's reforms in China at the beginning of the decade and the collapse of socialism in the Soviet bloc at its end. Today, private firms provide more than 90 percent of jobs in developing countries and are the main source of tax revenues, contributing to public funding for health, education, and other services (World Bank, 2004). But much remains to be done to stimulate private sector development in many regions where state property has until recently been dominant. Areas of activity include both privatization of existing state-owned assets and improvement of the investment climate and business environment that will allow new private firms to flourish. In this report we will provide a broad overview of trends in the Arab world as well as in two regions – Latin America and the countries formerly belonging to the Soviet bloc – that serve as points of comparison. We will examine the relative contributions of the state-controlled and private sectors to the economies of these regions, the main sources of finance for the private sector, and the role of Foreign Direct Investment (FDI) in private sector development.

2. General trends in privatization and private sector development in developing countries

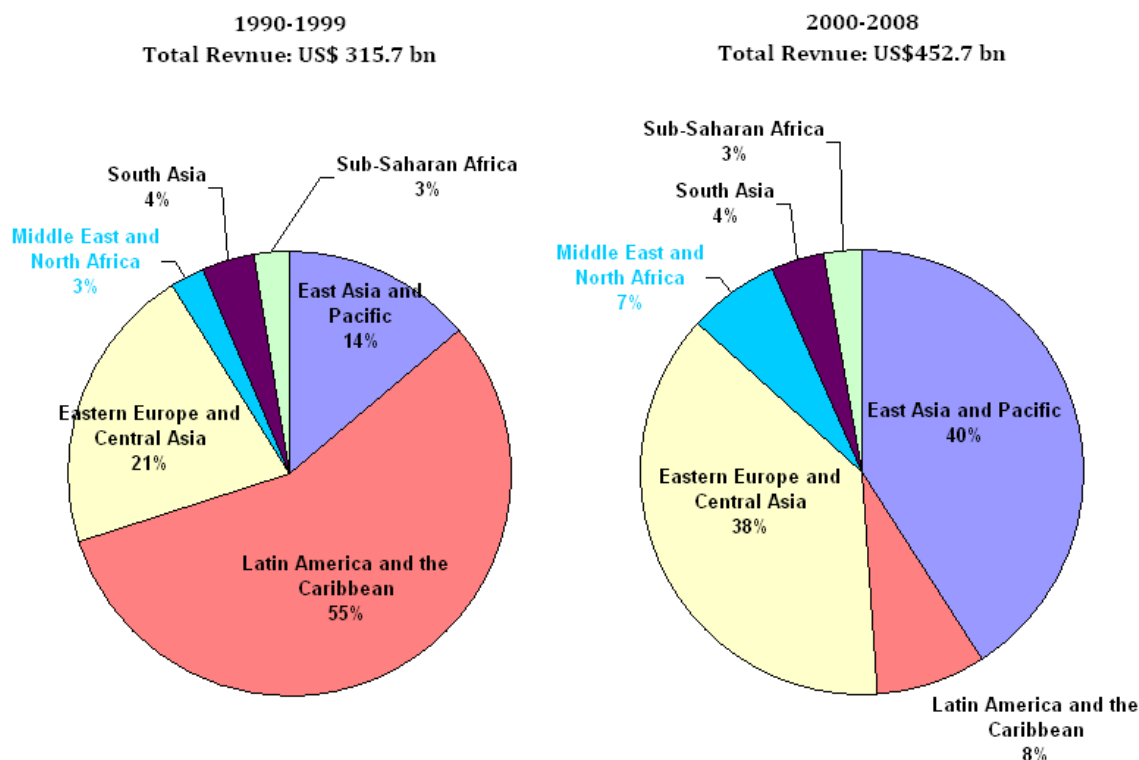
As Figure 1 depicts, the 1990s saw considerable growth in privatization revenues, climaxing in 2000. The recession that followed brought a steep decline, but the mid-2000s saw a recovery, with a record year in 2009. However, it is worth bearing in mind that even the privatization wave of the 1990s affected only a small minority of state-owned assets in the world (Ramamurti, 1999).



Source: Privatization Barometer (2009)

Figure 2 demonstrates that during this period privatization activity (measured by revenues) was very unevenly distributed in the developing world. In the 1990s, Latin America was clearly taking the lead, followed by Central and Eastern Europe and East Asia and the Pacific. The level of activity in other regions could be described as marginal. In the 2000s, the East Asia - Pacific and Eastern Europe - Central Asia regions moved into the lead, while the Latin America - Caribbean region was marginalized; the Middle East and North Africa (MENA) showed some improvement, but remained quite marginal in the overall picture. However, one should also bear in mind that this was a bigger piece of a bigger pie: the total privatization revenue rose 43% in the last decade in comparison with the 1990s.

Figure 2: Total Privatization Revenues by Regions (% of total revenues for developing countries)



Source: Privatization in the Middle East and North Africa: Region Fact Sheet

A number of surveys of the literature on the subject show quite conclusively that private ownership is generally superior to state ownership of industry (Boubakri & Cosset, 1998; Nellis, 1999; Megginson & Netter, 2001; Djankov & Murrell, 2002). While one might object that the comparison of privatized with state-owned enterprises can be afflicted with selection bias, since if we consider enterprises from a single industry, those left in state ownership are liable to be poorer performers than the privatized ones for reasons not related to privatization, there are studies which are not susceptible to this line of criticism (for example, Djankov and Murrell, 2002, take great pains to deal with the issue of selection bias in the studies they survey).

However, there is also evidence that privatization does not *always* work. For example, in their meta-survey of the transition literature, Djankov and Murrell (2002) found that privatization did not have a statistically significant effect on various measures of performance in the countries of the former Soviet Union; amore recent study by Estrin et al. (2009) also found that the economic (productivity) effects of privatization in the Commonwealth of Independent States were generally smaller than in Central and East European countries, and in the case of domestic owners are negative or insignificant. Clearly there are some other

factors at work here. What are they? Here are some important ones identified by the relevant literature:

Competition. One of the key factors of interest here is competition in product markets, which can be at least as important as privatization itself for inducing improvements in the efficiency of the management of an enterprise (Dabrowski et al., 1991; Pinto et al., 1993; Carlin et al., 1995; Nellis, 1999; Djankov & Murrell, 2002). Privatization will often fail to improve enterprise performance if the privatized enterprises are not forced to compete in the market, either with other domestic enterprises or with foreign competitors (or both). This result would seem to be especially important for strategic industries, which tend to be monopolies, thus indicating the need for allowing foreign competition when it is possible and the need for appropriate regulation when it is not.

Some even go so far as to suggest that in at least some cases (for example, if privatization is costly and time-consuming, putting a strain on the available resources a country has at its disposal), liberalization and deregulation might be pursued first, and privatization later (Stiglitz, 1998; Ramamurti, 1999).

Institutional framework. The importance of well-regulated institutions for economic development is not a new topic, and interest has greatly increased in the last 20 years as a result of the work of Oliver Williamson and Douglass North. Economists such as Dani Rodrik, Simon Johnson and Daron Acemoglu have provided some of the most interesting contributions on this subject in recent years (see, for example, Rodrik 2007; Acemoglu, Johnson & Robinson, 2002, 2005; Acemoglu & Johnson, 2005). Of course, the property rights transferred in privatization are of little worth if those rights cannot be enforced. In a study of particular relevance for our topic, Glaeser et al. (2001) compared the performance of the highly regulated Warsaw Stock Exchange, which has become the largest stock exchange in Central and Eastern Europe, with that of the Prague exchange, which had very little regulation in the first half of the 1990s. In Poland, they find, securities laws regarding disclosure and other measures protecting investors were crucial for the development of the market, whereas the Czech Republic, where decision makers deliberately opted for a model with very little regulation (and consequently little protection of minority shareholders and other measures in accordance with what is generally accepted as corporate governance good practice), saw the emergence of “tunnelling” (asset-stripping) as well as massive de-listing in the early 1990s.

Djankov and Murrell (2002) conclude that flaws in the post-Soviet regulatory framework were the main reason for the lack of statistically significant positive results concerning the effects of privatization in post-Soviet countries. In addition to capital market regulation stressed by

Glaeser et al. (2001), Nellis (1999) points to the importance of an effective mechanism for enterprise exit (bankruptcy). The importance of hard budget constraints has also been clearly shown by research (see, e.g., Dabrowski et al. 1991; Carlin et al., 1995), which indicates that avoidance of government subsidies (whether explicit or implicit) or bailouts is important for the economic performance of firms.

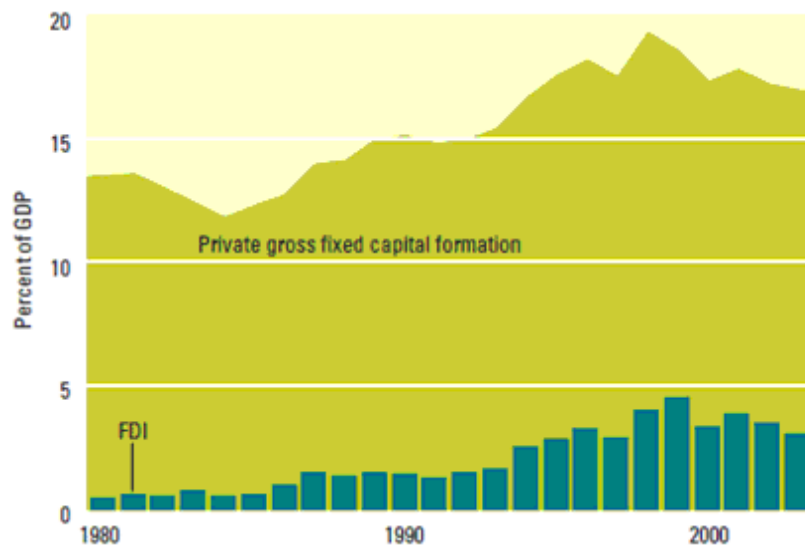
Who is the private owner? Another important factor affecting the efficacy of privatization in achieving desirable restructuring results is the type of owner: some owners are better than others at inducing restructuring. The survey by Djankov and Murrell (2002) finds the overall verdict in the literature on transition countries to be a negative one for insiders (i.e., managers and employees) and a positive one for investment funds and foreigners. The positive result concerning investment funds should, however, be treated with caution in the light of studies of Polish and Czech mass voucher privatization programs, in which investment funds played a crucial role. These studies tend to show investment fund ownership being associated with poor economic performance (Weiss & Nikitin, 1998; Nellis, 1999; Blaszczyk et al., 2003).

Political legitimacy. Purely political factors such as public opinion are often dismissed as having no economic significance. However, they can have very important implications for the success of economic policies. In two papers, Henisz et al. (2005a, b) examine the shift from state domination to neo-liberal paradigms of economic policy, using the particular examples of privatising and deregulating reforms of the telecommunication and electricity industries in numerous countries around the world. They find that the political legitimacy of reforms has important consequences for the risk of those reforms' being rolled back, which can in turn cause serious problems for foreign investors who have moved into the deregulated and privatised industries. They identify some factors that are important for legitimacy. First, reforms have low legitimacy if a country adopts them simply in response to pressure from multilateral lenders such as the World Bank or IMF, and they have higher legitimacy if neighboring countries have adopted them. Privatisation without regulatory reform, which leaves consumers facing a private monopoly in the place of a state-owned one, also makes reforms very unpopular. The authors also find that the likelihood of adopting a comprehensive package of reforms depends on the economic performance of an industry (poor performance creates demand for reform) and on the presence of sufficient institutional checks and balances, which make domestic politicians less likely to adopt reform (since policy makers are less likely to adopt controversial measures when there is effective opposition from, e.g., the parliament) but make foreign investors more likely to enter the market due to their greater confidence that reforms will not be reversed once adopted. A statistical analysis of data on over 1,000 electrical infrastructure investment projects in 83

countries in the period 1989-1999 shows that countries that adopt reforms due to pressure from multilaterals tend to intervene in markets later, reversing reforms or altering reformed regulatory frameworks and thus creating serious losses for foreign investors. (Henisz et al., 2005b).

In addition to privatization, we are also concerned in this report with private sector investment and the conditions that affect it. Foreign investment is becoming more important in developing countries, but the bulk of private investment remains domestic.

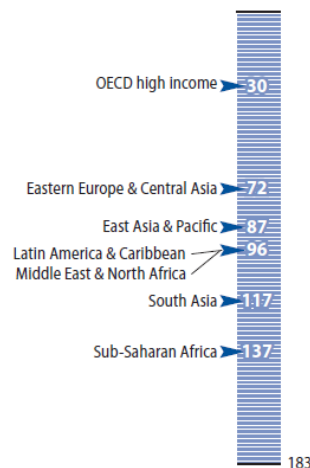
Figure 3: Domestic Private Investment and Foreign Direct investment: Annual Averages of 92 Developing Countries



Source: World Bank (2004)

In the World Bank’s annual Doing Business reports, economies are ranked on their ease of doing business, from 1 - 183, with first place being the highest. The ease of doing business index averages the economy's percentile rankings on 9 topics (namely: starting a business, dealing with construction permits, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business), made up of a variety of indicators, giving equal weight to each topic. Figure 4 shows the average ranking on the ease of doing Business for the region in comparison with other regions such as Latin America and Caribbean.

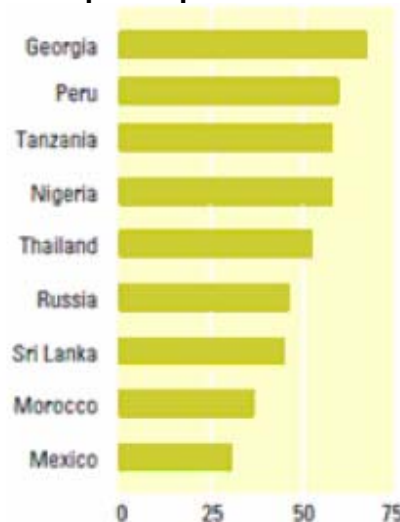
Figure 4: Regional average rankings on the Ease of Doing Business (1-183)



Source: World Bank (2010)

As one can see, the region of Eastern Europe and Central Asia ranked higher than other developing regions such as Latin America & Caribbean and MENA. Unfortunately, in many developing countries, a poor business climate leads to the informal economy accounting for more than half of economic activity (the share of informal output in GDP is shown for nine countries in Figure 5). Firms in the informal economy face more constraints than other firms, including insecure property rights, corruption, policy unpredictability, and, more importantly, limited access to finance and public services. Relieving these constraints allows entrepreneurs to expand their activities and provides incentives to move into the formal economy (De Soto, 1989, 2000).

Figure 5: Informal output as percent of GDP in nine countries

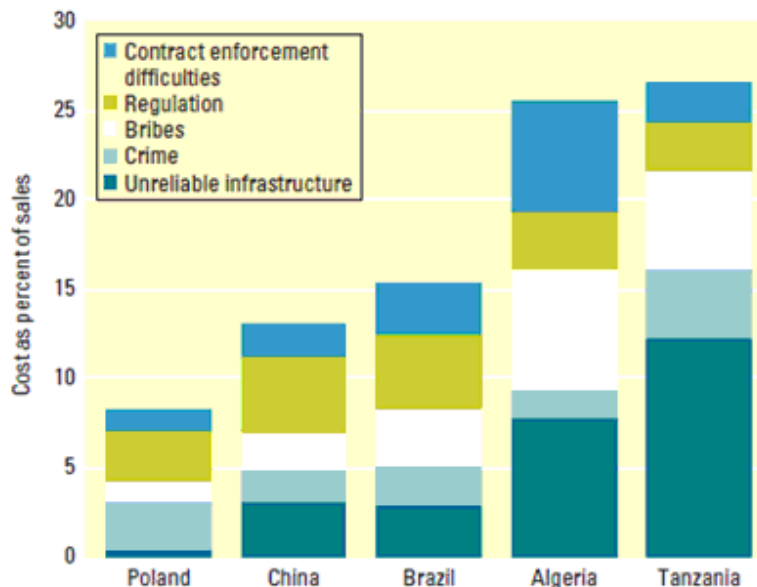


Source: Schneider (2002)

he high costs of operating formally, which lead to this state of affairs, vary widely among developing countries both in level and composition. As Figure 6 depicts, the costs of contract

enforcement difficulties, inadequate infrastructure, crime, corruption, and regulation can amount to over 25 percent of sales, which is more than three times what firms typically pay in taxes (World Bank, 2004).

Figure 6: Costs of a poor business environment in 5 countries



Source: World Bank (2004)

Access to external finance is also very often a barrier to private sector development, especially in developing countries. In a review of the literature on the relationship between financial sector development and economic development, Demirgüç-Kunt and Levine (2008:2) state that:

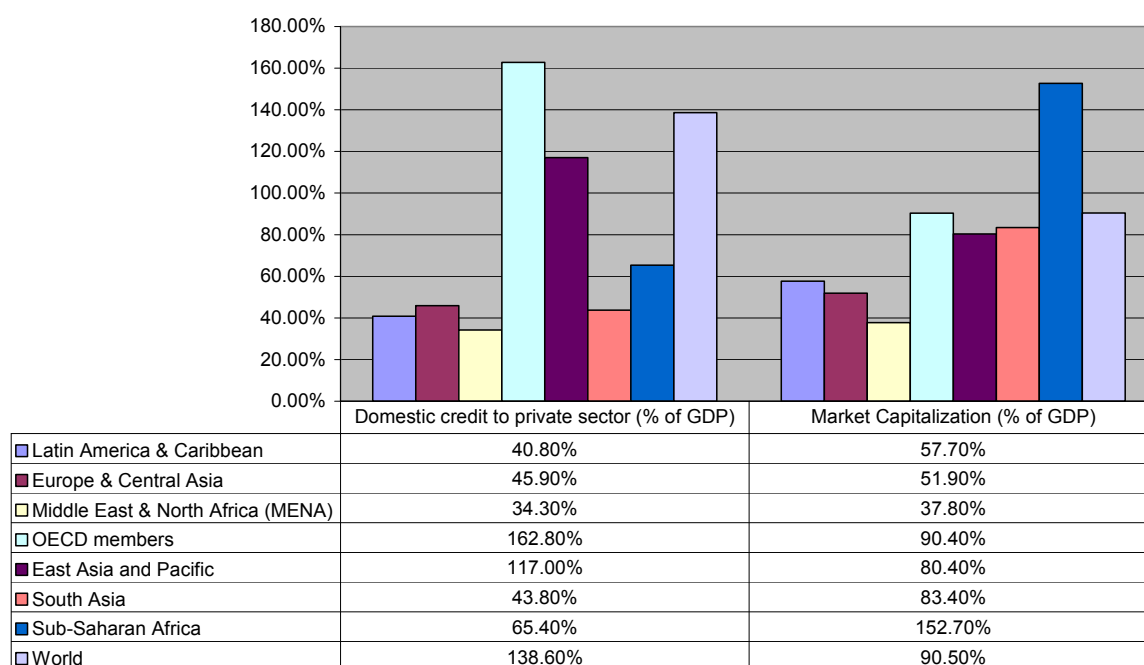
First, countries with better developed financial systems tend to grow faster. Specifically, countries with (i) large, privately owned banks that funnel credit to private enterprises and (ii) liquid stock exchanges tend to grow faster than countries with corresponding lower levels of financial development. The level of banking development and stock market liquidity each exerts an independent, positive influence on economic growth. Second, simultaneity bias does not seem to be the cause of this result.

Figure 7 shows domestic credit to the private sector and market capitalization as a percentage of GDP for the world and seven groups of countries (Latin America and the Caribbean, Europe and Central Asia², the Middle East and North Africa, East Asia and Pacific, South Asia, Sub-Saharan Africa and OECD members) in 2009. It shows the huge gap between developing regions and OECD members in terms of credit activity; it is

² The region of "Europe and Central Asia" in this report includes 20 countries, of which 19 are post-communist countries: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Georgia, Kazakhstan, Kosovo, Kyrgyzstan, Lithuania, Macedonia, Moldova, Montenegro, Romania, Russia, Serbia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan (Turkey is the one member of this group that is not post-communist).

particularly worth noting that the MENA region has the lowest levels of credit activity. We will explore this issue further for the three regions covered in this report in later sections. If we compare this figure with Figure A1 in the appendix (showing 2010 GDP per capita in these seven regions) and use the OECD countries as a benchmark, we see that sub-Saharan Africa, the East Asia-Pacific region and South Asia have market-capitalization-to-GDP ratios that are much higher than one would expect if there were a simple relationship between this ratio and a nation’s per capita income, whereas the MENA region’s is far lower than that of any other region.

Figure 7: Domestic Credit to Private Sector 2009 and Market Capitalization 2010 (% of GDP)



Source: World Bank Data Base (2009)

One of the most important factors in the quality of the business environment – particularly with respect to its effect on the development of the private sector – is the protection of property rights by the national justice system. In Table 1 we present a number of indices of property rights protection for the world and various regions. Of the five developing regions, we can see that the Middle East and North Africa is in second place (behind Asia and Oceania), whereas the two other regions we are using as benchmarks –Latin America and the post-communist countries of Central and Eastern Europe and the former Soviet Union – do significantly more poorly, on some measures being indistinguishable from the poorest-performing region, Africa.

Table 1: Property Rights Indices for the World and Various Regions

Region	International Property Rights Index	Legal and Political Environment	Physical Property Rights	Intellectual Property Rights
World	5.6	5.3	6.2	5.4
North America	7.8	7.8	7.3	8.3
Western Europe	7.5	7.7	7.2	7.7
Asia and Oceania	6.0	5.6	6.6	5.6
Middle East and North Africa	5.7	5.3	6.7	5.2
Central & Eastern Europe and Former Soviet Union	5.1	5.0	5.8	4.6
Latin America and Caribbean	5.0	4.4	5.7	4.8
Africa	4.8	4.1	5.6	4.6

Source: International Property Rights Index (2011)

3. Latin America

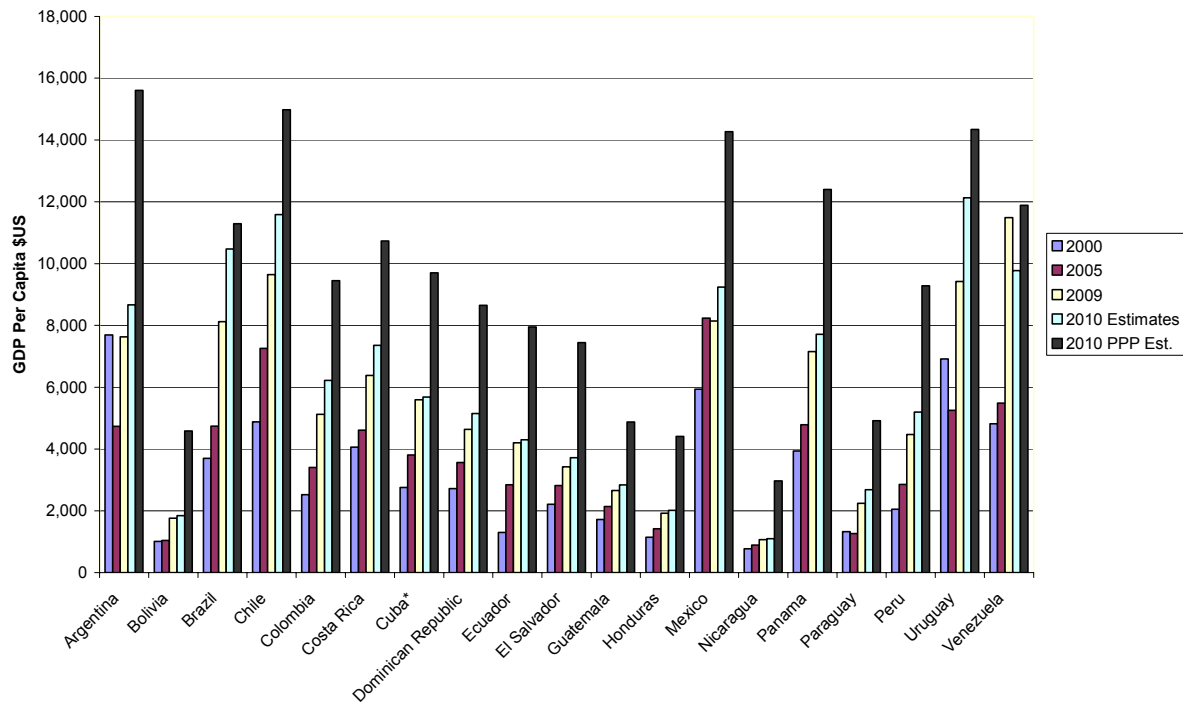
Latin America has an area of approximately 14.1% of Earth's land surface area which includes twenty countries: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Puerto Rico, Uruguay, and Venezuela. As of 2010, it's population was estimated at more than 590 million (CIA World FACTBOOK, 2011) and its combined GDP at 5.16 trillion United States dollars (6.27 trillion at purchasing power parity) (International Monetary Fund, 2010). The Latin American expected economic growth rate is about 5.7% for 2010 and 4% in 2011 (International Monetary Fund, 2010).

The economic growth of the area is promising. According to current predictions, two of the five largest economies in the world in 2050 will belong to this region (Brazil and Mexico, which together with China, the United States, and India are predicted to be the largest economies of the world by that time; see Goldman Sachs, 2007).

In the region, Brazil has the largest population (almost 200 million people which consists one-third of the region's population) and the largest GDP – around 2.2 trillion \$US in 2010 (estimated). On a per capita basis as of 2010, Latin America included five nations classified

as high-income countries: Argentina, Chile, Uruguay, Mexico and Panama, each with over 12,000 \$US at PPP (see Figure 8). The figure also demonstrates significant rates of growth in the past decade.

Figure 8: GDP Per Capita for Latin American countries, 2000-2010



Note: Missing Puerto Rico

* Cuba 2008 is used instead of missing 2009

Sources: World Bank Data Bases (2000, 2005, and 2009); International Monetary Fund (2010)

With respect to privatization, the 1990s were a decade of much progress in the region. According to López de Silanes and Chong (2004), Latin America accounted for 55% of total privatization revenues in the developing world in the 1990s (see also Figure 2), and the share of state-owned enterprises in the economy dropped more substantially there than in Asia and Africa. However, they also point out that the countries of the region saw little progress in the early 2000s (though, as we have noted, this was a world-wide trend; see Figure 1). It is claimed that 90 percent of Latin American and Caribbean jobs are generated by the private sector (ECLAC, 2009).

3.1. Savings, credit and investment

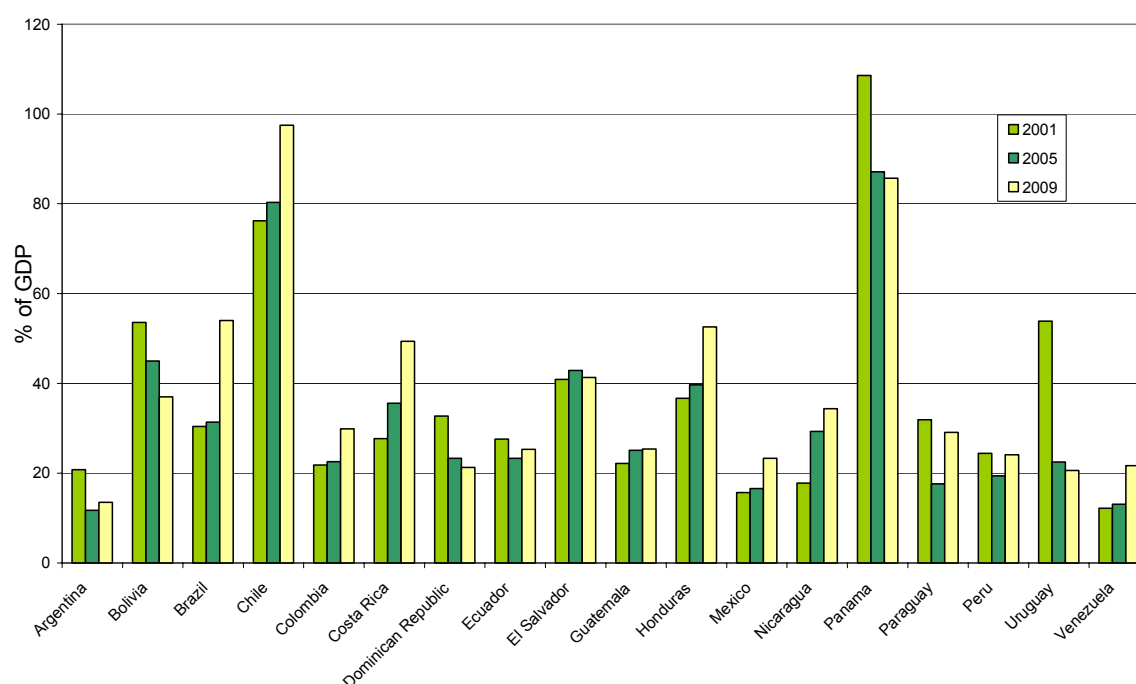
Savings have traditionally been low in Latin America (with net national savings consistently under 10% of gross domestic income since the early 1980s, compared with rates of between 14 and 16% in a comparison group of 25 developing countries), and contrary to expectations, increases in interest rates and reductions in government budget deficits and inflation rates in

the most recent two decades have not changed this situation (Reinhardt 2008). Saving rates in Latin America seem to be affected by a degree of inertia, suggesting that culture may play an important role.

Productivity in the small business sector is relatively low. One study of ten Latin American countries found that the labor productivity (the ratio of production to employment) of Small and Medium-sized Enterprises (SMEs) was only 20-60 percent that of the larger firms in eight of those countries; in the remaining two (Brazil and Costa Rica), where the comparison was more favorable, the best figure achieved was only 77% of the productivity of larger businesses (Peres and Stumpo, 2000). This is linked to the fact that 80% of SMEs in the region face credit constraints (International Finance Corporation, 2010).

On average for the region of Latin America, domestic credit to the private sector accounts for 31% to 39% of GDP during the last decade, compared to 57% in Central and Eastern Europe and the former Soviet Union (see section 4.1). Figure 9 depicts the domestic credit to private sector for the countries in the region in 2001, 2005, and 2009.

Figure 9: Domestic credit to private sector (% of GDP) for Latin America



Note: Missing Cuba and Puerto Rico

Source: World Bank Data Bases (2000, 2005, and 2009)

As one can see, Panama and Chile have by far the highest share of lending to the private sector in GDP, and Brazil, Chile, Colombia, Costa Rica, Honduras, and Nicaragua show almost a stable continuous growth during the last decade. The general trend for the region shows a decrease between 2000 and 2004 and a continuous increase afterwards. The bulk

of investment has gone to the energy sector, telecommunications, transportation, and water and sanitation (World Bank Data Base).

3.2. Business environment

As we saw in Table 1, Latin America's performance with regard to the protection of property rights is very poor. However, there is significant differentiation within the region, as we see in Table 2. Chile and Uruguay perform particularly well, and Costa Rica and Panama are also well above the regional average. However, there are particularly dismal performances by Venezuela and Bolivia, where the rule of law is very significantly impaired.

Table 2: Property rights indices for the countries of Latin America

Country	International Property Rights Index	Legal and Political Environment	Physical Property Rights	Intellectual Property Rights
Argentina	4.7	4.1	5.1	5.0
Bolivia	3.9	3.2	4.5	4.0
Brazil	5.3	5.0	5.5	5.5
Chile	6.7	7.3	7.0	5.8
Colombia	5.1	3.8	6.0	5.4
Costa Rica	5.9	6.6	6.1	5.0
Ecuador	4.4	3.0	5.3	4.8
El Salvador	4.9	4.4	6.0	4.4
Guatemala	4.5	3.5	6.1	4.0
Guyana	4.6	4.1	5.7	4.0
Honduras	4.7	3.9	5.7	4.4
Mexico	5.0	4.2	5.7	5.0
Nicaragua	4.1	3.5	4.9	3.9
Panama	5.6	4.6	6.8	5.3
Paraguay	4.0	2.9	5.4	3.6
Peru	4.9	3.7	6.5	4.4
Uruguay	6.1	7.0	6.0	5.2
Venezuela	3.4	2.3	4.4	3.5

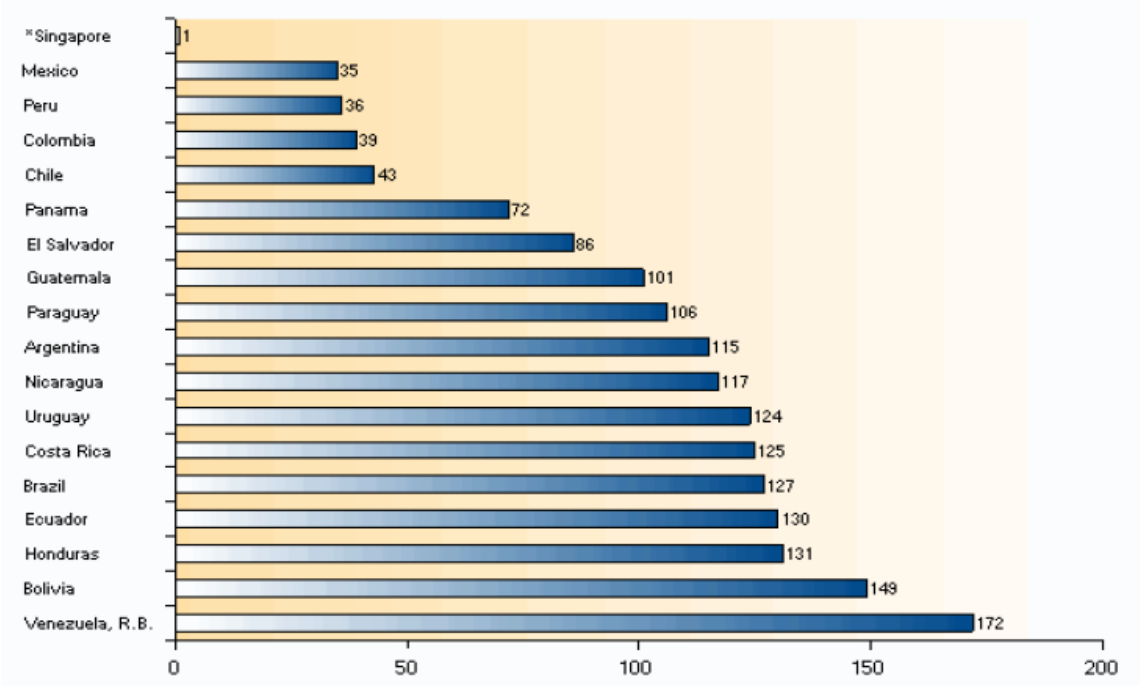
Source: IPRI (2011)

Figure 10 depicts the overall ranking of Latin American Countries in the Ease of Doing Business. We see that Mexico, Peru, Colombia, and Chile are well ahead of the other countries in the region; not surprisingly, given what we saw in Table 2 with respect to property rights, Venezuela and Bolivia are bringing up the rear (World Bank, 2010).



Another comprehensive index which shows the ease of doing business is the 5-year measure of cumulative change which shows whether, and to what extent, doing business has become easier or more difficult and costly. Figure 11 shows the ranking among the countries in the region. As the figure demonstrates, Colombia, Peru, Guatemala, and Mexico (respectively) show a huge improvement (over 12% improvement in ease of doing business), followed by Paraguay (over 8%), while Argentina and Venezuela show regression.

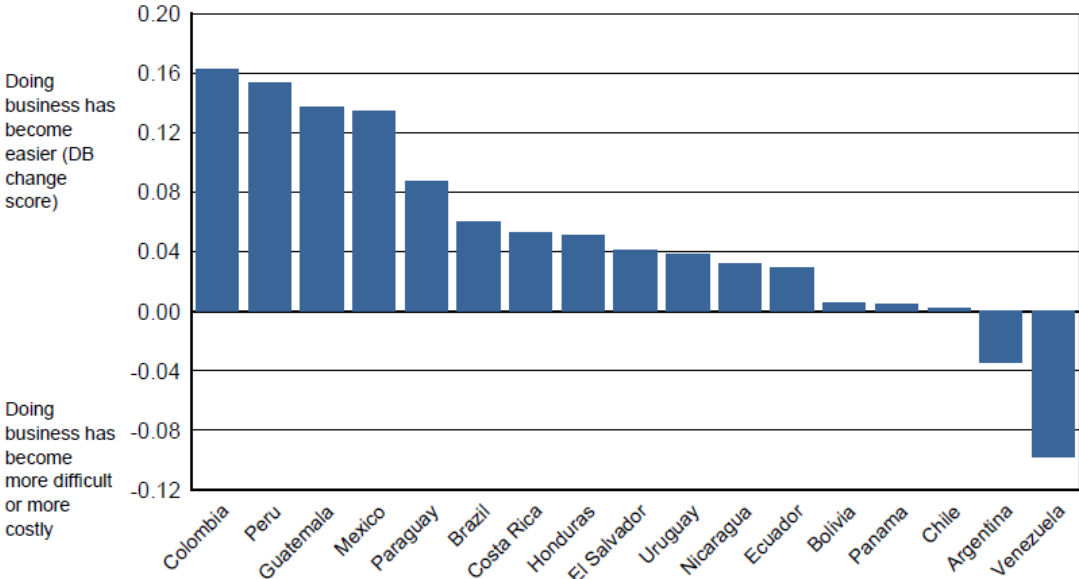
Figure 10: Latin America - Aggregate rankings for period June 2009 - June 2010



Note: Singapore is shown as a benchmark; missing Cuba, Dominican Republic, and Puerto Rico
 Source: World Bank (2010)



Figure 11: the distribution of cumulative change across the 9 indicators (2006-2011)



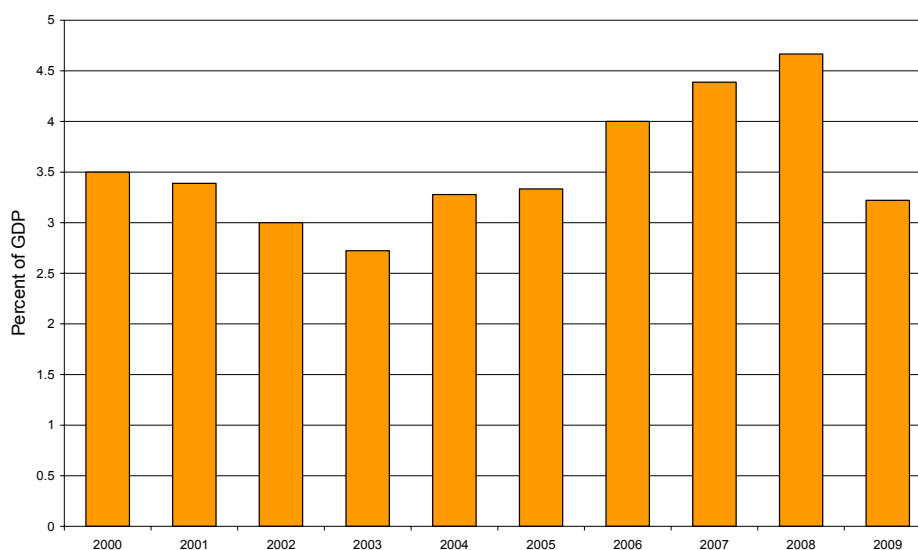
Note: missing Cuba, Dominican Republic, and Puerto Rico
 Source: World Bank (2006) and World Bank (2010)

One of the effects of a poor business environment is the fact that, as mentioned in the introduction, the informal economy accounts for more than half of economic activity in many developing countries (see Figure 5). As for Latin America and the Caribbean countries, informal activity accounts for about 41 percent of the region’s gross domestic product (Schneider, 2002). Firms in the informal economy face many of the same constraints as other firms, including insecure property rights, corruption, policy unpredictability, and limited access to finance and public services.

3.3. Foreign Direct Investment

Figure 12 shows the average net inflows of FDI as a percentage of GDP in Latin America in the last decade. The general trend for the net inflow of FDI shows a continuous increase since 2003 up to 2008. The decrease in the flow into the region for 2009 is due to the global financial crisis.

Figure 12: Net Inflows of FDI to Latin America 2000-2009 (% of GDP)



Note: Cuba and Puerto Rico are excluded
Source: World Bank Data Bases (2000-09)

4. Post Communist Countries of Europe and Asia

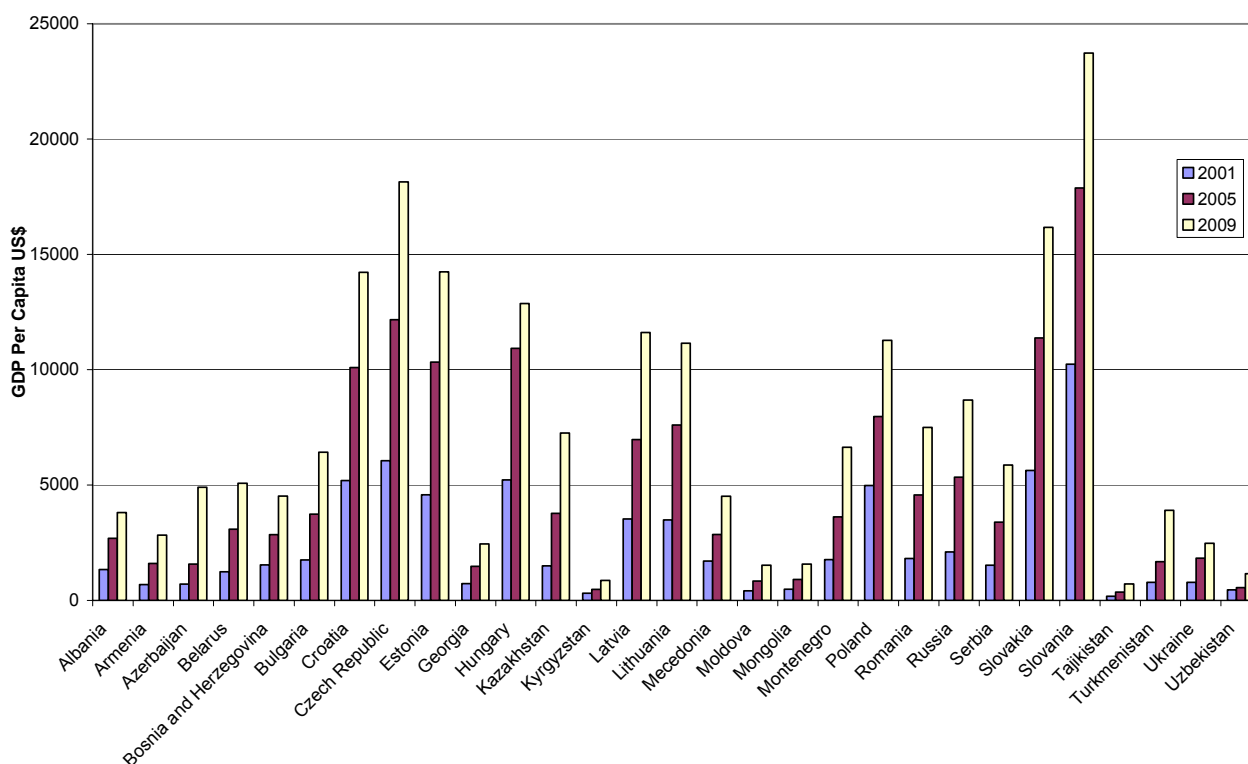
This region includes 29 countries of Eastern Europe and Central Asia; namely, Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Macedonia, Moldova, Mongolia, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. Average standards of living registered a catastrophic fall in the early 1990s in many parts of the former Comecon³ - most notably, in the former Soviet Union - and began to rise again only toward the end of the decade. Most of the countries that have joined the European Union since 2004, however, bounced back quite

³ The **Council for Mutual Economic Assistance**, 1949–1991, was an economic organization comprising the countries of the Eastern Bloc along with a number of communist states elsewhere in the world.

quickly in the 1990s and have grown considerably since then, although all have suffered from the 2009 recession. Today, all post-communist countries in Europe are dominated by flourishing private sectors.

Figure 13 shows the development of GDP per capita for the countries in the region during the last decade.

Figure 13: GDP Per Capita for the post-communist countries of Europe and Asia, 2001-2009



Source: World Bank Data Bases (2001, 2005, and 2009)

As one can see, the figure depicts a huge increase in the GDP per capita in 2000s for the countries in the region while Slovenia, the Czech Republic, Slovakia, Croatia, Estonia, and Hungary are outstanding for having over 10,000 US GDP per capita since 2005 respectively (since 2001 for Slovenia). Latvia, Lithuania, and Poland reached this level at the end of the decade. Not surprisingly, there is a huge gap between the countries that have been in the European Union since 2004 on the one hand and the non-members and countries that joined in 2007 (Bulgaria and Romania) on the other (Croatia being the exception).

Table 3 shows the private sector share in GDP in the countries of the region.

Table 3: Private sector share of GDP (%)

	Population mid- 2010 (million)	Private sector share of GDP mid- 2010 (EBRD estimate in per cent)
Albania	3.2	75
Armenia	3.2	75
Azerbaijan	8.4	75
Belarus	9.7	30
Bosnia and Herzegovina	3.8	60
Bulgaria	7.6	75
Croatia	4.4	70
Estonia	1.3	80
FYR Macedonia	2.0	70
Georgia	4.5	75
Hungary	10	80
Kazakhstan	15.7	65
Kyrgyz Republic	5.1	75
Latvia	2.3	70
Lithuania	3.4	75
Moldova	3.4	65
Mongolia	2.8	75
Montenegro	0.7	65
Poland	38.0	75
Romania	21.7	70
Russia	142.2	65
Serbia	9.9	60
Slovak Republic	5.4	80
Slovenia	2.0	70
Tajikistan	6.8	55
Turkey	69.7	70
Turkmenistan	6.5	25
Ukraine	46.6	60
Uzbekistan	26.0	45

Source: EBRD (2010)

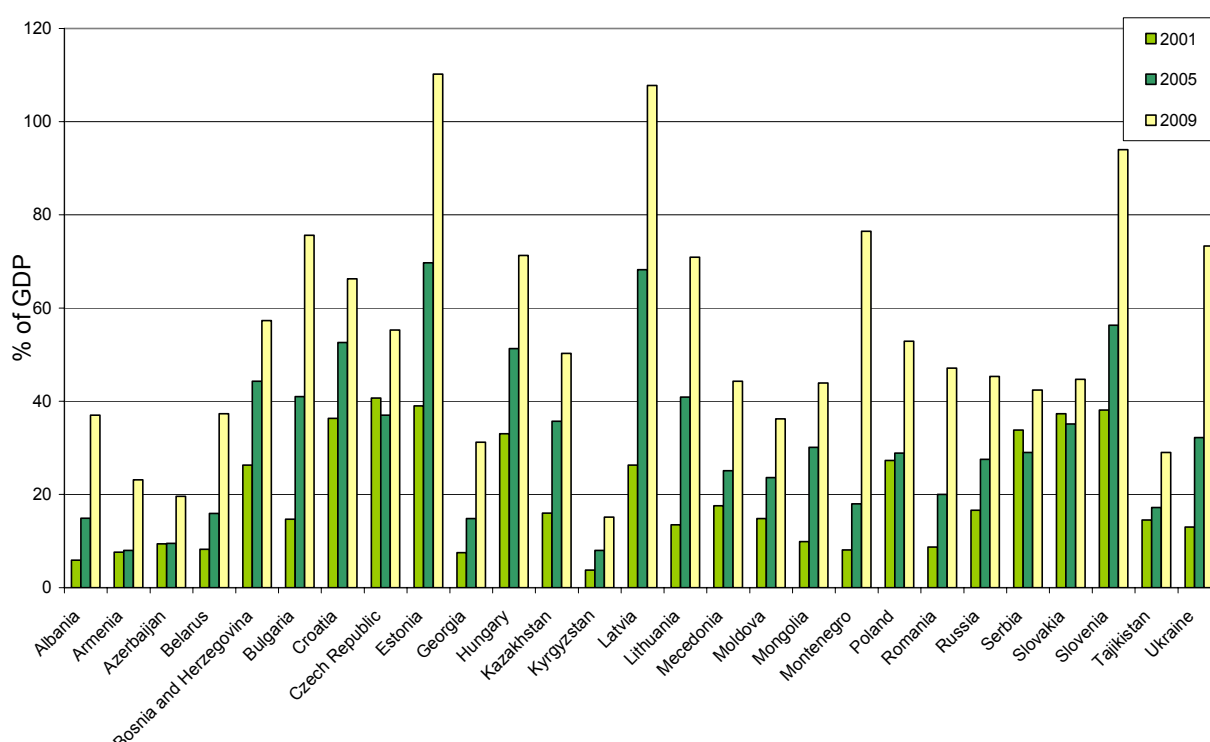
The highest shares (80%) are noted in the EU member states Estonia, Hungary, and Slovakia, the lowest in the former Soviet republics of Turkmenistan (25%), Belarus (30%)

and Uzbekistan (45%). With the exception of the latter three countries, however, all others have private sector shares of over 50%.

4.1. Savings, credit and investment

On average for the region, domestic credit to private sector rose from 20% of GDP in 2001 to 57% in 2009. Figure 14 depicts the domestic credit to private sector for the countries in the region in 2001, 2005, and 2009.

Figure 14: Domestic credit to private sector for the post-communist countries of Europe and Asia



Note: Missing Turkmenistan and Uzbekistan
 Source: World Bank Data Bases (2000, 2005, and 2009)

As one can see, Estonia, Latvia, and Slovenia have the largest shares of lending to the private sector in GDP, with huge increases during the last decade, and are followed by Montenegro, Bulgaria, Ukraine, Hungary, Lithuania, Croatia, Bosnia and Herzegovina, Poland, and Czech Republic, which have all reached figures of over 50% of GDP. The general trend for the region shows a continuous, stable, and high growth in lending to the private sector. Interestingly, the credit crunch in 2008 and 2009 did not reverse this trend, although it slowed down the pace of growth, which shows the robustness of the improvement in the economy of the post communist countries of Europe and Central Asia. Again, as in

Latin America, the bulk of investment has gone to energy, telecommunications, transportation, and water and sanitation (in that order; see World Bank Data Base).

4.2. Business environment

Like Latin America, this region shows overall poor performance in the area of property rights protection (Table 1). Table 4 shows clearly that this is due to the performance of the non-EU members in the region; all except Croatia and Montenegro have IPRI scores below 5, whereas all EU member states have scores of at least 5.3.

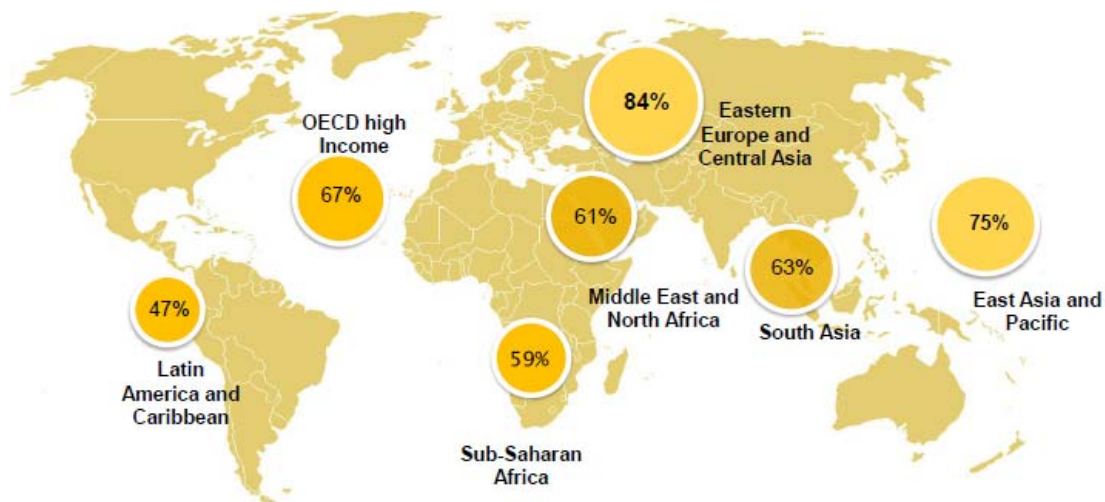
Table 4: Property Rights Indices for the Post-Communist Countries of Europe and Central Asia

Country	International Property Rights Index	Legal and Political Environment	Physical Property Rights	Intellectual Property Rights
Albania	4.4	4.5	5.5	3.3
Armenia	4.2	4.2	5.9	2.5
Azerbaijan	4.4	3.8	6.2	3.2
Bosnia-Herzegovina	4.1	4.1	4.9	3.3
Bulgaria	5.3	5.0	5.6	5.4
Croatia	5.3	5.3	5.7	4.8
Czech Republic	6.5	6.3	6.3	6.9
Estonia	6.7	7.1	7.1	5.8
Georgia	4.1	4.1	6.0	2.3
Hungary	6.4	6.1	6.3	6.9
Kazakhstan	4.4	4.4	5.6	3.2
Latvia	5.5	5.9	5.8	4.8
Lithuania	6.0	5.8	6.3	5.9
Macedonia	4.7	4.6	5.5	3.9
Moldova	3.9	3.7	5.6	2.3
Montenegro	5.2	5.4	6.6	3.6
Poland	6.2	6.4	5.6	6.6
Romania	5.5	5.2	5.8	5.4
Russia	4.6	3.5	5.2	5.0
Serbia	4.2	4.1	5.2	3.2
Slovakia	6.3	5.7	6.7	6.5
Slovenia	5.8	6.8	4.7	5.9
Ukraine	4.0	3.5	4.4	4.2

Source: IPRI (2011)

With respect to the Ease of Doing Business rankings (see section 2), in 2011, Georgia was the leader among the countries of Eastern Europe and Central Asia, with the world ranking 12, followed by Estonia (17), Lithuania (23), and Latvia (24) (World Bank, 2010). Figure 15 shows the percentage of countries with at least one positive doing business reform in 2009/2010.

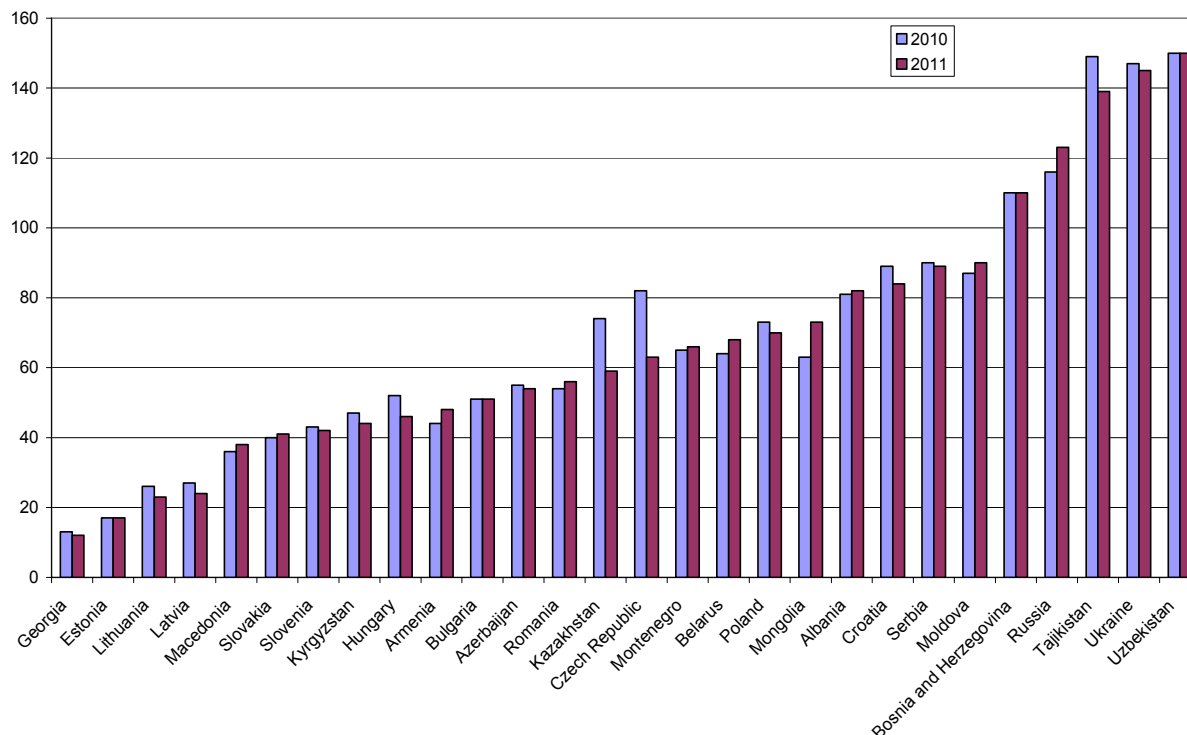
Figure 15: Percentage of countries with at least one positive doing business reform in 2009/2010



Source: World Bank (2010)

As figure 15 demonstrates, the highest percentage of reformers was found in Eastern and Central Europe (moreover, this was the case for the 7th year in a row). Figure 16 depicts the world ranking of the ease of doing business for 28 of the 29 post-communist countries of Europe and Asia in 2010 and 2011 (Turkmenistan is not included in the report).

Figure 16: The World Ranking of the Ease of Doing Business for Post-Communist Countries of Europe and Central Asia



Note: Missing Turkmenistan

Source: World Bank (2010)

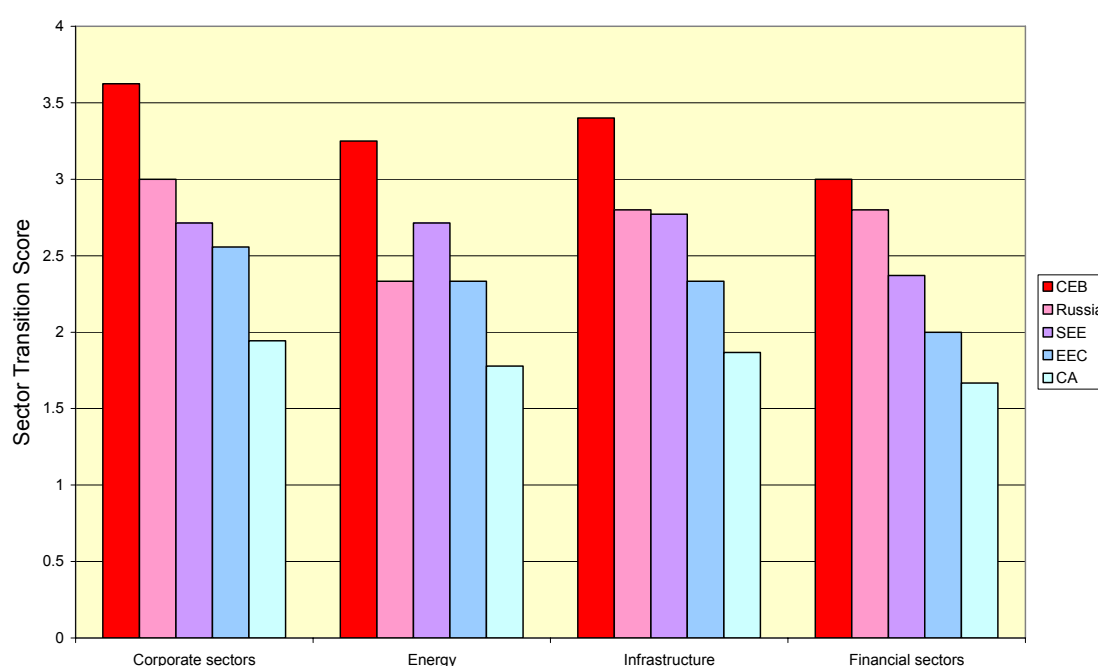
As one can see, the general trend shows an improvement in the ease of doing business in these countries, with the Czech Republic and Kazakhstan showing the biggest jumps, and regression in Albania, Armenia, Belarus, Macedonia, Moldova, Mongolia, Montenegro, Romania, Russia, and Slovakia.

In Poland, Romania, Russia, Slovakia, and Ukraine firms that believe their property rights are secure reinvest between 14 and 40 percent more of their profits in their businesses than those who do not. Improving policy predictability and reducing barriers to competition by governments can increase the likelihood of new investment by more than 30 percent. Governments also influence barriers more directly through their regulation of market entry and exit and their response to anticompetitive behaviour by firms. Barriers to competition in the region remain pervasive, reducing incentives for firms to innovate and increase productivity. For example, competitive pressure is reported to be significant by 90% of firms in Poland but only 40% of firms in Georgia (World Bank, 2004).

Interesting evidence on how reform progress can vary across industries is provided in the Transition Report 2010 of the European Bank for Reconstruction and Development (EBRD). Focusing on two main reform areas – *the development of domestic capital markets and local currency finance* and *the improvement of the business environment* – the report shows how

the relevant indicators for Russia and four groups of post-communist Countries – Central Europe and the Baltic States (CEB), South-eastern Europe (SEE), Eastern Europe and Caucasus (EEC), and Central Asia (CA)⁴ – vary across four sectors: the Corporate Sector (agribusiness; general industry, and real estate), Energy Sector (natural resources; sustainable energy, and electric power), Infrastructure (telecommunications; water and wastewater; urban transport; roads, and railways), and Financial Sector (banking; insurance and other financial services; micro-, small and medium-sized enterprise finance; private equity, and capital markets).

Figure 17: Summary of 2010 Sector Transition Indicators



Source: EBRD (2010)

Figure 17 depicts the results of this analysis. As one can see, the highest sectoral scores are typically in Central Europe and the Baltic states, while the lowest scores are uniformly in Central Asia. It is also interesting to note that in the most advanced CEB region, there is a significant difference between the level of reform achieved in the most reformed – corporate – and least reformed – financial – sector. Indeed, for all groups of countries the financial sector is the least reformed one; the exception is Russia, where the least reformed sector is (hardly surprisingly) energy.

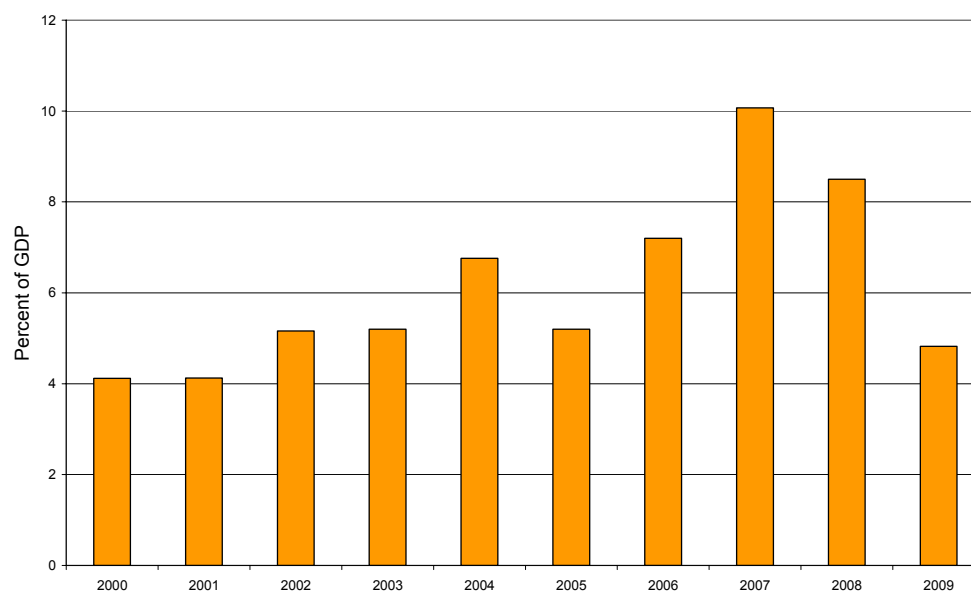
⁴ Central Europe and the Baltic states (CEB) includes Croatia, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia; South-eastern Europe (SEE) includes Albania, Bosnia and Herzegovina, Bulgaria, Macedonia, Montenegro, Romania, and Serbia; Eastern Europe and Caucasus (EEC) includes Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine; and Central Asia (CA) includes Kazakhstan, Kyrgyzstan, Mongolia, Tajikistan, Turkmenistan, and Uzbekistan.

In the EBRD-World Bank Business Environment and Enterprise Performance Surveys (BEEPS), firms in the region rate the main obstacles to doing business every three years. However, the views expressed in the BEEPS are difficult to compare across firms and countries. Focusing on *relative* obstacle ratings removes firm differences in reference points and “tendencies to complain” from the data. This approach reveals that many transition countries share the same three main business environment concerns: skills availability, corruption, and tax administration. Poor physical infrastructure and crime are also among the top concerns, particularly further east in the region. Regression analysis of constraint determinants also suggests that despite the rise of mobile telephony, landline availability still matters; that transparent implementation of tax rules may matter more than simpler documentation or less tax preparation time, and that removing skill bottlenecks is more important than increases in education spending (EBRD, 2010).

4.3. Foreign Direct Investment

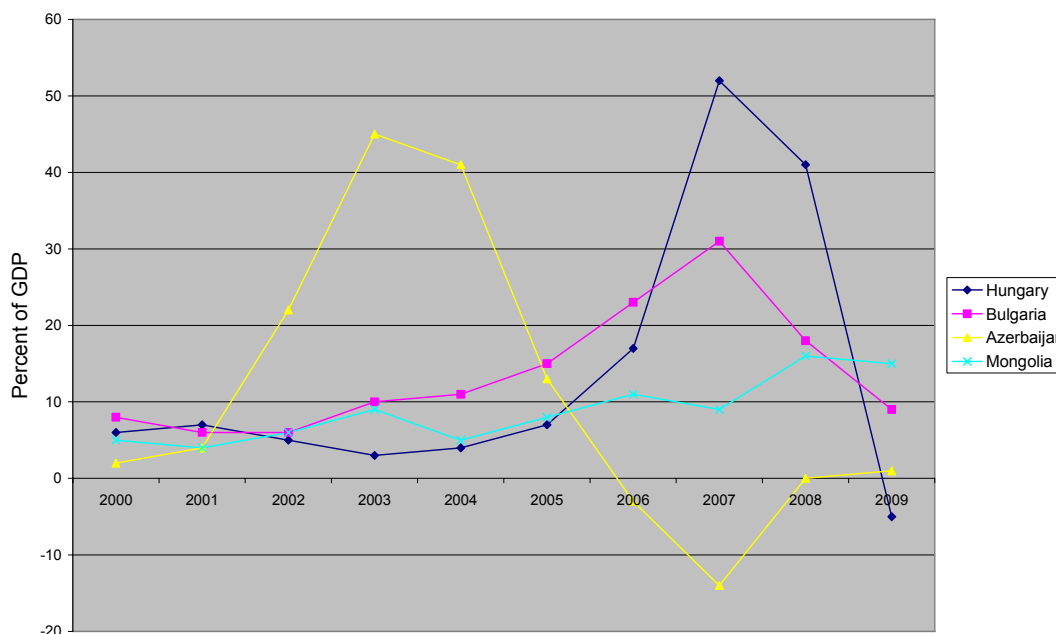
Figure 18 shows the average net inflows of FDI to the region as a percentage of GDP during the last decade. We can see an increase for the region during most of this period. The decrease in the flow of FDI into the region for 2008 and 2009 is due to the global financial crisis and was, as we have seen in section 3.3, also experienced in Latin America. Figure 19 depicts those countries with more ups and downs. As one can see, Azerbaijan shows a huge decline at the end of the decade in the net inflow of FDI after its high jump in the middle of the last decade, the latter jump having been caused by oil investment projects in the Caspian Sea. The same happened in Hungary four years later, which is more consistent with the global trend regarding global recession. Bulgaria has been chosen as a good example to show the general trend in the region. Mongolia, almost unaffected by the global crisis, shows almost continuous improvement in the net inflow of FDI; here the foreign investment activity is largely related to opportunities in natural resource industries such as copper mining.

Figure 18: The Average Net Inflows of FDI to post-communist countries of Europe and Asia, 2000-2009 (% of GDP)



Source: World Bank Data Bases (2000-2009)

Figure 19: Net Inflows of FDI as % of GDP for Azerbaijan, Hungary, Mongolia, and Bulgaria (2000-2009)



Source: World Bank Data Bases (2000-2009)

5. Middle East and North Africa (MENA)

The MENA region referred to in the World Bank nomenclature covers an extensive area including the majority of the Middle Eastern and Maghreb Countries, extending from Morocco to Iran. As of 2009, the area had a population of roughly 381 million people (about 6% of the total world population), with 58% of this in urban areas, and is responsible for the GDP of over US\$1.1 trillion (World Bank Database, 2009). The countries included are: Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Malta, Morocco, Oman, the Palestinian National Authority, Qatar, Saudi Arabia, Syria, Tunisia, Turkey, United Arab Emirates, and Yemen.⁵

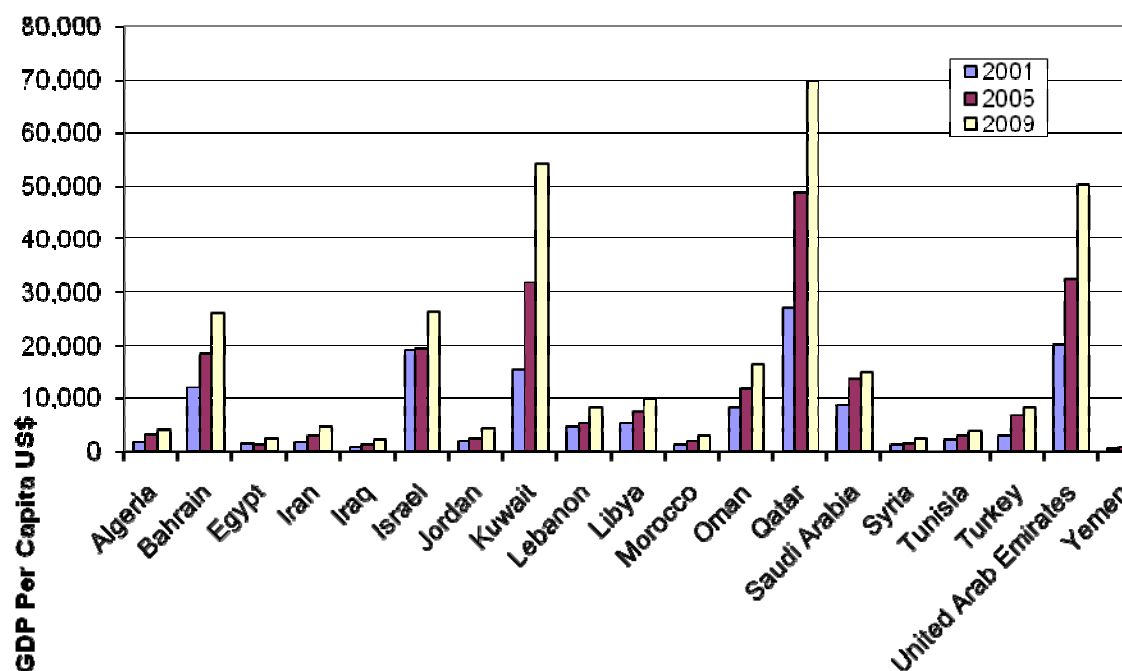
The MENA region has vast reserves of petroleum and natural gas (60% of the world's oil reserves and 45% of the world's natural gas reserves) that make it a vital source of global economic stability – or instability (Oil and Gas Journal, 2009). As of 2011, 8 of the 12 OPEC nations are within the region.

Figure 20 shows the development of GDP per capita for the countries in the region during the last decade. As one can see, their GDP per capita in 2000s recorded a continuous increase. Qatar, Kuwait, United Arab Emirates, Bahrain, and Israel stand out with GDP per capita of over \$20,000 as of 2009 (almost \$70,000 for Qatar and over \$50,000 for Kuwait and United Arab Emirates), followed by Oman and Saudi Arabia. Not surprisingly, there is a huge gap between the Arab countries with huge oil and gas reserves but small populations and other countries of the region (Israel is an exception in this respect, with high GDP per capita but no oil reserves).

⁵ MENA countries are listed at:

<http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/MENAEXT/0,,menuPK:247619~pagePK:146748~piPK:146812~theSitePK:256299,00.html>. All the MED-11 countries – Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, the Palestinian Authority, Syria, Tunisia, and Turkey – are included in the MENA region.

Figure 20: GDP Per Capita for Middle East and North Africa, 2001-2009



Note: Missing Palestinian Authority
 Source: World Bank Data Bases (2001, 2005, and 2009)

5.1. Savings, credit and investment

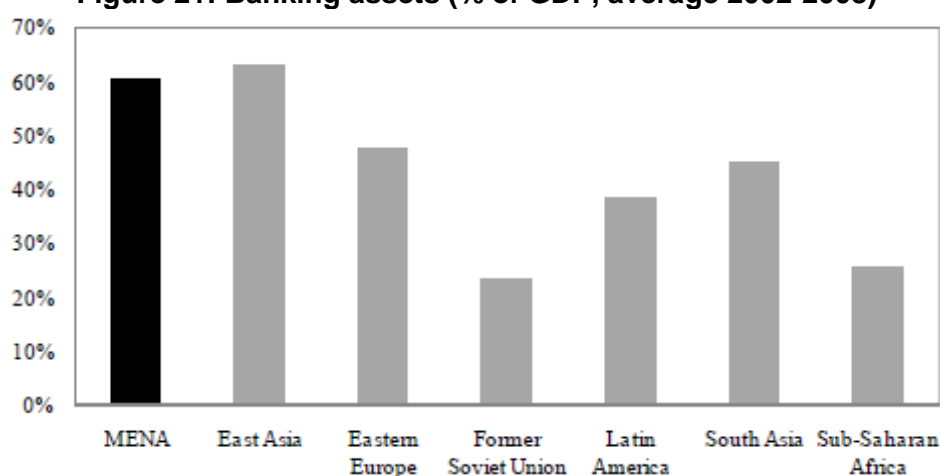
On average for MENA region, the domestic credit to private sector rose from 40% of GDP in 2001 to almost 50% in 2009. Table 5 depicts the domestic credit to private sector for the countries in the region in 2001 and 2009. The highest shares of lending to the private sector in GDP are noted in the UAE (93%), Israel (85%) and Bahrain (80%), and are followed by Lebanon, Jordan, Tunisia, Morocco, and Kuwait, while Iraq and Yemen have the lowest share.

Table 5: Domestic Credit to Private Sector for MENA Countries

Countries	Population 2011 Est. Million	Domestic credit to private sector (% of GDP)	
		2001	2009
Algeria	35	8	16
Bahrain	1.2	47	80
Egypt	82	55	36
Iran	78	23	37
Iraq	30	1.8	6
Israel	7.5	85	85
Jordan	6.5	76	72
Kuwait	2.6	64	63
Lebanon	4.1	86	74
Libya	6.6	24	11
Morocco	32	45	64
Oman	3	39	49
Qatar	0.8	35	52
Saudi Arabia	26	27	52
Syria	23	8	20
Tunisia	11	68	68
Turkey	79	15	37
United Arab Emirates	5	52	93
Yemen	24	6	7
AVERAGE		40	49

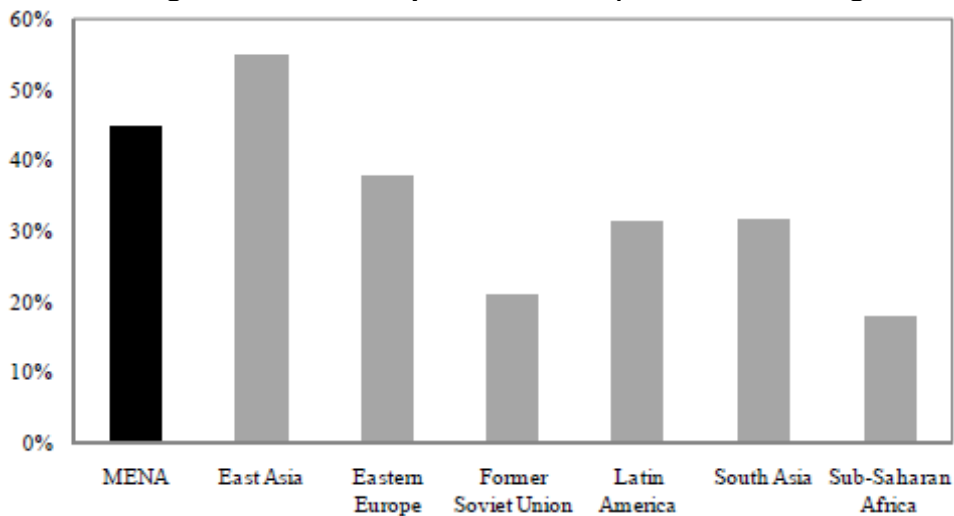
Source: World Bank Data Bases (2000 and 2009) and CIA World Factbook (2011)

Figures 21 and 22 show that among developing regions, the Middle East and North Africa region has the second most developed banking sector (after East Asia) in terms of assets and credit activity (generated largely due to the abundance of oil revenues in the region). (With respect to the other regions examined in this report, Central and Eastern Europe comes in third place, Latin America fifth, and the former Soviet republics are comparable to sub-Saharan Africa.)

Figure 21: Banking assets (% of GDP, average 2002-2008)

Source: World Bank Financial Structure Database (cited in Anzoategui et al., 2010)

Figure 22: Banking sector credit to private sector (% of GDP, average 2002-2008)

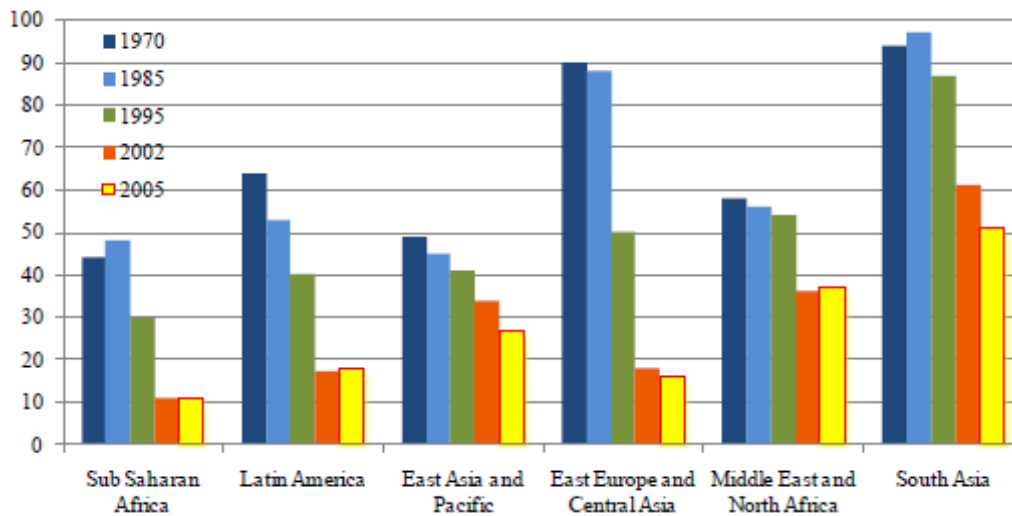


Source: World Bank Financial Structure Database (cited in Anzoategui et al., 2010)

However, using both the Herfindahl and Lerner indices to measure competition, Anzoategui et al. (2010) studied the region's banking sector and found it to suffer from a low degree of competition compared to the banking sectors of other regions, and also concluded that this situation did not improve in the period from 1994 to 2008. They blame a poor credit information environment and excessive restrictions on entry into the sector.

The low level of competition in the banking sector is related to the high share of state-owned banks in the sector. As we can see in Figure 23, extensive privatization of the banking sector has taken place everywhere in the world in the last 40 years. Interestingly, while the Middle East and North African region has participated in this trend, it has done less than the other regions and is still left with one of the largest state shares (second only to South Asia. Though larger and relatively privileged (for example, they face lower funding costs), state-owned banks have inferior profitability compared to those in the private sector (Farazi et al., 2011).

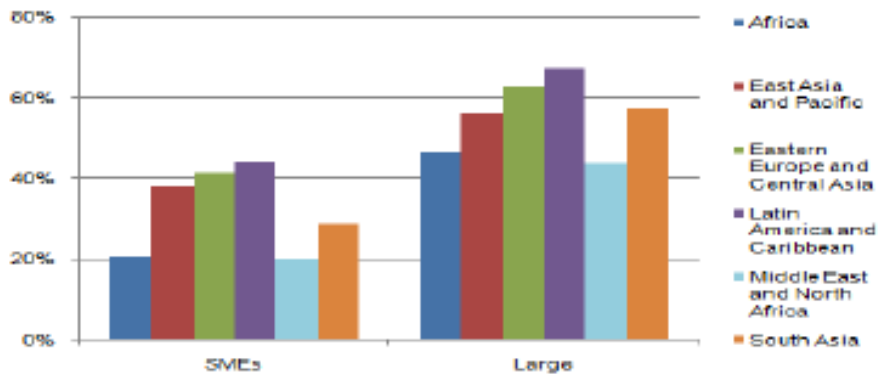
Figure 23: Share of state banks in total banking sector assets (%), 1970-2005



Source: Levy-Yeiati et al. (2007), cited in Farazi et al. (2011), for 1970-2002; Farazi et al. (2011) for 2005. MENA countries include Egypt, Jordan, Lebanon, Morocco, Tunisia and Yemen.

The effects of the low degree of competition in the sector can be seen in Figure 24, showing the percentage of firms with loans or credit lines from financial institutions in various regions. As we can see, the Middle East and North Africa region is one of the poorest performers with respect to lending to both large firms and SMEs. Given that, as we have seen (Figures 20 and 22), the region does well in terms of credit to the private sector as a percentage of GDP, it is clear that the lending activity of banks in the region is strongly focused on a narrow, privileged group of customers. In addition to the low level of competition, some factors indicated as underlying the low level of lending to the SME sector by Rocha et al. (2011) include: poor registries of movable assets that could be used as collateral, poor public credit registries, and the scarcity of private credit bureaus that could improve the availability of credit information (Figure 24).

Figure 24: Percentage of firms with loans or credit lines from financial institutions



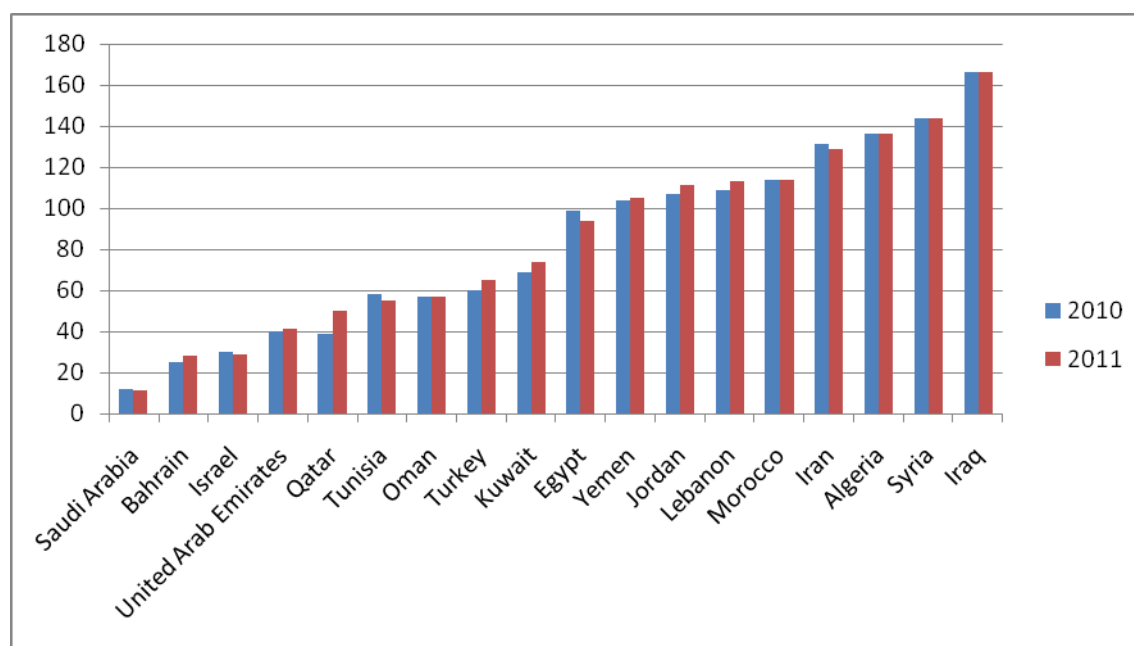
Source: World Bank Enterprise Surveys (2006-2009), cited in Rocha et al. (2011)

5.2. Business environment

As we saw in Table 1, this region is one of the leaders in the developing world with respect to the security of property rights. As we have seen with other regions, however, there is considerable variance across countries (Table 6). The leaders, with IPRI scores of 6.5 or better, are the United Arab Emirates, Bahrain, Oman and Saudi Arabia (in that order). But there are others with much poorer performance (notably Iran with 4.2, Algeria with 4.3 and Lebanon with 4.4).

As for regional average rankings on the Ease of Doing Business, as we saw in Figure 4 (see section 2), the MENA region has the same average as Latin America and Caribbean (96), which is somewhat lower than Eastern Europe and Central Asia (72). Figure 25 demonstrates the world ranking of the Ease of Doing Business for the countries in MENA region. As one can see, Saudi Arabia has the leading position (11th in the world), followed – at a great distance – by Bahrain, Israel, United Arab Emirates, and Qatar. Bringing up the rear are Iraq, Syria, Algeria, and Iran.

Figure 25: The World Ranking of the Ease of Doing Business for the countries of MENA Region



Note: Missing Palestinian Authority and Libya
Source: World Bank (2010)

Table 6: Property rights indices for the countries of the Middle East and North Africa

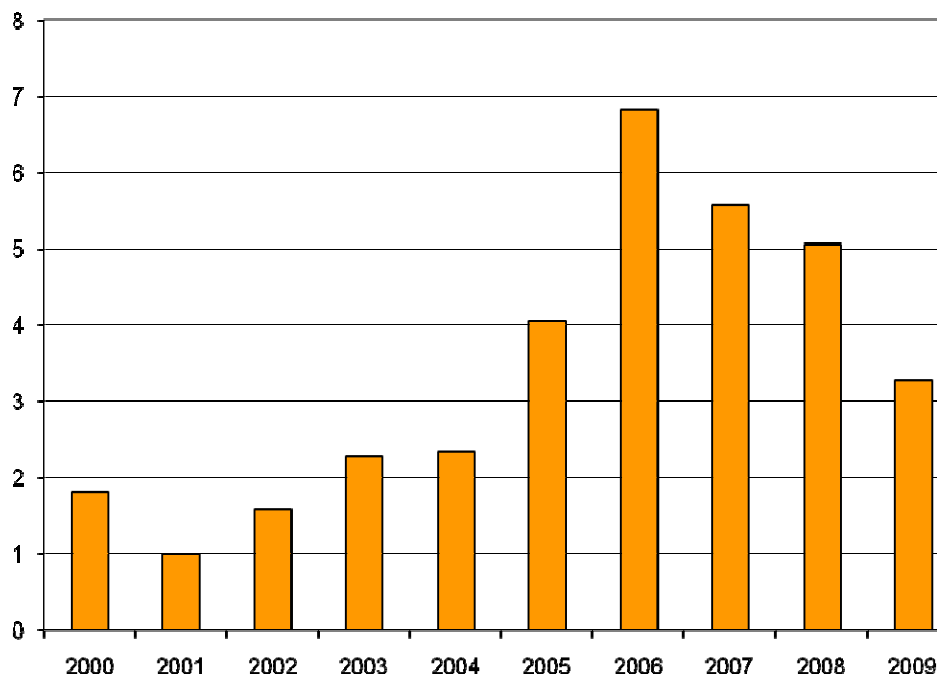
Country	International Property Rights Index	Legal and Political Environment	Physical Property Rights	Intellectual Property Rights
Algeria	4.3	3.5	5.4	3.9
Bahrain	6.7	5.9	8.1	6.0
Egypt	5.2	4.6	6.2	4.9
Iran	4.2	3.5	5.4	3.8
Israel	6.3	6.1	5.9	7.0
Jordan	6.1	5.6	6.8	5.8
Kuwait	5.9	6.2	6.6	5.0
Lebanon	4.4	3.3	6.5	3.3
Libya	3.7	4.3	4.3	2.6
Morocco	5.3	4.6	6.2	5.1
Oman	6.7	6.6	7.8	5.6
Qatar	7.1	7.9	7.5	5.9
Saudi Arabia	6.5	5.6	7.9	5.9
Syria	4.8	3.7	6.2	4.6
Tunisia	6.0	5.7	7.2	5.2
Turkey	5.3	4.6	6.1	5.1
United Arab Emirates	7.2	6.7	7.8	7.0

Source: International Property Rights Index (2011)

5.3. Foreign Direct Investment

Figure 26 shows the average net inflows of FDI to the region as a percentage of GDP during the last decade. We can see an increase for the region to 2006 and a continuous decrease afterwards. The decrease in the flow of FDI into the region from 2007 onwards is due to the global financial crisis and was, as we have seen in section 3.3, also experienced in Latin America and Eastern Europe and Central Asia. Table 7 shows the net inflow of FDI to the countries of MENA region. As we can see, Jordan – albeit with enormous fluctuations – has the highest record of net inflow of FDI (23% of its GDP in 2006 in the last decade) in the region. Lebanon also continuously shows a high percentage of net inflow of FDI. However, with the exceptions of Egypt, Israel and Bahrain (as well as Tunisia in 2006), FDI represents a small share of GDP in the countries of the MENA region.

Figure 26: The Average Net Inflows of FDI to the countries of MENA Region, 2000-2009 (% of GDP)



Note: Missing Palestinian Authority, Qatar, and UAE
Source: World Bank Data Bases (2000-09)

Table 7: Net Inflows of FDI to the countries of MENA Region, 2000-2009 (% of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Algeria	1	2	2	1	1	1	2	1	2	2
Bahrain	5	1	3	5	8	8	18	10	8	1
Egypt	1	1	1	0	2	6	9	9	6	4
Iran	0	1	3	2	2	2	1	1	0	1
Iraq	0	0	0	0	1	2	1	2	2	2
Israel	6	1	1	3	2	4	10	5	5	2
Jordan	11	3	2	5	8	16	23	15	12	9
Kuwait	0	0	0	0	0	0	0	0	0	0
Lebanon			7	14	9	12	12	13	14	14
Libya	0	0	1	1	1	2	4	7	4	3
Morocco	1	0	0	5	1	3	4	4	3	2
Oman	0	0	1	0	0	5	4	8	4	5
Saudi Arabia	-1	0	0	0	0	4	5	6	8	3
Syria	1	1	1	1	1	2	2	3	3	3
Tunisia	4	2	4	2	2	2	11	4	6	4
Turkey	0	2	0	1	1	2	4	3	3	1
Yemen	0	2	1	-1	1	-2	6	4	6	0
Average	1.81	1	1.59	2.29	2.35	4.06	6.82	5.59	5.06	3.29

Note: Missing Palestinian Authority, Qatar, and UAE

Source: World Bank Data Bases (2000-09)



6. Conclusions

The business environment in the MENA region cannot be characterized as a favorable one, but it is far from being so poor as to preclude development, as in the case of much of sub-Saharan Africa; it is even significantly better than that of South Asia, which has experienced a great deal of private sector development in the last two decades. (Four countries in the region can be singled out as having particularly poor business environments: Iran, Algeria, Syria and Iraq, the latter having one of the worst in the world, largely due to internal security problems.) Private property rights are on the average relatively well protected in the region, especially with regard to physical (as opposed to intellectual) property, where protection levels are almost on a par with the developed world. It is, however, important to remember that this is a regional average, and if we look at particular countries, we note that there are several where the situation with regard to the protection of property rights is very far below the average (these countries include Algeria, Iran, Lebanon, and Syria, with the situation especially dire in Libya).

Privatization has made a great deal of progress in the developing world, particularly in Latin America, though the MENA countries have lagged somewhat. Privatization policy makers in these countries need to pay particular attention to improvements in competition and the institutional environment, as the region suffers particular deficits in these areas, particularly with respect to competition. With respect to the latter, much attention has focused in recent years on improvements in the business environment, which are necessary to spur entrepreneurship and encouragement movement from the informal economy into the formal sector. In this area the post-communist countries have been leaders; while Latin America and the MENA region have also seen significant improvement, they still lag behind the new European Union member states as well as some of the post-Soviet states (although the MENA region performs very well with respect to the protection of property rights). The area where the MENA region needs improvement most drastically is in the financial sector. Although rich in savings, it performs very poorly in these countries with respect to the provision of credit to the private sector (particularly small and medium-sized enterprises), largely due to the insufficient level of competition in the sector. A few countries (including Egypt, Lebanon and Libya) have even seen significant decreases in domestic lending to the private sector as a percentage of GDP in the last decade (although the regional trend was in the opposite direction).

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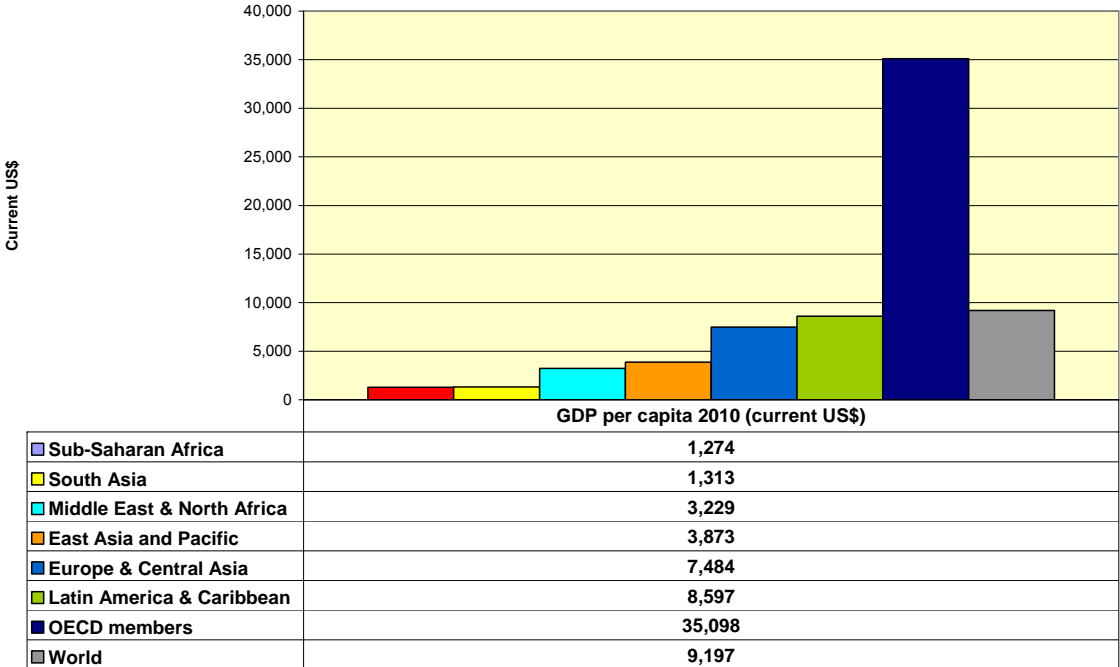
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Appendix

Figure A1: GDP Per Capita for Seven Different Regions 2010 (current US\$)



Source: World Bank Data Bases (2009 and 2010)
 Note: Data for Middle East and North Africa is dated 2009