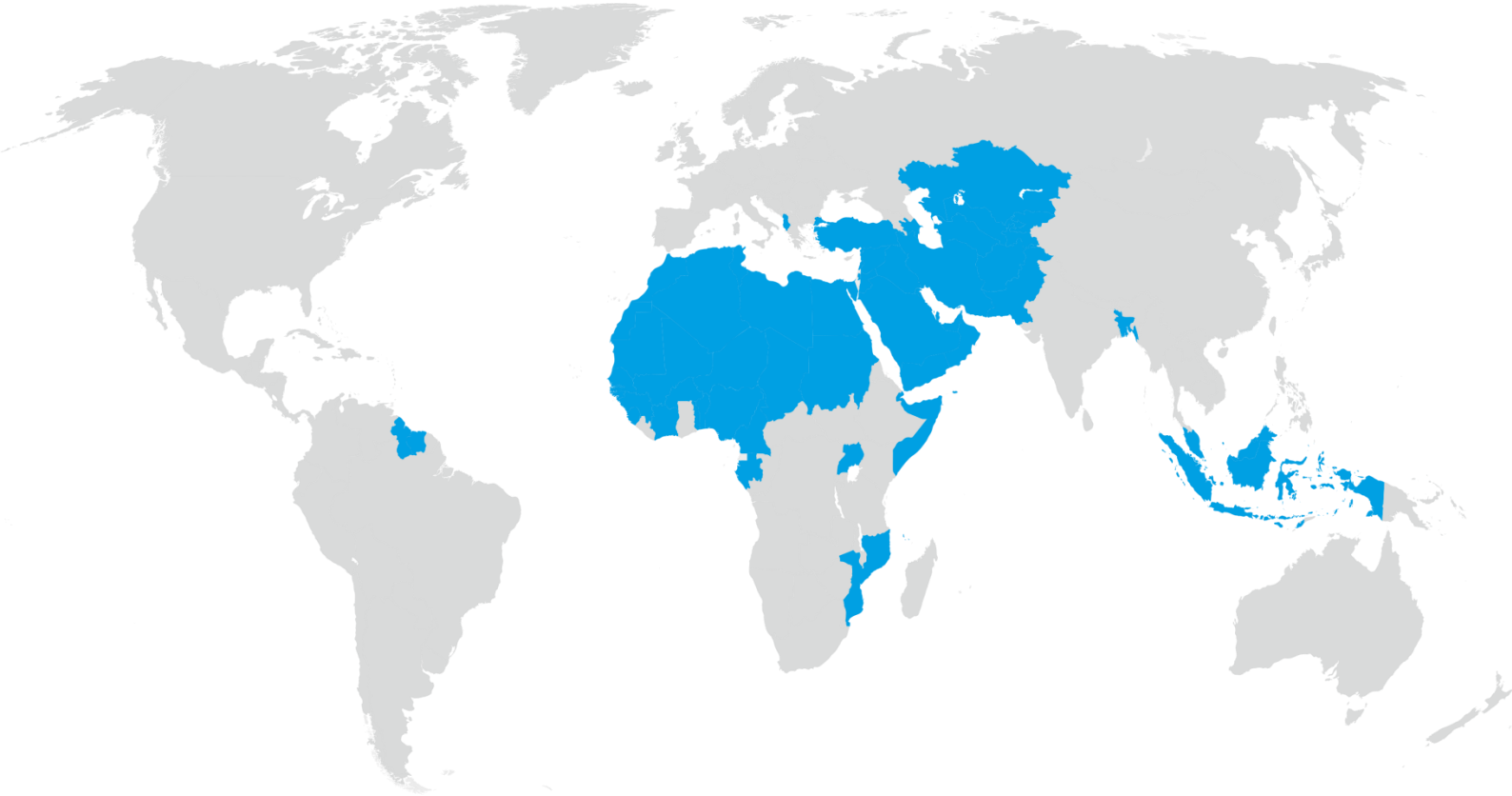
2015 OIC ECONOMIC OUTLOOK

"Promoting Investment for Development"

ORGANISATION OF ISLAMIC COOPERATION

STATISTICAL ECONOMIC AND SOCIAL RESEARCH AND TRAINING CENTRE FOR ISLAMIC COUNTRIES

SESRIC



OIC ECONOMIC OUTLOOK

2015

"PROMOTING INVESTMENT FOR DEVELOPMENT"

© 2015 The Statistical, Economic and Social Research and Training Centre for Islamic Countries (SESRIC)

Kudüs Cad. No: 9, Diplomatik Site, 06450 Oran, Ankara –Turkey
Telephone +90–312–468 6172
Internet www.sesric.org
E-mail pubs@sesric.org

The material presented in this publication is copyrighted. The authors give the permission to view, copy, download, and print the material presented provided that these materials are not going to be reused, on whatsoever condition, for commercial purposes. For permission to reproduce or reprint any part of this publication, please send a request with complete information to the Publication Department of SESRIC.

All queries on rights and licenses should be addressed to the Publication Department, SESRIC, at the aforementioned address.

ISBN: 978-975-6427-39-2

Cover design by Savaş Pehlivan, Publication Department, SESRIC.
Inner design by Kenan Bağcı.

SESRIC hereby expresses its profound appreciation to Republic of Turkey Ministry of Food, Agriculture and Livestock for providing printing facilities.

For additional information, contact Research Department, SESRIC through: research@sesric.org

CONTENTS

ACRONYMS

BNEF	Bloomberg New Energy Finance
CSR	Corporate Social Responsibility
EDBI	Ease of Doing Business Index
ESG	Environmental, Social and Corporate Governance
FDI	Foreign Direct Investment
FFI	Financial Freedom Index
GCC	Gulf Cooperation Council
GCF	Gross Capital Formation
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
GIIN	Global Impact Investing Network
GNI	Gross National Income
HIPC	Heavily Indebted Poor Countries
ICT	Information and Communication Technology
IFPRI	International Food Policy Research Institute
IFS	International Financial Statistics
ILO	International Labour Organisation
IMF	International Monetary Fund
IPFSD	Investment Policy Framework for Sustainable Development
IPR	Intellectual Property Rights
LAC	Latin America and the Caribbean
LDC	Least Developed Countries
LPI	Logistics Performance Index
MENA	Middle East and North Africa
MGI	McKinsey Global Institute

MNE	Multinational Enterprise
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
OIC	Organisation of Islamic Cooperation
PIM	Public Investment Management
PPI	Private Participation in Infrastructure
PPP	Purchasing Power Parity
PPPs	Public Private Partnerships
PRIA	Principles for Responsible Investment Association
R&D	Research and Development
SII	Social Impact Investment
SIITF	Social Impact Investment Taskforce
SPEED	Statistics of Public Expenditure for Economic Development
SRI	Socially Responsible Investing
SSA	Sub-Saharan Africa
SWFI	Sovereign Wealth Fund Institute
TPS-OIC	Trade Preferential System among the Member Countries of the OIC
UAE	United Arab Emirates
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNSD	United Nations Statistics Division
UNWTO	United Nations World Tourism Organization
USD	United States Dollar
WB	World Bank
WDI	World Development Indicators
WEF	World Economic Forum
WTO	World Trade Organization

Acknowledgements

This report has been prepared by a research team at SESRIC led by Kenan Bağcı and comprising Cem Tintin, Mazhar Hussain and Fadi Farasin. The work was conducted under the general supervision of Nabil Dabour, Director of Research Department at SESRIC, who provided comments and feedback.

FOREWORD

Global economic growth remains moderate, reflecting a further slowdown in emerging economies and a weak recovery in developed economies. While developed countries could grow on average only by 1.8% in 2014, this rate in developing countries was 4.6%. Although developing countries continue to have a stronger outlook, the glory years of developing countries as the engine of the world economy may be badly missed if measures to boost aggregate demand and investment are not taken. Commodity-exporting developing countries are likely to become more vulnerable to shifting investor sentiment. Sharply falling oil and other commodity prices have already begun to reduce economic activity in developing countries, including many of the OIC countries.

In the light of the recent global economic developments, the *OIC Economic Outlook 2015* analyses the trends in major economic indicators for the OIC member countries, as a group, during the latest five-year period for which the data are available (2010-2014). It investigates these trends in a comparative manner with their counterparts in the groups of the developed and non-OIC developing countries as well as with the world average. In so doing, the report highlights a number of constraints and challenges confronting the OIC member countries in their efforts towards enhancing their economic development and progress.

Significant resources and potentials are already available in OIC countries to stimulate growth and development. While 21 OIC countries possess total value of assets exceeding US$ 3.3 trillion in their sovereign wealth funds, 21 least developed OIC countries are still waiting investors to break the vicious circle of poverty. Given this state of affairs, the *OIC Economic Outlook 2015* report underlines the urgent need for improving the investment climate in OIC countries.

In line with the slowing down in economic activity worldwide, trade and investment flows were also severely affected. While global trade increased only by 1% in 2014, global foreign direct investment flows decreased by more than 15%. Similar to global trends, FDI flows to OIC countries were falling during the last three years and the total merchandise exports of OIC countries were also falling in the last two years. The good news is that the share of intra-OIC trade in 2014 reached 19.9%, slightly below the OIC Ten-Year Programme of Action target of 20% in 2015.

In order for OIC countries to target a higher share of intra-OIC trade to be realized during the forthcoming period, they should give special attention to enhancing economic diversification in their economies and improving their productive capacities. This requires improving the overall investment climate for private and foreign investors and effectively allocating available resources into productive economic sectors. In the light of this urgent need, the *OIC Economic Outlook 2015* provides a comprehensive overview of investments in OIC member countries under the theme of "*Promoting Investment for Development*".

Amb. Musa Kulaklıkaya
Director General
SESRIC

EXECUTIVE SUMMARY

Recent Economic Developments in the World and OIC Countries

Production, Growth and Employment

Production

Global GDP – expressed in current USD and based on PPP – has witnessed an increasing trend over the period 2010-2014, reaching to US$ 107.9 trillion in 2014 compared to US$ 88.2 trillion in 2010. Developing countries witnessed more rapid increase in GDP from US$ 47.2 trillion in 2010 to US$ 61.5 trillion in 2014. Total GDP of developed countries was recorded at US$ 46.5 trillion in 2014 compared to US$ 40.9 trillion in 2010. OIC countries also witnessed an increasing trend in economic activity and their GDP increased from US$13.0 trillion in 2010 to US$ 16.2 trillion in 2014. As a group, the OIC countries produced only 15% of the world total output and 26.4% of that of the developing countries in 2014. The average GDP per capita in OIC countries also increased from US$ 8,461 in 2010 to US$ 9,884 in 2014.

Growth

The slowdown in the global economy continued in 2014 with growth rate plunging down to 3.4%. However, the outlook for 2015 and 2016 is positive with expected growth rates of 3.5% and 3.8%, respectively. While the recovery in the developed countries remained slow, the developing countries seem to be the driving force of the growth in the world economy. On the other hand, the global per capita GDP growth has also witnessed a declining trend with 4.0% growth rate in 2014 and it is forecasted to reach 3.5% in 2015 and 4.4% in 2016. In 2014, growth in GDP per capita was recorded at 5.0% in developing countries and expected to decrease to 4.0% in 2015 before climbing up to 5.2% in 2016. On the other hand, the developed countries witnessed a comparatively very low growth rate of 2.7% in their GDP per capita in 2014, which is estimated to increase to 2.8% and 3.4% in 2015 and 2016, respectively. OIC countries also witnessed slowdown in their economic activity and their average growth rate declined from 4% in 2013 to 3.8% in 2014. They are forecasted to grow at the same rate in 2015 with 3.8% and at an accelerated rate in 2016 with average growth

rate of 4.4%. The average growth rate of the real per capita GDP in OIC countries has been positive during the period 2010-2014, which was recorded at 3.1% in 2014 but forecasted to decrease to 2.7% in 2015 before bouncing back to 4.0% in 2016.

Production by Sectors

In terms of the average shares of the value-added of the four major sectors in the global GDP in 2013, service sector recorded the largest share with 66.2%, followed by the industrial sector (both manufacturing and non-manufacturing) with 29.3%, while the share of agriculture, fishing and forestry was relatively small (4.5%). A similar structure has been also observed in the case of OIC countries as a group. The average share of agriculture in OIC economies has gradually declined from 12.6% in 2000 to 10.3% in 2013. A more stable trend was observed in non-OIC developing countries, where the average share of agriculture in the economy has for long remained around 9% and was recorded at 8.9% in 2013.Services sector accounted for 47.5% and industry sector (manufacturing and non-manufacturing together) accounted for 42.2% in OIC countries, which was respectively 54.4% and 36.7% in non-OIC developing countries.

GDP by Major Expenditure Items

When the shares of the major expenditure items in the total GDP are considered, final household and government consumption continued to be the highest in the total GDP over the years. In 2013, household consumption accounted for the lion share of 53.4% followed by gross capital formation (25.8%) and general government final consumption (13.5%). The relative shares of the major expenditure items in the total GDP of OIC countries registered significant variation from the world. In 2013, final household and general government spending accounted for 66.9% of the total GDP of OIC countries. These figures marked a decrease in the shares of both consumption types compared to the previous years.

Unemployment

Unemployment is one of the most serious problems facing the world today. Despite recovery in the economic activities lately, the global unemployment rate for adults remained at 6.0% of the total labour force, unchanged from 2013. The number of unemployed people around the world is estimated at 202 million in 2014, with 1.2 million additional unemployed compared with the previous year and about 31 million more compared with the pre-crisis level in 2007. Youth continued to suffer from lack of decent job opportunities across the globe. According to the latest estimates, some 73.7 million young people were unemployed in 2014. OIC countries recorded significantly higher average unemployment rates compared to the world and non-OIC developing countries during the period 2000-2014. During this period, total unemployment rate in OIC countries changed between 7.8% and 9.1%. After the global financial crisis, unemployment rates in developed countries increased from a level below 6% to over 8%. During the post-crisis period (2009-2013), average unemployment rate in developed countries remained higher than the rate in OIC countries. As of 2014, OIC countries recorded a rate of 7.6%. However, it is estimated that developed countries managed to lower the rate to 7.4%, which is again lower than the rate in OIC countries. Average unemployment rate in non-OIC developing countries remained significantly lower than the OIC average during the whole period under consideration (between 2% to 3%). The

figures on youth unemployment in OIC countries are even less promising. As of 2014, youth unemployment in OIC countries estimated at 16.4%, compared to 16.0% in developed countries and 11.2% in non-OIC developing countries.

Labour Productivity

Globally, labour productivity has witnessed an increasing trend during the period 2010-2014. The average global output per worker has increased from US$ 22,460 in 2010 to US$24,180 in 2014. During this period, labour productivity in OIC countries, in terms of average output per worker, has increased from US$ 23,500 in 2010 to US$ 25,100 in 2014. The labour productivity gap between the developed and developing countries remained substantial throughout this period as output per worker in the developed countries was estimated at US$ 89,800 in 2014 compared to just US$ 20,500 in non-OIC developing countries.

Inflation

Inflation is on decline across the globe reflecting primarily the impact of decline in prices for oil and other commodities, and weakening demand in some advanced economies like euro area and Japan. The latest estimates show that global inflation rate has decreased from 5.3% in 2011 to 3.6% in 2014, and it is expected to remain around this level in 2015 and 2016. Price volatility is not foreseen to be a major concern for developed and developing countries. Inflation rate is expected to be at 3.0 and 3.5% in 2015 and 2016, respectively, in developed countries and at 3.7% for non-OIC developing countries. In the OIC countries, average inflation rate for 2011 was higher than the average of the developed and developing economies. However, in line with the global trends, inflation in the OIC countries declined to 3.0% in 2014.

Fiscal Balance

In the wake of tightening polices implemented especially in the developed countries, fiscal balances are improving systematically across the world. World fiscal deficit as a percentage of GDP witnessed a declining trend from -4.8% in 2010 to -2.5% in 2014. In the group of developed countries, the fiscal balance deficit as percentage of GDP has declined from -8.2% in 2010 to -4.6% in 2014. Developing countries have also recorded fiscal deficits but remained relatively in better position than the developed countries with a deficit of -0.9% of GDP. In the OIC countries, fiscal deficit was recorded at -1.5% of GDP in 2014 and it is expected to increase to -2.7% in 2015 before declining to -2.1% in 2016.

Trade and Finance

Merchandise Trade

Total merchandise exports from OIC countries fell for two consecutive years and reached US$ 2.1 trillion in 2014, compared to their historically highest level of US$ 2.3 trillion observed in 2012. Accordingly, the share of OIC countries in total exports of developing countries contracted to 27.7% in the same year, compared to 30.4% in 2012. Similarly, after its peak of 12.9% in 2012, the share of OIC countries in the total world merchandise exports, which was recorded at US$ 18.4 trillion, decreased to 11.7% in 2014.

Total merchandise imports of OIC countries experienced a strong post-crisis bounce-back and increased from $1.2 trillion in 2009 to $2.0 trillion in 2014. The share of OIC countries in global merchandise imports reached 10.9% in the same year. Their share in total developing country merchandise imports, on the other hand, sustained its expansion for three successive years since 2011 and reached 27.3% in 2014.

Services Trade

The OIC countries as a group continued to be net importer of services. They collectively exported US$ 299 billion worth of services in 2013 and imported US$ 511 billion in the same year. These figures marked significant decreases over their 2009 values of US$ 232 billion and US$ 367 billion, respectively. Accordingly, OIC shares in developing country services exports and imports dropped to 19.3% and 27.1% in 2013. While the collective share of OIC member countries in the total world services exports fell from 6.5% in 2009 to 6.3% in 2013 and their share in the total world imports increased from 10.7% to 11.4% during the same period.

Intra-OIC Merchandise Trade

OIC countries registered a total of US$ 826 billion intra-OIC merchandise trade in 2014. In the post-crisis period, intra-OIC trade registered a relatively stronger upturn compared to the OIC countries' trade with the rest of the world. Accordingly, as of 2014, intra-OIC trade accounted for 19.9% of OIC countries' total merchandise trade. Intra-OIC exports were recorded at US$ 402 billion in 2014, as compared to US$ 404 billion in 2013. Intra-OIC imports, on the other hand, were recorded at US$ 424 billion in 2014, registering a slight decrease over their 2012 value of US$ 430 billion.

FDI Flows and Stocks

World total FDI inflows stood at US$ 1.23 trillion in 2014, of which 42.4% was attracted by developing countries. FDI flows to OIC countries, on the other hand, continue to remain below its potential. In 2014, OIC countries were able to attract only US$ 132 billion in FDI, compared to US$ 144 billion in 2011. The shares of OIC countries in both developing countries and global FDI inflows were recorded at 23.6% and 10.8% in 2014, respectively. Of US$ 25 trillion global inward FDI stock in 2013, OIC countries hosted only 7.3%.

Financial Sector Development

The level of financial sector development in OIC countries remains shallow. As a sign of low financial deepening, the average volume of broad money relative to the GDP in OIC countries was 54.6% in 2014, compared to 118.3% in non-OIC developing countries and 120% in developed countries. In the same year, the domestic credit provided by the financial sector in OIC countries was on average equivalent to 49.2% of the GDP whereas this figure was 112.2% in non-OIC developing countries and 204.5% in developed countries.

External Debt and Reserves

The total external debt stock of OIC countries continued to increase and it reached US$ 1.4 trillion in 2014. Average debt-to-GNI for the indebted OIC countries increased to 20.7% in 2013 compared to 18.6% in 2011. During the same period, total external debt stock of OIC countries as percentage of total developing countries debt increased slightly from 25.6% to 25.9%. Reserves are usually considered as an important instrument to safeguard the economy against

abrupt external shocks. World total monetary reserves, including gold, reached US$ 12.5 trillion in 2014, of which US$ 1.8 trillion are owned by OIC countries. However, the share of OIC countries in total reserves of the developing countries declined from 23.4% to 22.9% during 2009-2014.

ODA and Remittances

In 2013, net ODA flows from all donors to developing countries reached US$ 103.9 billion. As of the same year, OIC countries, with US$ 51.9 billion, accounted for half of the total ODA flows to developing countries. In 2013, the top 5 member countries received 38.2% of total ODA flows to OIC countries whereas the top 10 received 60.5% of them. The inflows of personal remittances to OIC member countries increased from US$ 108 billion in 2011 to US$ 117 billion in 2013, but sharply declined to US$ 96.6 billion in 2013. Remittances flows to non-OIC developing countries, on the other hand, relatively improved during the same period and increased from US$ 260 billion in 2011 to US$ 270 billion in 2013.

Promoting Investment for Development in OIC Countries

Investment, Growth and Development

Difficulties in achieving development goals has led many developing countries to fundamentally re-examine their development policies and in the process discover the importance of investment as a crucial driving force behind economic growth, development, modernization, income growth, poverty reduction and employment creation. The role of investment in fuelling economic growth and development is not anecdotal, but one that is proven empirically and theoretically. In fact, a high investment rate is a key differentiating feature of countries that enjoy sustained high growth rates.

In the case of OIC countries there is a positive correlation between total investment (as percentage of GDP) and economic growth; that is, as the share of total investment in GDP increases so does economic growth. However, total investment in OIC countries is significantly lower than that observed in non-OIC developing countries. In OIC countries total investment as percentage of GDP stands at 24.9% while in non-OIC developing countries it stands at 33.3%. In the specific case of foreign direct investment (FDI) the correlation between FDI and economic growth in OIC countries is positive, but not quite strong. This indicates that the impact of FDI on economic growth in OIC countries is very limited. The reason FDI has very limited impact on economic growth in OIC countries can be attributed to three sets of reasons: crowding of local investments, quality of FDI and absorptive capacity of OIC countries.

The investment and business environment in OIC -as measured by the World Bank *Doing Business* indicators- fairs poorly when compared with both non-OIC developing countries and developed countries. In 2015 the average score for OIC countries was 55.5, which is behind the score of 60.2 recorded by non-OIC developing countries and 76.2 recorded by developed countries. At regional level, the best business environments were observed in OIC countries in East Asia & Pacific region, which recoded an average score of 66.4 in 2015, while the least favourable business environment was observed in OIC countries in Sub-Saharan Africa which

recorded a low score of 49.6. Nonetheless, OIC countries in Sub-Saharan Africa have been improving their business environment over the past few years. In fact, the largest improvement on the *Doing Business* among OIC regions has been achieved by OIC countries in Sub-Saharan Africa which succeeded to increase their average score from 42.2 in 2010 to 49.6 in 2015.

Although OIC countries score lower on the sub-indicator of *Starting a Business* than developed countries and non-OIC developing countries, their performance is improving the greatest. OIC average score has improved from 67.0 in 2010 to 76.8 in 2015 and is now converging with the score achieved by non-OIC developing countries.

In OIC countries, it is more difficult for businesses to get electricity than it is in advanced countries and in non-OIC developing countries. Although OIC countries have improved on the *Getting Electricity* indicator from a score of 60.0 in 2010 to a score of 64.0 in 2015, they are still lagging significantly behind developed countries that scored 81.6 in 2015 and non-OIC developing countries that scored 70.4 in 2015. Also, OIC countries perform poorly on the *Getting Credit* indicator. The average score for OIC countries was 32.4 in 2015, which is significantly lower than the average score of 47.4 for non-OIC developing countries and 59.3 for developed countries for the same year.

Finally, on the *Enforcing Contracts* indicator, OIC countries perform lower than non-OIC developing countries and developed countries. Nonetheless, one console for OIC countries is that while both developed countries and non-OIC developing countries have witnessed a slight deterioration on the *Enforcing Contracts* indicator between the years 2010-2015, OIC countries in contrast have experienced a slight improvement from a score of 50.1 in 2010 to a score of 51.2 in 2015.

Improving Effectiveness of Public Investment

Governments use public spending to achieve both economic growth and equity goals. Such spending often consists of long-term investments in infrastructure, education, health, and research and development, short-term social spending on items such as social security and direct food subsidies to poor households as well as military expenditures for security of its people. At a time when the level and quality of investment have been consistently inadequate and public spending on physical and human capital well below optimal levels, it is critical that resources are allocated in accordance with the developmental priorities of the country. The design and implementation of public expenditure priorities require detailed assessment of the benefits and costs of the expenditures. Assessments should be ideally made at a level where all the expenditures are aimed at a single outcome. However, such data are not readily available in many cases.

Total value of public investment made by 31 OIC countries, for which time series data are available over the period 2005-2013, increased from US$ 71.5 billion in 2005 to US$ 173 billion in 2013, corresponding to an increase over 140%. Private investment in these OIC countries also increased from US$ 190 billion to US$ 422 billion during the same period, with a 122% total increase. Accordingly, the share of public investment in total investment increased in OIC countries from 26.2% in 2005 to 28.1% in 2013.

The reason that governments spend on public assets is technically explained by the presence of some forms of market failure. If there are strong justifications for government involvement to deal with market failures, it must be ensured that the benefits outweigh the costs. If interventions are poorly designed and implemented, they may create more problems than they solve.

It has been traditionally argued that public investment in energy, transport and telecommunications improves the access to additional productive capacities and stimulates growth. In contrast, ineffective use of public capital has been cited as one of the determinants in explaining the differences in growth performance across countries. Moreover, due to difficulties in assessing the profitability of investments, particularly on human capital, it remains a challenge for governments to allocate appropriate resources to different forms of public investment.

Weak investment planning, management and oversight can undermine the positive impacts that investments can make to growth. Therefore, the impact of public investment depends to a large extent on how governments manage it. According to the Public Investment Management (PIM) index developed by IMF, the average performance of OIC countries in public investment efficiency is comparably weaker than non-OIC developing countries. Low efficiency in public investment can be due to a number of reasons. These include poor project selection, delays in design and completion of projects, corrupt procurement practices, cost over-runs, incomplete projects and failure to operate and maintain assets effectively, which result in benefits that are less than projected.

Resource-rich countries commonly establish sovereign wealth funds (SWFs) to manage the national savings for the purposes of investment. Currently, 21 OIC countries have one or more SWFs, with total value of assets exceeding US$ 3.3 trillion and accounting almost 45% of total funds in the world. This provides OIC countries a unique opportunity to fill investment gap and foster economic diversification. For efficient use of SWFs in domestic investment, it must be ensured that the funds are utilized within the context of the general public investment plan and there is a sustainable flow of funds for investment to ensure that they do not become destructive due to large fluctuations in flow of funds to national economy.

Leveraging Private Investment

Public sector can take the lead in making large scale investments to transform the economies, but significant constraints and inefficiencies are often observed in such investments. In developing countries, public enterprises typically face low technology levels, high costs of unskilled labour and lack of intermediary materials which makes them unable to implement enough infrastructure projects for long years. Private sector dynamism should be utilized to improve the productivity and competitiveness benefits of investment projects. In many cases, private sector participants also face significant challenges before or after undertaking major investment projects.

There are important policy issues for encouraging private sector investment including investment regulations, trade policy, competition policy, tax policy, human resource development and investment financing. In this context, special attention should be paid to clear and transparent laws and regulations, mechanisms for settling investment disputes,

protection of property rights, and non-discrimination as core investment policy principles. Economic policies should be in line with the principles of competition and avoid any unfounded restriction. While providing certain incentives to investors, tax system should be able to raise revenues to strengthen the key enablers of investment ranging from human capital development to infrastructure development.

The World Bank Private Participation in Infrastructure (PPI) Database provides information on the private sector participation in infrastructure investment for 138 developing countries, 49 of which are OIC member countries, for the period 1990-2014. According to the database, in 49 OIC countries, 1,056 privately funded infrastructure projects took place, making up US$ 484.2 billion between 1990 and 2014. US$ 245.2 billion in OIC countries was utilized to finance 247 telecom infrastructure projects, accounting for over 50% of total investment in OIC countries. The second biggest investment was made in energy infrastructure involving US$ 157.4 billion private investment with 507 projects. Transport and water infrastructure investment reached together to totally US$ 81.6 billion, pointing out the disproportionality of private infrastructure investment.

In general, it has been observed that the relatively more industrialised OIC countries such as Turkey, Indonesia and Malaysia have the biggest volumes of private infrastructure investment. This is due to the fact that these countries possess necessary resources to undertake private infrastructure investment such as higher human capital levels or more financial resources. They also have more incentive to invest in infrastructure as better infrastructure further supports the development of industry. Many OIC countries, located mostly in sub-Saharan Africa and central Asia, on the other hand, lag behind their peers in terms of private investment in infrastructure. Out of 49 OIC member countries, 30 countries reported no private infrastructure projects at all for water and sewage, followed by 20 in transport, 11 in energy and 5 in telecom. Comoros, Djibouti, Gabon, Mauritania, Suriname and Turkmenistan had no private activity in three out of four categories.

Moreover, a growing number of individuals, foundations and institutional investors have become interested in finding investments that deliver both a social and a financial return. This new approach is built mainly on the beliefs that investment in some cases can be more effective than donations in helping the poor and social motivations harnessed to financial ones can sometimes do perform more effectively. In this context, OIC countries can develop their regulatory infrastructure to accommodate more “responsible investment” in addressing the various socio-economic and environmental challenges.

Trends and Policies in Attracting Foreign Direct Investment

OIC member countries have become more integrated with the world economy through trade, tourism, and capital flows. An important dimension of this integration is known as foreign direct investment (FDI). FDI is expected to have positive effects on economic growth and development by generating externalities and spillover. Over the last two decades, the OIC group achieved to attract increasingly more FDI, which increased from around US$ 16.4 billion in 1993 to US$ 132.3 billion in 2014 (a 8.1 fold increase) and share of OIC countries in world total FDI inflows jumped from 7.8% in 1993 to 10.7% in 2014. However, when the FDI potential of OIC member countries is taken into account, the FDI performance of the OIC

group is found to be far from being sufficient. In other words, the volume of FDI inflows is less than what their potential suggests.

A detailed analysis on the share of greenfield FDI projects in OIC member countries showed that, on average, only one fifth of all FDI projects was leading to a construction or building up a totally new facility or factory. This limits the contribution of FDI to employment creation, economic growth and development in OIC member countries. Therefore, it remains a challenge for OIC countries to host FDI projects that can potentially generate more value-adding to their economies.

With respect to intra-OIC FDI figures, intra-OIC FDI instocks reached US$ 67,159 million and intra-OIC FDI inflows amounted US$ 22,140 million by 2012. Figures on realized FDI projects in OIC member countries pointed out that the volume of intra-OIC FDI flows is still under its potential, although a remarkable increase was recorded over the last decade.

Overall, during the last five to ten years, OIC member countries, on average, experienced a contraction in their average market size and deterioration in the overall macroeconomic environment and quality of institutions. Moreover, the OIC group is still facing some significant challenges related to the regulatory framework for FDI and economic freedoms. Specifically, it is found that forming a foreign subsidiary requires significantly higher amount of time and efforts (compared with the world average) in a business environment where property rights are weakly protected and varying levels of corruption are observed. The existence of these challenges not only reduces FDI flows directed to OIC member countries but also affect the type of FDI projects that take place. On the positive side, in recent years, OIC member countries achieved to increase their trade openness through lowering tariffs and non-tariff barriers and improving the quality of infrastructure, among others. These positive developments in the OIC group constitute an advantage in the near future for attracting more foreign investors.

Policy Issues for Investment Promotion and Facilitation

Many countries in the world are facing major challenges in terms of allocating resources and implementing public investment projects in physical infrastructure as well as human capital development. Due to trade-offs between physical and human capital development as well as conflicts between the interests of present and future generations, prioritization of public investment decisions is not an easy task. Theoretical and empirical researches also give few insights for optimal public resource allocation across different sectors and across different public investment projects. In principle, the relative allocations within and across programs should focus on increasing productivity and competitiveness, and identify the areas where social returns are the highest and externalities and spillover effects are significant.

In this context, a targeted approach is proposed for stimulating private investment. Accordingly, there is a need to identify sectors with significant growth impacts, detect the barriers to investment in these sectors, understand the needs of the firms, strengthen key enablers of investment and ensure the effectiveness of investment.

While promoting investment, special attention should be paid to the degree of economic diversification. Heavy concentration of economic activities in few sectors makes the economy

vulnerable to external shocks. Diversification of production base in industry, services and agriculture sectors will allow further investment by both domestic and international investors and strengthen the sustainability of the economy. Therefore, apart from government-led investment promotion policies, private sector should be given opportunity to invest and grow in any growth-inducing and employment-generating economic activity. This requires once again an investment friendly environment with facilitating regulations, deep financial market, labour force with required skills and capabilities, solid infrastructure, access to technology and knowledge, and effective coordination channels between public authorities and private sector representatives.

Considering the FDI potential of OIC member countries and their young and dynamic population, they are expected to host more FDI inflows in near future. However, the success of OIC member countries on hosting more foreign investors is closely linked to the reforms needed to be made in a broad spectrum. OIC member countries need to invest more into human capital and infrastructure, and complete reforms to improve macroeconomic environment, trade openness, and the quality of institutions by reducing risk factors (i.e. country risks such as political instability).

A particular concern of potential foreign investors in many OIC member countries is the existence of cumbersome formal procedures to form a foreign subsidiary that require both long time and huge efforts. Moreover, as the state of corruption index showed, in different stages and during their operations, foreign investors face the existence of corruption at varying degrees in some OIC member countries that discourage investors. In addition to these fundamental reforms, OIC member countries can also utilise different incentive schemes to attract more FDI. However, these schemes need to be designed with utmost care and by benefiting from the experience of other countries and guidelines prepared by international institutions. Otherwise, these incentives schemes would turn to be a failure story, as observed in several developing countries.

Part I

RECENT ECONOMIC DEVELOPMENTS IN THE WORLD AND OIC COUNTRIES

This part includes:

1. Production, Growth and Employment
2. Trade and Finance

PART I

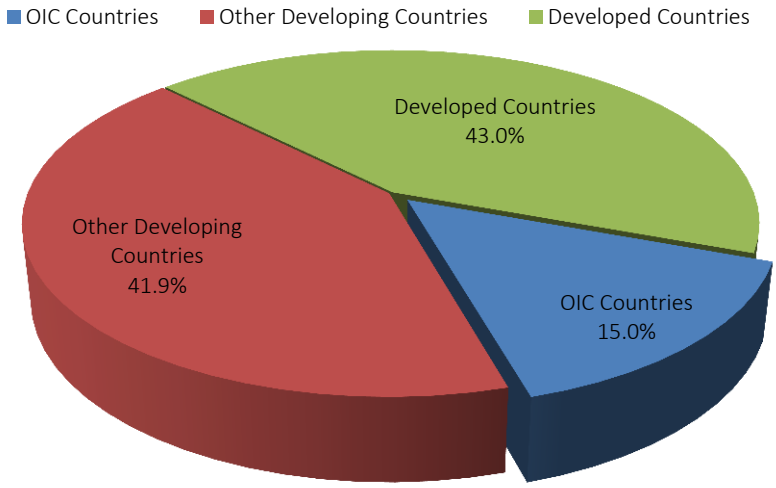
This part analyses the trends in major economic indicators in the OIC member countries, as a group, during the latest five-year period (2010-2014) for which the data are available. It investigates these trends in a comparative manner with their counterparts in the groups of the developed and other developing countries as well as with the world average and highlights a number of constraints and challenges confronting the OIC member countries in their efforts towards enhancing their economic development and progress.

The first chapter of this Part evaluates the developments in production, growth and employment. This includes GDP, GDP per capita, GDP growth, decomposition of GDP, inflation, fiscal balance, labour force participation and unemployment. The second chapter deals with trade and finance indicators, including exports and imports of goods and services, intra-OIC trade, current account balance, foreign direct investment flows, financial sector development, external debt and reserves, and official development assistance and remittances.

Section 1

Production, Growth and Employment

Figure 1.1: Gross Domestic Product, PPP Current USD (2014)



Source: IMF WEO Database April 2015.

PRODUCTION

Contribution of the OIC member countries to the global output remains below potential

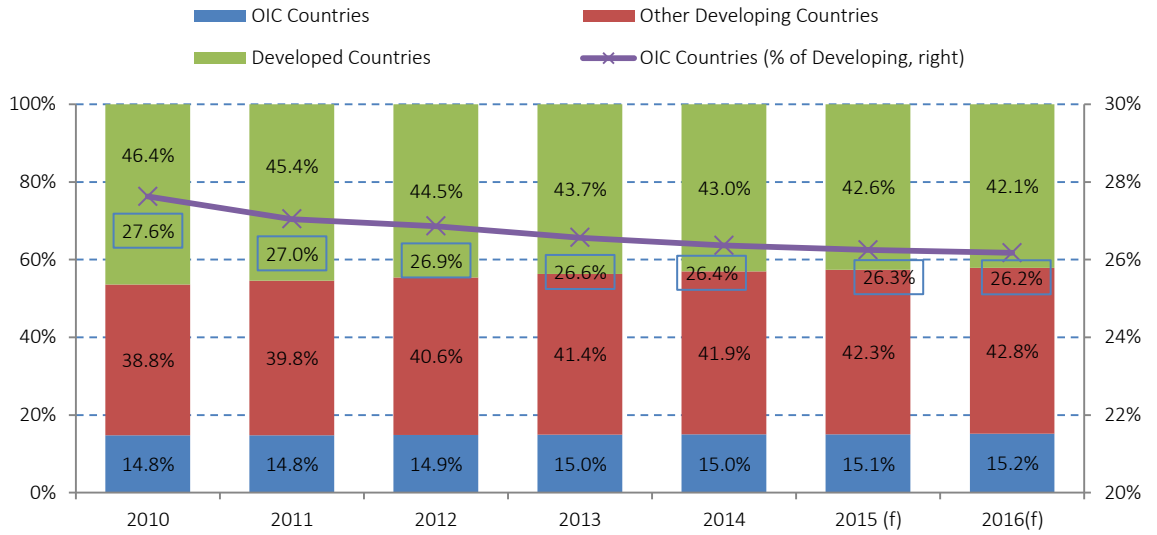
The group of OIC countries are well-endowed with potential economic resources in different fields and sectors such as agriculture, energy, mining and human resources, and they constitute a large strategic trade region. Yet, this inherent potential does not manifest itself in the form of reasonable levels of economic and human development in many individual OIC countries as well as in the OIC countries as a group. In 2014, having accounted for 23.1% of the world total population, the 55 OIC member countries produced only 15.0% of the world total GDP – expressed in current USD and based on PPP (Figure 1.1).[1]

The global economic activity landscape has witnessed pivotal shift over the past several years and the dominance of developed countries group as the leading producer is on decline. During the period under consideration, the share of developing countries in global output has witnessed an upward trend increasing from 53.6% in 2010 to 57.0% in 2014. The estimates show that the share of developing countries will climb up to 57.9% by the end of 2016. During the same period, the share of developed countries has declined from 46.4% in 2010 to 43.0% in 2014 and it is expected to decrease further to 42.1% by the end of 2016.

Over the last 5 years, the group of OIC countries has increased its share in the world output only by 0.2 percentage point to reach 15.0% in 2014 (Figure 1.2). Considering the fact that the individual countries such as United States and China had higher shares than that of the OIC countries as a group

[1] Following the recent release of the 2011 International Comparison Program (ICP) survey for new purchasing-power-parity benchmarks, the IMF estimates of purchasing-power-parity weights and GDP valued at purchasing power parity have been updated. Therefore, the analyses based on updated GDP data may significantly differ compared to earlier versions of the OIC Economic Outlook Report.

Figure 1.2: Gross Domestic Product, PPP Current USD



Source: IMF WEO Database April 2015.

(16.1 and 16.3%, respectively in 2014), it can be stated that the contribution of the OIC countries to the world output is below potential. On the other hand, the share of the OIC countries in the total GDP of developing countries group has declined steadily and was recorded at 26.4% in 2014, a decrease by 1.2 percentage points over the 5-year period under consideration (Figure 1.2).

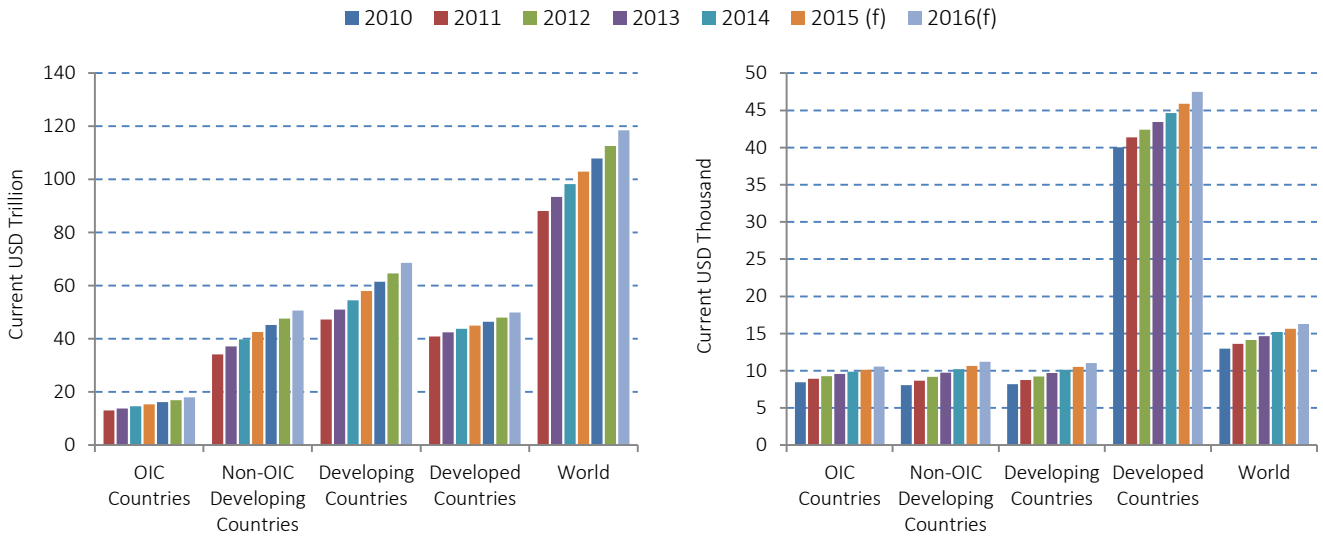
The decline in the share of the OIC countries in total GDP of the developing countries indicates that the OIC economies have performed poorer than non-OIC developing countries in expanding their output. Although the projections for 2015 and 2016 indicate that the GDP of the OIC countries as a whole will continue to grow, it is predicted that the share of the OIC countries in the world output will be stable around 15% through 2015 and 2016. However, the share of the OIC countries in the total output of the developing countries is estimated to shrink further to 26.3% in 2014 and 26.2% in 2016 (Figure 1.2).

PRODUCTION

Share of OIC countries in total world GDP remained at 15% in 2014

Global GDP – expressed in current USD and based on PPP – has witnessed an increasing trend over the period 2010-2014, reaching US$ 107.9 trillion in 2014 compared to US$ 88.2 trillion in 2010 (Figure 1.3, left). During the same period, developing countries witnessed more rapid increase in GDP as the total GDP in these countries climbed up from US$ 47.2 trillion in 2010 to US$ 61.5 trillion in 2014. On the other hand, developed countries witnessed comparatively a moderate increase as their GDP reached US$ 46.5 trillion in 2014 compared to US$ 40.9 trillion in 2010. During the same period, the average GDP per capita in the world – expressed in current USD and based on PPP – has increased continuously and reached US$ 15,189 in 2014, compared to US$ 12,968 in 2010 (Figure 1.3, right). Meanwhile, in 2014 GDP per capita was recorded at US$ 44,638

Figure 1.3: Total GDP (left) and GDP per capita (right), based on PPP



Source: SESRIC staff calculations based on IMF WEO Database April 2015, (f: forecast).

in developed countries and US$ 10,135 in developing countries. In other words, GDP per capita in developed countries is about 4.5 times higher than that in developing countries. This huge gap between developing and developed countries is expected to continue in coming years.

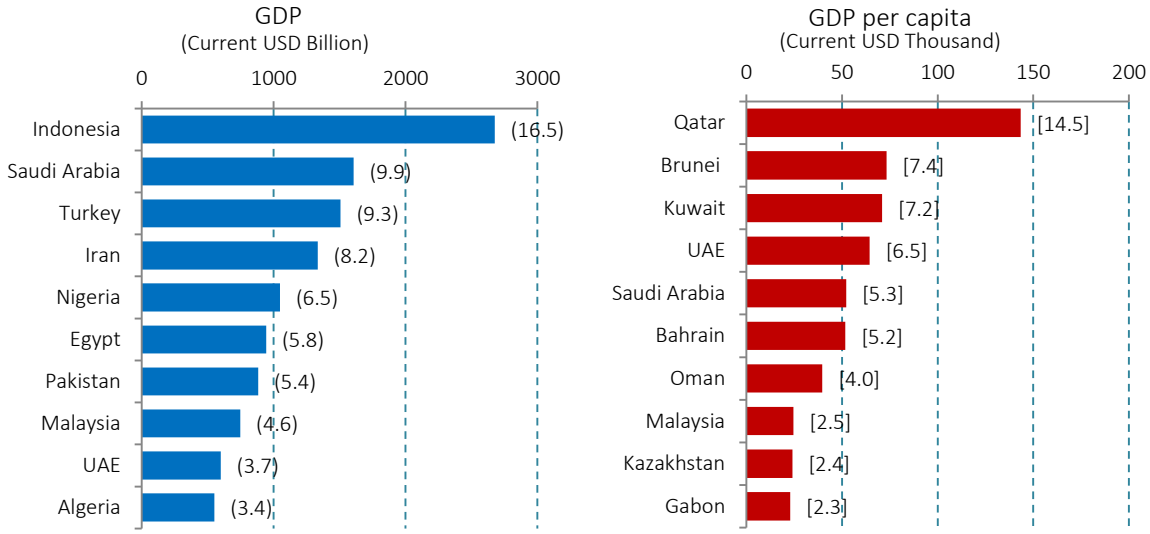
On the other hand, the global economic activity landscape has witnessed pivotal shift over the past several years and the dominance of developed countries group as the leading producer is on decline. During the period under consideration, the share of developing countries in global output has witnessed an upward trend increasing from 53.6% in 2010 to 57.0% in 2014. The estimates show that the share of developing countries will climb up to 57.9% by the end of 2016. During the same period, the share of developed countries has declined from 46.4% in 2010 to 43.0% in 2014 and it is expected to decrease further to 42.1% by the end of 2016.

GDP Per Capita

The gap between average GDP per capita in OIC countries and the world continued to diverge

OIC countries also witnessed an increasing trend in economic activity and their GDP increased from US$ 13.0 trillion in 2010 to US$ 16.2 trillion in 2014. During the same period, non-OIC developing countries experienced a more rapid increase in their output as the total GDP in these countries reached US$ 45.3 trillion in 2014, a level which is well above the US$ 34.2 trillion they recorded in 2010. Though the share of OIC countries in the world total GDP remained stable at around 15%, their share in the total GDP of developing countries group has declined steadily and was recorded at 26.4% in 2014, a decrease by one percentage point over the 5-year period under consideration. During the same period, the average GDP per capita in the OIC countries has increased continuously and reached US$ 9,884 in 2014, compared to US$ 8,461 in 2010 (Figure 1.3,

Figure 1.4: Top 10 OIC Countries by GDP and GDP per capita (2014)



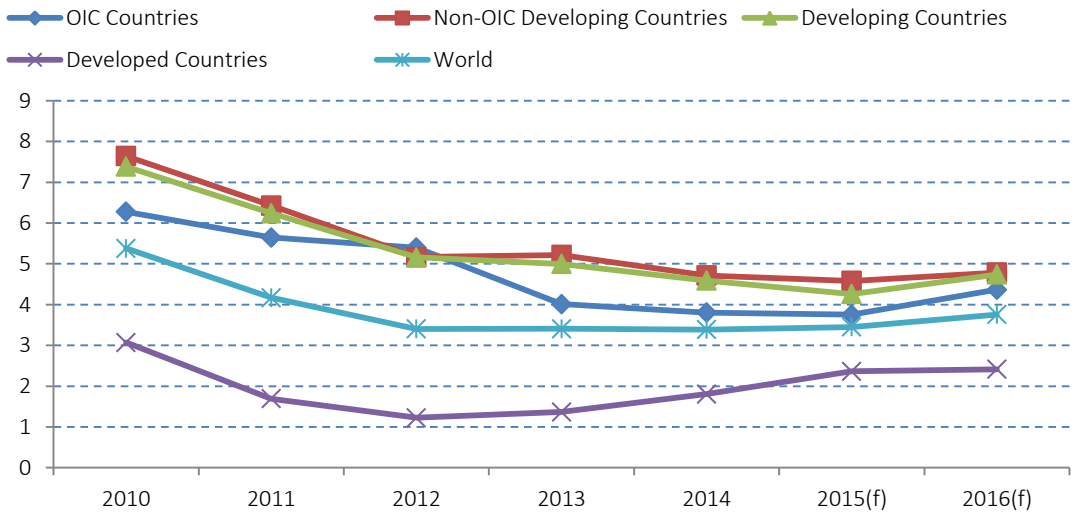
Source: IMF WEO Database April 2015 and SESRIC BASEIND Database. The numbers in round (square) brackets on left (right) hand side indicate the share (ratio) of the related country's GDP (GDP per capita) in the overall GDP (to the average GDP per capita) of the OIC countries as a group.

right). The gap between the average per capita GDP levels of the OIC member countries and those of non-OIC developing countries has widened over the years. During the 2010-2012, average GDP per capita in the OIC countries was higher than the non-OIC developing countries. However, the situation was reversed from 2013 onward and the average per capita GDP differential between OIC countries and non-OIC developing countries was recorded at US$ 345 in 2014. The latest estimates show that this gap is expected to worsen in coming years. During the same period, the average GDP per capita in the OIC countries has also diverged from the world average as the gap increased from US$ 4,507 in 2010 to US$ 5,305 in 2014.

Furthermore, it is observed that the total GDP of the OIC countries is still produced by a few member countries. In 2014, the top 10 OIC countries in terms of the volume of GDP produced 73.4% of the total OIC countries output (Figure 1.4, left). Indonesia has the highest share in OIC GDP (16.5%) followed by Saudi Arabia (9.9%), Turkey (9.3%) and Iran (8.2%) The overall economic performance of the group of OIC member countries remained highly dependent on the developments in these ten countries. As a matter of fact, fuel is the main source of export earnings for 5 out of these 10 OIC countries; namely Saudi Arabia, Iran, Nigeria, United Arab Emirates and Algeria.

Among the OIC countries, Qatar registered the highest GDP per capita in 2014 followed by Brunei, Kuwait and United Arab Emirates (Figure 1.4, right). The per capita GDP of Qatar was 15 times higher than the average of the OIC countries as a group, a situation which reflects a high level of income disparity among the OIC countries. Among the top 10 OIC countries by GDP per capita 6 are from the Middle East region. Furthermore, in 2014, Qatar was ranked first, Brunei was ranked 4th, Kuwait was ranked 5th and United Arab Emirates was ranked 7th among the 186 countries in the world in terms of their per capita income levels.

Figure 1.5: GDP Growth in the World



Source: SESRIC staff calculations based on IMF, World Economic Outlook, April 2015.

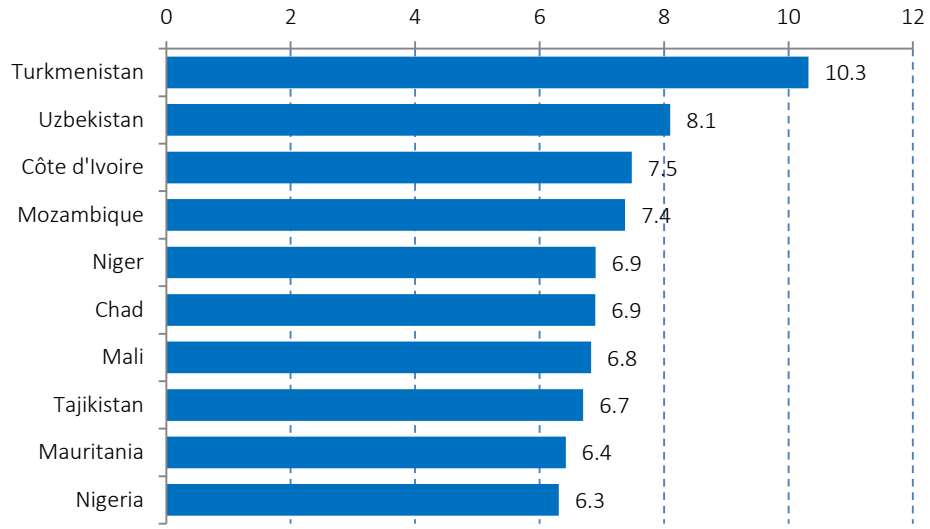
GDP Growth

Global economy continued to slow down and grew only by 3.4% in 2014

After bottoming out in 2009, global economy has since been experiencing positive growth rates. So far, recovery in global economy has mainly stemmed from positive economic growth rates occurred in developing countries. During the recent years, non-functioning austerity measures in the Euro zone economies, high fiscal imbalances in the United States and the European Union countries raised fears at a global scale and hampered investment and international trade. As a result, the world economic growth rate decreased from 5.4% in 2010 to 4.2% in 2011 (Figure 1.5). The sovereign debt crisis in the euro area, which was expected to result in a recession due to the impacts of bank deleveraging on related assets, has further hampered the world economic growth in 2012, recorded at 3.4%. The slowdown in global economy remained constant in 2013 with 3.4% growth rate. The global economy could not speed up and 2014 as well and could grow again at the same rate of 3.4% in that year. After demonstrating signs of recovery at the beginning of 2015, the growth rate of the world economy is predicted to reach 3.5% by the end of the year. The positive economic outlook for the USA and euro area in 2015 and 2016, supported by the decline in oil prices, seem to fuel the world economic growth. As a result, by following the positive momentum in 2015, it is predicted that the global economy will grow by 3.8% in 2016 (Figure 1.5).

In general, developing countries have fuelled the world output growth rate since 2010, while major developed economies were contracting. In 2015, developing countries are expected to grow by 4.3%, which is almost two percentage points higher than the developed countries, and will continue to be the engine of the growth in the world economy. However, as a result of long-lasting painful fiscal and monetary measures, the recovery in developed economies in terms of

Figure 1.6: Top 10 OIC Countries in terms of GDP Growth Rate (2014)



Source: IMF WEO Database April 2015 and SESRIC BASEIND Database.

real GDP growth rate is projected to remain at 2.4% in 2016.. Developing countries are expected to see an increase in the average growth rate that will climb up from 4.3% in 2015 to 4.7% in 2016.

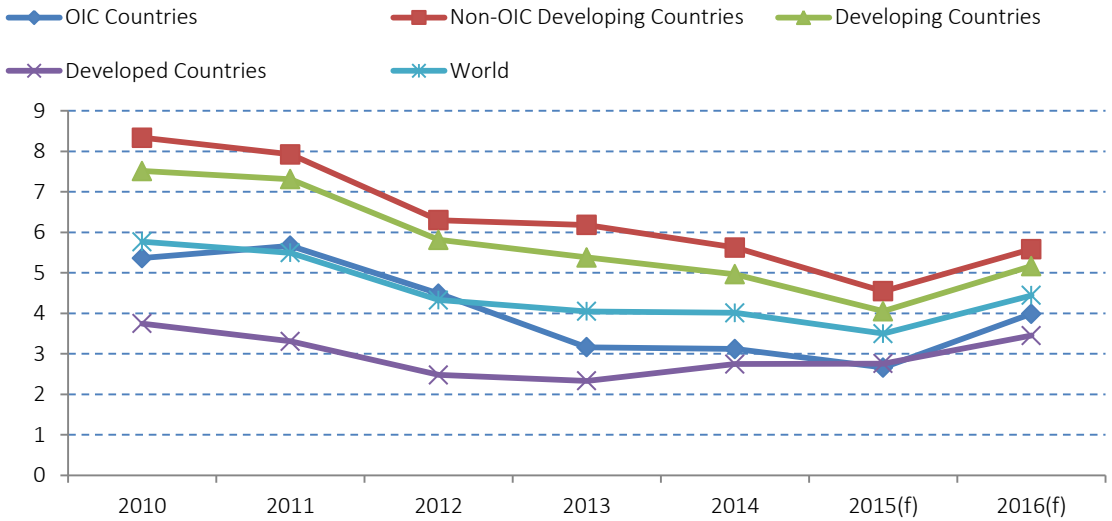
GDP Growth

Growth rates in OIC countries continued to fall for four consecutive years

The GDP growth of OIC countries has slowed down to 3.8% in real terms in 2014, as compared to 4% in 2013 (Figure 1.5). Although this is in line with the persistent slowdown in across-the-board economic activity, which started to take hold in 2011, prospects for growth in OIC countries remained bleak amid the decline in oil prices and resulting macroeconomic distress and sharp downward revisions to growth forecasts for oil exporting countries like Saudi Arabia, Iraq, Iran, Nigeria and United Arab Emirates. The economic performance of non-OIC developing countries, on the other hand, has so far been highly influenced by the pace of growth in the two leading Asian economies, namely China and India. However, the average real GDP growth rates in non-OIC developing countries were above the OIC average during the period 2010-2014. Moving forward, the average rate of growth in the OIC countries will likely show a similar performance in 2015, with average growth rate forecasted to be around 3.8%. This recovery is expected to be consolidated further to 4.4% in 2016. Nevertheless, these figures are not better than the predicted average growth rates for the group of non-OIC developing economies (4.6% for 2015 and 4.8% for 2016), as well as the world as a whole (Figure 1.5).

At the individual country level, Turkmenistan, with a growth rate of 10.3% in 2014, was the fastest growing economy in the group of OIC countries, followed by Uzbekistan (8.1%) and Côte d'Ivoire (7.5%). Turkmenistan was also the second fastest growing economy in the world, whereas Uzbekistan was ranked at 4th position. On the other hand, majority of the OIC top-10 fastest growing economies are from Sub-Saharan Africa (7) and Central Asia

Figure 1.7: Real GDP per capita Growth, Annual Percentage Change



Source: SESRIC staff calculations based on IMF WEO Database April 2015 and SESRIC BASEIND Database.

regions (3). Whereas five of the OIC LDCs were among the top 10 fastest growing OIC countries in 2014: Mozambique, Niger, Chad, Mali and Mauritania with their real GDP growth rates ranging between 7.4% and 6.4% (Figure 1.6).

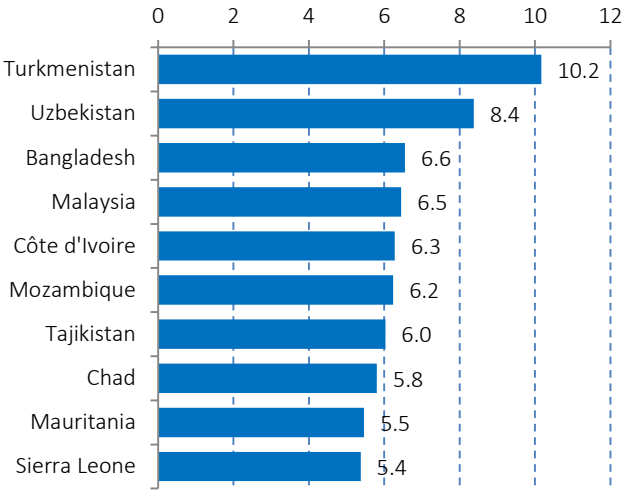
GDP per Capita Growth

Turkmenistan, with a per capita GDP growth rate of 10.2% in 2014, was the fastest growing economy among OIC countries

Globally, GDP per capita has witnessed significant recovery in 2010, registering a growth rate of 5.8% compared to growth rate of 1.1% in 2009. Nevertheless, this recovery was short lived and growth rate decelerated to 4.0% in 2014. The global real GDP per capita is forecasted to grow by 3.5% in 2015 and 4.4% in 2016. As in the case of real GDP growth, developing countries remained at the helm and drived the growth in per capita GDP. In 2014, growth in GDP per capita was recorded at 5.0% in developing countries, but expected to decrease to 4.0% in 2015 before climbing up again to 5.2% in 2016. On the other hand, developed countries witnessed comparatively very low growth rate of 2.7% in 2014 and estimated to increase to 2.8% and 3.4% in 2015 and 2016, respectively.

The average growth rate of the real per capita GDP in the OIC countries has been positive during the period 2010-2014 (Figure 1.7). This implies that the real GDP in the OIC member countries has grown on average faster than the population. This can be interpreted as a real increase in standards of living in the OIC community. However, a similar downward trend, as in the case of real GDP growth, is also observed for real GDP per capita growth rates. OIC countries seem to suffer from this trend as well. Following a short-lived recovery in the aftermath of the global financial crisis, the average real GDP per capita growth rate in OIC countries had started to decline again starting from 2012 and was recorded at 3.1% in 2014, as compared to 5.7% in 2011. The average real GDP per capita growth rate is forecasted to decrease slightly to 2.7% in 2015 before bouncing back to 4.0% in 2016. During the

Figure 1.8: Top 10 OIC Countries in terms of GDP per capita Growth Rate (2014)



Source: IMF WEO Database April 2015.

recent years, the pace of the real GDP per capita growth in the OIC member countries remained below the averages of world, developing and non-OIC developing countries.

At the individual country level, Turkmenistan, with a per capita GDP growth rate of 10.2% in 2014, was the fastest growing economy in the group of OIC countries, followed by Uzbekistan (8.4%) and Bangladesh (6.6%). Turkmenistan was the second fastest growing economy in the world after Romania whereas Uzbekistan and Bangladesh were ranked at 5th and 16th position, respectively. On the other hand, 5 of the OIC top-10 economies with fastest growth of per capita GDP are from Sub-Saharan Africa and three from Central Asia region. Whereas 5 of the OIC LDCs were among the top 10 OIC countries in 2014, namely Bangladesh, Mozambique, Chad, Mauritania and Sierra Leone with their real per capita GDP growth rates ranging between 6.6% and 5.4% (Figure 1.8).

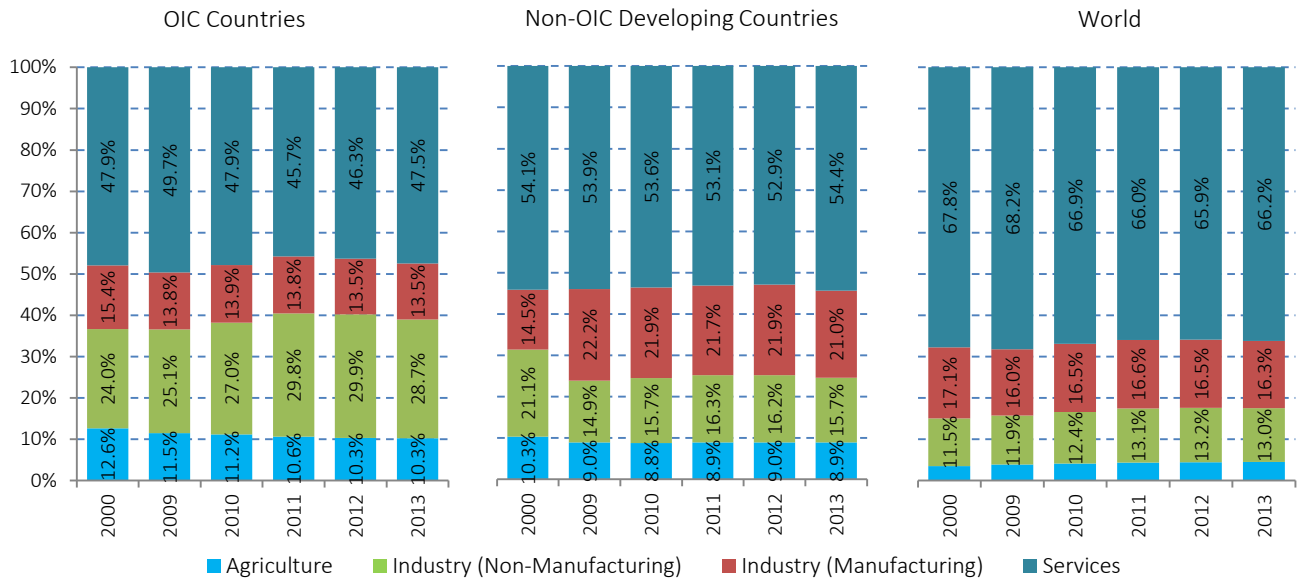
STRUCTURE OF GDP

Share of services in total GDP of OIC countries reached 47.5% in 2013

According to the latest estimates, as shown in Figure 1.9, service sector has the largest share of global total output in 2013 (66.2%), followed by the industrial sector (both manufacturing and non-manufacturing) (29.3%), while the share of agriculture, fishing and forestry is relatively small (4.5%). Over the years, the share of services has registered a decline of 1.6 percentage points from 2000 to 2013 whereas the shares of non-manufacturing industry and agriculture sectors increased by 1.5 and 1.0 percentage points respectively during the same period.

The analysis of value-added by major sectors in the total GDP of the OIC countries and non-OIC developing countries also shows a similar structure. Although agriculture is widely known to be the primary economic activity and assumed to play a major role in the economies of developing countries, this feature does not stand firm in the case of OIC and non-OIC developing countries as groups. Indeed, the share of agriculture in the total GDP of OIC countries has gradually declined from 12.6% in 2000 to 10.3% in 2013 (Figure 1.9). Coupled with the economic recovery and increase in the share of the non-manufacturing industry, the share of the agricultural sector witnessed a continuous downward trend. With industrial activity recovering, the average share of agriculture in OIC economies contracted to 10.3% in 2013. A more stable trend was observed in non-OIC developing countries, where the average share of agriculture in the economy has for long remained about 9% and was recorded at 9.0% in 2012 and 8.9% in 2013.

Figure 1.9: Value-added by Major Sectors of the Economy (% of GDP)

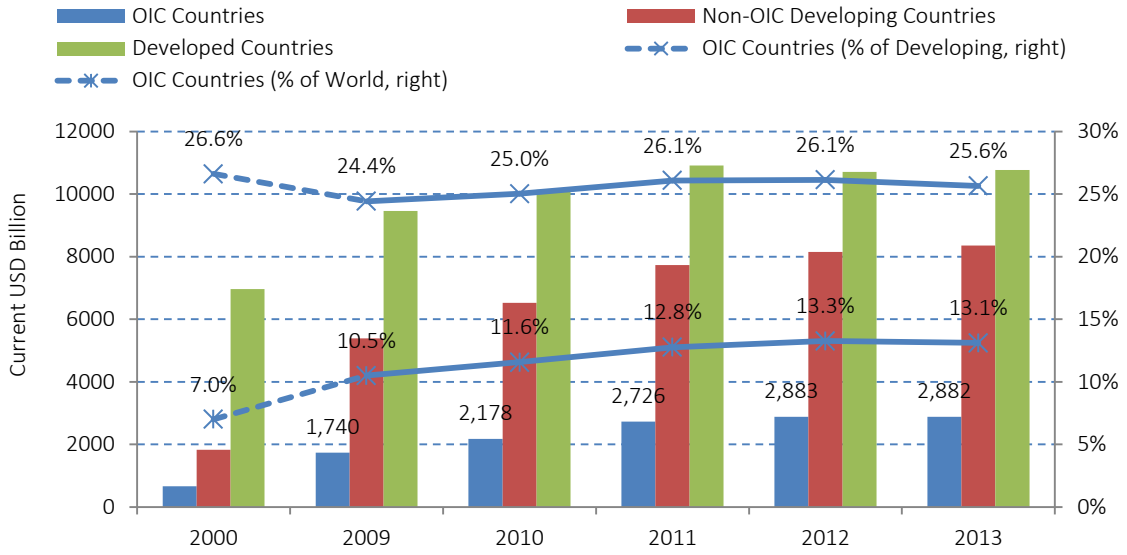


Source: SESRIC staff calculations based on UNSD National Accounts Main Aggregates Database, August 2015.

At the individual country level, in 2013, the agricultural sector accounted for more than one third of the total value-added in 10 OIC member countries; namely in Somalia, Sierra Leone, Guinea-Bissau, Togo Comoros, Sudan, Niger, Mali, Benin, and Burkina Faso– all of which were listed among the LDCs in the same year according to the UN classification. The share of agriculture in GDP varied substantially among the OIC countries, with the highest share of 60.2% in Somalia and the lowest shares below one% in Qatar (0.1%), and Bahrain and Kuwait (0.3%).

In contrast, the services sector continued to play a major role in the economies of many OIC countries as the most important source of income. After a rapid contraction in 2008 with the outbreak of the global financial crisis and the resulting decrease in its share, the average share of the service sector in total GDP of OIC countries increased to 47.9% in 2009, which was mainly offset by a contraction in the non-manufacturing industry (Figure 1.9). With the recovery in real economic activity from 2010 onwards, the average share of the services sector in OIC economies has returned back to its pre-crisis levels with shares of 46.3% and 47.5% in 2012 and 2013, respectively. In 2013, the contribution of the services sector to the economy was still less than one third of the GDP in 6 OIC member countries; namely in Brunei, Chad, Qatar, Mauritania, Sierra Leone and Somalia (UNSD National Accounts Main Aggregates Database). The share of the services sector in GDP varied from 28.4% in Sierra Leone to 81.6% in Maldives. As for non-OIC developing countries, the services sector continued to account for over half of the total GDP and its share was recorded at 54.4% in 2013 (Figure 1.9).

Figure 1.10: Industrial Production, Volume and Share (right)



Source: SESRIC staff calculations based on UNSD National Accounts Main Aggregates Database, August 2015.

INDUSTRIAL PRODUCTION

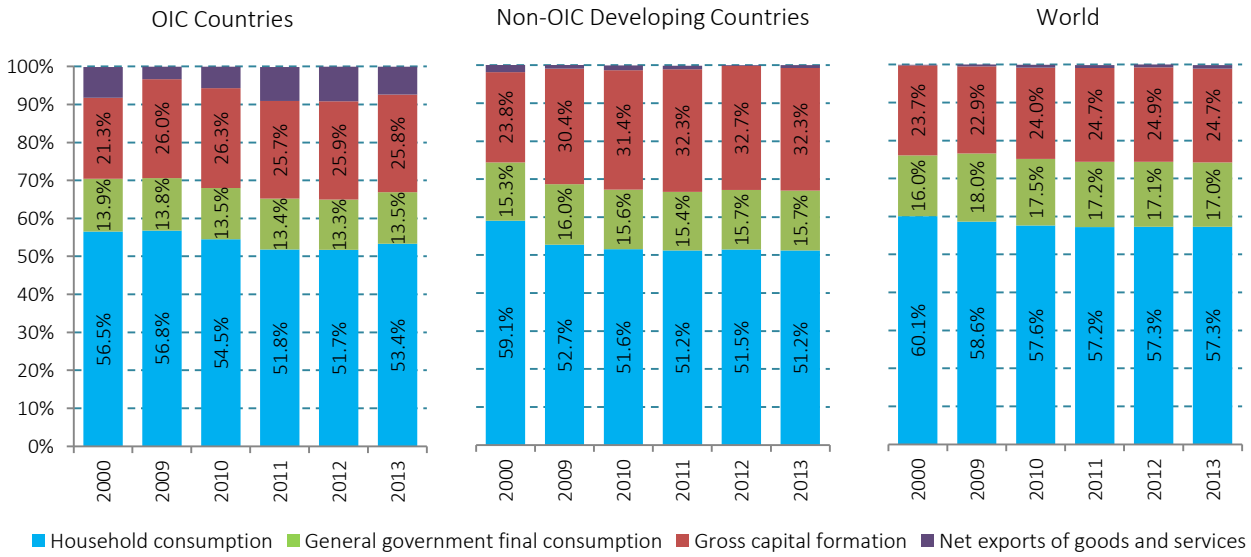
Increasing trend in the share of OIC countries in total world industrial production ceased in 2013

Industry sector – including manufacturing – accounted on average for 42.3% of the total GDP of the OIC member countries in 2013 (Figure 1.9). Its share in 2008 was significantly lower than that of the services sector, however, the situation started to improve in the period 2009-2011 and, with the picking up of global industrial activity, the relative share of industry in economic activity is quickly catching up with the services sector. Compared to non-OIC developing countries where the industrial sector's contribution to the GDP averaged at 36.7% in 2013, the latter apparently constitutes a larger portion of the economic activity in the OIC member countries.

However, the share of industry in the GDP of a country, per se, does not reflect the actual industrialization level of its economy. Particularly in the case of OIC countries, the oil industry accounts for a significant portion of the total value-added of industry sector. Figure 1.9 reveals that, in year 2000, the share of manufacturing sector in total GDP of the OIC countries was 15.4%. In 2009, however, the share of the sector contracted significantly to 13.8% before improving slightly to 13.9% in 2010. Most recently, in 2013, the share of the manufacturing industry stands at 13.5% which is still below the 15.4% level observed in year 2000. As compared to the OIC countries, the manufacturing sector in non-OIC developing countries contributes significantly larger share to their total GDP where its share was recorded at around 21.0% in 2013.

According to the Figure 1.10, the share of the OIC countries as a group in the world total industrial production has reached 13.1% in 2013. This marks 6.1 percentage points increase since year 2000. Despite this upward trend, the share of the OIC countries in the total gross fixed capital formation of the

Figure 1.11: GDP by Major Expenditure Items (% of GDP)



Source: SESRIC staff calculations based on UNSD National Accounts Main Aggregates Database, August 2015.

developing countries has been on decline and contracted from 26.6% to 25.6% over the same period. This indicates the relatively poor performance shown by the OIC countries in industrial production, as compared to non-OIC developing countries.

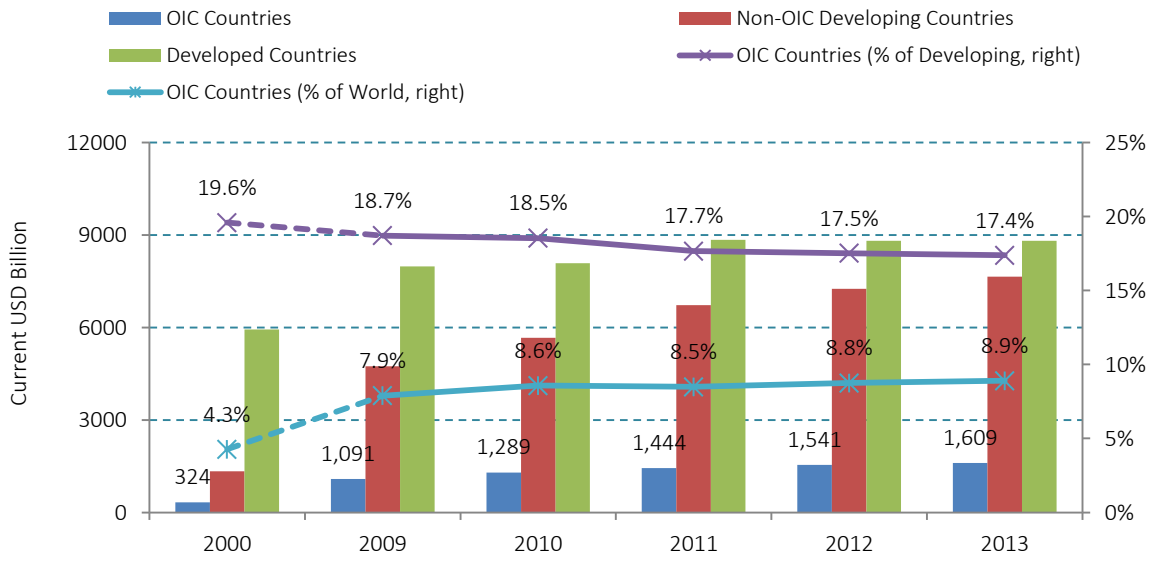
GDP BY EXPENDITURE ITEMS

The share of household consumption in the total GDP of OIC countries decreased by 3.4 percentage points since 2009

The analysis of global GDP by major expenditure items reveals that the share of final consumption (both by household and government) continued to be the highest in the total GDP over the years. As shown in Figure 1.11, in 2013 household consumption accounted for the lion share of 53.4% followed by gross capital formation (25.8%) and general government final consumption (13.5%). The share of net exports in total world GDP was negligible. During the period 2000-2013, the share of gross capital formation in total world GDP has increased by 4.5 percentage points whereas the share of household consumption declined by 3.2 percentage points.

The relative shares of the major expenditure items in the total GDP of OIC and non-OIC developing countries registered significant variation from the world. In 2013, final household and general government spending accounted for 66.9% of the total GDP of OIC countries. As constituents of the final consumption expenditure, expenditure by households and governments accounted for 53.4 and 13.5% of the GDP, respectively. These figures marked a decrease in the shares of both consumption types compared to the previous years. The share of household consumption in the total GDP of the OIC member countries has decreased by 3.4 percentage points since 2009 whereas the share of government spending has contracted by 0.3 percentage points over the same period. The decrease in the share of final consumption was mainly accommodated by an expansion in the share of net exports from 3.3% in 2009 to 6.3% in 2013. On the other hand, the share of final

Figure 1.12: Gross Fixed Capital Formation, Volume and Share (right)



Source: SESRIC staff calculations based on UNSD National Accounts Main Aggregates Database, August 2015.

consumption in total GDP of non-OIC developing countries was recorded at 66.9% in 2013 and household consumption, with a 51.2% share in GDP, was again the main source of final consumption expenditure in these countries (Figure 1.11).

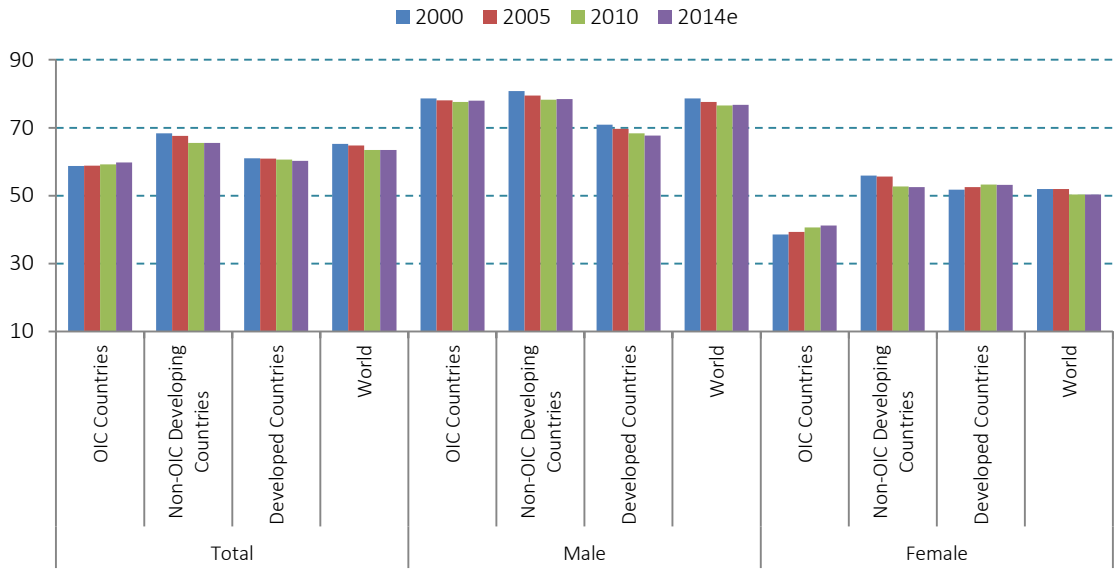
Gross Capital Formation

In 2013, 25.8% of the total GDP generated in OIC countries was invested in productive assets

Gross capital formation measures the amount of savings in an economy which are transformed into investments in production. As the analysis of GDP by major expenditure items revealed in Figure 1.11, 25.8% of the total GDP generated in the OIC member countries was invested in productive assets in year 2013. In comparison, non-OIC developing countries on average channelled 32.3% of their GDP into productive investments. The share of gross capital formation in the GDP of OIC countries as a group has increased by 4.5 percentage points over its year 2000 level of 21.3%, whereas it increased by as much as 8.5 percentage points in the group of non-OIC developing countries over the same period. Yet, one can argue that gross capital formation, as an indicator, is flawed primarily by the significant fluctuations in inventories and, most of the time, non-availability of the industry-level inventory information. Gross fixed capital formation, on the other hand, is promoted as being a better indicator on the net additions of productive assets created during a specific year.

In view of the above argument, Figure 1.12 offers a look at the gross fixed capital formation trends in the OIC countries in comparison to non-OIC developing as well as developed countries. According to the Figure 1.12, the share of the OIC countries as a whole in world total fixed capital formation reached 8.9% in 2013. This marks 4.6 percentage points increase since year 2000. Despite this upward trend, the share of the OIC countries in the total gross fixed capital formation of the developing countries has been on decline and contracted from 19.6%

Figure 1.13: The Labour Force Participation Rates, 2000-2014



Source: SESRIC staff calculations based on ILO, WESO 2015 Dataset, (e: estimated).

to 17.4% over the same period. This indicates the relatively poor performance shown by the OIC countries in accumulating investment capital, as compared to non-OIC developing countries.

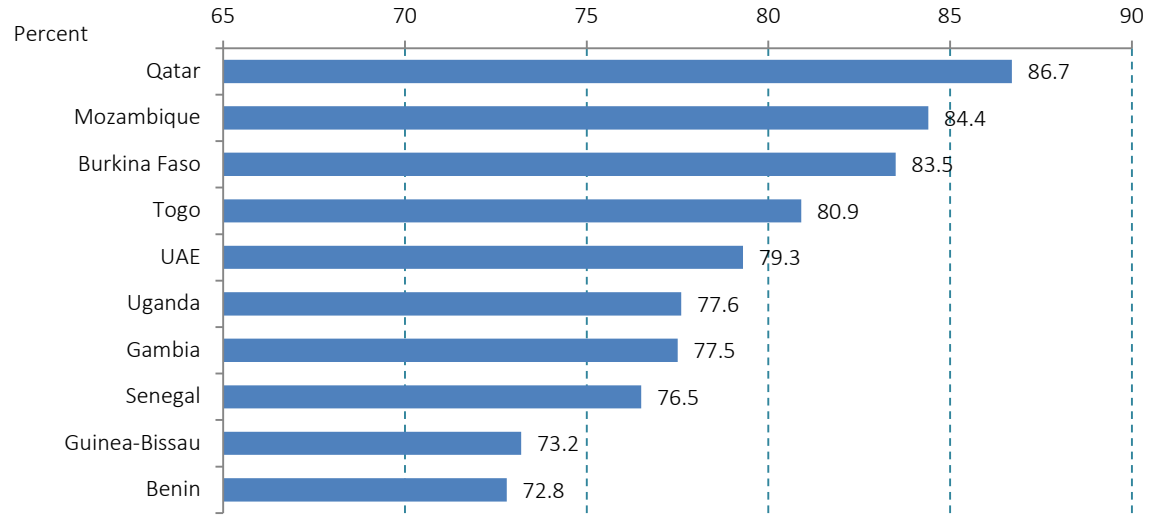
LABOUR FORCE PARTICIPATION

LFPR in OIC countries remained lower than other country groups in 2014

Although unemployment rate is accepted as one of the leading macroeconomic variables which commonly used to examine the performance of the economy, it may not accurately reflect the health of labour market as the definition focuses on people seeking employment for pay but not the magnitude of people who are not working actually. Due to this, it might be ideal to first consider the labour force participation rate (LFPR), which measures the proportion of people aged 15 and above that engages actively in the labour market, either by working or actively searching for a job. It provides an indication of the relative size of the supply of labour available to engage in the production of goods and services.

As shown in Figure 1.13, the average labour force participation rate in OIC member countries, contrary to other country groups, followed a slightly increasing trend, which stood at 59.8% in 2014 compared to 63.5% in the world, 65.6% in non-OIC developing countries and 60.3% in developed countries. In case of labour force participation rate for the male population, OIC member countries recorded a rate of 78% compared to 76.7% in the world, 78.5% in non-OIC developing countries and 67.7% in developed countries. Although, OIC member countries registered globally comparable performance in terms of total and male labour force participation rates, their performance in case of female labour force participation rate remained significantly lower. Female labour force participation rate in OIC member countries was recorded at 41.2% in 2014, which is significantly lower than the world average of 50.3%, the average of 52.6% in non-OIC

Figure 1.14: Top 10 OIC Member Countries by Labour Force Participation Rate, 2014



Source: ILO, WESO 2015 Dataset.

developing countries and the average of 53.2% in developed countries.

However, there is an increasing trend in labour force participation rates in OIC countries, particularly in female participation rates. Since 2000, female participation rate increased from 38.6% to 41.2% in 2014. An upward trend in this indicator is also observed in the case of developed countries from 51.8% in 2000 to 53.2% in 2014, while in non-OIC developing countries, female participation showed a declining trend and fell to 52.6% in 2014 from its level of 55.9% in 2000.

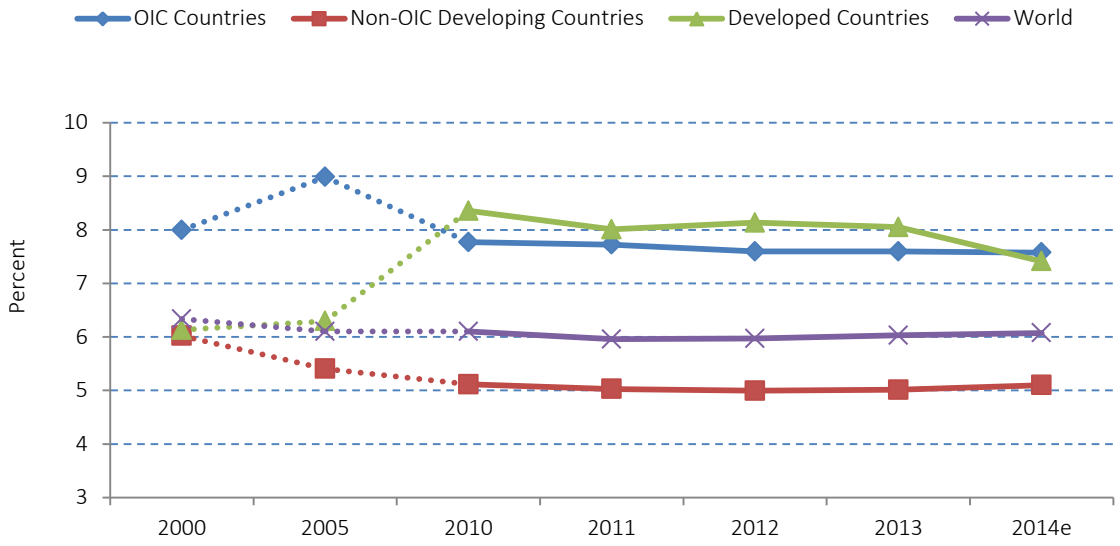
At the individual country level, Qatar registered the highest labour force participation rate (86.6%) in 2014, followed by Mozambique (84.1%), Burkina Faso (83.3%), Togo (81%), and United Arab Emirates (80.5%). It is worth mentioning that, with the exception of Qatar and United Arab Emirates, all top 10 performing member countries belong to least developed countries according to UN classification (Figure 1.14). On the other hand, lowest participation rate was recorded in Palestine with 41.4%. It is followed by Jordan (41.8%), Iraq (42.4%), Algeria (44.2%) and Iran (45.4%). At the global level, with respect to labour force participation rate, Qatar is ranked at 5th, Mozambique at 8th and Burkina Faso at 10th position. It is also worth mentioning that 12 out of the world 20 countries with lowest participation rates in 2014 are OIC member countries.

UNEMPLOYMENT

After five years interval, OIC countries have again the highest unemployment rate in the world with 7.6%

Unemployment remained one of the most challenging issues across the globe. According to the ILO World Employment and Social Outlook 2015 report, almost 202 million people were unemployed in 2014 around the world, with 1.2 million additional unemployed compared with the previous year and about 31 million more compared with 2007. This reflects the fact that

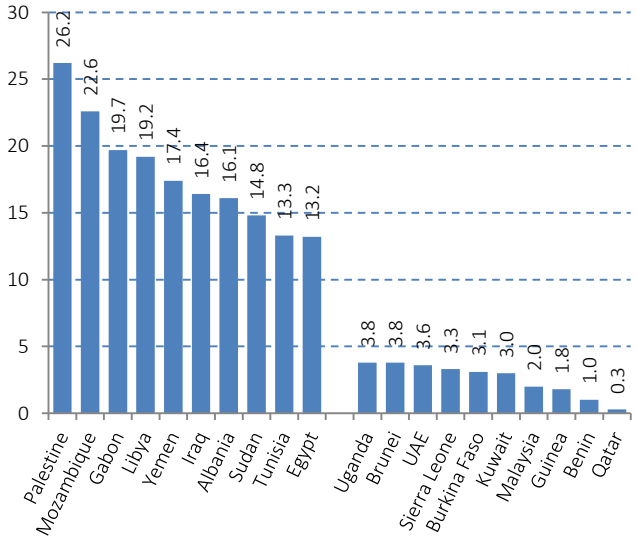
Figure 1.15: Total Unemployment Rate (% of Total Labour Force)



Source: SESRIC staff calculations based on ILO, WESO 2015 Dataset, (e: estimated).

employment is not expanding sufficiently fast to keep up with the growing labour force. Whereas, around 23 million people estimated to have dropped out of the labour market due to discouragement and rising long-term unemployment. According to the same report, the global unemployment rate remained at 5.9% of the global labour force, 0.1 percentage point lower than the year before. Due to mixed expectations about world economy for 2015, very little improvement is expected in the global labour market and the global unemployment rate is expected to stabilize at 5.9% between 2015 and 2017.

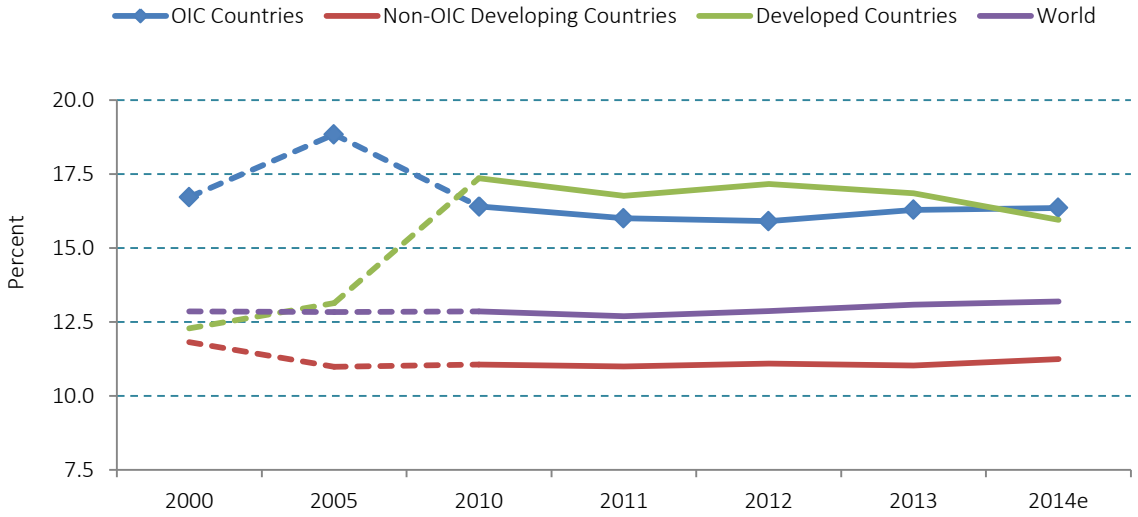
Figure 1.16: OIC Countries with Lowest and Highest Unemployment Rates



Source: ILO, WESO 2015 Dataset.

According to the latest available data, OIC countries recorded significantly higher average unemployment rates compared to the world, developed and non-OIC developing countries during the period 2000-2008 (Figure 1.15). During this period, total unemployment rate in OIC countries changed between 7.8% and 9.1%. After the global financial crisis, unemployment rates in developed countries increased from a level below 6% to over 8%. During the post-crisis period (2009-2013), average unemployment rate in developed countries remained higher than the rate in OIC countries. As of 2014, OIC countries attained a rate of 7.6%, while it is estimated that developed countries managed to lower the rate to 7.4%, which is again lower than the rate in OIC countries. Average unemployment rate in non-OIC

Figure 1.17: Youth Unemployment Rate



Source: SESRIC staff calculations based ILO, WESO 2015 Dataset, (e: estimated).

developing countries remained significantly lower (around 2-3%) than the OIC average during the whole period under consideration.

Unemployment rates for male are typically lower than the rates for female in all country groups. Despite significant improvement since 2005, female unemployment in OIC countries remains highest with 9.4% in 2014. It is estimated at 5.3% in non-OIC developing countries and 7.4% in developed countries for the same year. Male unemployment in OIC countries has decreased from 7.8% in 2005 to 6.6% in 2014 and from 5.2% to 4.9% in non-OIC developing countries during the same period. On the other hand, there is an upward trend in male unemployment rates in developed countries, which increased from 6.1% in 2005 to 7.4% in 2014.

At the individual country level, unemployment rates varied among OIC countries (Figure 1.16). The unemployed people in 2014 constituted less than 1% of total labour force in Qatar (0.3%), which is also the lowest rate in the world. Benin (1%), Guinea (1.8%) and Malaysia (2%) are also among the ten countries in the world with lowest unemployment rates. However, unemployment is a serious concern in Palestine (26.2%), Mozambique (22.6%) and Gabon (19.7%).

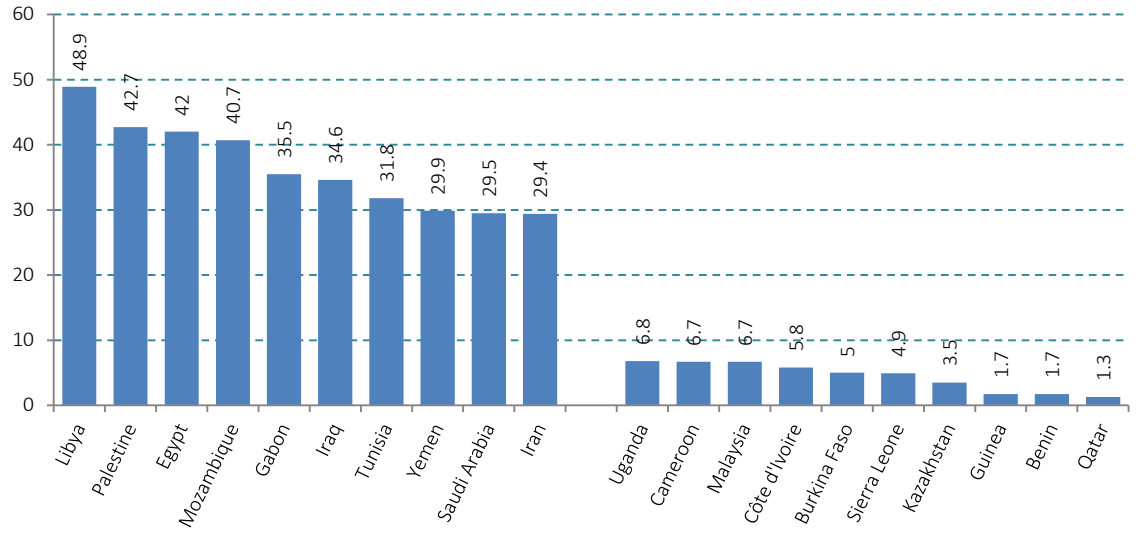
YOUTH UNEMPLOYMENT

16.4% of young population in OIC countries were jobless in 2014

Youth (aged 15 to 24 years) continued to suffer from lack of decent job opportunities across the globe. According to the latest ILO estimates, some 73.7 million young people were unemployed in 2014. There were 30.5 million fewer young people in employment in 2014 than in 2007, while the global youth unemployment rate has reached 13% in 2014, which is almost three times as high as the adult unemployment rate (ILO, 2015). It is particularly high in the Middle East and North Africa (29.5%).

The figures on youth unemployment in OIC countries are even less promising. It remained constantly above 16% and also well

Figure 1.18: OIC Countries with Lowest and Highest Youth Unemployment Rates



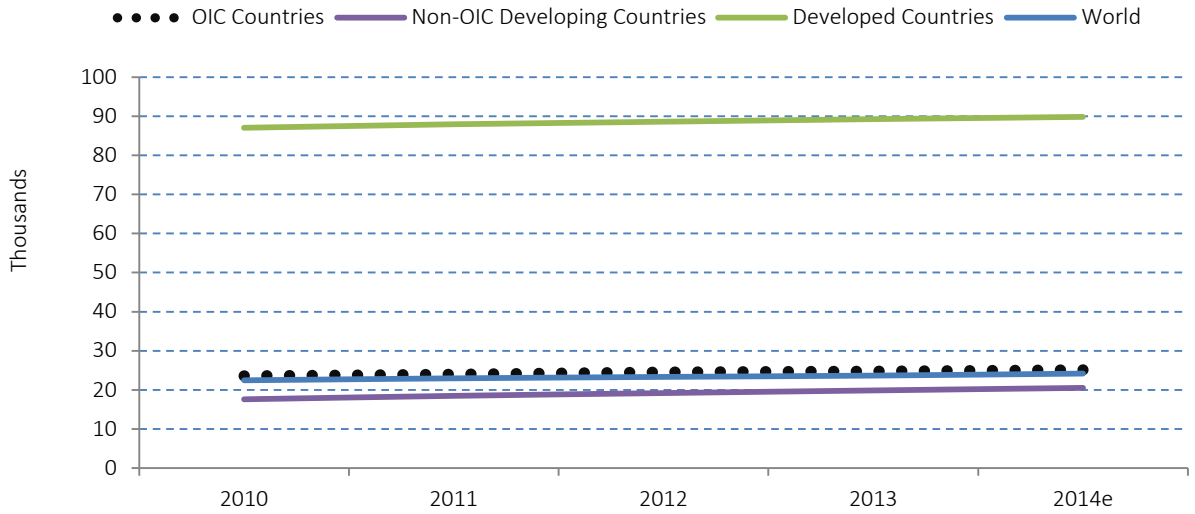
Source: ILO, WESO 2015 Dataset.

above the averages of non-OIC developing and developed countries during the period between 2000 and 2014, except a slightly lower rate in 2012 with 15.9%. After the crisis, the problem of youth unemployment in developed countries became even more serious compared to that in OIC countries (Figure 1.17). As of 2014, however, youth unemployment in developed countries (16%) dropped to the levels below the OIC countries (16.4%), while it was as low as 11.2% in non-OIC developing countries.

As in other major labour market indicators, despite some improvement since 2005, female unemployment among young people is the highest in OIC countries. It fell to 18.2% in 2014 from its level of 22.3% in 2005. While female unemployment among youth has been decreasing in non-OIC developing countries during the period under consideration, it followed an upward trend in developed countries. As of 2014, it was estimated at 11.5% in non-OIC developing countries and 14.8% in developed countries. With respect to male unemployment among youth in 2014, it increased to 15.3% in OIC countries and 11.1% in non-OIC developing countries, but decreased to 17% in developed countries compared to the year before.

There are again wide discrepancies in youth unemployment rates across OIC countries. Qatar (1.3%), Benin (1.7%) and Guinea (1.7%) are the countries with lowest unemployment rates in 2014, which are also among top five countries in the world (Figure 1.18). Kazakhstan (3.5%) also recorded a low youth unemployment rate and remains among the top ten countries in the world. In contrast, the highest youth unemployment rate was estimated in Libya (48.9%), followed by Palestine (42.7%), Egypt (42%), Mozambique (40.7%) and Gabon (35.5%). In 2014, youth unemployment rate was above 20% in 21 OIC countries and above the world average of 13% in 31 countries.

Figure 1.19: Labour Productivity (GDP per worker, US$ PPP)



Source: SESRIC staff calculations based on ILO, WESO 2015 Dataset, (e: estimated).

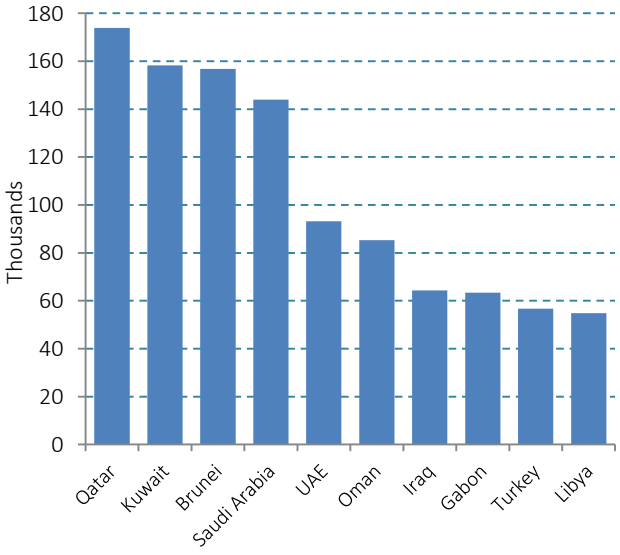
LABOUR PRODUCTIVITY

Only five OIC member countries recorded output per worker higher than the average of developed countries

Productivity plays a pivotal role in the development of an economy. It helps to increase real income and improve living standards by catalysing the economic growth. Labour productivity is usually defined as the output per unit of labour input or output per hour worked. It helps to identify the contribution of labour to the GDP of a country and provides a base for cross country comparison and explanation of income disparities.

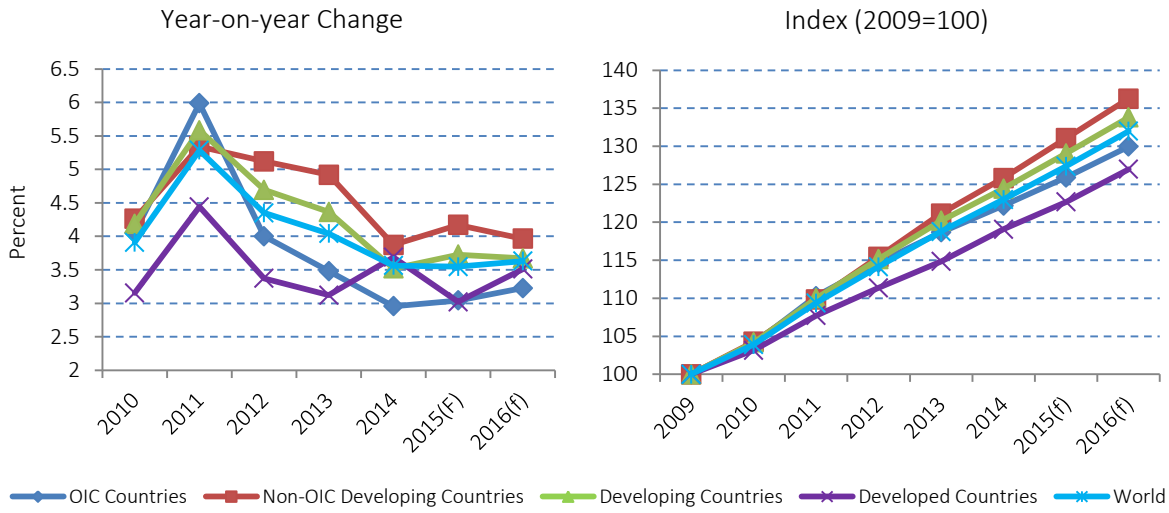
At the global level, labour productivity has witnessed an increasing trend during the period 2010-2014. As shown in Figure 1.19, output per worker in OIC countries has increased from US$ 22,400 in 2010 to US$ 25,100 in 2014. The labour productivity gap between the developed and developing countries remained substantial throughout this period as output per worker in the developed countries was estimated at US$ 89,800 in 2014 compared to just US$ 20,500 in non-OIC developing countries and US$ 25,100 in OIC countries, expressed in constant 2011 international dollar in PPP. This means that an average worker in the group of non-OIC developing countries produces only 22.8% of the output produced

Figure 1.20: Top 10 Countries with Highest Labour Productivity, 2014



Source: ILO, WESO 2015 Dataset.

Figure 1.21: Annual Average Inflation (Consumer Prices)



Source: IMF WEO Database April 2015 and SESRIC BASEIND Database.

by an average worker in the developed countries and an average worker in OIC countries produces only 28% of the output produced by an average worker in the developed countries.

At the individual country level, Qatar registered the highest output per worker (US$ 174,000) in 2014, followed by Kuwait (US$ 158,300), Brunei Darussalam (US$ 156,900), Saudi Arabia (US$ 144,000) and United Arab Emirates (US$ 93,200). Among the OIC member countries, the lowest labour productivity level was recorded in Niger (US$ 2,900) followed by Guinea (US$ 3,000) and Guinea-Bissau (US$ 3,000). Only five member countries recorded output per worker higher than the average of developed countries (Figure 1.20).

INFLATION

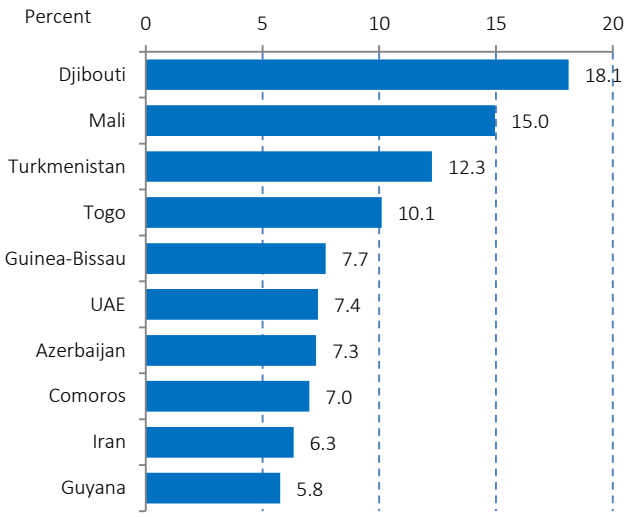
Global inflation rate decreased from 5.3% in 2011 to 3.6% in 2014 due to economic slowdown

Inflation is on decline across the globe reflecting primarily the impact of decline in prices for oil and other commodities, and weakening demand in some economies like euro area and Japan. The latest estimates show that global inflation rate has decreased from 5.3% in 2011 to 3.6% in 2014, and it is expected to remain around this level in 2015 and 2016.

As seen in Figure 1.21, price volatility is not foreseen to be a major concern for developed and developing countries. In the aftermath of the crisis, developed countries did not follow an uncontrolled monetary expansion, despite the existence of high pressure from public. As a result, the change in consumer prices will remain low and the inflation rate is expected to be 3.0 and 3.5% in 2015 and 2016, respectively. In developing countries, the inflation rate decreased from 5.6% in 2011 to 3.5% in 2014. The expected inflation for 2015 and 2016 is at 3.7% for these countries.

In the OIC countries, average inflation rate for 2011 was higher than the average of the developed and developing economies.

Figure 1.22: Top 10 OIC Countries by Annual Average Inflation (2014)



Source: IMF WEO Database April 2015 and SESRIC BASEIND Database.

However, in line with the global trends, inflation in the OIC countries declined to 3.0% in 2014. The average consumer price index marked an increase of 17.4% in the OIC countries during 2010-2014 (Figure 1.21, right panel). This is well below the average increase recorded in non-OIC developing countries (20.7%) as well as in the world (18.4%) during the same period.

In the short-term outlook, inflationary pressures are projected to remain contained for the OIC countries, supported by the recent decrease in oil prices. The forecasts show that the growth in average consumer prices in the OIC countries will remain constant at 3.0% in 2015 before picking up slightly to 3.2% in 2016 (Figure 1.21, left panel).

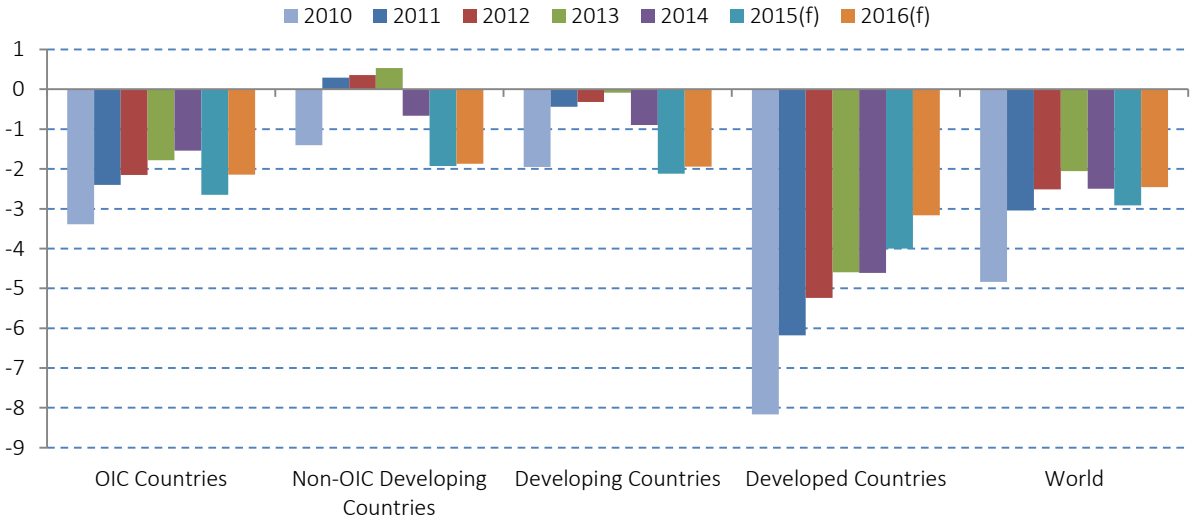
At the individual OIC country level, Djibouti recorded the highest average consumer prices inflation rate of 18.1% in 2014, which was also the 4th highest in the world (Figure 1.22). Guyana, with an average inflation rate of 5.8%, was ranked 10th within the OIC group and 47th in the world.

FISCAL BALANCE

All country groups recorded fiscal deficits in 2014 and this is expected to continue

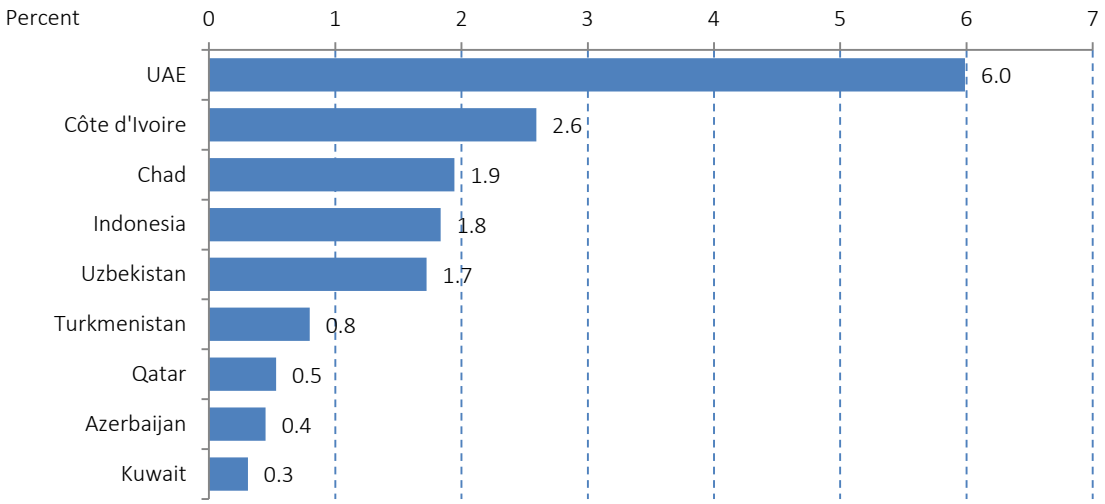
Latest statistics show that the fiscal tightening policies especially in developed countries have achieved the expected effect

Figure 1.23: Fiscal Balances (% of GDP)



Source: IMF WEO Database April 2015 and SESRIC BASEIND Database.

Figure 1.24: Top 10 OIC Countries by Fiscal Balance% of GDP (2014)



Source: IMF WEO Database April 2015 and SESRIC BASEIND Database.

and global fiscal balances are improving. As shown in Figure 1.23, world fiscal balance deficit as a percentage of GDP witnessed a declining trend from -4.8% in 2010 to -2.5% in 2014. The forecast shows that an increase is expected in coming years where the ratio is projected at -2.9% for 2015 before declining to -2.5% in 2016. A similar trend is being observed in the developed countries group where fiscal balance deficit as% of GDP has declined from -8.2% in 2010 to -4.6% in 2014. This ratio is expected to decrease further to -4.0% in 2015 and -3.2% in 2016 for these countries. Developing countries also have registered negative fiscal balances but are in relatively better position than the developed countries. In 2014, the ratio was observed at -0.9% for developing countries group and it is expected to increase to -2.1% in 2015 before declining to -1.9% in 2016.

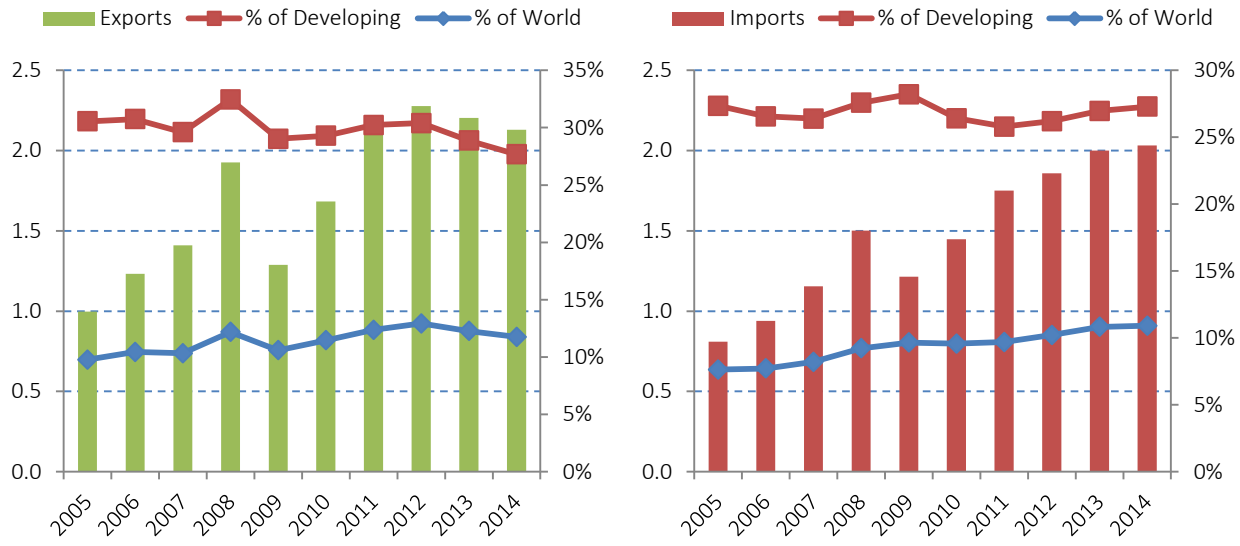
During the period under consideration, the OIC member countries as a group also witnessed improvement in fiscal balances. In 2014, OIC countries recorded fiscal balance of -1.5% of GDP. However, the fiscal deficit is expected to increase to -2.7% in 2015 before declining to -2.1% in 2016.

At the individual country level, 9 out of 54 OIC countries with available data have recorded fiscal balance surplus in 2014. Among these countries, highest fiscal surplus was recorded by United Arab Emirates (6.0%), followed by Côte d'Ivoire (2.6%), Chad (1.9%), and Indonesia (1.8%). Top three OIC countries were ranked among the world top 20 countries with respect to fiscal balance surplus. United Arab Emirates was ranked 10th in the world whereas Côte d'Ivoire and Chad were ranked 15th and 18th, respectively.

Section 2

Trade and Finance

Figure 2.1: Merchandise Exports and Imports (US$ Trillion)



Source: IMF Directions of Trade Statistics (DOTS).

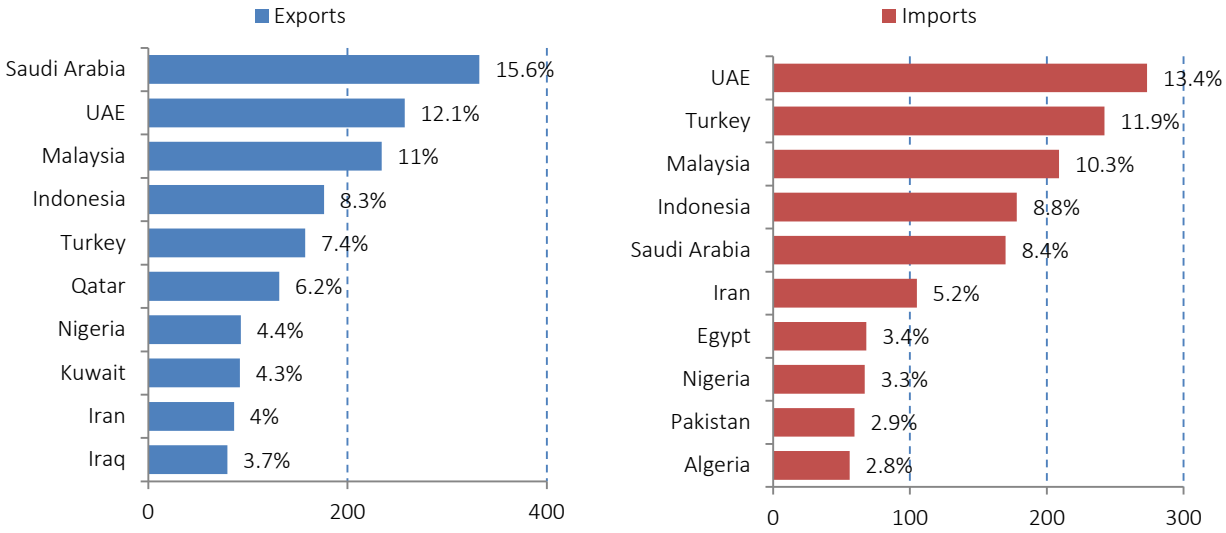
MERCHANDISE TRADE

Share of OIC countries in world's total exports decreased to 11.7% in 2014 compared to 12.9% in 2012.

The total value of world **merchandise exports,** according to the IMF Directions of Trade Statistics (DOTS), was recorded at US$ 18.4 trillion in 2014, as compared to US$ 18.2 trillion in 2013. The 1% increase is lower than the 2% increase in the last year and much lower than the 20% annual average growth observed in years 2010 and 2011.

After the sharp fall in 2009, from $1.9 trillion to US$ 1.3 trillion, total merchandise exports from OIC countries increased significantly and reached US$ 1.7 trillion in 2010 (Figure 2.1, left). Pursuing a continuous upward trend till 2012, total merchandise exports of OIC countries reached their historically highest level of US$ 2.3 trillion in 2012, surpassing the pre-crisis peak of US$ 1.9 trillion observed in 2008. This upward trend was stronger than those observed in non-OIC developing countries and the world as a whole, resulting in an increase in the shares of OIC countries in total developing country and world exports. Since then, however, total merchandise exports of OIC countries fell in two consecutive years and reached US$ 2.1 trillion in 2014. Accordingly, the share of OIC countries in total exports of developing countries contracted to 27.7% in the same year, compared to 30.4% in 2012, and continued to remain below its pre-crisis level of 32.5% observed in 2008. OIC countries' collective share in total world merchandise exports also followed a similar trend between 2012 and 2014 and decreased to 11.7 % in 2014, following the recent peak of 12.9% in 2012. This can be partly explained by falling commodity prices, where OIC countries have significant concentration. Moving forward, to achieve long-term sustainable growth in merchandise trade and higher share in total world exports, OIC countries will apparently need more competitive economic sectors with significant diversification levels and higher technological intensity.

Figure 2.2: Top OIC Merchandise Exporters and Importers (2014, US$ Billion)



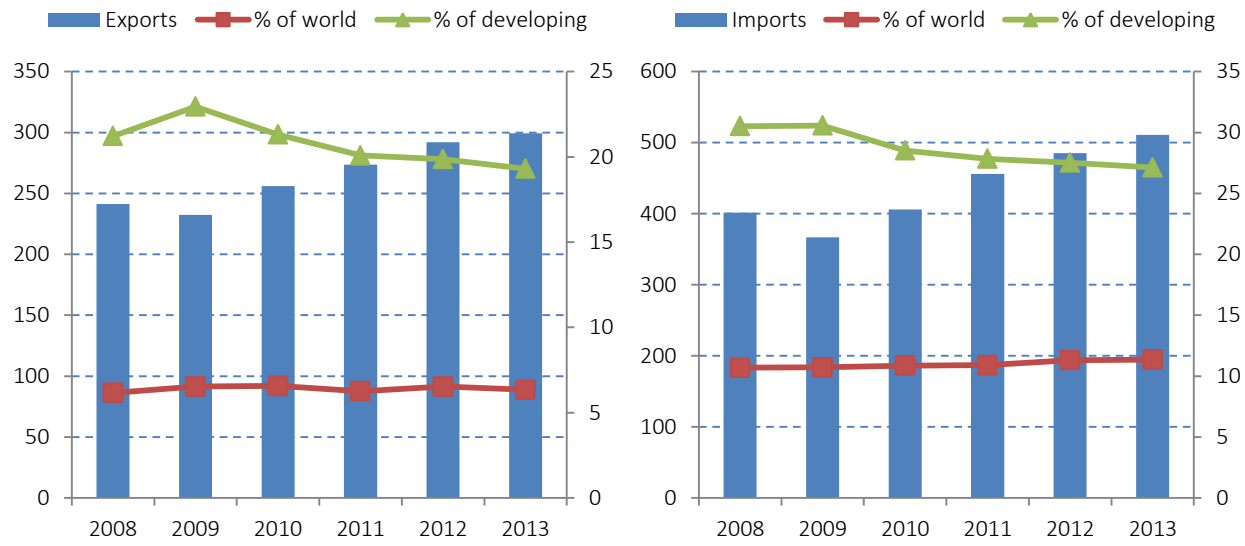
Source: IMF Directions of Trade Statistics (DOTS).

On the other hand, total **merchandise imports** of OIC countries experienced a stronger post-crisis bounce-back and increased from $1.2 trillion in 2009 to $2.0 trillion in 2014 (Figure 2.1, right), recording a double-digit (10.9%) compound annual increase during this period. The share of OIC countries in global merchandise imports continued to expand, though at a slower pace, throughout the period under consideration and reached 10.9% in 2014, compared to 9.2% in 2008. Their share in total developing country merchandise imports, on the other hand, was recorded at 27.3% in 2014, sustaining its expansion for three years in a row since 2011.

In terms of the shares of the individual member countries in total merchandise exports from the OIC region, it has been observed that the bulk of total exports from the OIC countries continued to be concentrated in a few countries (Figure 2.2, left). In 2014, the top 5 largest OIC exporters accounted for 54.3% of total merchandise exports of all member countries whereas the top 10 countries accounted for 77%. Saudi Arabia, with US$ 332 billion of merchandise exports and 15.6% share in total OIC exports, was once again the largest exporter in 2014. It was followed by the United Arab Emirates (US$ 257 billion, 12.1%), Malaysia (US$ 234 billion, 11%), Indonesia (US$ 176 billion, 8.3%) and Turkey (US$ 157 billion, 7.4%).

As in the case of exports, merchandise imports of OIC countries were also heavily concentrated in a few countries. As depicted in the right panel of Figure 2.2, with US$ 273 billion and US$ 242 billion of imports, United Arab Emirates and Turkey, respectively, took the lead in 2014 in terms of volume of merchandise imports and together accounted for 25.4% of total OIC merchandise imports. They were followed by Malaysia (US$ 209 billion, 10.3%), Indonesia (US$ 178 billion, 8.8%) and Saudi Arabia (US$ 170 billion, 8.4%) which collectively accounted for a further 27.4% share in the OIC merchandise imports. Again, the top 5 OIC importers accounted for 52.8% of total OIC merchandise imports, whereas the top 10 countries accounted for 70.3%.

Figure 2.3: Services Exports and Imports (US$ Billion)



Source: UNCTAD STATS.

To sustain long-term economic growth, OIC countries need to reduce the high reliance on exports of mineral fuels and non-fuel primary commodities, which involve the least technological intensity, and devise and implement specific policies for adopting more advanced manufacturing methods to increase the share of more technology intensive commodities in exports. This is also necessary for increasing competitiveness of tradable products in international export markets.

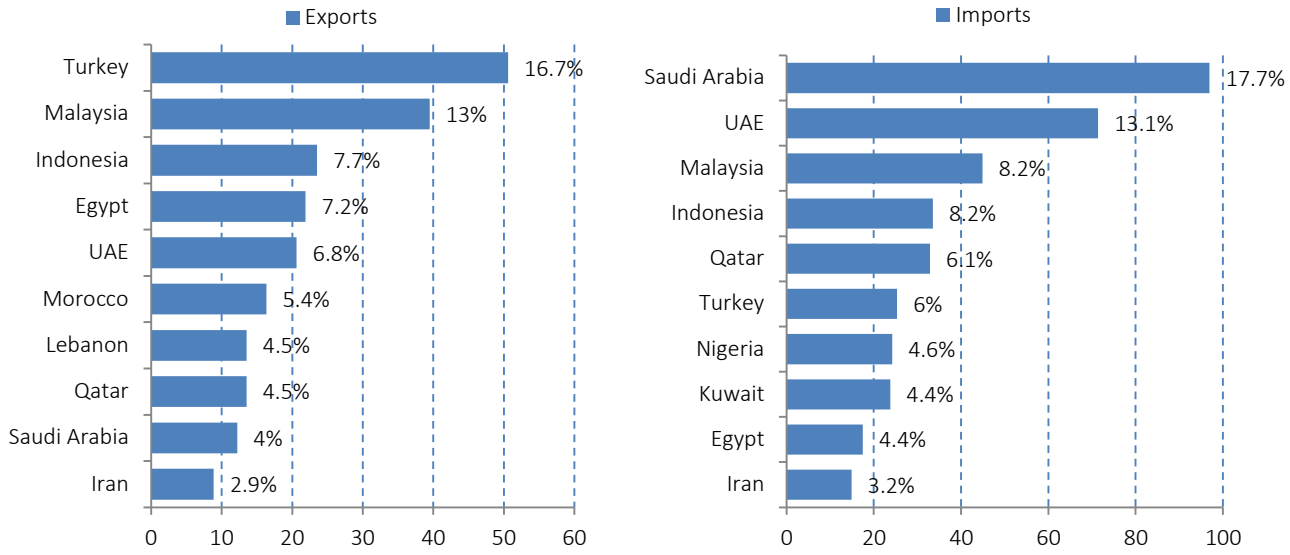
SERVICES TRADE

Share of OIC countries in total services exports of all developing countries is falling for five consecutive years

The services sector plays an increasingly important role in the global economy and the growth and development of countries. It is also a crucial component in poverty reduction and access to basic services, including education, water and health services. The services sector has emerged as the largest segment of the economy, contributing growing shares in gross domestic product (GDP), trade and employment. According to 2014 editions of the World Bank's World Development Indicators and United Nations' National Accounts Main Aggregates Databases the services sector accounted on average for 65%-67% of the global value-added during 2010-2013 and it is expanding more rapidly than the other two main sectors of the economy, namely, agriculture and the industry. The sector accounts for 44% of employment worldwide, and trade in services constitutes nearly 20% of world trade of goods and services, with two thirds of global foreign direct investment (FDI) flowing into the sector (UNCTAD, 2013).

Yet these figures do not translate into a strong presence in world trade. In 2013, world **services exports** totalled only US$ 4.7 trillion, compared to US$ 18.5 trillion of merchandise exports in the same year. As a group, the OIC countries remained net importers of services. According to UNCTAD, OIC countries exported US$ 299 billion worth of services in 2013, whereas the OIC services imports were

Figure 2.4: Top 10 OIC Services Exporters and Importers (2014, US$ Billion)



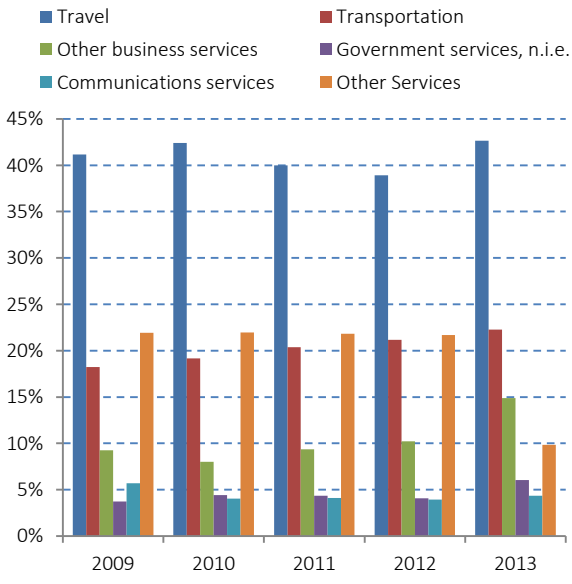
Source: WTO.

recorded at US$ 511 billion in the same year (Figure 2.3). The OIC services trade volume exhibited a constant increase since 2009, where the OIC exports and imports of services were recorded at US$ 232 billion and US$ 367 billion, respectively.

The share of OIC member countries in both services exports and imports of developing countries have followed a downward trend during the period under consideration (Figure 2.3). While OIC countries accounted for 22.9% and 30.6% shares in developing country services exports and imports in 2009, respectively, these shares dropped to 19.3% and 27.1% in 2013. While the collective share of OIC member countries in the total world services exports fell from 6.5% in 2009 to 6.3% in 2013 and their share in the total world imports increased from 10.7% to 11.4% during the same period.

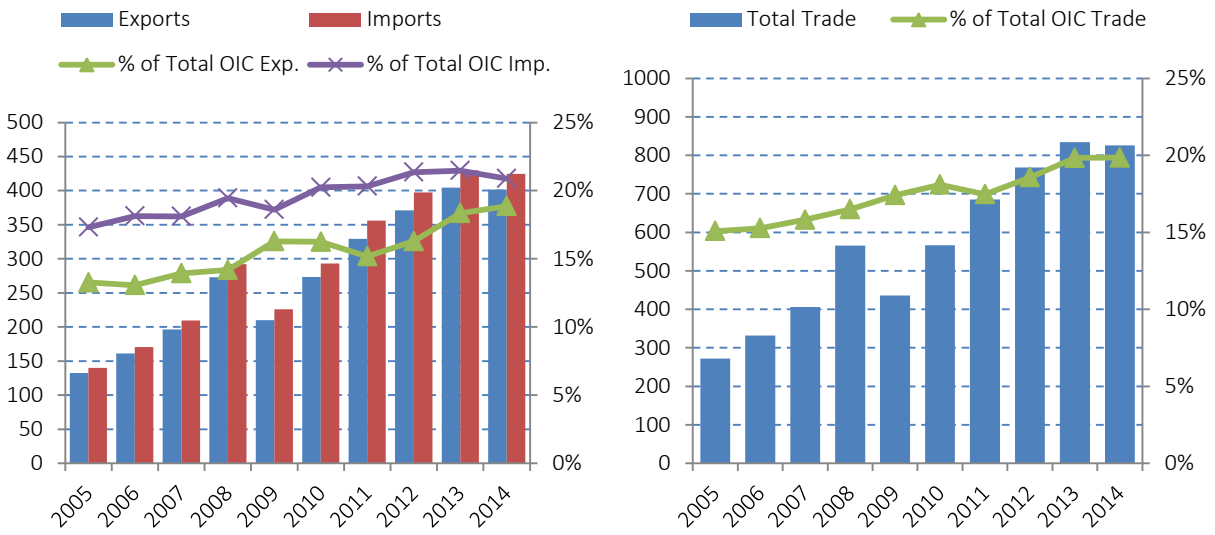
Figure 2.4 shows the top 10 OIC countries according to the sizes of their services exports and imports. Turkey, with US$ 51 billion exports and 16.7% share in total OIC services exports, was the top exporter in services in 2014 (Figure 2. 4, left). It was followed by Malaysia (US$ 39 billion, 13%), Indonesia (US$ 24 billion, 7.7%), Egypt (US$ 22 billion, 7.2%) and United Arab Emirates (US$ 21 billion, 6.8%). In 2014, top 10 OIC countries accounted for 72.6% of total OIC services exports. As far as the service imports are concerned, the Saudi Arabia registered the highest service imports with a cumulative amount of US$ 97 billion and 17.7% share in

Figure 2.5: Services Exports (US$ Billion)



Source: UN Service Trade Database.

Figure 2.6: Intra-OIC Merchandise Exports and Imports (US$ Billion)



Source: IMF Directions of Trade Statistics (DOTS).

OIC total services imports. It was followed by UAE (US$$ 71 billion, 13.1%), Malaysia (US$$ 45 billion, 8.2%), Indonesia (US$ 34 billion, 8.2%) and Qatar (US$ 33 billion, 6%). The top 10 OIC services importers collectively accounted for 70.5% of total services imports of OIC countries.

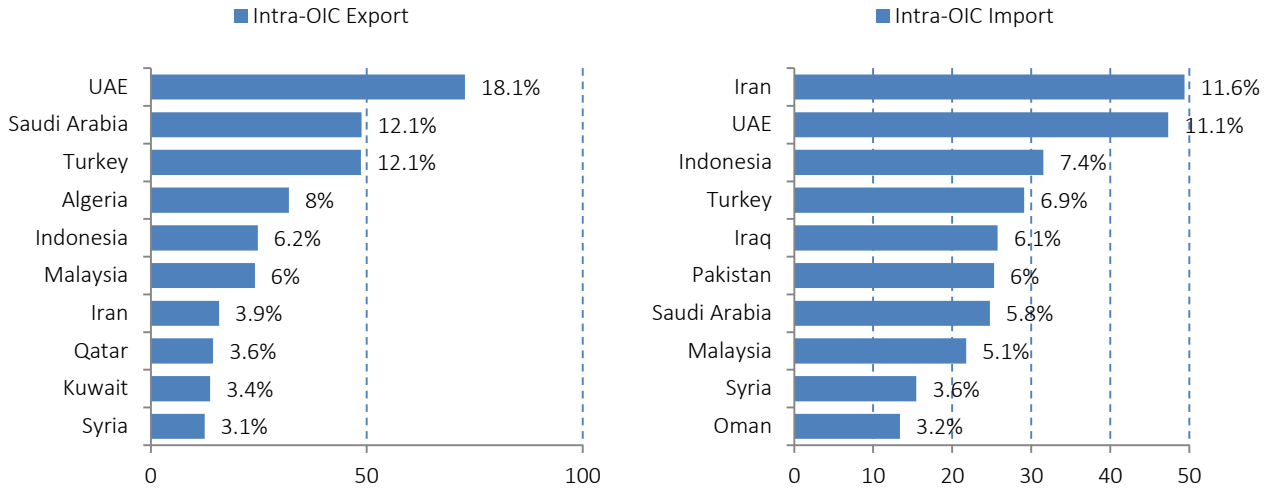
As depicted in Figure 2.5, much of the OIC services exports are concentrated in travel and transportation services. During the period under consideration, the share of travel-related services exports has generally been above 40%, with the exception of 2012. The travel sector was followed by transportation sector, whose share has been steady around 18-22%. The share of other business services category, including, but not limited to, research and development, and legal services, in total OIC services exports has also been significant as the subsector increased its share to a level close to that of the transportation services.

INTRA-OIC TRADE

Share of intra-OIC trade in total trade of OIC countries reached 19.9% in 2014.

After witnessing a sharp fall in 2009, total **merchandise trade among the OIC countries** recovered quickly and, following a steep upward trend, reached US$ 834 billion in 2013 (Figure 2.6, left). In 2014, however, this number decreased slightly to US$ 826 billion. However, given the fact that total exports of OIC countries fell 3.3% per year since 2012, the share of intra-OIC trade continued to rise. Accordingly, the share of intra-OIC trade increased from 18.6% in 2012 to 19.8% in 2013 and further increased to 19.9% in 2014. Over the last ten years, this share has continuously increased, except in the year 2011. It should be well recognized that this is indeed a great achievement in realizing the 20% target stated in the OIC Ten-Year Programme of Action in 2005 and every efforts towards achieving this goal should be further supported.

Figure 2.7: Intra-OIC Merchandise Exports and Imports, 2014, US$ Billion



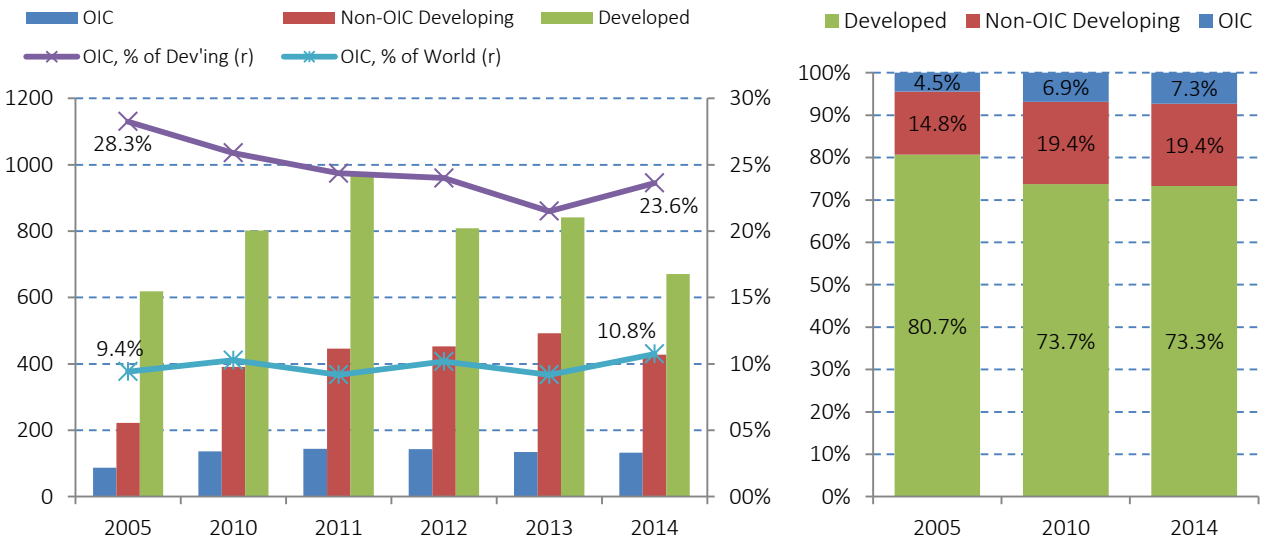
Source: IMF Directions of Trade Statistics (DOTS).

However, one precautionary remark should be made. According to a SESRIC report (2014a), the structure of intra-OIC trade evolved over the years towards more non-fuel primary commodities and less mineral fuels. The share of mineral fuels in total intra-OIC trade decreased from 28% in 2005 to 21.9% in 2012. On the other hand, mineral fuels account around 50% of total OIC exports, but only 3% to 7% of total mineral fuels exported by OIC countries were made to other OIC countries. The falling oil prices since more than a year, therefore, reduced the monetary value of total exports of OIC countries to the world, but narrowly affected the volume of intra-OIC trade. This, then, contributed to increase in the share of intra-OIC trade. Therefore, while evaluating the policy impacts on intra-OIC trade, the role of commodity prices should be taken well into consideration.

On the other hand, **intra-OIC exports** were recorded at US$ 404 billion in 2013 and US$ 402 billion in 2014, as compared to as low as US$ 210 billion in 2009, which had been preceded by a substantial decrease from its 2008 level of US$ 273 billion, and only US$ 132 billion in 2005 (Figure 2.6, right). The share of intra-OIC exports in total OIC exports continued to increase since 2011 and reached 18.9% in 2014. Intra-OIC imports reached US$ 430 billion in 2012 and slightly decreased to US$ 424 billion in 2014 (Figure 2.6, right). Again, these figures compared favourably to US$ 225 billion bottom observed in 2009, when the global economic crisis were unfolding in its most severe form, and only US$ 140 billion in 2005. The share of **intra-OIC imports** in total OIC imports reversed its increasing trend which had been observed since 2009 and declined from 21.5% to 20.9% between 2013 and 2014.

In order to increase the share of trade among them in their total merchandise trade even further, OIC countries should not only focus on operationalizing the OIC Trade Preferential System (TPS-OIC) with broader participation from the member countries, but also promote diversification and competitiveness of their tradable products taking into account their mutual needs and benefits from trade.

Figure 2.8: Inward FDI Flow (left) and Stock (right) (US$ Billion)



Source: UNCTAD STAT.

Figure 2.7 (left) depicts the top 10 member countries in terms of the volume of their intra-OIC exports. In 2014, top 5 OIC intra-OIC exporters accounted for as much as 56.5% of total intra-OIC exports whereas the top 10 exporters for 76.5%. United Arab Emirates ranked first with US$ 73 billion, and 18.1%, of total intra-OIC exports and it was followed by Saudi Arabia (US$ 49 billion, 12.1%), Turkey (US$ 49 billion, 12.1%), Malaysia (US$ 32 billion, 8%) and Indonesia (US$ 25 billion, 6.2%).

The top OIC countries in terms of intra-OIC imports are depicted in Figure 2.7 (right). In 2014, Iran, with US$ 49.4 billion total volume and 11.6% share in total, was the largest importer from OIC countries. It was followed by UAE with US$ 47.3 billion and 11.1% share and Indonesia US$ with 31.5 billion and 7.4% share. Top 5 OIC countries accounted for 43.1% of total intra-OIC imports and top 10 countries accounted for 66.8%.

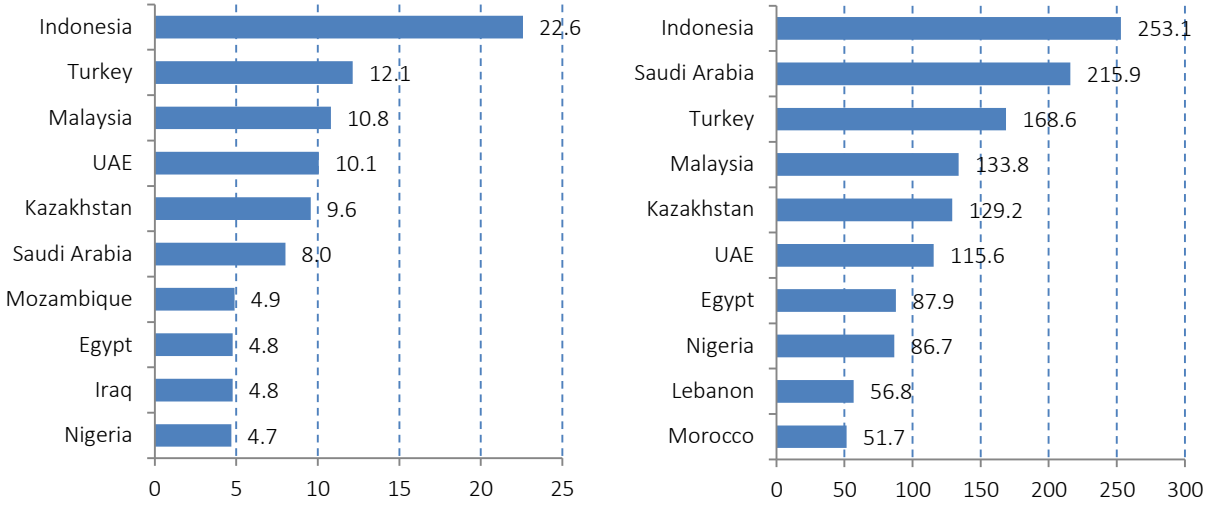
FDI Inflows

Share of OIC countries in total world FDI inflows reached 10.8% in 2014, highest level since 2009.

World total **foreign direct investment** (FDI) inflows amounted to US$ 1.23 trillion in 2014, marking a more than US$ 230 billion decrease over previous year's value of US$ 1.47 billion. As of 2005, 66% of global FDI inflows, which was then worth of US$ 927 billion, were destined for developed countries, while the rest (i.e., 34%) for developing economies. In 2012, developing countries accounted for 42.4% of the global FDI inflows and in 2014, the share of developing countries further increased to 45.5%, reflecting the improved investment climate in these countries.

Figure 2.8 (left) depicts the total FDI flows to OIC countries in comparison to non-OIC developing and developed countries. It is observed from the figure that, during the period under consideration, FDI flows to OIC

Figure 2.9: Top 10 Hosts of Inward FDI Flows (left) and Stock (right) (US$ Billion, 2014)



Source: UNCTAD STAT.

countries generally remained sub-potential (see section 7 for further discussions). The total US$ value of FDI inflows to OIC member countries was recorded at US$ 138 billion in 2009 following an across-the-board decline in global FDI flows and, since then, remained in the US$ 130-145 billion band. In 2014, the total value of FDI flows to OIC countries was recorded at US$ 132 billion, registering a decrease for three consecutive years from its 2011 value of US$ 144 billion. The share of OIC countries in total flows to developing countries, on the other hand, has generally been on decline until 2013 and was recorded at 21.5% in 2013. However, this share increased for the first time since 2009 and reached to 23.6% in 2014. Depending on the trend in FDI flows to developed countries and non-OIC developing countries, its share in global FDI flows showed rather a fluctuating trend between 9% and 11% and reached 10.8% in 2014 compared to 9.2% level in 2013.

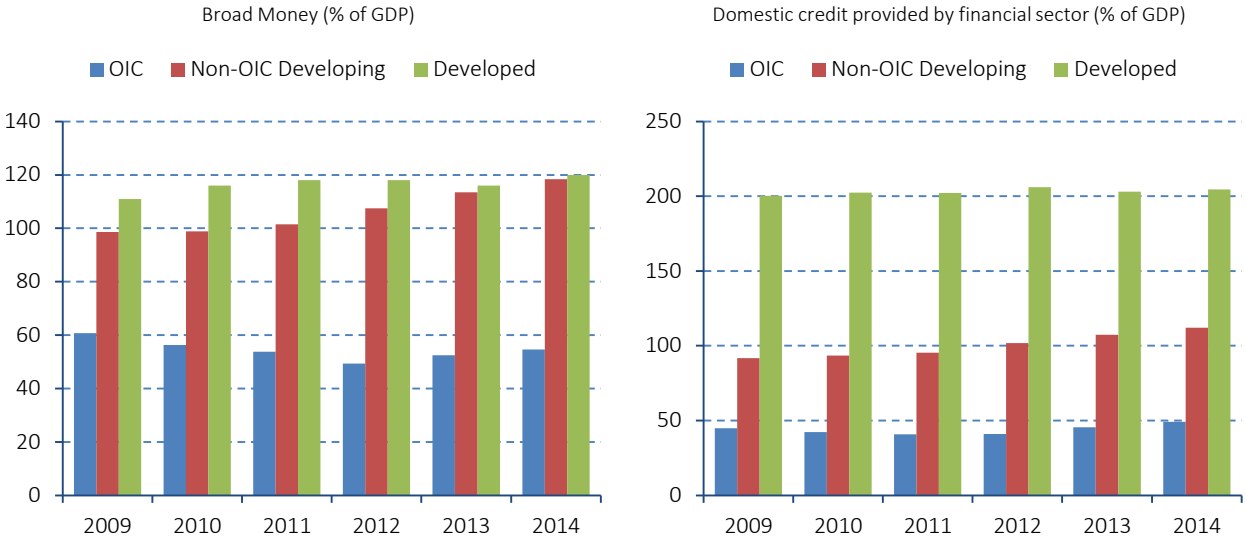
Global inward FDI stock reached US$ 25 trillion in 2014. OIC countries, on the other hand, collectively hosted 7.3% of the global FDI stock, which marked an improvement over their share of 4.5 percentage point in 2005 and 0.4 percentage point change compared to 2010 (Figure 2.8, right). Furthermore, the bulk of the inward FDI stock in developing countries is hosted by non-OIC developing countries, which collectively recorded a 19.4% share in global inward FDI stock in 2014. Overall, developing countries increased their share in the world from 19.3% to 26.7% between 2005 and 2014, which was offset by a decrease in the share of developed countries.

FDI Inflows

Five OIC countries accounted for 49.2% of all FDI flows to OIC countries in 2014.

Like in the case of other major macroeconomic aggregates of the OIC group, FDI flows to OIC countries also exhibited a high level of concentration, with bulk of it persistently being directed to a few of them. The top 5 OIC countries with largest inward

Figure 2.10: Financial Sector Development



Source: World Bank WDI.

FDI flows together accounted for 49.2% of total FDI flows to OIC countries, whereas the top 10 countries accounted for 69.8% (Figure 2.9, left).In 2014, Indonesia took the lead in FDI inflows with US$ 22.6 billion of inward FDI flow, and a 17.1% share in total FDI flows to OIC countries. Indonesia was followed by Turkey (US$ 12.1 billion, 9.2%), Malaysia (US$ 10.8 billion, 8.2%), United Arab Emirates (US$ 10.1 billion, 7.6%) and Kazakhstan (US$ 9.6 billion, 7.2%).

A similar picture is observed in the case of inward FDI stock as well: top 5 countries hosted 50% of total OIC inward FDI stocks whereas the top 10 countries 72.1%. With US$ 253 billion of inward FDI stocks (14% of the OIC total), again, Indonesia ranked first among the list of OIC countries with largest inward FDI stock in 2014. Indonesia was followed by Saudi Arabia (US$ 216 billion, 12.0%), Turkey (US$ 169 billion, 9.4%), Malaysia (US$ 134 billion, 7.4%) and Kazakhstan (US$ 129 billion, 7.2%).

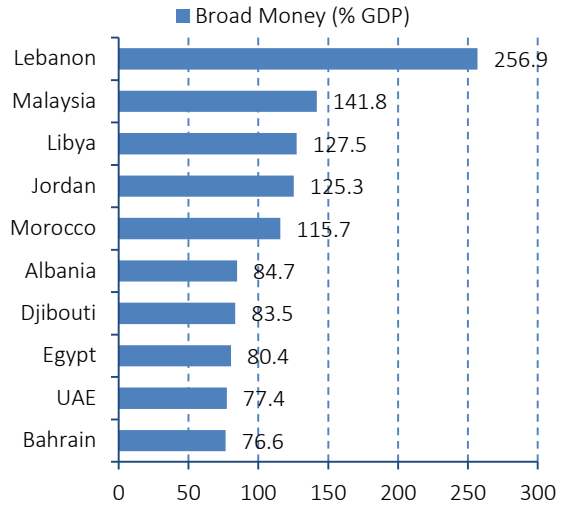
Overall, this state of affairs suggests that a significant majority of the OIC countries are still not able to set up favourable economic frameworks and to provide the foreign businesses with adequate regulatory as well as physical infrastructure to attract more FDI flows. Consequently, OIC countries, in general, need to take swift measures to foster an environment conductive to attracting more foreign investments. To achieve this goal, reforms are needed to improve the business climate and to introduce investment incentives tailored to the needs of both domestic and foreign investors. This, in turn, requires building adequate infrastructure as well as investing in modern technologies to enhance their productive capacities, which is still a significant challenge to majority of them.

FINANCIAL SECTOR

Degree of financial deepening in OIC countries remained unsatisfactory.

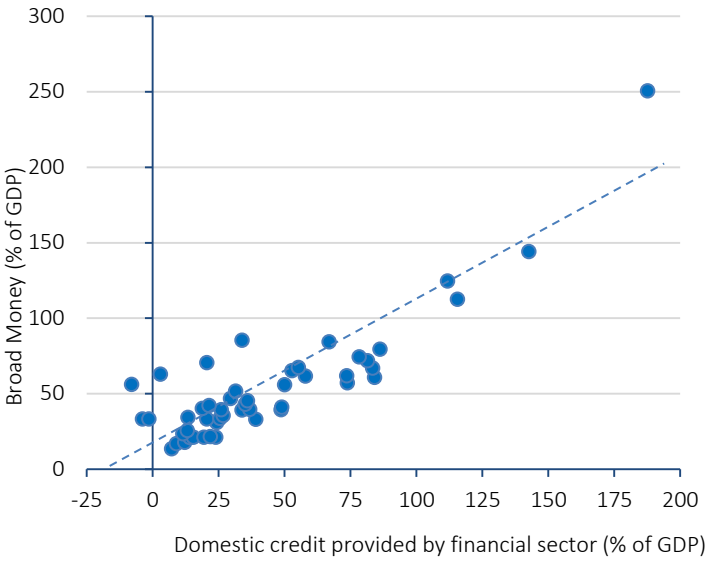
A well-functioning financial system can pave the way for rapid economic development through, inter alia, the efficient allocation of domestic savings into productive economic

Figure 2.11: Financial Sector Development (2014)



Source: World Bank WDI.

Figure 2.12: Liquidity versus domestic credit



Source: World Bank WDI.

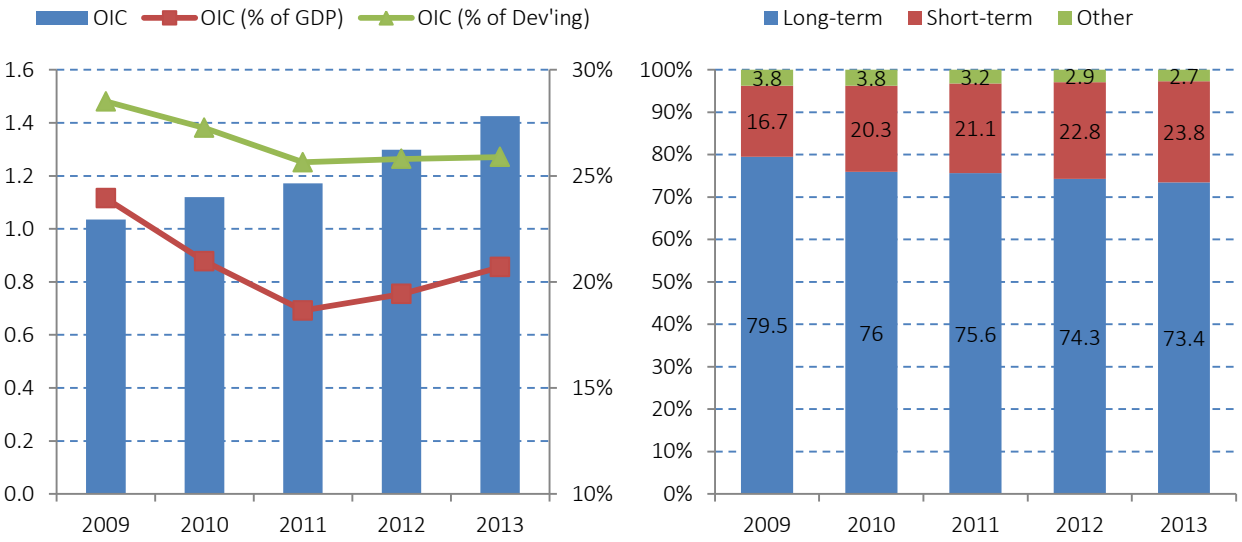
activities. The importance of this role has indeed gained much attention in the recent literature on economic growth, and a strong consensus has emerged in the last decade that well-functioning financial intermediaries have a significant impact on economic growth (Levine, 2004).

A commonly used indicator for determining the degree of **financial deepening** is the ratio of broad money to GDP. A higher ratio is generally associated with greater financial liquidity and depth. As shown in Figure 2.10 (left), the average volume of broad money relative to the GDP of OIC countries was recorded at 54.6% in 2014, compared to as much as 118.3% in non-OIC developing countries and 120% in developed countries. Apparently, the financial sector in the member countries lag behind in the provision of sufficient liquidity and better investment opportunities to the economy at lower cost. This state of affairs partially manifests itself in low levels of credit provided by the financial sector as % of GDP. In 2014, the financial sector on average provided credit to the domestic economy as much as 49.2% of the GDP in OIC countries whereas, in non-OIC developing countries, this figure was 112.2% (Figure 2.10, right). Domestic credit by financial sector in developed countries, on the other hand, was on average in the excess of twice the size of GDP in 2014 (204.5%).

The degree of **financial development** varies substantially across the OIC countries. While some member countries have relatively more advanced financial systems including vibrant banking, insurance and other financial institutions, and effective financial regulatory and supervisory regimes; many others lag behind in terms of their stages of financial development. This, in turn, offers a significant room for improvement of financial systems in OIC countries.

Taking into account the widely accepted view that the financial deepening confers important stability benefits to the economy, albeit with caveats, many OIC countries are apparently deprived of these stability benefits. Yet, there are some exceptions to

Figure 2.13: External Debt (left) and Term Structure of External Debt (right)



Source: World Bank WDI.

this such as Lebanon, Malaysia, Libya and Jordan where financial depth, as measured by the volume of broad money relative to GDP, is at average level of developed countries. In Lebanon, for instance, the total size of broad money which includes, inter alia, all narrow money and deposits, was more than twice the size of the GDP (256.9%), as shown in Figure 2.11. Similarly, in Malaysia, the size of liquidity in the economy corresponded to 141.8% of the GDP. In Libya, Jordan and Morocco, the relative size of broad money to GDP was more than 100%.

A report by IMF argues that financial deepening, through an increase in financial transaction volumes, can enhance the capacity of the financial system of a country to intermediate capital flows without large swings in asset prices and exchange rates (IMF, 2011). Deeper financial markets are argued to provide alternative sources of funding domestic financial market during times of international stress, limiting adverse spill-overs, as evidenced in the recent global financial crisis. Figure 2.12, in this regard, supports this argument for OIC countries by depicting the strength of relationship between broad money and availability of credit in 2014.

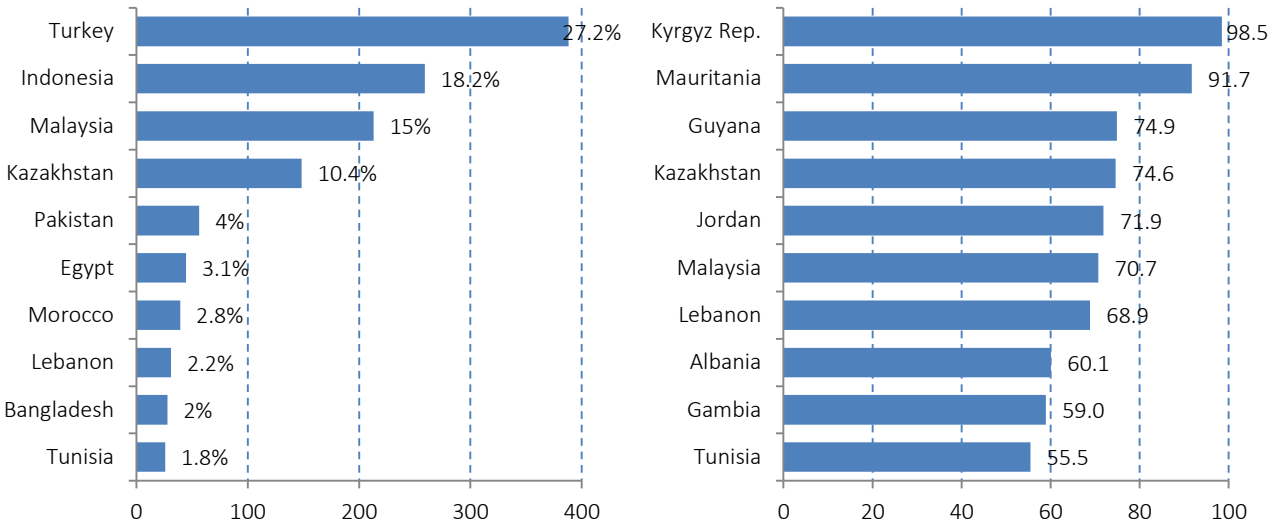
Yet, the evidence suggests that deeper financial markets can also attract volatile capital inflows, complicating macroeconomic management of the country's economy. Moreover, financial deepening can occur too quickly, leading to credit booms and subsequent busts. At the systemic level, all these factors, if properly managed, can attenuate the need to accumulate foreign assets, and, at the global level, promote global adjustment (Maziad et al., 2011).

EXTERNAL DEBT

Share of short term debts continued to expand and reached 23.8% in 2013.

The total external debt stock of OIC countries showed an increasing trend during the period under consideration. In 2013, the total external debt of OIC countries increased by

Figure 2.14: Top 10 Indebted OIC Countries (left) and Debt Stock as % of GNI (right)



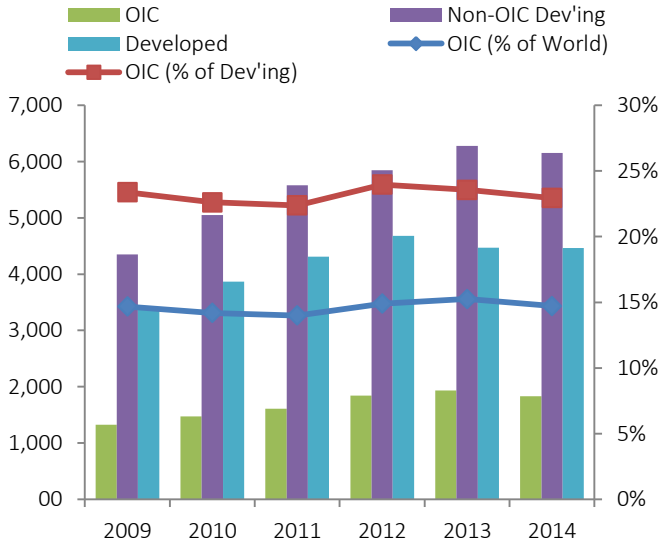
Source: World Bank WDI.

more than US$ 120 billion over the previous year's value and reached US$ 1.42 trillion. On the other hand, 21 OIC countries still continue to be classified as Heavily Indebted Poor Countries (HIPC) by the World Bank. In line with the increasing amount of debt in absolute terms, Figure 2.13 (left) illustrates that both the relative size of OIC debt to their GDP and their share in the total developing countries debt has been increasing since 2011. In this regard, average debt-to-gross national income (GNI) for the indebted OIC countries increased from 18.6% in 2011 to 20.7% in 2013. During the same period, total external debt stock of OIC countries as percentage of total developing countries debt also increased from 25.6% to 25.9%.

When the term structure of external debt of OIC countries is considered, it is observed that long-term debt continued to account for the largest portion of total OIC external debt, with 73.4% share in 2013. However, the share of short-term debt is constantly rising, which reached 23.8% in 2013 compared to only 16.7% in 2009 (Figure 2.13, right).

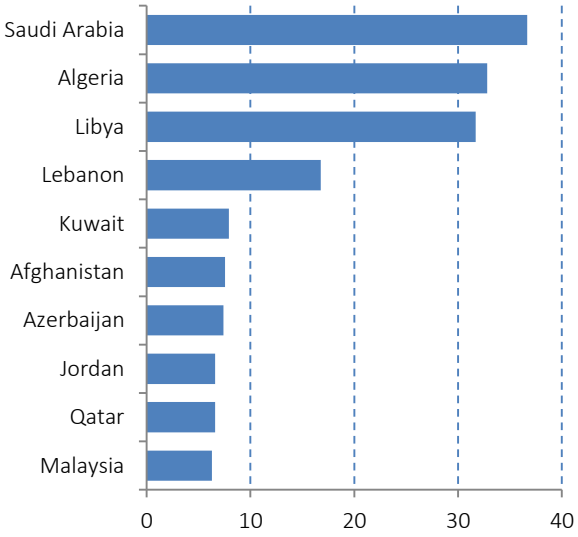
In terms of debt stock in absolute terms, Turkey was the most indebted OIC country in 2013 (Figure 2.14, left). The country held US$ 388 billion in debt which constituted 27.2% of total OIC external debt. Turkey was followed by Indonesia, Malaysia, Kazakhstan and Pakistan which had external debt levels varying from US$ 259 to 57 billion. Top 5 OIC countries accounted for as much as 74.7% of total OIC external debt whereas the top 10 countries for 86.5%. However, given the size of a country's economic output, looking at the absolute size of debt stock might be misleading. Debt-to-GNI ratio, in that sense, is argued to give a more accurate view of a country's indebtedness, adjusting it for the size of gross national income. In terms of relative size of external debt to GNI, Kyrgyz Republic, with a 98.5% debt-to-GNI, was the most indebted OIC country in 2013 (Figure 2.14, right). It was followed by Mauritania, Guyana, Kazakhstan and Jordan, with debt-to-GNI ratios varying from 91.7% to 71.9%.

Figure 2.15: Reserves including Gold (US$ Billion)



Source: World Bank WDI.

Figure 2.16: Top 10 OIC Countries by Total Reserves in Months of Exports



Source: World Bank WDI.

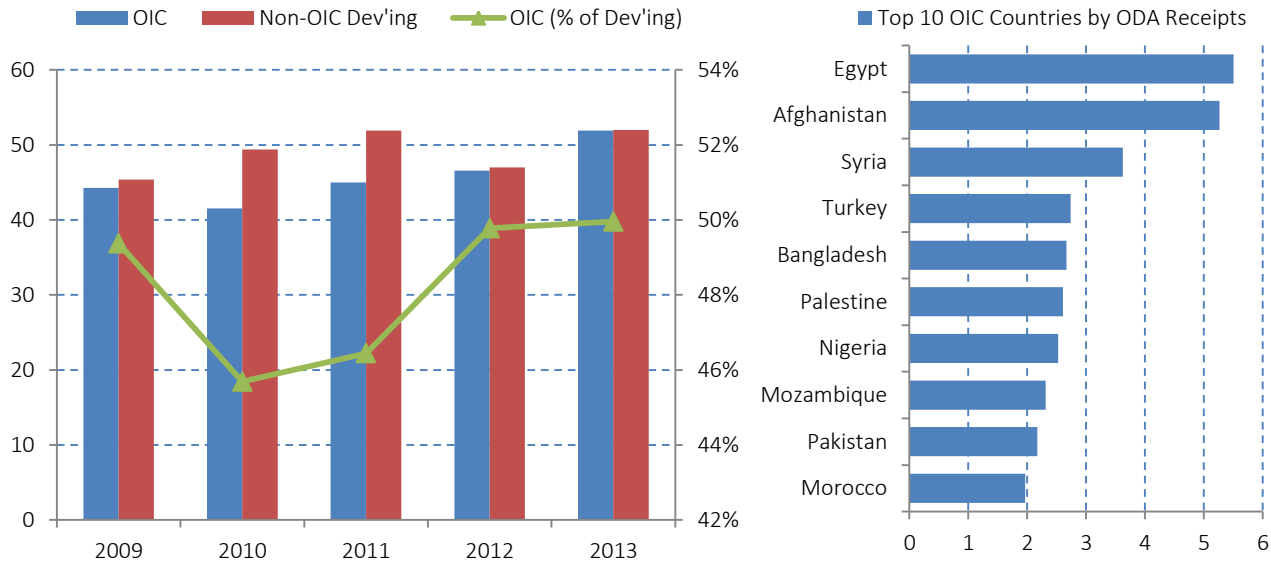
RESERVES

After many years of constant increase, total reserves of OIC countries fell in 2014.

Reserves are usually considered as an important instrument to safeguard the economy against abrupt external shocks. World total monetary reserves – including gold – increased from US$ 9 trillion in 2009 to US$ 12.5 trillion in 2014. Of this amount, US$ 4.5 trillion are possessed by developed countries while the remaining US$ 8 trillion are owned by developing countries (Figure 2.15). Total reserves of OIC countries increased from US$ 1.3 trillion in 2009 to US$ 1.8 trillion in 2014. However, the share of OIC countries in total reserves of the developing countries declined from 23.4% to 22.9% during this period. As of 2014, developing countries' share of world total reserves corresponded to around two thirds (64.1%). Although the bulk of this can be explained by the increasing trade flows from, and the resulting trade surpluses of, some emerging economies such as China, other newly industrialized countries in Asia, as well as oil exporting countries in the Middle East; the financial reform efforts in some developing countries (mainly, those with chronic current account deficits) to improve their reserves position also played a role. Capital account liberalization in some developing countries has apparently brought about the need for accumulating reserves as an insurance against financial volatilities including sudden stops/reversals of capital influx.

Figure 2.16, on the other hand, displays the top 10 OIC countries by volume of reserves in months of exports in 2014. Saudi Arabia, with reserves equivalent to 36.7 months of exports, topped the list, whereas Libya and Algeria followed closely with reserves equivalent to 32.8 and 31.7 months of exports, respectively. Only in four OIC member countries, the reserves are equivalent to more than 10 months of their exports.

Figure 2.17: Official Development Assistance, US$ Billion



Source: World Bank WDI.

ODA AND REMITTANCES

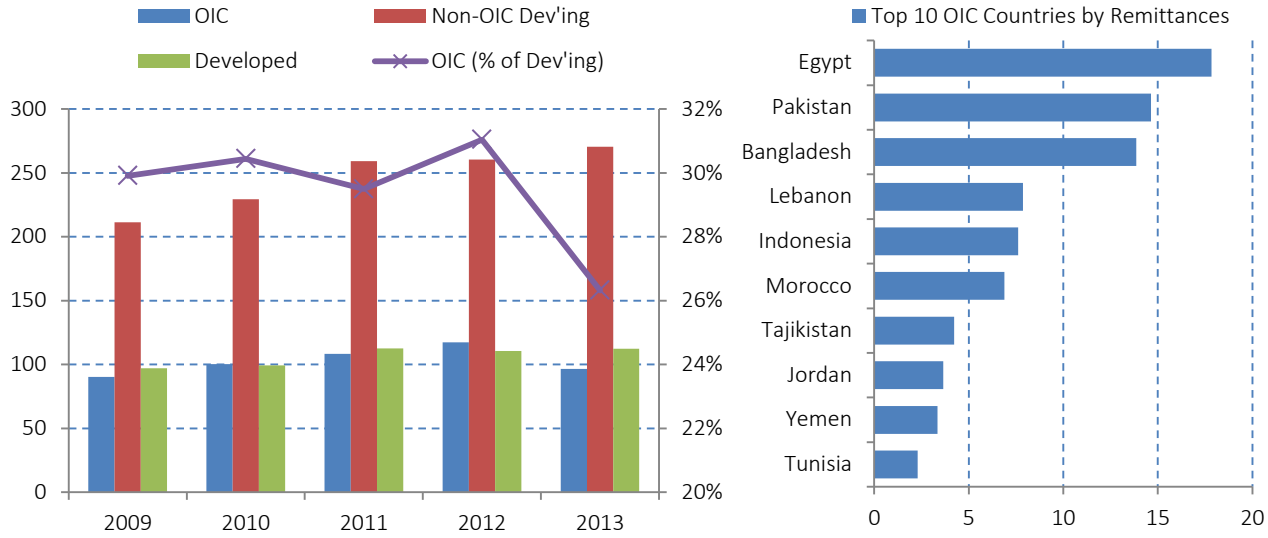
Ten OIC countries recevied 60.5% of total ODA flows to OIC countries in 2013.

Official development assistance (ODA) continues to be an important source of financing for many developing countries, including OIC countries. In 2013, net ODA flows from all donors to developing countries reached US$ 103.9 billion compared to US$ 89.6 billion in 2009 (Figure 2.17, left). Since 2010, ODA flows to OIC countries exhibited an upward trend. As of 2013, OIC countries, with US$ 51.9 billion, accounted exactly for half of the total ODA flows to developing countries, the highest share observed since 2009.

ODA inflows to OIC countries show similar characteristics, when their concentration level is concerned. In 2013, the top 5 member countries received 38.2% of total ODA flows to OIC countries whereas the top 10 received 60.5% of them (Figure 2.17, right). Egypt, with total inflows of US$ 5.5 billion and 10.6% of OIC total, ranked first. It was followed by Afghanistan (US$ 5.3 billion, 10.1%), Syria (US$ 3.6 billion, 7%), Turkey (US$ 2.7 billion, 5.3%) and Bangladesh (US$ 2.7 billion, 5.1%).

Figure 2.18, on the other hand, shows that the inflows of personal **remittances** to OIC member countries increased from US$ 108 billion in 2011 to US$ 117 billion in 2013, but sharply declined to US$ 96.6 billion in 2013. As the financial and economic crisis of 2008 affected the economies of the developed countries at first place, significant number of immigrant workers from developing countries experienced fall in their incomes as a major source of remittances to their home countries. This resulted in a decrease in remittance flows to OIC as well as non-OIC developing countries. Remittance flows to non-OIC developing countries, on the other hand, relatively improved during the examined period and increased from US$ 260 billion in 2011 to US$ 270 billion in 2013.

Figure 2.18: Personal Remittances, US$ Billion



Source: World Bank WDI.

At the individual country level, it is observed that even a more significant portion of inward remittance flows to OIC countries concentrate on a few members. In year 2013, 63.9% of the remittance flows to OIC countries were accounted by the top 5 countries whereas 85% by the top 10 countries (Figure 2.18, right). In the list of top remittance receivers in the OIC region, Egypt took the first place with US$ 17.8 billion of remittances inflows or 18.5% of remittances inflows to OIC countries. It was followed by Pakistan (US$ 14.6 billion, 15.1%), Bangladesh (US$ 13.9 billion, 14.3%), Lebanon (US$ 7.9 billion, 8.1%) and Indonesia (US$ 7.6 billion, 7.9%).

Part II

Promoting **Investment** for **Development** in OIC Countries

This part includes:

3. Investment, Growth and Development
4. Improving Effectiveness of Public Investment
5. Leveraging Private Investment
6. Trends and Policies in Attracting Foreign Direct Investment
7. Policy Issues for Effective Investment Promotion and Facilitation

PART II

This special Part of the *OIC Economic Outlook 2015* provides a comprehensive overview of investments in OIC member countries under the theme of "*Promoting Investment for Development*". It highlights the current investment climate in OIC countries and sheds light on the state of public, private and foreign direct investments as well as on some policy issues related to improving efficiency and attracting investments.

In this context, section 3 reviews the literature on the importance of investment for economic growth and development, briefly analyses the linkages between investment and growth in the case of OIC countries, and ends with a deeper analysis of the investment climate in OIC countries. Section 4 focuses on how to improve the effectiveness of public investment. Section 5 discusses the issues related to participation and encouragement of private sector in investment for development. Section 6 highlights some major issues related to foreign direct investment (FDI) and assesses FDI policies and institutional framework in OIC countries. Finally, section 7 provides some policy recommendations on how to promote and facilitate investment in OIC countries.

SECTION 3

Investment, Growth and Development

The development trajectory to high income levels is often multifaceted and requires overcoming many obstacles at different stages of development. The problems faced by developing economies are generally of similar characteristics. These countries need to tackle various issues including, among others, improving productive base of the economy by building up the physical and human capital stocks, ensuring full employment, enhancing productivity and competitiveness, achieving economic diversification, and dealing with some fiscal and monetary policy challenges. Despite serious concerns on resources and potentials, many developing countries are struggling to achieve their development goals and fulfil their aspirations for prosperity. This has led many developing countries to fundamentally re-examine their development policies and in the process discover the importance of investment (local and foreign, private and public) as a crucial driving force behind economic growth, development, modernization, income growth, poverty reduction and employment creation.

Against this backdrop, this section sets the stage for Part II of this report "*Promoting Investment for Development in OIC Countries"*. This section starts with a short review of the literature on the importance of investment for economic growth and development before moving on to analyse the linkages between investment and growth in the case of OIC countries. The section then concludes with a detailed analysis of the investment climate in OIC countries.

3.1 Role of Investment in Economic Growth and Development

The role of investment in fuelling economic growth and development is not anecdotal, but one that is proven empirically and theoretically (Caballero, 1999). Additionally, evidence on the predominant role of investment for long-run growth has been supported by cross country and

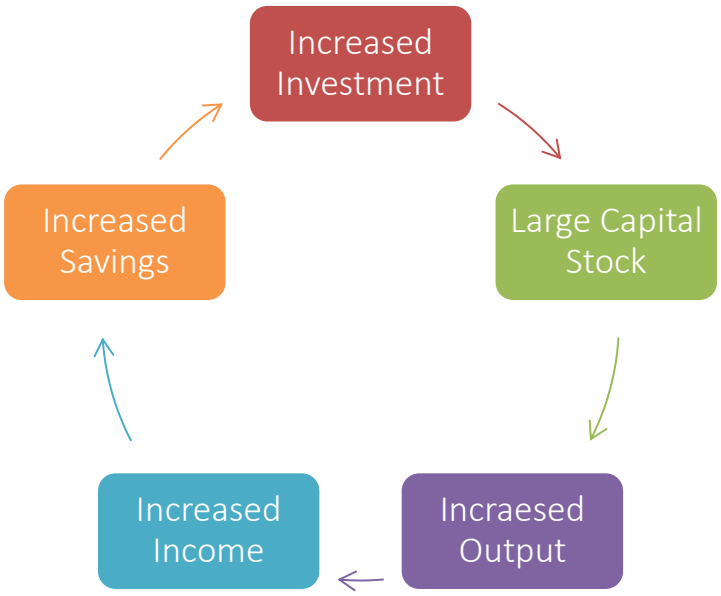
country-level analysis indicating that there is a positive association between investment and growth, as has been shown in the case of many African countries (UNCTAD, 2014).

A high investment rate is a key differentiating feature of countries that enjoy sustained high growth rates. In countries where growth is high, total domestic and foreign investment often exceeds 25% of gross domestic product (GDP). On the opposite side, countries with low investment rates often struggle with low growth rates. Case in point is Sub-Saharan Africa, where gross capital formation has hovered at around 18% of GDP for the last two decades (OECD, 2006). Where investment is low, the productive capacity of the economy fails to increase. This results in lower rates of growth and job creation and fewer opportunities for the poor masses to break away from the poverty cycle.

The manner in which investment leads to economic growth is best explained by the Harrod-Domar Growth Model illustrated in Figure 3.1. As shown in the figure, the model stresses the importance of savings and investment as key determinants of growth. Basically, the model suggests that investment can increase the capital stock of an economy and generate economic growth through the increase in production of goods and services. Extending the logic presented by the Harrod-Domar growth model we can link investment to development as follows: increased investment leads to increased income which helps generate revenue for governments to achieve development through expanding access to health, education and infrastructure services, which in turn, increases productivity and lead to economic growth.

Figure 3.1

Harrod-Domar Growth Model



In general, countries at every stage of development, but particularly the developing countries, are in need of more investment in many sectors to promote growth and productivity. Investment in infrastructure is particularly important for the development of least developed countries (LCDs). LCDs generally suffer from insufficient, inappropriate and poorly maintained infrastructure. Investing in infrastructure makes it possible for producers to use modern technology, and by introducing modern technology to producers, infrastructure expansion directly stimulates productive activities. Furthermore, investment in education and training produces skilled and more productive labour. Investment in agriculture is vital for reducing poverty. Investment in agricultural research and extension services improves and facilitates the dissemination of the results of scientific researches which then lead to an increase in production (Anwer & Sampath, 1999.) Also investment produces trade related benefits for developing countries by its long-term contribution

to the integration of these countries to the world economy through the process of higher imports as well as exports.

However, the focus should not be on the quantity of investment. The World Bank's 2005 World Development Report (World Bank, 2004) highlighted that it is not just the quantity of investment that matters for promoting growth. What ultimately counts are the productivity gains that result from product and process innovations brought about through investments, as well as the extent to which jobs and capital flow from declining industries to expanding and emerging economic activities. The investment climate consequently needs to provide opportunities and incentives for firms and entrepreneurs to develop, adapt and adopt better ways of doing Business (World Bank, 2014).

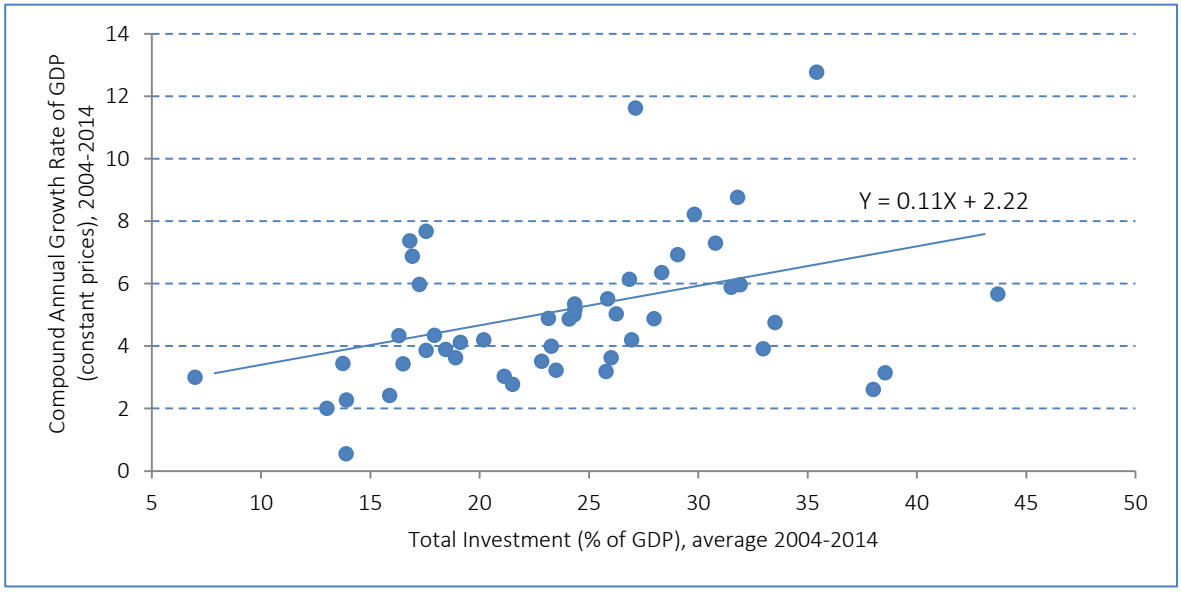
3.2 Investment and Growth in OIC Countries

The role of investment in fuelling economic growth and development appears to be critical. Figure 3.2 shows the relationship between total investment and economic growth in the case of the OIC countries. It is clear that there is a positive correlation between total investment (as % of GDP) and economic growth; that is, as the total investment increases in an economy so does economic growth. More specifically, a one percentage point increase in total share of investment in GDP is associated with a 0.11 percentage point increase in economic growth.

Taking into account the importance of investment for growth and development it is useful to compare the amount of investment in the economies of the OIC countries to other country groups. Figure 3.3 demonstrates that the weighted average of total investment as percentage of GDP in OIC countries is significantly lower than that observed in non-OIC developing countries. In OIC countries total investment (as % of GDP) stands at 24.9% while in non-OIC developing countries it stands at 33.3%. However, it is well above the rate observed in developed countries (20.7%).

Figure 3.2

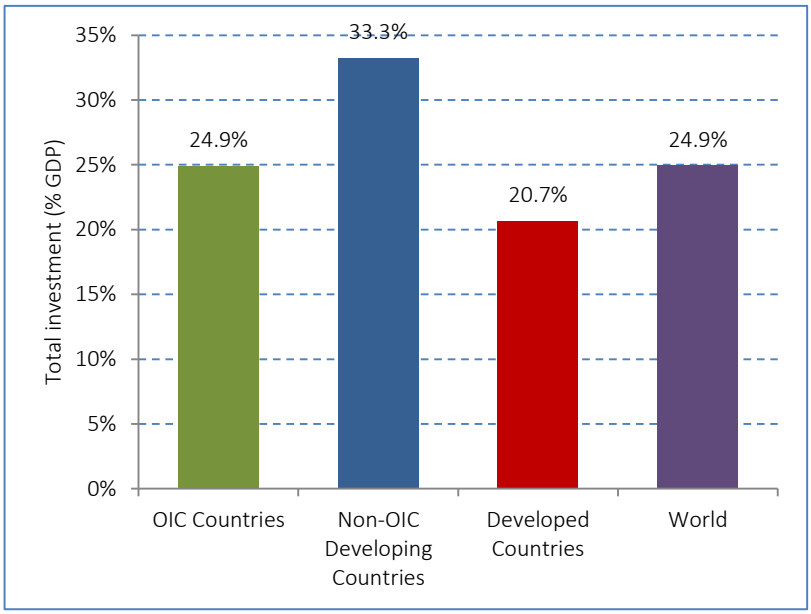
Correlation between Investment and Growth in OIC Countries



Source: SESRIC Staff Calculations based on IMF WEO Database April 2015.

Figure 3.3

Total Investment as a percentage of GDP, 2014



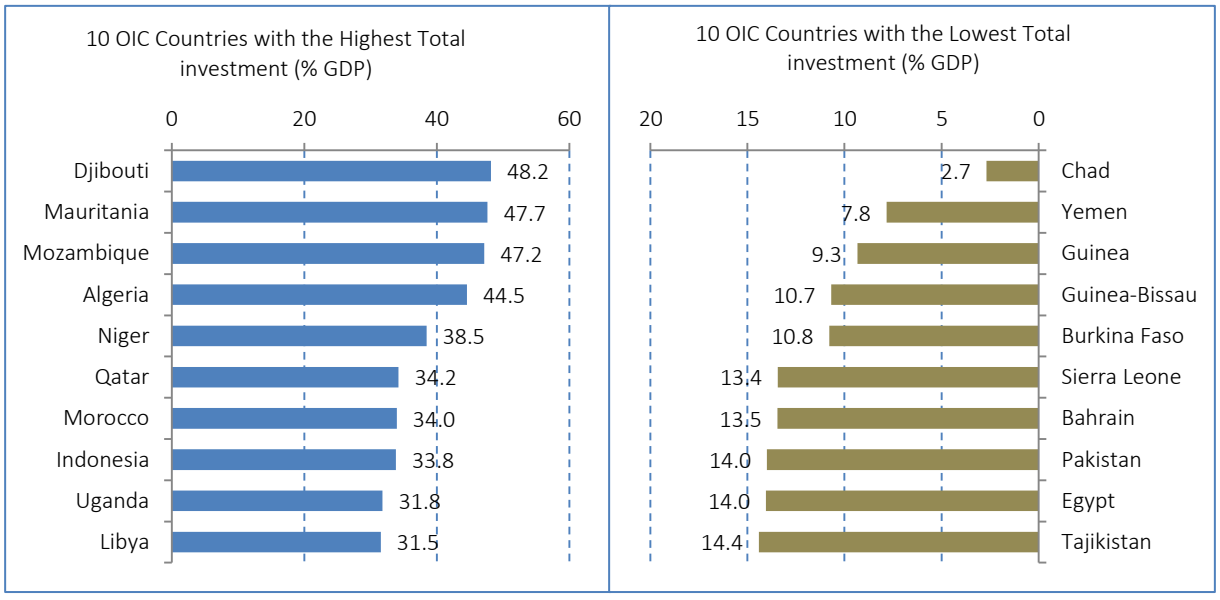
Source: SESRIC Staff Calculations based on IMF WEO Database April 2015.

At the individual country level, the level of investment differs considerably among the OIC countries (Figure 3.4). The highest level of total investment as percentage of GDP is observed in Djibouti (48.2%), followed by Mauritania (47.7%) and Mozambique. On the other side of the scale, the lowest level of total investment as percentage of GDP is observed in Chad (2.7%) followed by Yemen (7.8%) and Guinea (9.3%).

One type of investment that is the focus of considerable attention is foreign direct investment (FDI). According to the International Monetary Fund (IMF), foreign direct investment refers to an investment made to acquire lasting interest in enterprises operating outside of the economy of the investor. Further, in cases of FDI, the investor´s purpose is to gain an effective voice in the management of the enterprise. Figure 3.5 shows that the correlation between FDI and economic growth in OIC countries is also positive but quite weak. This indicates that the impact of

Figure 3.4

OIC Countries with the Highest and Lowest Total Investment as a percentage of GDP, 2014

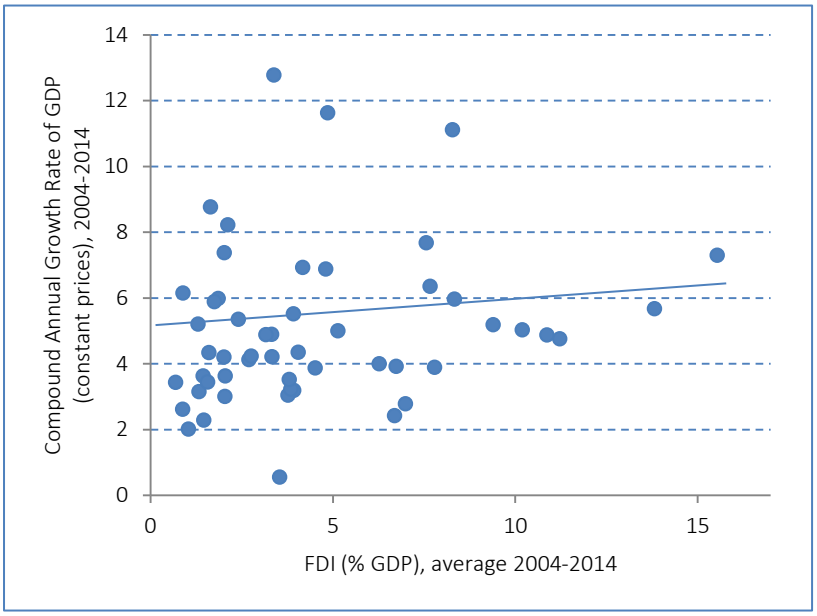


Source: IMF WEO Database April 2015. Data were available for 51 OIC countries. Data were not available for Iraq, Palestine, Somalia, Suriname, Syria, and Turkmenistan.

FDI on economic growth in OIC countries is very limited. The reason that FDI has very limited impact on economic growth in OIC countries can be attributed to three sets of reasons: crowding out of local investments, quality of FDI and absorptive capacity of OIC countries.

Figure 3.5

Correlation between FDI and Growth in OIC Countries



Source: SESRIC Staff Calculations based on UNCTAD-Stat and IMF WEO Database.

In some cases, FDI crowds out local investment because local firms cannot compete with foreign firms due to limitations in size, financing and marketing power. In addition, expatriation of profits by foreign investors may lead to stagnant growth in the host country and transfers demand to the international market rather than the domestic market (Reis, 2002).

Quality of FDI is crucial for inducing growth in the economy. Alfaro and Charlton (2007) emphasize the critical role of sectorial composition of FDI inflows on the potential spillover advantages derived from FDI, as those advantages differ markedly across primary, manufacturing and services sectors. For example, FDI in the extractive sector may have limited beneficial spillovers for growth as it often involves mega projects that rarely employ domestically-produced intermediate goods or labour (Lim, 2001). The policy implication for OIC countries is that the policies are needed to direct FDI inflows to the dynamic sector of the economy and the emphasis should be on the quality of FDI and not the quantity.

Finally, for economies to reap benefits from FDI, they need to possess the necessary absorptive capacities in terms of institutional quality (Antras, 2003), human capacity, economic development, and financial development (Hermes & Lensink, 2004; Makki & Somwaru, 2004). These issues are discussed more in detail in section 6 of the Report.

3.3 Investment Climate in OIC Countries

Different economic performances observed in OIC countries are definitely linked to the variation in business and investment climate in these countries. There are many indicators that are used to assess the business and investment climate; however, no single indicator can be said to be superior to others. Moreover, it would not be feasible to develop an all-embracing methodology that can generate all the information needed for all types of investment climate policy analyses. This being said, some indicators stand out and are more frequently utilized and referenced in research. In this regard, the World Bank Doing Business indicators appear to be the most widely used and well regarded index of business and investment climate. For this reason the World Bank Doing Business

indicators will be utilized in this subsection of the report in order to assess and analyse the investment climate in OIC countries.

The Doing Business indicators measure business regulations and their enforcement from the perspective of a small to medium-size domestic firms. The ease of doing business indicator is a composite index of 10 sub-indicators that are: starting a business; dealing with construction permits; getting electricity; registering property; getting credit; protecting investors; paying taxes; trading across borders; enforcing contracts; and resolving insolvency.

In addition to focusing on the overall indicator, which is the doing business indicator, the following subsections will also pay attention to four sub-indicators which are: staring a business, getting electricity, getting credit and enforcing contracts. The rationale behind the selection of these four sub-indicators is as follows: starting a business indicates how conductive the investment and business climate are for entrepreneurs and entrepreneurship activities. Entrepreneurship activities by small and medium size companies in OIC countries carry an important weight in determining whether OIC countries will be able to accomplish their economic growth goals and create jobs. According to the findings of the World Bank Enterprise Surveys Dataset, access to electricity and finance are the most cited obstacles for all businesses including SMEs in the developing countries. This is why the sub-indicators of getting electricity and getting credit are chosen for further analysis. Finally the enforcing contract sub-indicator is selected because it indicates the efficiency of the judicial system without which investments cannot prosper.

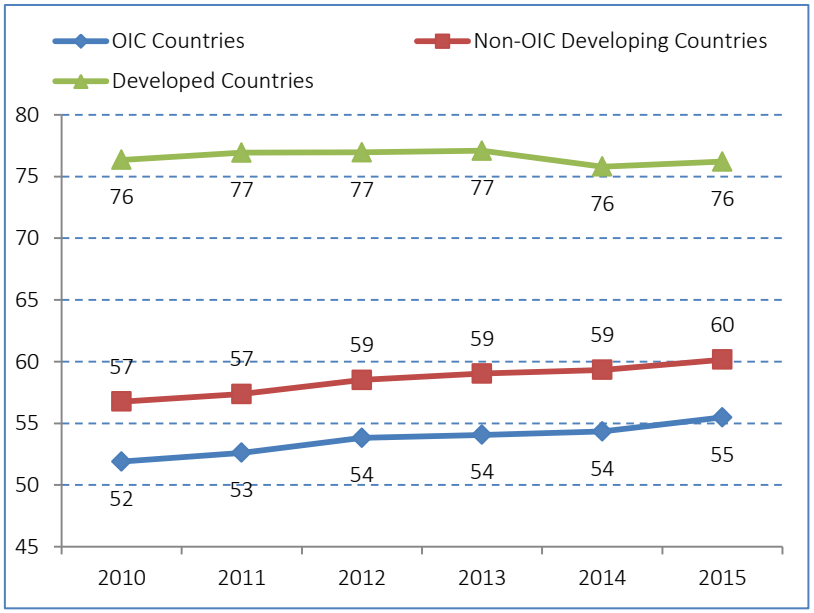
In presenting the results of the doing business indicators, the World Bank utilizes the "Distance to Frontier" concept. The distance to frontier shows the distance of each economy to the "frontier," which represents the best performance observed on each of the indicators across all economies in the Doing Business dataset since 2005. An economy's distance to frontier is reflected on a scale from 0 to 100, where '0' represents the lowest performance and '100' represents the frontier. For example, a score of 75 in a Doing Business in 2014 means an economy was 25 percentage points away from the frontier constructed from the best performances across all economies and across time. A score of 80 in Doing Business in 2015 would indicate the economy is improving.

3.3.1 Ease of Doing Business

Figure 3.6 shows the average value of ease of doing business indicator for OIC countries in comparison to other country

Figure 3.6

Ease of Doing Business Index



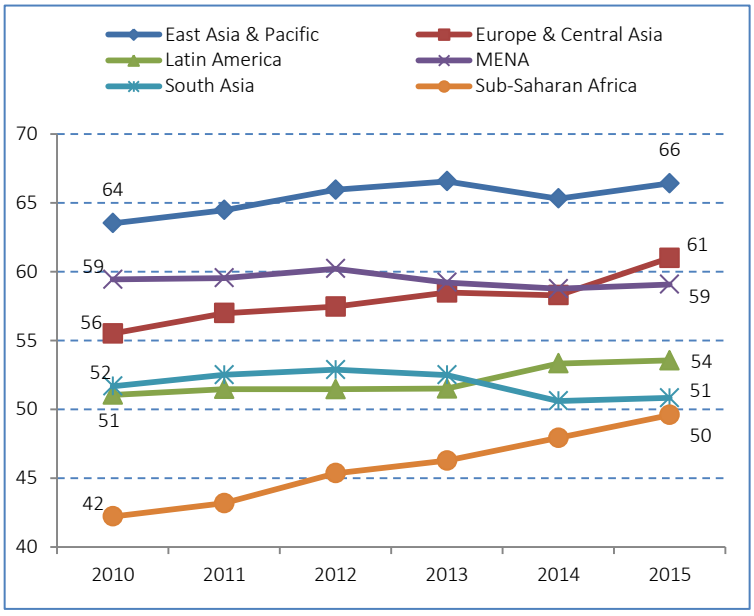
Source: SESRIC Staff Calculations based on World Bank Doing Business Dataset, 2015.

groups. As can be seen from the figure, the business environment in OIC countries is rather poor compared with both non-OIC developing countries and developed countries. In 2015 the average score for OIC countries was 55.5, which is behind the score of 60.2 recorded by non-OIC developing countries and 76.2 recorded by developed countries. However, the business environment in OIC countries has been improving steadily over time. OIC countries have been able to raise their average score from 51.9 in 2010 to 55.5 in 2015. This increase is in line with the increase observed in non-OIC developing countries.

The best business environments, as measured by the ease of doing business index, are observed in OIC countries in East Asia, which recorded an average score of 66.4 in 2015, while the least favourable business environment was observed in OIC countries in Sub-Saharan Africa which recorded a low score of 49.6, as depicted in Figure 3.7. Nonetheless, OIC countries in Sub-Saharan Africa have been improving their business environment over the past few years. In fact, the largest improvement on the index has been achieved by OIC countries in Sub-Saharan Africa by

Figure 3.7

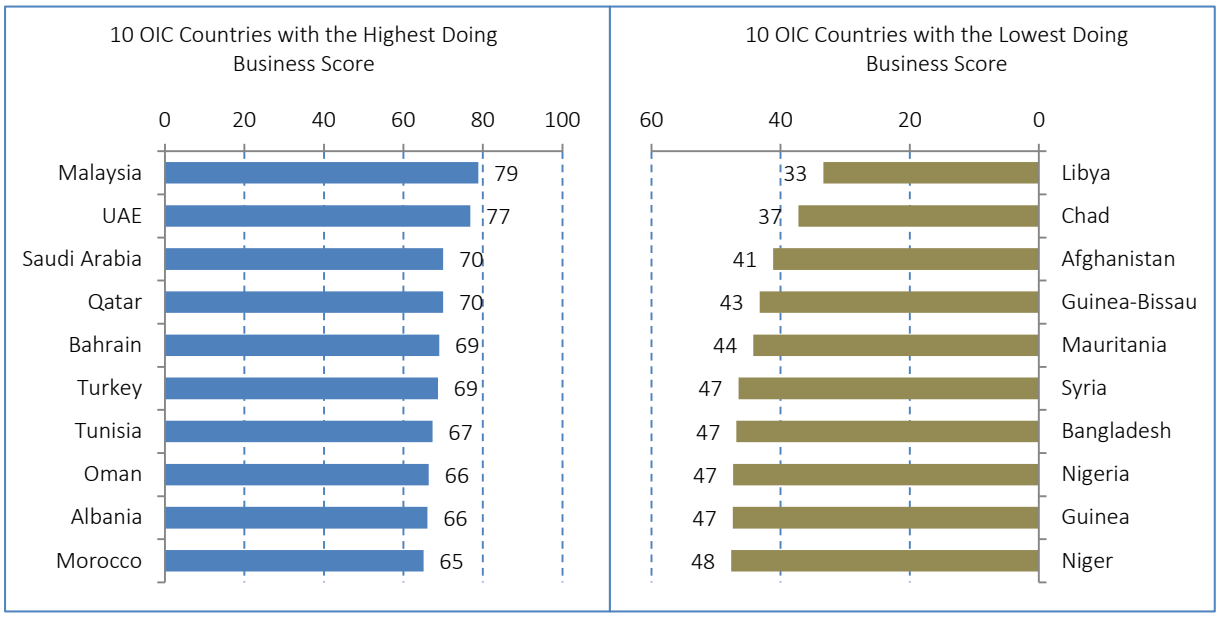
Doing Business Indicator in OIC Regions



Source SESRIC Staff Calculations based on World Bank Doing Business Dataset, 2015.

Figure 3.8

OIC Countries with the Highest and Lowest Doing Business Score in 2015



Source: World Bank Doing Business Dataset, 2015.

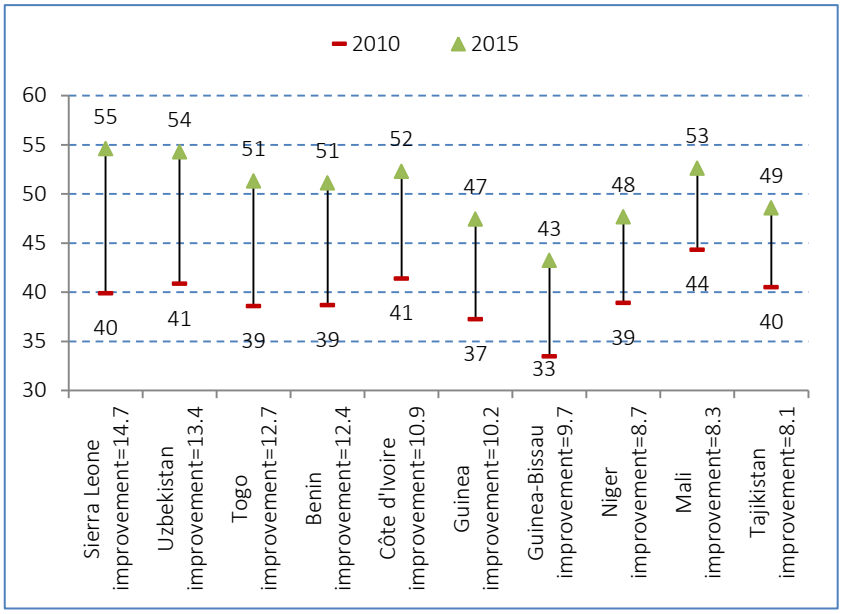
increasing their average score from 42.2 in 2010 to 49.6 in 2015. OIC countries in Europe and Central Asia and OIC countries in East Asia & Pacific have also improved their average performance, albeit at a slower rate than that of OIC countries in Sub-Saharan Africa. Contrary to the general trend observed in OIC countries as a group, OIC countries in the Middle East & North Africa and OIC countries in South Asia have witnessed deterioration in their business environments as measured by the ease of doing business index. The average score for OIC countries in the Middle East & North Africa has receded from 59.4 in 2010 to 59.1 in 2015 and in OIC countries in East Asia has receded from 51.7 in 2010 to 50.8 in 2015.

The OIC country with the highest score on the ease of doing business index in 2015 is Malaysia with a score of 78.8. Malaysia was closely followed by UAE with a score of 76.8 and Saudi Arabia with a score of 70.0 (Figure 3.8). Figure 3.8 indicates that the Gulf Cooperation Council (GCC) countries are performing well with all member countries (except for Kuwait) making it to the OIC top 10 list. On the other hand, the OIC country with the lowest score on the index is Libya, which is given a low score of 33.3 in 2015. Libya is followed by Chad with a score of 37.3 and Afghanistan with a score 41.2. It is observed that the majority of the countries (6/10) in the bottom 10 list of OIC countries are from the Sub-Saharan Africa region.

Over the past five years some OIC countries have made good strides in improving their business environment, as indicated in Figure 3.9. Sierra Leone has made the largest improvement with a 14.7 point jump from a score of 39.9 in 2010 to a score of 54.6 in 2015. This can be attributed to the reforms undertaken by Sierra Leone that have improved its score in the sub-indicators of getting electricity, registering property (Sierra Leone made registering property easier by introducing a fast track procedure, see World Bank 2014), paying taxes and enforcing contracts. Sierra Leone is followed by Uzbekistan, which enjoyed a 13.4 point improvement from a score of 40.8 in 2010 to 54.3 in 2015. In addition to making significant improvements in the areas of starting a business, registering property, paying taxes, and resolving insolvency, Uzbekistan was also able to improve in the area of protecting investors by introducing a requirement for public joint stock companies to disclosure information about related party transactions in their annual report, setting higher standards for disclosure, and establishing the right of shareholders to receive all documents related to such transaction (World Bank, 2014). The third largest improvement between the years 2010 and 2015 was achieved by Togo with a 12.7 point increase. Togo had great success in the areas

Figure 3.9

OIC Countries Achieving the Greatest Improvement (2010 vs 2015)



Source: World Bank Doing Business Dataset, 2015.

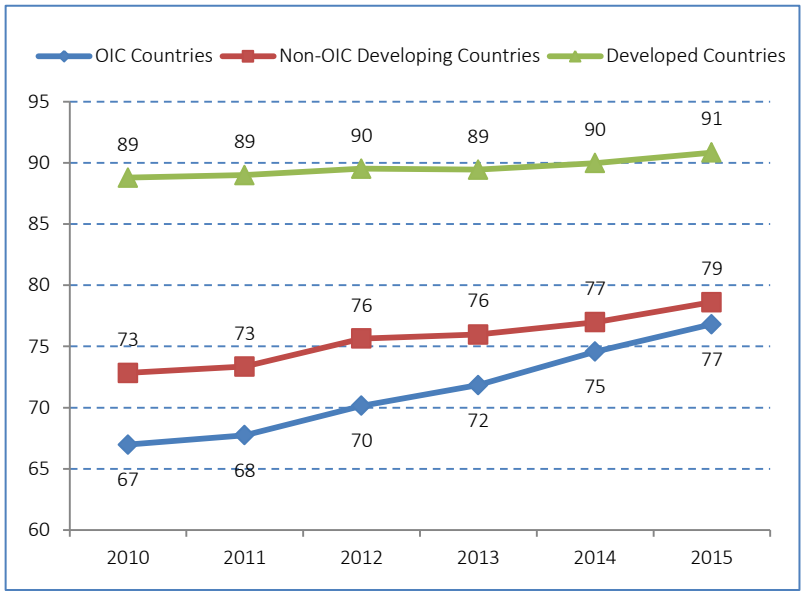
of: starting a business, dealing with construction permits, getting credit and resolving insolvency.

3.3.2 Starting a Business

The starting a business indicator records all procedures officially required, or commonly done in practice, for an entrepreneur to start up and formally operate an industrial or commercial business, as well as the time and cost to complete these procedures and the paid-in minimum capital requirement. Figure 3.10 shows how OIC countries fair against other country groups on the *starting a business indicator*. Although OIC countries score lower on this indicator than developed countries and non-OIC developing countries, their performance is improving the greatest. OIC average score on this index has improved from 67.0 in 2010 to 76.8 in 2015 and OIC countries are on the way to close the gap with the score achieved by non-OIC developing countries.

Figure 3.10

Starting a Business Indicator

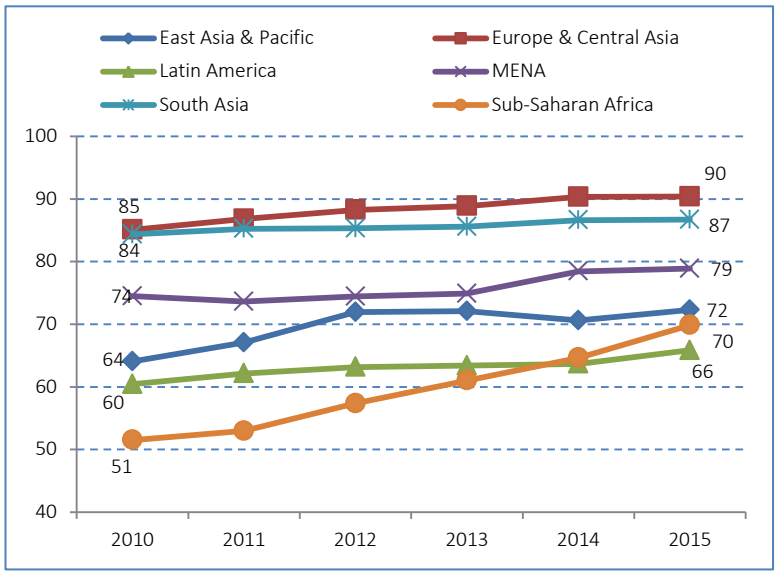


Source: SESRIC Staff Calculations based on World Bank Doing Business Dataset, 2015.

The highest score on Starting a Business indicator was achieved by OIC countries in Europe and Central Asia, as shown in Figure 3.11. OIC Countries in Europe and Central Asia recoded a score of 90.4 in 2015 which is on par with the score observed in developed countries. OIC countries in South Asia follow closely with a score of 86.7 in 2015, and OIC countries in the Middle East and North Africa come in third place with a score of 78.9. Generally speaking, all OIC regions recorded improvements on the Staring Business indictors with the largest improvements observed in OIC countries in Sub-Saharan Africa (18.4 point increase from 51.5 in 2010 to 69.9 in 2015) followed by OIC countries in East Asia

Figure 3.11

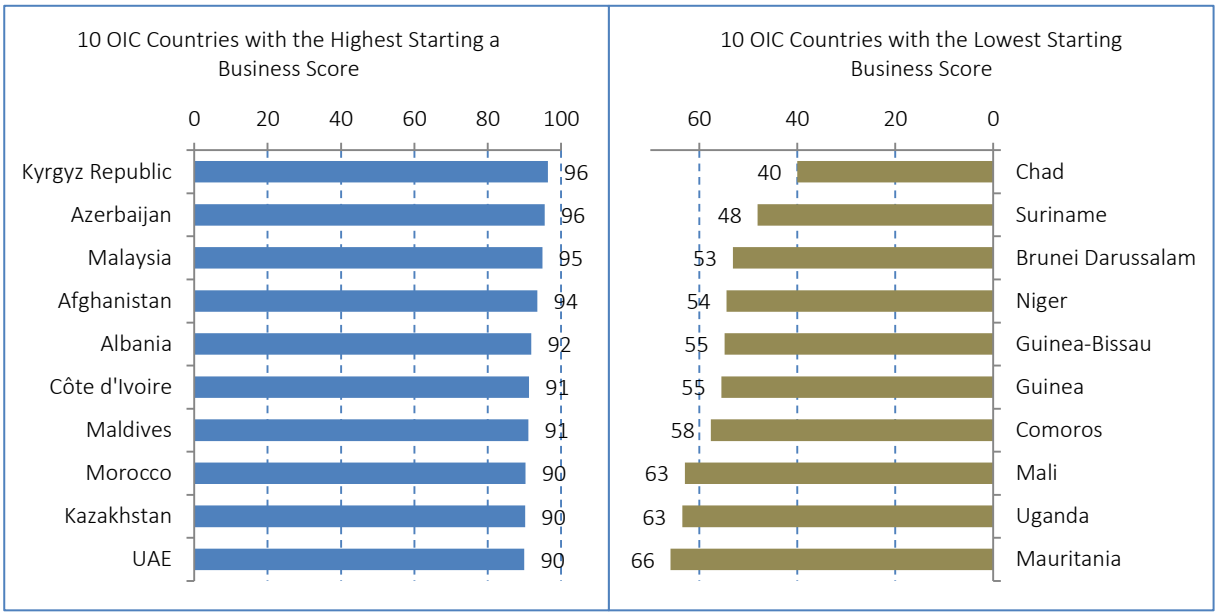
Starting a Business Indicator in OIC Regions



Source: SESRIC Staff Calculations based on World Bank Doing Business Dataset, 2015.

Figure 3.12

OIC Countries with the Highest and Lowest Starting a Business Score in 2015



Source: World Bank Doing Business Dataset, 2015.

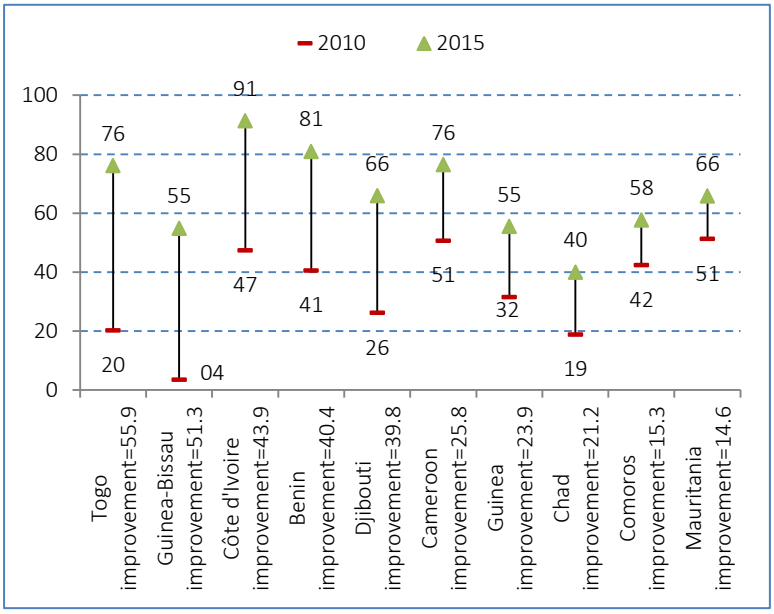
& Pacific (8.2 point increase from 64.1 to 72.3) and OIC countries Europe and Central Asia (5.3 point increase from 85.1 in 2010 to 90.4 in 2015).

Figure 3.12 shows OIC countries with the highest and lowest score on the Starting a Business indicator. All the OIC countries with the highest score on the Starting a Business indicator recorded score that are comparable to those observed in developed countries. The figure also reveals that the list of OIC countries with the lowest scores on the Starting a Business indicator is dominated by OIC countries in Sub-Saharan Africa.

Although OIC countries in Sub-Saharan Africa are given low scores on the Starting a Business indicators, they have recorded remarkable gains in the area of starting a business (see Figure 3.13). The greatest improvement in the area of starting a business is observed in Togo, which made starting a business easier by enabling the

Figure 3.13

OIC Countries Achieving the Greatest Improvement between 2010 & 2015 on the Starting a Business Indicator



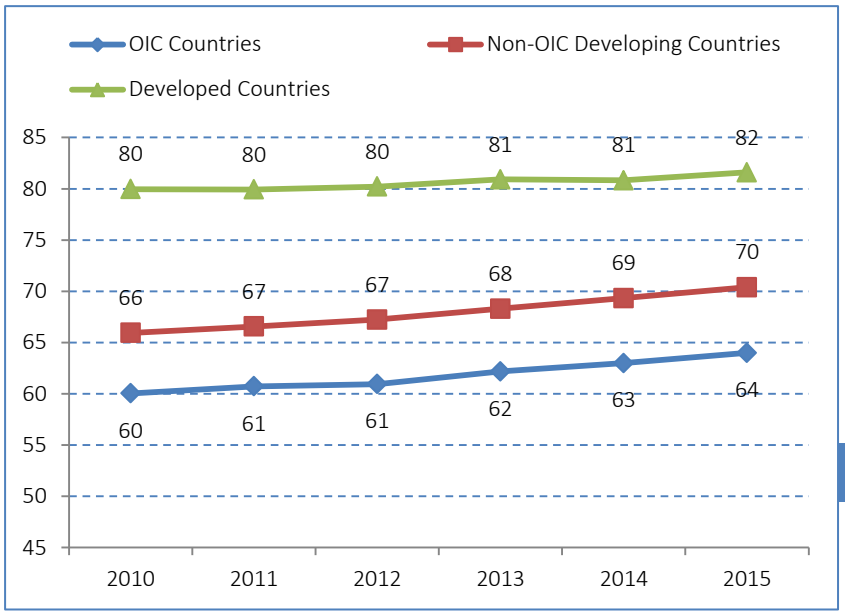
Source: World Bank Doing Business Dataset, 2015.

one-stop shop to publish notices of incorporation and eliminating the requirement to obtain an economic operator card. Togo is followed by Guinea-Bissau which recorded an impressive improvement from a score of 3.5 in 2010 to 54.8 in 2015. The third largest improvement is observed in Côte d'Ivoire which made starting a business easier by reducing the minimum capital requirement, lowering registration fees, and enabling the one-stop shop to publish notices of incorporation (World Bank, 2014).

3.3.3 Getting Electricity

As mentioned before, getting electricity is the number one obstacle faced by companies in the developing world. The Getting Electricity indicator measures all the procedures required for a business to obtain a permanent electricity connection and supply for a standardized warehouse. Figure 3.14 shows the performance of OIC countries on this indicator with comparison to other country groups. In OIC countries it is more difficult for businesses to get electricity than it is in advanced countries and in non-OIC developing countries. Although OIC countries have on average improved on the Getting Electricity indicator from a score of 60.0 in 2010 to a score of 64.0 in 2015, they still lag way behind developed countries that scored 81.6 in 2015 and non-OIC developing countries that scored 70.4 in 2015.

Figure 3.14
Getting Electricity Indicator



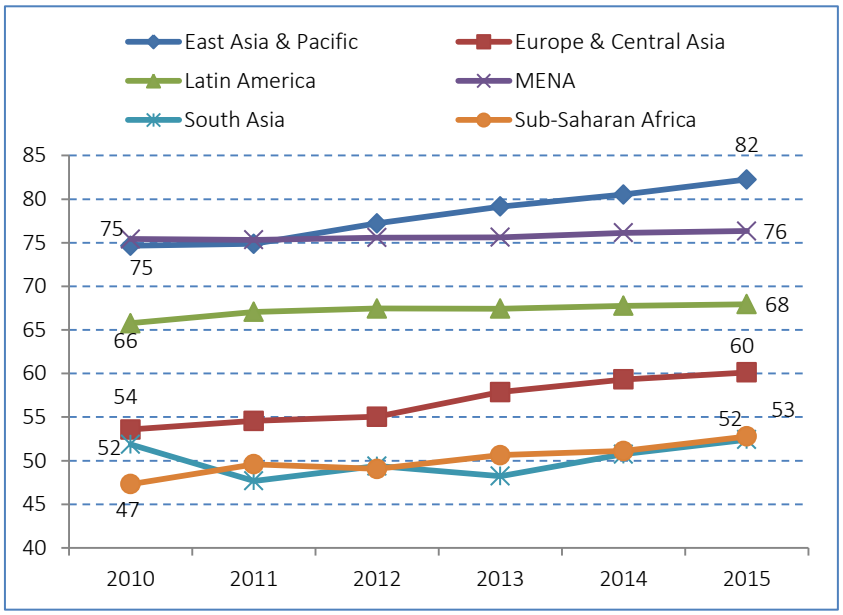
Source: SESRIC Staff Calculations based on World Bank Doing Business Dataset, 2015.

In OIC countries getting electricity is the easiest in countries located in East Asia & Pacific, followed by OIC countries located in the Middle East & North Africa and OIC countries located in Latin America (Figure 3.15). On the other side of the scale, the most strenuous challenges in getting electricity for businesses were observed in OIC countries located in South Asia, followed by OIC countries located in Sun-Saharan Africa and OIC countries located in Europe & Central Asia.

Not only do countries in East Asia & Pacific enjoy the highest score on the Getting Electricity indicator, they are also the countries that have record the largest improvement on this indicator over the past few years. This improvement has allowed them to overtake the number one spot from OIC countries located in the Middle East & North Africa. In 2010, OIC countries located in the Middle East & North Africa were ahead with a score of 75.4 compared to a score of 74.6 for OIC countries located in East Asia & Pacific; however, OIC countries located in the Middle East & North Africa were only able to modestly increase their score by a mere 0.9 point to 76.3 in 2015 compared to a significant improvement of 7.6 points to reach a score of 82.3 for OIC countries

Figure 3.15

Getting Electricity Indicator in OIC Regions



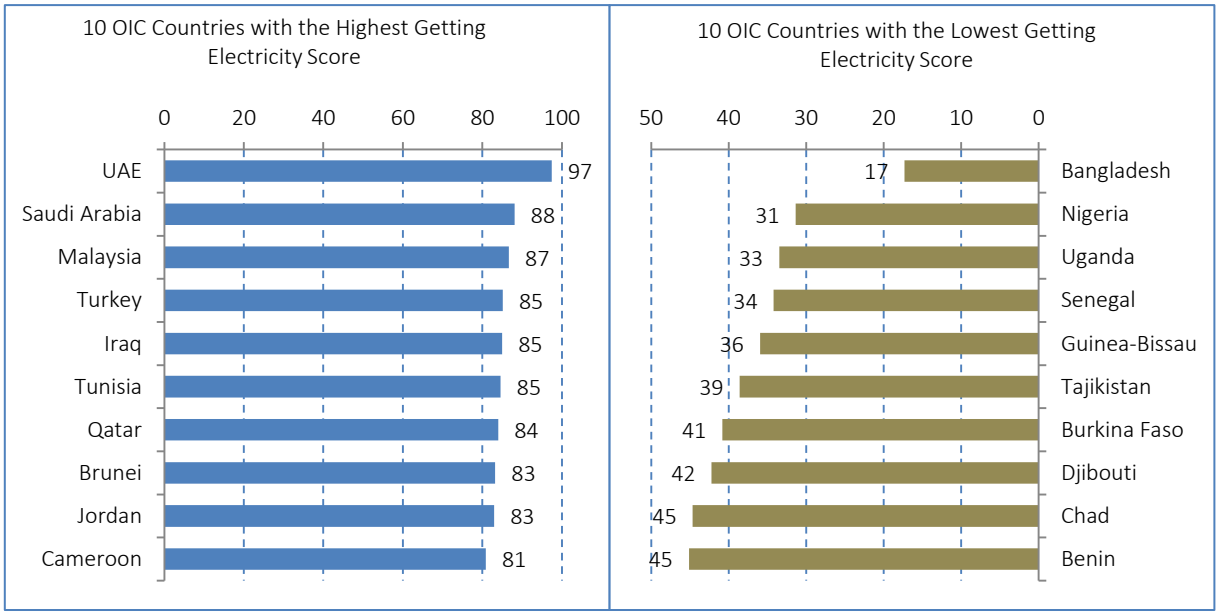
Source: SESRIC Staff Calculations based on World Bank Doing Business Dataset, 2015.

located in East Asia and Pacific. The second largest improvement is observed in OIC countries located in Europe & Central Asia that improved by 6.6 points from a score of 53.6 in 2010 to a score of 60.1 in 2015. Third in place are OIC countries located in Sub-Saharan Africa that improved by 5.5 points from a score of 47.3 in 2010 to a score of 52.8 in 2015.

At the individual country level, there is huge variability in the ease of getting electricity, as Figure 3.16 illustrates. In United Arab Emirates it is very easy for business to get electricity, a fact highlighted by the high score of 97.4 on the Getting Electricity indicator. With this high score the United Arab Emirates is ranked number four globally on the Getting Electricity indicator just behind South Korea, Taiwan and Germany. Saudi Arabia comes in second place among OIC countries with a score of 88.1 and Malaysia in third place with a score of 86.7. On the other hand, companies faced great difficulties

Figure 3.16

OIC Countries with the Highest and Lowest Getting Electricity Score in 2015



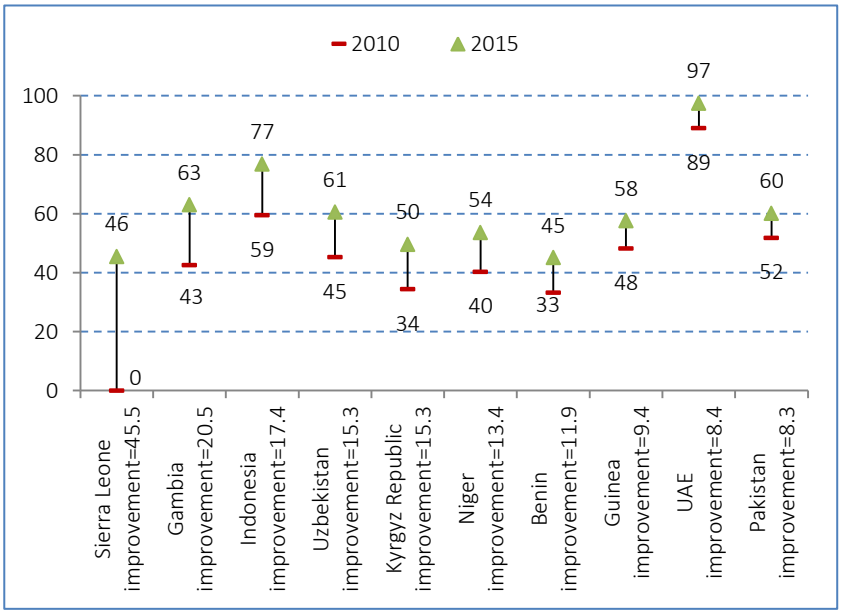
Source: World Bank Doing Business Dataset, 2015.

in getting electricity in Bangladesh which scores 17.3, followed by Nigeria with a score of 31.4 and Uganda with a score of 33.5.

The greatest improvement in getting electricity since 2010 was observed in Sierra Leone which recorded a jump of 45.5 points on the Getting Electricity indicator (see Figure 3.17). This jump can be partially attributed to reforms undertaken in Sierra Leone that made getting electricity easier by eliminating the need for customers to submit an application letter inquiring about a new connection before submitting an application and making the process faster by improving staffing at the utility. Gambia recorded the second largest improvement among OIC countries on the Getting Electricity indicator. Gambia improved from a score of 42.6 in 2010 to a score of 63.0 in 2015. Gambia is then followed by Indonesia that achieved an improvement of 17.4 points from a score of 59.5 in 2010 to a score of 76.9 in 2015. In Indonesia the electricity company in Jakarta made getting electricity easier by eliminating the need for electrical contractors to obtain multiple certificates guaranteeing the safety of internal installations (World Bank, 2014).

Figure 3.17

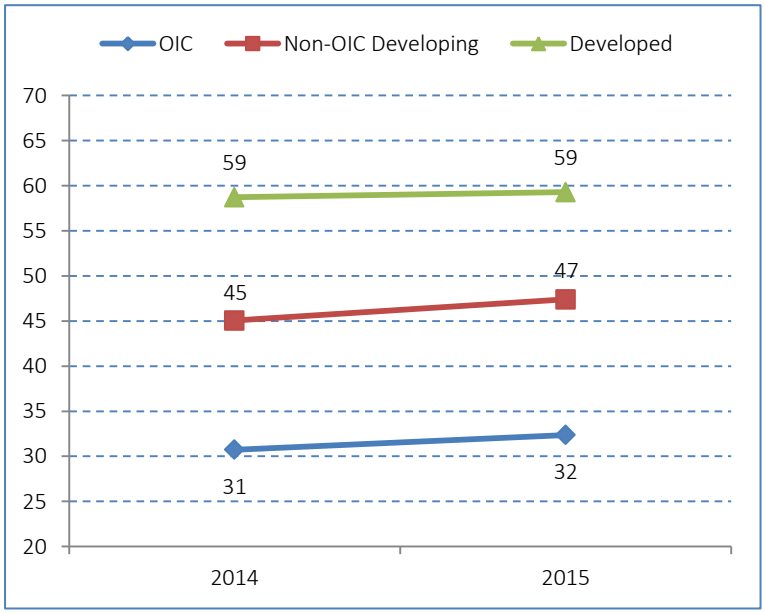
OIC Countries Achieving the Greatest Improvement between 2010 & 2015 on the Getting Electricity Indicator



Source: World Bank Doing Business Dataset, 2015.

Figure 3.18

Getting Credit Indicator



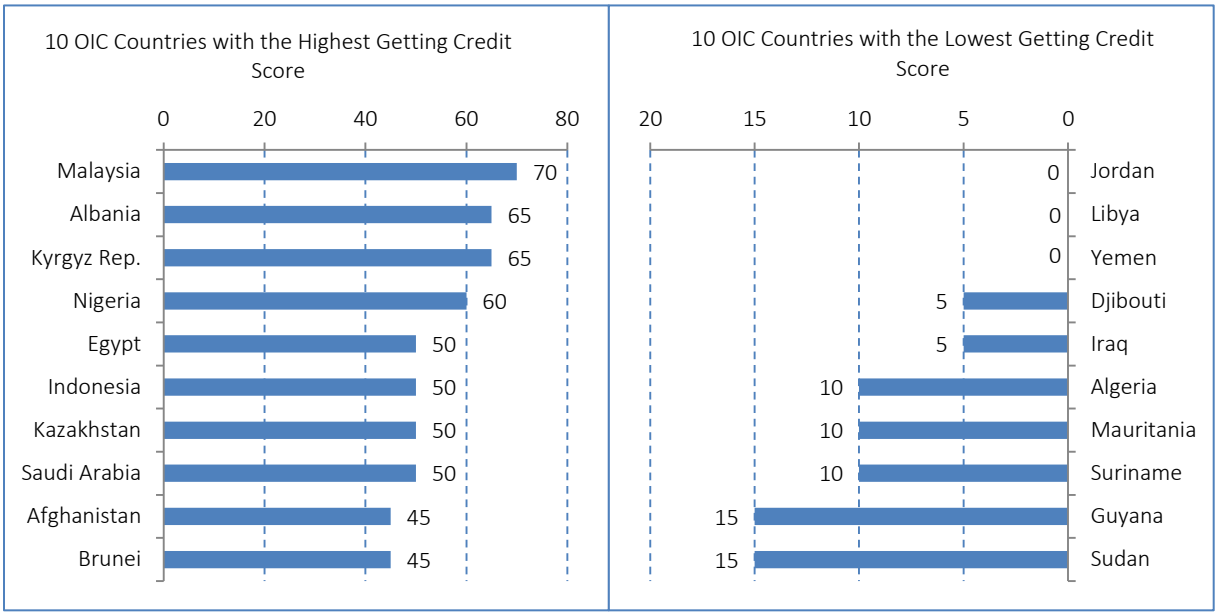
Source: SESRIC Staff Calculations based on World Bank Doing Business Dataset, 2015.

3.3.4 Getting Credit

The issue of financial inclusion is of great importance in the context of developing countries in general and OIC countries in specific. As one of the sub-indicators of ease of doing business index, the Getting Credit indicator measures the legal rights of borrowers and lenders with respect to secured transactions through

Figure 3.19

OIC Countries with the Highest and Lowest Getting Credit Score in 2015



Source: World Bank Doing Business Dataset, 2015.

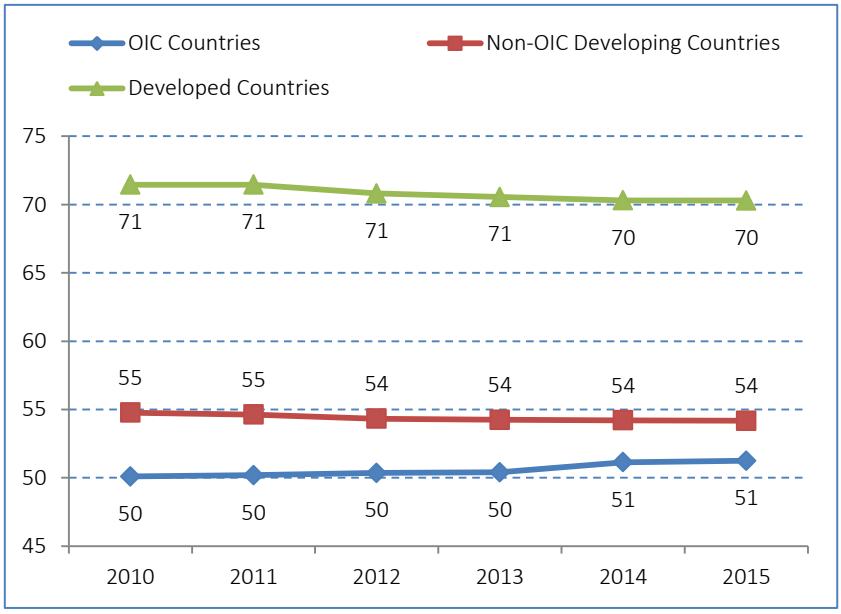
one set of indicators and the sharing of credit information through another. The first set of indicators measures whether certain features that facilitate lending exist within the applicable collateral and bankruptcy laws. The second set measures the coverage, scope and accessibility of credit information available through credit reporting service providers such as credit bureaus or credit registries.

On average, OIC countries perform poorly on the Getting Credit indicator (Figure 3.18). The average score for OIC countries was 32.4 in 2015, which is significantly lower than the average score of 47.4 for non-OIC developing countries and 59.3 for developed countries for the same year.

The highest score on the Getting Credit indicator was observed in Malaysia which registered a score of 70 (See Figure 3.19). Malaysia is followed by Albania and Kyrgyz Republic which both scored an identical score of 65. On the opposite side, three OIC countries scored

Figure 3.20

Enforcing Contracts Indicator



Source: SESRIC Staff Calculations based on World Bank Doing Business Dataset, 2015.

zero on the Getting Credit indicator, namely Jordan, Libya and Yemen.

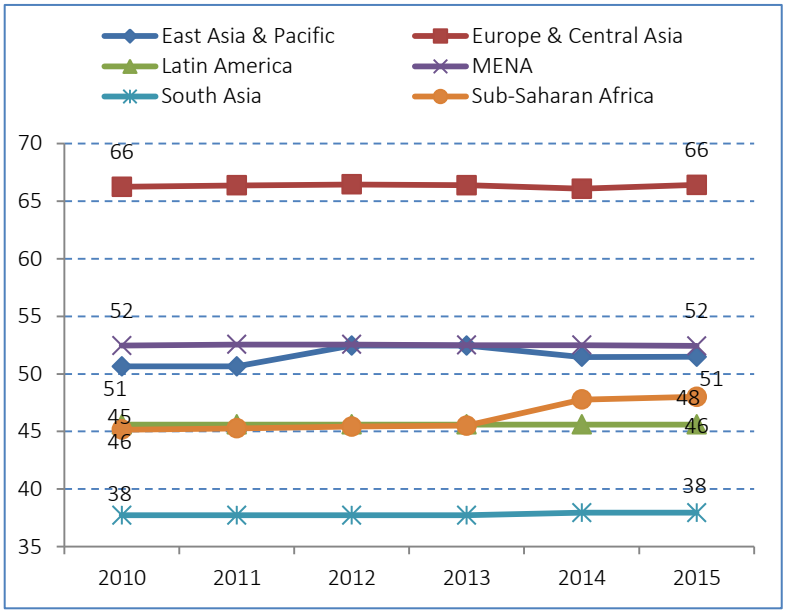
3.3.5 Enforcing Contracts

The efficiency of the judicial system in resolving a commercial dispute is also highly critical in improving the business and investment climate. On this front, OIC countries on average perform lower than non-OIC developing countries and developed countries as shown in the scores of enforcing contract index (Figure 3.20). However, one console for OIC countries would be that while both developed countries and non-OIC developing countries have witnessed a slight deterioration on this index between the years 2010-2015, OIC countries in contrast have experienced a slight improvement from a score of 50.1 in 2010 to a score of 51.2 in 2015.

In 2015, the highest average scores on the Enforcing Contract indicator was observed in OIC countries in

Figure 3.21

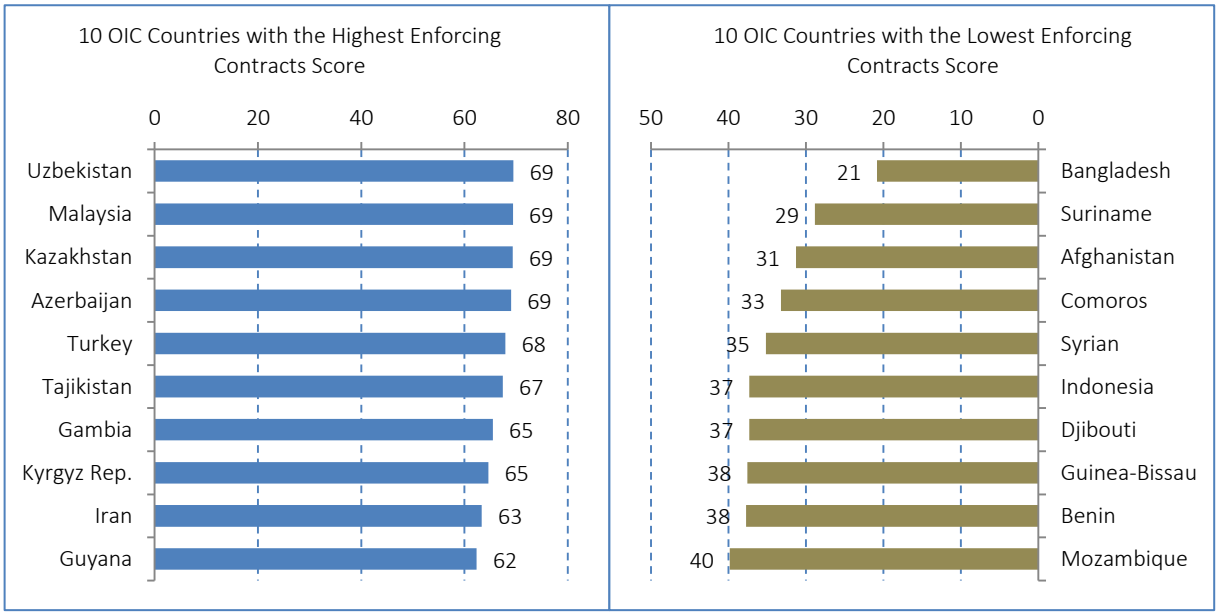
Enforcing Contracts Indicator in OIC Regions



Source: SESRIC Staff Calculations based on World Bank Doing Business Dataset, 2015.

Figure 3.22

OIC Countries with the Highest and Lowest Enforcing Contracts Score in 2015



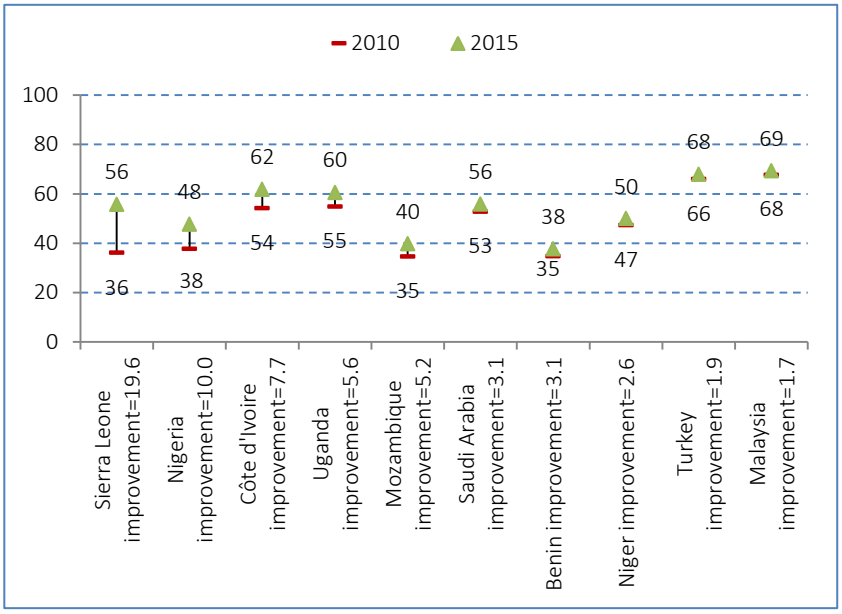
Source: World Bank Doing Business Dataset, 2015.

Europe & Central Asia with a score of 66.4, followed by OIC countries in the Middle East & North Africa with a score of 52.4 and OIC countries in East Asia & Pacific with a score of 51.5. The lowest scores were observed in OIC countries in South Asia with an average score of 37.9, followed by Latin America with a score of 45.6, and Sub-Saharan Africa with a score of 48.0 (see Figure 3.21).

Uzbekistan scored the highest mark on the Enforcing Contracts indicator in 2015 with a score of 69.5; Malaysia and Kazakhstan follow closely with score of 69.4 and 69.3, respectively (Figure 3.22). The list of ten OIC countries with the highest score on the contract enforcement indicator is dominated by OIC countries located in Europe & Central Asia who occupy six of the 10 spots on the list. When it comes to countries with the lowest scores, Bangladesh takes the lead with a low score of 20.8 followed by Suriname with a score of 28.8 and Afghanistan with a score of 31.3

Figure 3.23

OIC Countries Achieving the Greatest Improvement between 2010 & 2015 on the Enforcing Contracts Indicator



Source: World Bank Doing Business Dataset, 2015.

Finally, the greatest improvement in the index value was observed in Sierra Leone, which in the period 2010-2015 increased its score by 19.6 points from 36.1 in 2010 to 55.7 in 2015 (Figure 3.23). Sierra Leone is followed by Nigeria which registered an improvement of 10.0 point and Côte d'Ivoire which improved by 7.7 points.

SECTION 4

Improving Effectiveness of **Public Investment**

In order to address the challenges of socio-economic development and create an enabling environment for long-term development, governments across the regions pursue diverse policies with a view to raising the standards of living and alleviating poverty. The policy instruments are generally plenty, but when it comes to long-term development, the key instrument is the investment in physical and human capital. Private sector investments generally offer limited spectrum for poverty alleviation and the overall community welfare, and they narrowly touch on the projects with significant externalities. Whenever they engage in large-scale investment projects, this is usually due to a partnership agreement with the public sector.

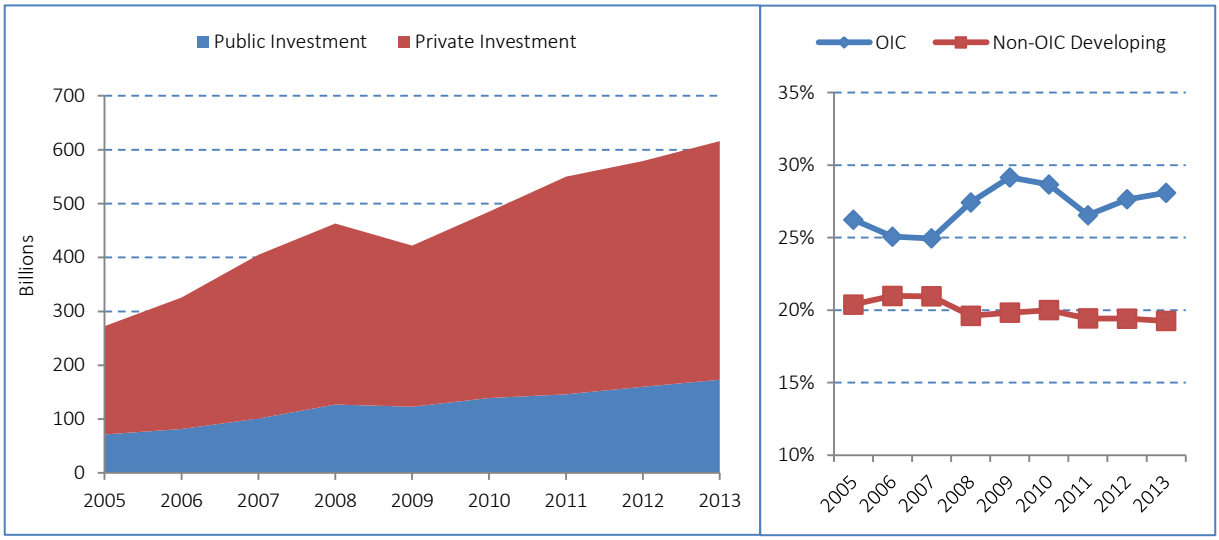
Governments, on the other hand, spend for many purposes, including education, health, social protection, defence and infrastructure, among others, but not all of them can be characterized as public investment. Depending on the priorities of each country, investment may take the form of infrastructural expenditures with special sectorial focus, such as on transportation or energy, or it may be more oriented towards human capital. Governments have to take critical decisions in optimally allocating their limited resources to various spending and investment choices, as the impacts of these choices on separate groups of people and on economic activities in different sectors can substantively evolve over time. With the heightening concern over climate change, it is also particularly vital to align investment policies with these concerns in order to achieve sustainable development.

Total investments in OIC countries have been increasing to achieve the economic development goals. Figure 4.1 illustrates the total public and private investment made by 31 OIC countries, for which time series data are available, over the period 2005-2013. Total value of public investment

Figure 4.1

(a) Public and Private Investment in OIC Countries (Current USD Billion)

(b) Share of Public Investment in Total Investment



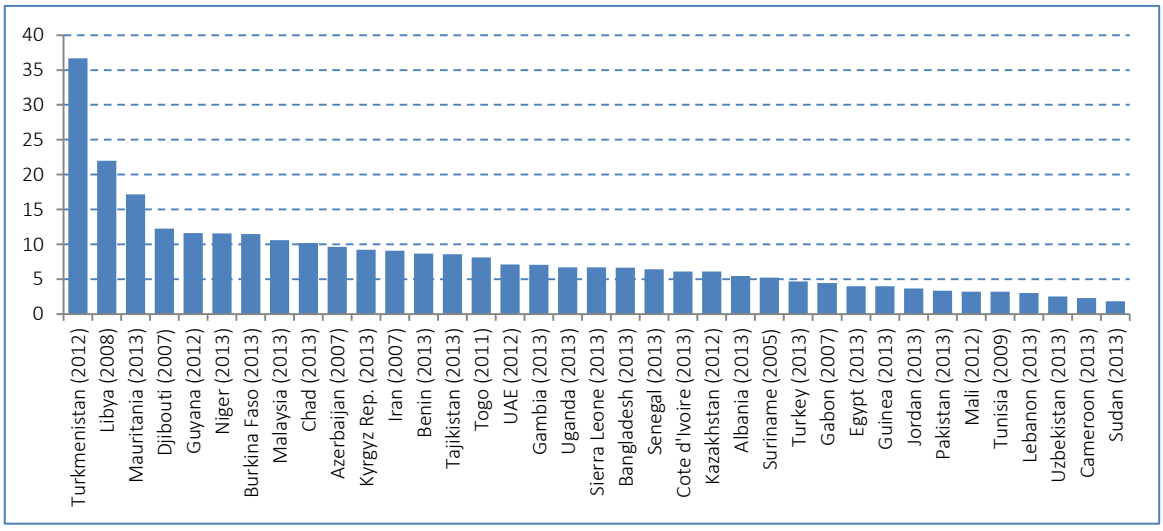
Source: Staff calculation based on World Bank WDI. Note: 31 OIC countries and 46 non-OIC developing countries.

increased from US$ 71.5 billion in 2005 to US$ 173 billion in 2013, corresponding to an increase over 140% (left panel). Private investment in OIC countries increased from US$ 190 billion to US$ 422 billion during the same period, with a 122% total increase. Accordingly, the share of public investment in total investment increased in OIC countries from 26.2% in 2005 to 28.1% in 2013 (right panel). On the other hand, non-OIC developing countries experienced a decline in the share of public investment during this period and reached 19.3% in 2013.

At individual country level, with 36.7% share of public investment in total GDP, Turkmenistan is the OIC country with highest share of public investment. It is followed by Libya (22%) and Mauritania (17.2%). On the other hand, Sudan (1.8%), Cameroon (2.3%) and Uzbekistan (2.5%) are the OIC

Figure 4.2

Share of Public Investment in GDP



Source: SESRIC staff calculation based on World Bank WDI. Note: Latest year available for 37 OIC countries.

countries with lowest share of public investment.

Despite increasing share of public investment in total investment, there is widespread evidence of wasteful public investment spending, including for "white elephant" projects that are characterized by large cost overruns, time delays, and inadequate maintenance. According to IMF (2015), about 30% of the potential value of public investment, on average, is lost to inefficiencies in the investment process. The study finds that increasing public investment efficiency could double the impact of that investment on growth. It predicts significant "efficiency gaps" in public investment spending and shows that strengthening public investment management institutions could eliminate up to two-thirds of the efficiency gaps.

In this connection, this section discusses some important issues in improving effectiveness of public investments. It starts with assessing the structure of general public expenditures in OIC member countries. Main policy issues in improving efficiency and effectiveness of public investment are discussed in the succeeding subsection. Then, an analysis is made on the sectoral investment policies, more specifically in transportation, energy and agriculture. The section ends with discussions on how to stimulate public investment for sustainable development.

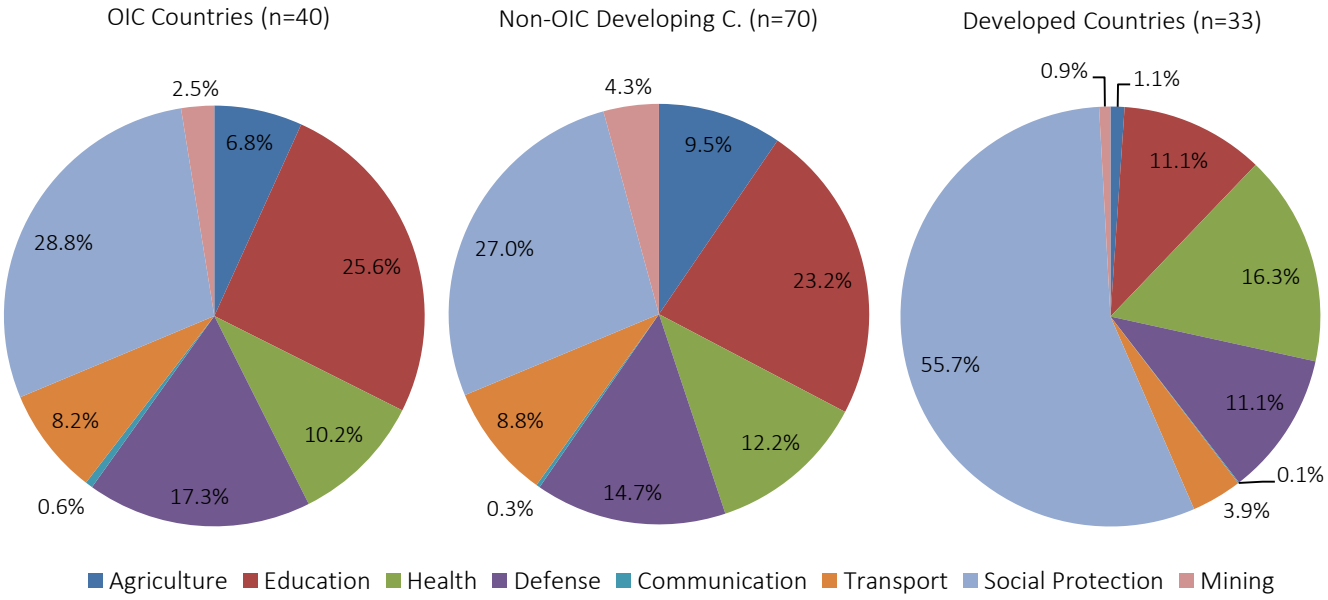
4.1 Assessment of General Public Expenditures

Governments use public spending to achieve both economic growth and equity goals. Such spending often consists of long-term investments in infrastructure, education, health, and research and development, short-term social spending on items such as social security and direct food subsidies to poor households as well as military expenditures for security of its people. It is critical that resources are allocated in accordance with the developmental priorities of the country. The design and implementation of public expenditure priorities require detailed assessment of the benefits and costs of the expenditures. Assessments should be ideally made at a level where all the expenditures are aimed at a single outcome. However, such data are not readily available in many cases.

Public spending is one of the main policy tools used to promote development and to reduce disparities across regions. Studies have shown that certain public investments in rural areas, for instance, contribute greatly to overall economic growth and poverty reduction (IFPRI, 2007). In order to effectively allocate public spending to boost growth and reduce poverty, policy makers need a clear understanding of how public investments translated into targeted development goals. Returns to public investments and expenditures can vary widely across countries as well as within the countries. Therefore, regional targeting is critical in achieving growth and reducing poverty.

The disaggregated public spending data on different subcategories is not readily available. The most comprehensive and publicly available dataset on public expenditure has been compiled by International Food Policy Research Institute (IFPRI) under the Statistics of Public Expenditure for Economic Development (SPEED) database for the period of 1980-2011. The data is available in eight different sectors: agriculture, education, health, defence, social protection, mining, transport and communication. Based on this database, Figure 4.3 shows the shares of total expenditures on different sectors in three different country groups. The shares are calculated using the latest available data between 2005-2011, expressed in constant 2005 international PPP dollars, for 40 OIC countries, 70 non-OIC developing countries and 33 developed countries.

Figure 4.3
Structure of Public Spending



Source: SESRIC staff calculation based on SPEED database, IFPRI.

The bulk of the public resources in OIC countries, with 28.8% share, is allocated for social protection programmes and it is followed by education expenditures with 25.6%. This is also the highest share of resources allocated to education in any country group, where the shares in non-OIC developing countries and developed countries are 23.2% and 11.1%, respectively. The third sector with largest share in public spending in OIC countries is defence and it accounts for 17.3% of total public spending. Again, compared to other country groups, OIC countries allocate the largest share to defence. The spending that are related to human and physical capital investment, which include education, health, communication and transport, collectively account for 44.6% of total public spending. While this number is almost the same in non-OIC developing countries (44.5%), it is significantly lower in developed countries (31.4%).

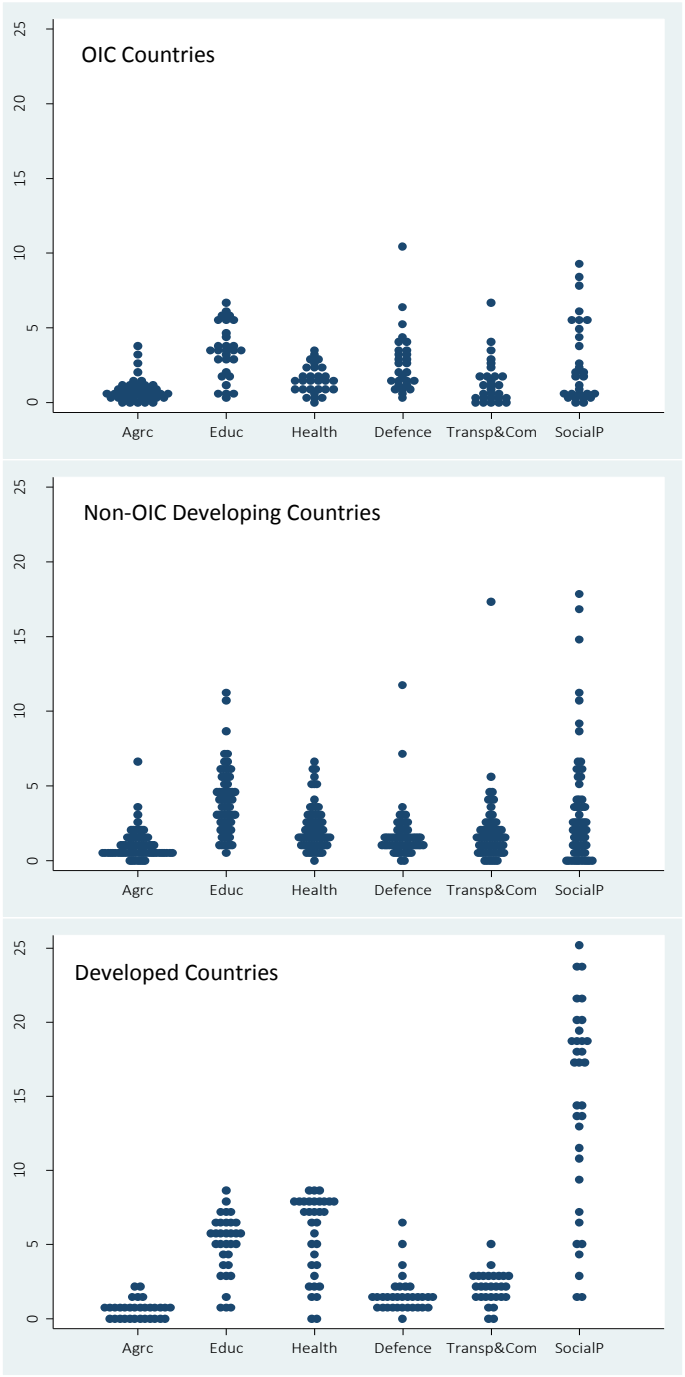
Non-OIC developing countries in general show similar structure to OIC countries in resource allocation of public expenditures. Social protection, education and defence are the three important areas where much of resources are allocated. On the other hand, having well-functioning infrastructure as well as education system, majority of the resources in developed countries are allocated for social protection and health of ageing population.

Finally, Figure 4.4 shows the distribution of countries with respect to percentages of sectoral expenditures in total GDP in different country groups. While only 7 OIC countries allocate more than 5% of their GDP to education, this number is 16 in non-OIC developing countries and 20 in developed countries. While distribution of social protection expenditures is uneven across the regions, it is more unevenly distributed in developed countries. Expenditure patterns in OIC countries are more similar in agriculture and health, while relatively divergent in other categories. While allocating significant resources on education, many OIC countries allocate minor shares of public spending to transport and communication infrastructure.

4.2 Rationale for Public Investment and Its Management

Government involvement in the economy may have different justifications, but the nature of involvement affects the people in many aspects. Choices made on the distribution of investment across geography and sectors affect not only the quality of life, but also the behaviour of private sector and people themselves in their decisions where to live or conduct business. Public investment choices should be made based on careful evaluation on the expected costs and returns of the alternative options and should be effectively managed when the decision is made. When effectively managed, public investments can boost the growth and provide stimulus for private sector to leverage their investments. In contrast, if they turn to a waste of resources due to mismanagement or inferior choices of investment, growth opportunities may significantly be impeded.

Figure 4.4
Distribution of Public Spending



Source: SESRIC staff calculation based on SPEED database, IFPRI.

Public investment is generally defined as the capital expenditure on physical infrastructure (e.g. transport, telecommunication, etc.) and soft infrastructure (e.g. human capital development, research and development, etc.) with a productive use that extends beyond a year (OECD, 2014). Capital expenditure consists of direct investments (i.e. gross capital formation and acquisitions, less disposals of non-financial non-produced assets) and indirect investment, or capital transfers, (i.e. investment grants and subsidies in cash or in kind). Gross fixed capital formation (GFCF) is often used as the best available proxy for direct public investment.[2]

[2] In this report, public gross fixed capital formation (GFCF) is used as a proxy for public investment. GFCF is a useful but narrow definition since it does not cover all public spending that could be considered investment. For example, training of human capital is usually classified as consumption, although such expenditures could have long-term impacts.

Public investment usually takes the form of infrastructural expenditures with a productive life of several decades. However, government spending on education and health contributes to accumulation of human capital of society with extended benefits. Governments traditionally classify these spending as current expenditure and thus not a form of public investment. While governments often treat maintenance costs as a form of current outlay, these should be treated as capital outlays, since the absence of maintenance can reduce the productive life of an infrastructural asset (UNCTAD, 2009).

Having clarified the definition and scope of public investment, it is important to understand the rationale for public investment, its impacts and how to manage it in order to realize the expected outcomes from the resources allocated for public investment. As shown earlier, as of 2013, 31 OIC countries spent US$ 173 billion in public investment, representing 28.1% of total investment in these countries. Despite increasing trend of public investment in OIC countries, the recent global economic crisis forced countries to fiscal consolidation strategies due to budget constraints and reduced the resources for public investment. However, significant resources are required in developing countries to invest in new infrastructure and in developed countries to cover the maintenance costs associated with older investments. If contraction in public investment continues and infrastructure gap grows in countries with large investment requirements, this may have negative consequences on the long-term growth.

4.2.1 Rationale for public investment

There are several justifications for government intervention in the economy. In order to understand the rationale for public investment, three fundamental questions should be asked:

- What market failures leads the public sector to involve in the provision of goods and services;
- Which interventions are needed for optimal production of goods and services;
- What conditions are needed to ensure that interventions yield the desired outcomes?

The reason that governments spend on public assets is technically explained by the presence of some forms of market failure. Market failure leads to inefficient provision by private sector or entails excess rents to a private producer. In situations of market failure, there are a number of justifications, but two of them, namely natural monopolies and externalities, deliver particularly strong case for government intervention. In the case of natural monopolies, production by a single firm minimizes the costs, which mostly involve economies of scale (i.e. unit costs of production fall as output rises). Monopolies tend to produce too little and charge too much. In such cases, government intervention can lead to more production at a lower price, as they are assumed to maximize social welfare. A common example is the distribution of electricity and water by public enterprises.

Externalities provide another traditional justification for government involvement. Positive or negative externalities may arise if additional benefits and costs are generated from the activities of firms that are not reflected in the benefits and costs of the firm. However, firms may not charge for the benefits or they may use resources for which they do not pay. Consequently, they may end up producing significantly more or less than the socially optimum level. Externalities are among the principal justifications raised for public involvement in the provision of education services and prevention of communicable diseases (World Bank, 1998).

Public intervention to alleviate poverty can also be justified on ethical grounds for redistribution of welfare. As alternative forms of intervention, governments can either directly provide goods and services (such as roads and rail networks), provide financing for the production of goods and services (such as primary education) or provide subsidies only (such as those provided to poor people for their access to basic services).

Overall, if there are strong justifications for government involvement to deal with market failures, it must be ensured that the benefits outweigh the costs. There is no guarantee that government officials will succeed where markets fail. If interventions are poorly designed and implemented, they may create more problems than they solve. In order to ensure that interventions produce the desired impact, a series of conditions, ranging from institutional arrangements to regulatory conditions, should be in place and effectively functioning. A more detailed discussion on effective public investment is provided in section 4.3.

4.2.2 Impacts of public investment

It has been traditionally argued that public investment in the form of energy, transport and telecommunications improves the access to additional productive capacities and stimulates growth. A large body of empirical studies have found support for a positive and significant contribution of public investment to the level and growth of aggregate output; while the magnitudes vary from one study to another (see Straub, 2008 for survey of literature). Government projects are said to be more effective in boosting output in countries with higher efficiency of public investment (Abiad *et al.*, 2015). In contrast, ineffective use of public capital has been cited as one of the determinants in explaining the differences in growth performance across countries (see e.g., Calderon and Serven, 2008).

While public investment affects private production, investment and social welfare in different ways, each type of public investment will have more specific welfare implications. Taking the transport infrastructure as an example, an efficient transport infrastructure improves labour productivity through improving the mobility of workers and farmers, and their access to markets. It lowers the depreciation rate of private capital by improving endurance of vehicles. It improves the access of people to education and health services and facilitates other public services. If investments are not improving the quality of life, this indicates that resources are not effectively used in enhancing productive capacity of the economy.

On the other hand, public investment may also have adverse effects by crowding-out private investment. There are several potential reasons and these are mostly related to investment financing (Misch and Wolff, 2008). If public investment is financed by distortionary taxation, this reduces the profitability of private investment and crowds-out private investment. If public investment is financed from domestic financial markets, this reduces the resources available for private investment, increases costs of borrowing due to higher interest rates and crowds-out private investment. Or, if public investment is financed from international markets, national currency may be stronger due to large amount of foreign currency inflows and this may make the manufacturing sector less competitive abroad.

However, a study finds that public investment complements private investment, and that on average a 10% increase in public investment is associated with a 2% increase in private investment (Erden and Holcombe, 2005). Similarly, a recent paper by IMF examines the macroeconomic

impact of public investment and finds that such investment raises output in both the short and long term, crowds in private investment, and reduces unemployment (Abiad *et al.*, 2015). It suggests that for economies with clearly identified infrastructure needs and efficient public investment processes and where there is economic slowdown and monetary accommodation, there is a strong case for increasing public infrastructure investment. Improving public investment efficiency is also critical in mitigating the possible trade-off between higher output and higher public debt to GDP ratios. The paper argues that a key priority in many economies, particularly in those with relatively low efficiency of public investment, should be to raise the quality of infrastructure investment by improving the public investment process. [3]

4.2.3 Public investment and fiscal policy

Understanding the impacts of public investment is important also from fiscal policy perspective. There are three justifications for this: (i) it is easier to cut public investment than current spending for political and other reasons; (ii) external borrowing constraints prevent governments from undertaking productive investments; and (iii) fiscal policy can play important role in supporting growth and recovery during hard times (Arslanalp et al., 2010).

A decline in public investment in recent years was observed in developed countries due to fiscal consolidation following the global economic crisis. In fact, investment was already declining due to falling public savings, completion of major infrastructure investments, downsizing public sector and growing public sector involvement in infrastructure investments (IMF, 2005). Therefore, there have been voices to create a fiscal space[4] for funding critical public investment. Secondly, governments generally need long-term external borrowing in order to undertake critical public investments. A country's borrowing capacity depends primarily on its macroeconomic policies, strength of its financial and fiscal management records, the contribution of debt-financed public investment to growth and export competitiveness. Therefore, countries will strive to improve these conditions in order to secure foreign debt to finance large-scale investment projects. Finally, with regard to countercyclical role of fiscal policy, it is commonly observed that fiscal stimulus packages involve a sizable spending on public investment in order to enhance productivity and competitiveness for future growth.[5]

Only few governments around the world have the luxury to finance their infrastructure investments without borrowing, but there are also limits in borrowing. If all investments would be yielding sufficient returns over time to finance the investments, it would be easier to find adequate resources, but some investments may yield only non-monetary benefits, without directly contributing to the government budget. Moreover, if the information is available on the returns to potential public investments, it will be easier to decide on the volume and the most effective allocation of resources to investment. However, this information is rarely available and decisions

[3] Overall, if public infrastructure investment is complementary to private investment, the rate of return to private sector investments will increase, leading private sector investors to undertake more capital investment. However, public investment may crowd out private investment if they compete for the same resources, and the crowding out may be more significant if public sector produces output that is in direct competition with the goods and services provided by private sector (Erden and Holcombe, 2005).

[4] Fiscal space refers to room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position (Heller, 2005).

[5] The share of infrastructure spending in fiscal stimulus packages for 2009–10 among the G20 countries was around 20% in advanced countries, and more than 50% in emerging countries (Horton et al. 2009).

are rather arbitrarily made in an often opaque process. In some cases, revenue generation can be confined by the lack of institutional and regulatory quality. Therefore, debt sustainability remains a critical issue for governments facing the challenge of fiscal space, particularly in low and middle income countries.

There are several policy issues in facing the fiscal space challenge. These include, among others, the budgetary rules on deciding the size of investment budget, fiscal responsibility of subnational governments, private sector participation and institutional approaches. Below, some issues related to budgetary rules are discussed. On other issues, some analyses and discussions are made in the subsequent parts of this section.

Fiscal policy analysis focuses mainly on the overall fiscal balance and gross public debt. In this approach, the overall fiscal balance and public debt targets are set at levels that support specific output, inflation and balance of payment objectives, and ensure a sustainable debt path (IMF, 2004a). Main concern about this approach is that it may restrain the ability of countries to take advantage of opportunities to finance high-quality infrastructure projects. As an alternative approach, targeting the current fiscal balance, which excludes public investment, is advocated. In this approach, it is expected that public investment through borrowing will pay for itself by possibly generating higher future public revenues. Despite of its advantages, such as increasing the stock of capital and ensuring intergenerational equity, there are also concerns with this approach, particularly when public investment projects are not of high quality.

Given the advantages and disadvantages of different fiscal policy approaches under different settings, it is rather more critical to concentrate on promoting productive public investment instead of fiscal policy choices. With well-designed infrastructure projects, fiscal targets under different approaches will support the long-term growth and development. In the presence of appropriate screening and monitoring mechanisms, governments can manage to finance large scale productive investments with high financial and social returns, and without undermining the prospects for debt sustainability. In this respect, it is critical to determine the short and long-run fiscal impact of public investments with careful assessment on the consistency of the investment program with financing availability, short term macroeconomic stability and longer term debt sustainability. It is also key to ensure that public investments are of high quality, productive and cost effective (IMF, 2004a). It is also found that debt-financed projects have larger expansionary effects than budget-neutral investments financed by raising taxes or cutting other government spending (Abiad *et al.*, 2015).

4.2.4 Trade-offs between physical and human capital investment

For economic development, the evidence suggests that the key areas of investment expenditure include transport and communications infrastructure, human capital development, innovation promotion and private-sector development (Mizell L. and D. Allain-Dupré, 2013). However, it is rather difficult to identify the priorities for investment and it is commonly observed that governments have bias towards physical capital investments. Growth impacts of investments made on education and health are especially not easy to capture because of the complexity and longevity of the impacts of such investments.

Due to difficulties in assessing the profitability of investments, particularly on human capital, it therefore remains a challenge for governments to allocate appropriate resources to different forms

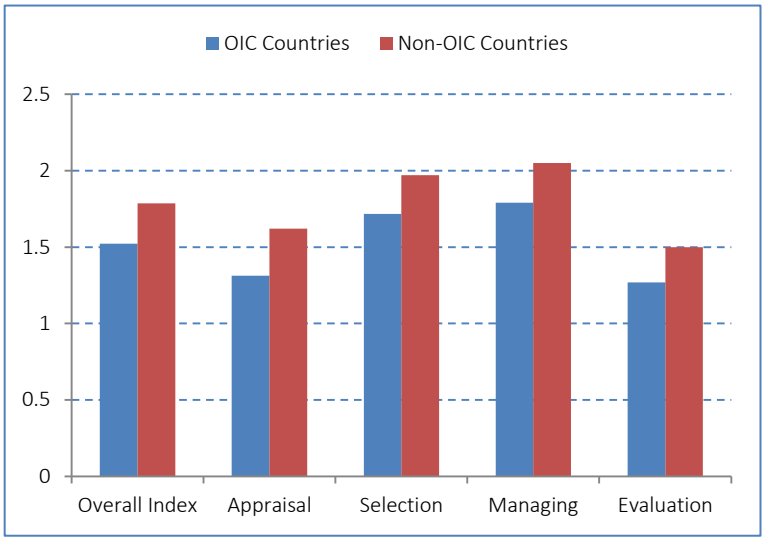
of public investment. The trade-off in low income countries is particularly challenging as the investment gap is massive in both spheres. In these countries, the impacts of investment on education and health are already evidenced. However, they also need investment in physical infrastructure to harness their natural resources, develop transportation networks and provide electricity, telecommunication, water and sanitation services to its people. Likewise, middle income countries face similar challenges and if they fail to invest in human capital and improve their productivity, they may face important bottlenecks in sustaining growth.

Budgetary constraints cause significant pressures on governments in effectively allocating the resources and they are well sensitized to the fact that opportunity costs of foregoing investment in certain areas can be quite high. Therefore, while identification of the priority areas for allocating resources should be on the top of the agenda, governments should also seek to overcome fiscal constraints by designing profitable infrastructure projects to be financed by alternative channels, such as private sector or international development institutions.

4.3 Improving Effectiveness of Public Investment

With governments struggling to achieve public investment goals under tight fiscal constraints, public investment management plays critical role in improving the efficiency and effectiveness of public investment. Weak investment planning, management and oversight can undermine the positive impacts that investments can make to growth. Therefore, the impact of public investment depends to a large extent on how governments manage it.

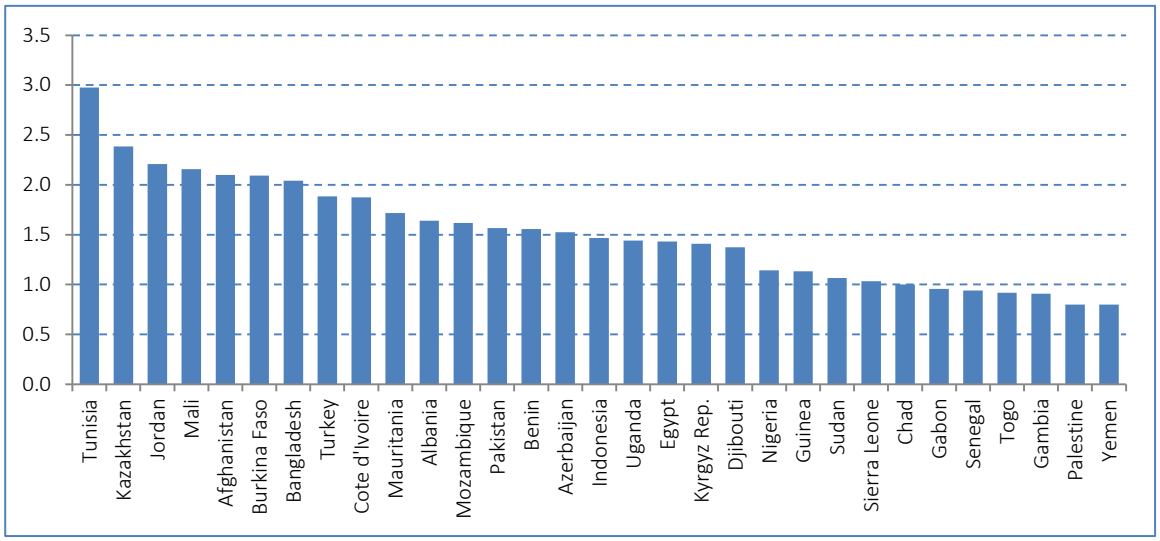
Figure 4.5
Public Investment Management Index Scores



Source: SESRIC staff calculation based on IMF Public Investment Management Index.

Figure 4.5 shows the average performance of OIC countries in public investment efficiency based on the Public Investment Management (PIM) index developed by IMF (see Box 4.1 for detailed information about the index). It shows the scores on overall index as well as on its four subcategories and covers 71 developing countries, 31 of which are OIC countries. As shown in the Figure, performance of OIC countries in public investment management is not as good as non-OIC developing countries. With an average score of 1.52 over 4, OIC countries demonstrate not a satisfactory overall picture. In appraisal and evaluation of projects, the scores are even gloomier, with scores of 1.31 and 1.27, respectively. In selection and managing of the public investment projects, however, OIC countries do comparably better and achieve scores 1.72 and 1.79 in these categories, respectively. In all categories, non-OIC developing countries show better performance reflected through 0.2-0.3 point higher scores.

Figure 4.6
Public Investment Management Index Scores



Source: IMF Public Investment Management Index.

At the individual country level, Tunisia (2.97), Kazakhstan (2.38) and Jordan (2.21) are the OIC countries with most effective public investment management system (Figure 4.6). Tunisia is ranked fourth among the 71 developing countries for which data are available. On the other end of the

Box 4.1: The Public Investment Management Index

The Public Investment Management (PIM) index captures quality and efficiency across four main stages of the public investment management cycle: appraisal, selection, implementation, and evaluation. The basic processes and best practices associated with the strongest score (4) in each stage are described below.

Strategic Guidance and Project Appraisal: The maximum score requires a well-defined public investment plan and/or sector strategies for most sectors, with full costing of recurrent expenditures and investment; a published document to detail appraisal standards; routinely undertaken economic appraisals for large projects; and independent checks by a regulator or office of appraisals.

Project Selection and Budgeting: Maximum score requires multiyear forecasts and the clear subsequent setting of annual budget ceilings; detailed information for a large share of donor-funded projects; consistently selected investments; coverage of fiscal policies and medium-term fiscal framework by the legislature's review; and publicly available information on key fiscal aggregates, external audit reports, and contract awards.

Project Implementation: A maximum score requires accurate data on the method used to award public contracts; an operative process for submission and timely resolution of procurement process complaints; the execution of more than 90 percent of the capital budget; broad expenditure commitment controls; and internal audits (that meet international standards) for all entities.

Project Evaluation and Audit: A maximum score requires ex-post evaluations routinely performed by the auditor general or the executive; audited expenditures (which should comply with auditing standards), including capital investments; and a complete and operational asset register.

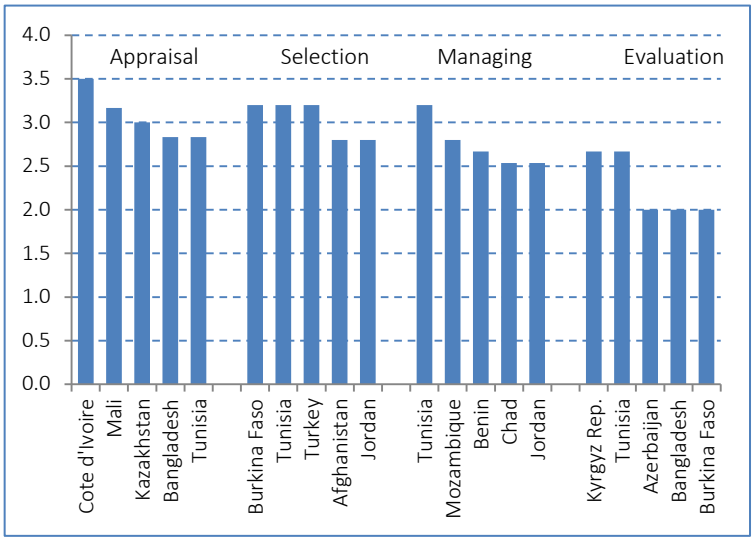
Source: Dabla-Norris et al. (2011) and IMF (2014).

spectrum, public investment efficiency is lowest in Yemen (0.8), Palestine (0.8) and Gambia (0.91).

Figure 4.7 shows the top OIC countries in four subcategories of the PIM index. Cote d'Ivoire, Mali and Kazakhstan in appraisal; Burkina Faso, Tunisia and Turkey in selection; Tunisia, Mozambique and Benin in managing; and Kyrgyz Republic, Tunisia and Azerbaijan in evaluation achieved the highest scores among the OIC countries.

Figure 4.7

Public Investment Management Index Scores



Source: SESRIC staff calculation based on IMF Public Investment Management Index.

4.3.1 National public investment systems

If there are significant gaps in effectively managing the public investment projects, as partially evidenced above, which approaches should be adopted to improve the effectiveness? A World Bank policy paper by Rajaram et al. (2010) identify eight "must have" features of national public investment systems: (1) investment guidance, project development, and preliminary screening; (2) formal project appraisal; (3) independent review of appraisal; (4) project selection and budgeting; (5) project implementation; (6) project adjustment; (7) facility operation; and (8) project evaluation (Figure 4.8).

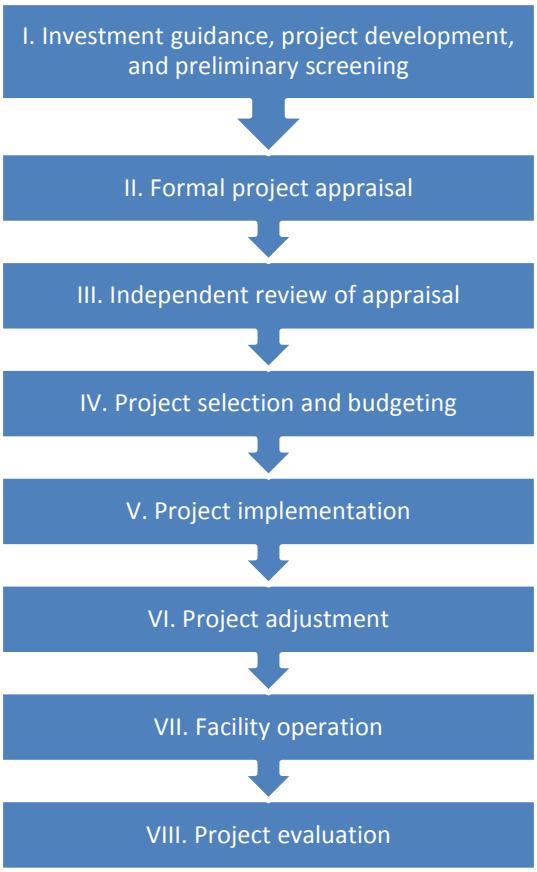
In this framework, investment policies should be guided by a national plan or other strategic documents that establishes development priorities at the highest decision-making levels. Moreover, there should be a formal process for project development. Project initiators should prepare a project profile with basic project information, specific problem to be addressed, project objective, main activities, expected results and estimated budget. In the second stage, a first level screening of all project proposals must be formally undertaken to ensure that they meet the minimum criteria of consistency with the strategic goals of government. Then, projects or programs that meet the first screening test may need to undergo more rigorous independent scrutiny of their cost-benefit, cost effectiveness and social and economic value.

In the project selection and budgeting stage, a politically independent procedure should be followed with participation of national and international technical experts for making decision on project selection. It is essential to link the projects to the budget cycle even though the project evaluation cycle may run along a different timetable so that to ensure consistency with long-term fiscal and debt management objectives. Project implementation covers a wide range of aspects, including efficient procurement, timely budget execution, and sound internal budgetary monitoring and control. Clear organizational arrangements, sufficient managerial capacity and regular reporting and monitoring are essential to avoid under-execution of budgets, rent-seeking and

corruption. The whole process should have some flexibility to allow changes in the disbursement profile to take account of changes in project circumstances.

Once a project is completed, there should be a process to ensure that the facility is ready for operation and services can be delivered. This requires an effective mechanism for handover of management responsibility for future operation and maintenance of the created assets and adequate budget funding of service delivery agencies to operate and maintain these assets. Finally, a desirable but often missing feature of government systems is a basic completion review and ex-post evaluation of completed projects. Ex-post evaluation should focus on the comparison of the project's outputs and outcomes with the established objectives in the project design, which is a missing feature of public investment management systems in many developing countries.

Figure 4.8
Features of Public Investment Systems



Source: Rajaram et al. (2010).

Low efficiency in public investment can be due to a number of reasons. These include poor project selection, delays in design and completion of projects, corrupt procurement practices, cost over-runs, in complete projects and failure to operate and maintain assets effectively so that the benefits are less than projected. Public investments should ideally be focused on increasing productivity and competitiveness, searching for the areas where social returns are the highest and externalities and spillover effects are significant. The most important concern when it comes to infrastructure investment, for example, is project selection. It is important to set up institutions that are capable of doing planning and cost-benefit analysis. If the focus is on quantity, then it is more likely that higher levels of public investment have undesirable effects such as crowding out private investment with little productivity gains for the economy. Public investment tends to crowd out private investment in case of distortions associated with the public investment process (Cavallo and Daude, 2008).

Existence of corruption is a factor that distorts decisions about the public investment. In the presence of corruption during the project selection and implementation processes, some projects will be poorly built and will require continuous repair or they will never be used, and will not generate the expected impacts on growth. Corruption can reduce growth by increasing public investment while reducing its productivity; it can reduce growth by reducing the quality of the existing infrastructure; or it can reduce growth by decreasing the government revenue needed to finance productive spending (Tanzi and Davoodi, 1998). There are, however, very successful

Box 4.2: Institutional Approaches to Strengthen the Public Project Implementation: The Cases of Norway and Austria

Strengthening fiscal institutions, particularly with an integrated public investment management process and a medium-term fiscal policy framework, is the key for improving public investment efficiency. Norway and Austria provide good examples of new approaches to strengthen the public investment decision making process.

Norway has developed a strong framework for fostering successful public investment outcomes. This two-stage framework—known as the Quality Assurance Scheme (QAS)—was adopted in 2000 to improve the quality of all state-financed projects over US$ 500 million by establishing a system in which politics and administration are clearly separated. The goal was to ensure improved quality-at-entry by establishing a system where politics and administration is well divided, with the interplay between these two sides well understood. The scheme helped reduce cost for the state and better use of public funds, which turned into more successful project outcomes.

The QAS has two "gateways" which help ensure that any project undergoes a comprehensive analysis before being approved. The first gateway of the system focuses on the cost-benefit analysis, including alternatives, before a government's decision is made. The second gateway is undertaken before a formal proposal to the Parliament is made and considers a project management strategy, including an independent consultant's views on costing. The scheme has helped to prevent controversies about the ineffective use of public funds and brought more attention to cost estimates.

In between the two stages, there are several coordination forums where the Ministry of Finance gathers key interested people for discussions, often resulting in common understanding and definition of terms and professional standards. As of 2013, the scheme has worked for 13 years involving 160 projects. Evidence indicates that the QAS has had a positive effect with a remarkable cost savings. A research paper shows that 32 of the 40 projects submitted to QAS in the period 2000–09 and implemented during 2000–12, were completed within or below the cost frame. The total net saving for the projects was estimated at about 7 percent of the total investment.

Australia also moved to depoliticize both the assessment and the decision processes for public investment. It established Infrastructure Australia, whose principal function was to assess infrastructure priorities independently of the originating infrastructural ministries and state governments. The goal was to obtain a clearer picture of which projects yielded the greatest value for money in relation to national infrastructural priorities.

The four key elements of the Australia approach are: the establishment of a body separate from state governments and ministries to provide an independent assessment of projects' value for money; the establishment of a shelf of priority projects for implementation, subject to financing availability; the provision of a national perspective on infrastructural priorities; and the ability of Infrastructure Australia to overcome any tendency of spending ministries to consider only a limited set of investment options.

Sources: IMF (2014); Samset and Volden (2013); UNCTAD (2009); and Sutherland et al. (2009).

examples of public project implementation process. The cases of Norway and Austria are particularly noteworthy (see Box 4.2 for more details on their approach).

OECD (2014) identifies three systematic challenges for the multi-level governance of public investment that hinder the achievement of the best possible outcomes:

Table 4.1: Recommendation of the OECD Council on Effective Public Investment across Levels of Government

Challenges	Principles	Actions
A. Co-ordinate public investment across levels of government and policies	***1. Invest using an integrated strategy tailored to different places***	*i) Design and implement investment strategies tailored to the place the investments aim to serve.* *ii) Seek complementarities and reduce conflicts among sectoral strategies* *iii) Encourage the production of data at the relevant sub-national scale to inform investment strategies and produce evidence for decision-making.*
	2. Adopt effective instruments for co-ordinating across national and sub-national levels of government	*Co-ordinate across levels of government to strengthen the efficiency and effectiveness of public investment.*
	3. Co-ordinate horizontally among sub-national governments to invest at the relevant scale	*Provide incentives and/or seek opportunities for co-ordination among regional and/or local governments to match public investment with the relevant geographical area.*
B. Strengthen capacities for public investment and promote policy learning at all levels of government	***4. Assess upfront the long-term impacts and risks of public investment***	*i) Use comprehensive, long-term assessments for investment selection.* *ii) Assess different types of risks and uncertainty associated with public investment, including longer-term impacts, at an early stage of the investment cycle as part of an appraisal.*
	5. Engage with stakeholders throughout the investment cycle	*i) Engage with public, private sector and civil society stakeholders in the design and implementation of public investment strategies to enhance social and economic value, and to ensure accountability.* *ii) Seek a balance when incorporating stakeholders' views, taking steps to prevent disproportionate influence by special interest groups.*
	6. Mobilise private actors and financing institutions to diversify sources of funding and strengthen capacities	*i) Match private financing arrangements to investment needs and government capacity, particularly at the sub-national level,* *ii) Involve private actors and financing institutions in public investment to offer more than just financing.*
	7. Reinforce the expertise of public officials and institutions involved in public investment	*Bolster the capacity of both officials and institutions associated with public investment.*
	8. Focus on results and promote learning from experience	*Clarify the outcomes to be achieved through public investment and pursue mechanisms to achieve them.*
C. Ensure proper framework conditions for public investment at all levels of government	***9. Develop a fiscal framework adapted to the investment objectives pursued***	*i) Employ a fiscal framework adapted to the different investment policy objectives pursued.* *ii) Set enabling conditions for sub-national governments to be able to exploit their own revenue raising potential,*
	10. Require sound and transparent financial management at all levels of government	*Adopt good practices for budgeting and financial accountability*
	11. Promote transparency and strategic use of public procurement at all levels of government	*i) Maximise transparency at all stages of the procurement cycle, promote the professionalization of the procurement function, and establish clear accountability and control mechanisms.* *ii) Use procurement to ensure effective public service delivery while pursuing strategic objectives at different levels of government.*
	12. Strive for quality and consistency in regulatory systems across levels of government	*Pursue high-quality and coherent regulation across levels of government by evaluating the regulatory framework when establishing investment priorities and programmes.*

Source: OECD (2014).

1. **Co-ordination challenges:** While it is difficult, it is important to ensure cross-sector, cross-jurisdictional and intergovernmental coordination. Moreover, the interests of diverse actors involved in public investment may need to be aligned.
2. **Capacity challenges:** Policies may fail to achieve their objectives if the capacities to design and implement investment strategies are weak. Evidence suggests public investment and growth outcomes are correlated to the quality of government. Several recent empirical studies suggest that deficiencies in public capital provision and its growth effects may be particularly linked to the existence of inefficient or corrupt bureaucracies (Esfahani and Ramirez, 2003).
3. **Challenges in framework conditions:** It is important to align good practices in budgeting, procurement and regulatory quality across levels of government for successful investment.

These challenges are widespread and can be observed in any country. In order to address these challenges, OECD Council adopted a set of recommendations in order to improve the management of public investment efficiency. These are presented in Table 4.1. A total of 12 principles are identified in the recommendation under three categories. The first category focuses on the importance of creating complementarities in policies and programmes across levels of government and policies to increase the effectiveness of public investment. The second category points out different capacities that should be present at all levels of government to reinforce conditions for effective investment and to promote constant improvement in all phases of investment projects, from the strategic selection of investment to its implementation and monitoring. Third category stresses the importance of good practices in fiscal decentralisation, public financial management, public procurement, and regulatory quality at all levels of government. All these recommendations are naturally relevant for OIC countries and it is strongly recommended that these recommendations are considered as much as possible by the OIC member countries to increase the efficiency of their public investment.

Not all investment projects are undertaken by central governments. It has been increasingly observed that many sub-national governments play an active role in planning and implementing various investment projects. According to Mizell and Allain-Dupré (2013), nearly two-thirds of public investment occurs at the sub-national level. Therefore, strengthening sub-national capacities becomes critical in improving the efficiency and effectiveness of public investment. Capacities should be improved in order to ensure, among others, the quality of the investment choices, economies of scale exploited through cross-jurisdictional coordination or reduced costs through more competitive procurement.

Table 4.2: Main public investment capacity challenges for sub-national governments

As seen by national governments	As seen by regional governments
- Sectoral priorities dominate over integrated approach - Weak long term strategic planning for public investment; a focus on short term priorities - Difficulty of involving private firms - Weak capacities for administering PPPs	- Lack of involvement of private actors - Reduced fiscal capacity for public investment - Lack of capabilities to administer public procurement - Excess of administrative procedures and red tape - Public employees' salaries not competitive with the private sector

Source: Mizell and Allain-Dupré (2013).

Sub-national governments, however, face challenges in various areas. Table 4.2 lists some of these challenges, as responded to an OECD questionnaire. Involvement of private sector in local public investment projects is a challenge seen by both national and sub-regional governments. Lack of capacities in planning and administering various steps of investment projects and limited fiscal capacities are also highlighted among the major challenges faced by local governments.

4.3.2 Role of sovereign wealth funds

Countries with large windfall gains possess a unique opportunity to accelerate growth and promote diversification through efficient public investments. Public investment can play a prominent role in boosting growth and long-term development prospects, but the extent to which public investment contributes to this goal depends on its efficiency. Indonesia and Malaysia have used oil revenue to finance investments and made a "big push" in industrial development (Albino-War et al., 2014). High capital spending may contribute to weaker fiscal positions, exacerbate fiscal vulnerability to sudden declines in commodity prices and deteriorate the fiscal position, which can be avoided by improving efficiency in public investment. This is particularly the case for countries with short horizon of windfall gains, such as Bahrain, Azerbaijan and Oman, which have less than a generation left before their natural resources are exhausted (Albino-War et al., 2014).

Resource-rich countries commonly establish sovereign wealth funds (SWFs) to manage the national savings for the purposes of investment. Currently, 21 OIC countries have one or more SWFs, with total value of assets exceeding US$ 3.3 trillion (Table 4.3). According to Sovereign Wealth Fund Institute (SWFI) statistics, as of July 2015, the total value of funds managed by SWFs in the world is US$ 7.36 trillion. Abu Dhabi Investment Authority (ADIA), with US$ 773 billion assets, is the largest SWF in the OIC countries and the second largest in the world. By possessing almost 45% of total funds in the world, OIC countries enjoy a unique opportunity to fill investment gap and foster economic diversification.

SWFs have long-term objectives, including intergenerational wealth transfer. They have traditionally invested in external securities due to a number of reasons including lack of domestic investment opportunities. Low returns in developed countries after the financial crisis encouraged national authorities to invest domestically, in particular to finance long-term infrastructure projects. This opens up some potential risks, including undermining hard-earned efforts to sustain macroeconomic stability and becoming a vehicle for politically driven "investments" that fail to add to national wealth (Gelb et al., 2014). For efficient use of SWFs in domestic investment, it must be ensured that the funds are utilized within the context of the general public investment plan and there is a sustainable flow of funds for investment to ensure that they do not become destructive due to large fluctuations in flow of funds to national economy. It is also critical to ensure that the resources of SWFs should not be used to finance public expenditure beyond budgetary controls and should be directed to productive investment opportunities (Gelb et al., 2014).

Table 4.3: Sovereign Wealth Funds in OIC Countries

Country	Funds	Assets (Billion USD)	Origin
United Arab Emirates	Abu Dhabi Investment Authority	773	Oil
	Investment Corporation of Dubai	183	Non-commodity
	Abu Dhabi Investment Council	110	Oil
	International Petroleum Investment Company	66.3	Oil
	Mubadala Development Company	66.3	Oil
	Emirates Investment Authority	15	Oil
	RAK Investment Authority	1.2	Oil
	Total	**1,214.8**	
Saudi Arabia	SAMA Foreign Holdings	757.2	Oil
	Public Investment Fund	5.3	Oil
	Total	**762.5**	**Oil**
Kuwait	Kuwait Investment Authority	592	Oil
Qatar	Qatar Investment Authority	256	Oil and gas
Kazakhstan	Samruk-Kazyna JSC	77.5	Non-commodity
	Kazakhstan National Fund	77	Oil
	National Investment Corporation	2	Oil
	Total	**156.5**	
Libya	Libya Investment Authority	66	Oil
Iran	National Development Fund of Iran	62	Oil and gas
Algeria	Revenue Regulation Fund	50	Oil
Malaysia	Khazanah Nasional	41.6	Non-commodity
Brunei	Brunei Investment Agency	40	Oil
Azerbaijan	State Oil Fund	37.3	Oil
Oman	State General Reserve Fund	13	Oil and gas
	Oman Investment Fund	6	Oil
	Total	**19**	
Iraq	Development Fund for Iraq	18	Oil
Bahrain	Mumtalakat Holding Company	10.5	Non-commodity
Nigeria	Nigerian Sovereign Investment Authority	1.4	Oil
Senegal	Senegal FONSIS	1	Non-commodity
Palestine	Palestine Investment Fund	0.8	Non-commodity
Gabon	Gabon Sovereign Wealth Fund	0.4	Oil
Indonesia	Government Investment Unit	0.3	Non-commodity
Mauritania	National Fund for Hydrocarbon Reserves	0.3	Oil and gas
Turkmenistan	Turkmenistan Stabilization Fund	n/a	Oil and gas
GRAND TOTAL		3,330.4	

Source: Sovereign Wealth Fund Institute (SWFI), July 2015. http://www.swfinstitute.org/sovereign-wealth-fund-rankings/

4.3.3 Stimulating Investment for Sustainable Development

Trillions of dollars will be invested over the next decades in infrastructure and services around the world.[6] This would maintain investment in conventional, emissions-intensive technologies, but endanger future growth. On the other hand, it offers a great opportunity if a new approach to public investment is adopted to minimize building of new risks and revert the current trend of continuously growing economic losses due to disasters and climate change. This requires a shift in long-term investment policies from conventional to green alternatives in order to achieve environmental and sustainability goals. It also requires reassessment of investment priorities and shifting incentives towards renewable energy, environmentally friendly waste management and other elements of sustainable development.

The McKinsey Global Institute has estimated that rates of environmental degradation are unsustainable for the long-term functioning of the global economy (MGI, 2011). Existing and future investment, therefore, must be 'greened' to avoid risky levels of climate change and adverse environmental impacts. Special attention should be paid to fostering investment in renewable energy generation, energy efficiency, sustainable transport, agriculture, forestry and land-use, waste and waste water. Increasing investment in clean energy infrastructure facilitates cost-effective access to energy, reduces pollution and associated health costs, reduces reliance on fossil-fuels, fosters innovation and creates new jobs. Moreover, the International Energy Agency estimates that every additional dollar invested today in clean energy can generate three dollars in future fuel savings by 2050 (OECD, 2015a).

Promoting green investment requires specific strategies and policies beyond those aimed at attracting investment in general. Green investment is closely related to other investment approaches such as socially responsible investment (SRI) and sustainable, long-term investment (see section 5.4 for detailed discussion on SRI). It requires the creation of an enabling policy framework and targeted investment promotion methods. A key challenge for governments in channelling investment to clean energy projects is the lack of designing and implementing clear and predictable domestic policy frameworks (OECD, 2015b).

Figure 4.9 shows the global new investments made in renewable energy during the period 2004-2014. Obviously, developing countries are playing a growing role in scaling up green investment. As of 2014, 48.5% of all new investments were made by developing countries. China accounts much of the surge by developing economies over recent years, by increasing investments up from just US$ 3 billion in 2004 to US$ 83.3 billion in 2014 (BNEF, 2015). Supportive government policies aimed at boosting power generation in the country was critical in this surge. In general, the creation of green growth strategies by a number of developing countries to advance water resources, sustainable agriculture, and clean energy played a role in this trend.

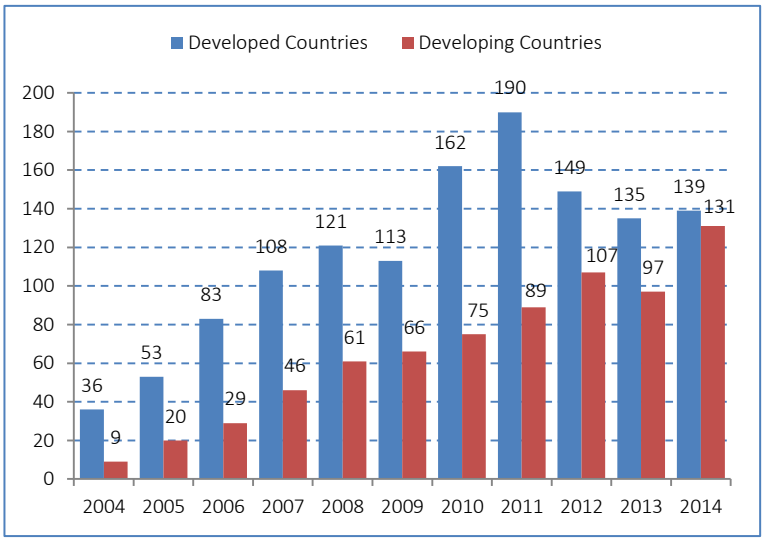
According to the World Economic Forum, there are additional investment needs of at least US$ 700 billion per year to meet the climate challenge. This is needed for clean-energy infrastructure, sustainable and low-carbon transport, energy efficiency in buildings and industry, and for forestry,

[6] Investment required for the water, agriculture, telecoms, power, transport, buildings, industrial and forestry sectors under current OECD growth projections is approximately US$ 5 trillion per year until 2020. The Food and Agriculture Organization (FAO) has estimated the gross investment requirements for primary agriculture in developing countries at US$ 125 billion per year to 2030. The OECD estimates that US$ 1.3 trillion needs to be invested annually to replace and maintain water infrastructure in developed countries and emerging markets alone (WEF, 2013).

to limit the global average temperature increase to 2°C above pre-industrial levels. Total investment in climate-change mitigation and adaptation in 2011 were estimated at US$ 268 billion from the private sector and US$ 96 billion from the public sector. However, investment in fossil-fuel intensive inefficient infrastructure continues to outpace the progress in green investment (WEF, 2013). As a result, greenhouse gas levels are rising amid growing concerns over global warming.

Figure 4.7

Global New Investment in Renewable Energy (Billion USD)



Source: Bloomberg New Energy Finance, Global Trends in Renewable Energy Investment 2015.

Public resources are limited; therefore, reliance on public-sector investment must be minimised and more attention should be paid to encouraging private finance. However, there are barriers that need to be removed for effective participation of private sector. These include, among others, inefficient fossil-fuel subsidies, lack of a predictable policy and regulatory environment, barriers to international trade and investment, and inadequate support to green technologies to promote their competitiveness. Therefore, a wide range of policy interventions are required to shift investment away from fossil fuels towards clean energy (OECD, 2015a). Moreover, to accelerate and guide the green growth transformation, governments, investors and international organizations must cooperate in identifying the challenges and promoting green investment.

SECTION 5

Leveraging Private Investment

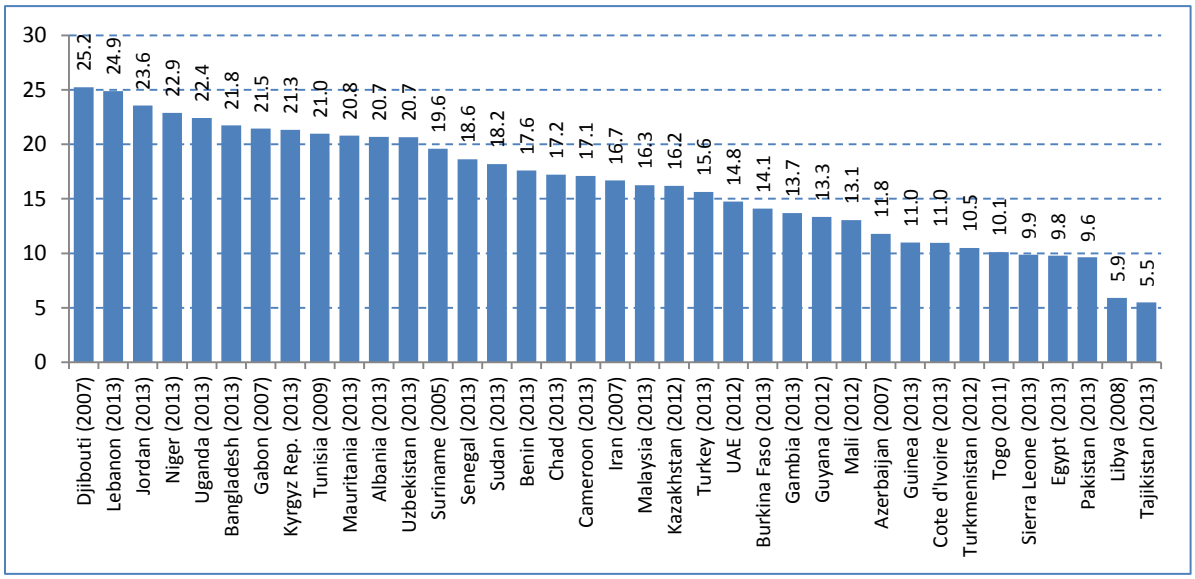
While efficient public investment is essential and required for development, a dynamic private sector can significantly contribute to development of an economy. Private investment help to create new jobs, increase employment, reduce poverty, improve welfare, enhance productivity and competitiveness, and encourage foreign investment by signalling a healthy economic outlook. Thereby, it significantly contributes to growth and development of an economy.

Entrepreneurial dynamism is a key factor in promoting private investment. Entrepreneurs create a positive externality through bringing new goods and new technology to the market. However, as discussed in SESRIC (2014b), entrepreneurial activity in OIC countries is clearly lagging behind developed as well as non-OIC developing countries and there are important constraints in promoting entrepreneurial activity. However, they require an enabling environment to materialize their innovative ideas and take advantage of emerging business opportunities so that to contribute to overall socio-economic well-being. On the other hand, improving investment climate is not enough if entrepreneurs are not innovative. Besides creating an enabling environment, improvement in innovative and entrepreneurial capacities of private sector actors is important for a dynamic and productivity-enhancing private sector.

Figure 5.1 shows the share of private investment in GDP, as measured by the share of private investment in gross fixed capital formation of an economy, in 37 OIC countries for which data are available. According to latest statistics, in 12 OIC countries, this ratio is above 20%. Djibouti is the OIC country with highest private sector investment share (25.2%), followed by Lebanon (24.9%) and Jordan (23.6%). Tajikistan (5.5%), Libya (5.9%) and Pakistan (9.6%) show limited participation of private sector to investment. While it is difficult to make any assessment based on these statistics without knowing the efficiency of investments and share of public sector in total investment, they reflect the extent of private sector dynamism in OIC countries.

Figure 5.1

Share of Private Investment in GDP



Source: World Bank WDI.

In this context, this section focuses on the various issues that are relevant for encouraging private sector participation in investments. Subsection 5.1 discusses some key policy issues related to creating an enabling environment and encouraging private investment. The next subsection investigates the patterns of private participation in infrastructure investment in OIC countries. The section concludes with some discussions on the social impact investment to promote the idea of "responsible investment" in OIC countries.

5.1 Policy Issues for Encouraging Private Investment

In order to attain a sustainable growth, countries have to make constant investments for improving their physical and human capital. Countries with higher growth rates are generally the ones in which shares of total investment in GDP exceed 25%. China, for example, achieved high economic growth rates over the last two decades thanks to investment rates that reach up to 48% of its GDP. On the other hand, countries in the sub-Saharan Africa invested only around 18% of GDP for the last two decades and failed to achieve high and sustainable growth rates. Low investment results in insufficient and poorly maintained physical infrastructure. By improving investment climate, countries with weaker economic prospects can stimulate private investment and transform the economies into more developed structures.

Public sector can take the lead in making large scale investments to transform the economies, but significant constraints and inefficiencies are often observed in such investments. There is a need for utilizing the private sector dynamism to improve the productivity and competitiveness benefits of investment projects. In many cases, private sector participants also face significant challenges before or after undertaking major investment projects. These can be related to regulations, enabling conditions or coordination among relevant stakeholders. This subsection highlights some of the policy issues that should be considered in improving investment climate and stimulating

private investment, and which actions should be taken by policy makers in formulating and implementing these policies.

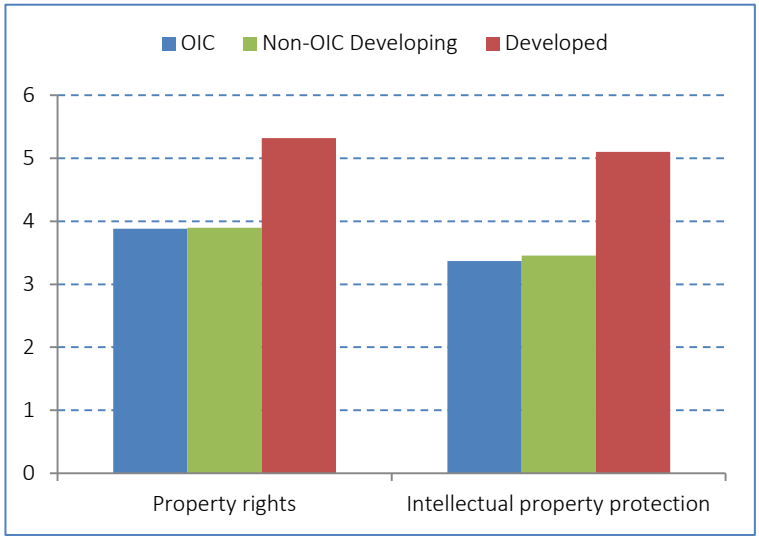
In making investment decisions, private sector considers and carefully evaluates numerous conditions and criteria around themselves. First and foremost, they seek stable macroeconomic conditions to initiate any investment plan and a reliable market to offer their goods and services. Policy issues for encouraging private investment go beyond these considerations to create a more investor friendly environment. Given the size of the market and assuming stable macroeconomic conditions, policy makers should provide a well-regulated and well-functioning business environment to attract private sector investment. Important policy issues that will be covered in this report can be classified under (i) investment regulations; (ii) trade policy; (iii) competition policy; (iv) tax policy; (v) human resource development; and (vi) investment financing. This subsection benefits from the "Policy Framework for Investment" of OECD and its supplementary documents. In assessing the performance of OIC countries, the data from World Economic Forum Global Competitiveness Report 2014-15 have been used. The data presented are indexed between 1 and 7, with higher numbers indicating more favourable conditions.

Investment Regulations

Investment policies directly influence the decision of investors. In order to create an enabling investment environment, special attention should be paid to clear and transparent laws and regulations, mechanisms for settling investment disputes, protection of property rights, and non-discrimination as core investment policy principles. Investors need to understand the practical implications of rules and regulations governing their investment, in terms of the conditions to satisfy, the procedures for a public review and the appeals process in the event of a dispute. Governments should ensure that the implementation and enforcement of laws and regulations dealing with investments and investors are clear and transparent and they do not impose unnecessary burdens on investors. A fair, transparent and predictable regulatory framework is a critical determinant of investment decisions and their contribution to development. It is especially important for SMEs that tend to face particular challenges to entering and complying with the rules of the formal economy.

Moreover, investors need to be confident that their ownership of, or right to use, property is legally recognised and protected. Particularly, governments should implement laws and regulations for the protection of intellectual property rights (IPR) and effective enforcement mechanisms. If the level of protection is not adequate to encourage innovation and investment, new strategies, policies and programmes should

Figure 5.2
Indicators of Investment Regulation



Source: World Economic Forum, Global Competitiveness Report 2014-2015.

be developed to meet the needs of the investors for better protection. IPR give businesses an incentive to invest in research and development, fostering the creation of innovative products and processes.

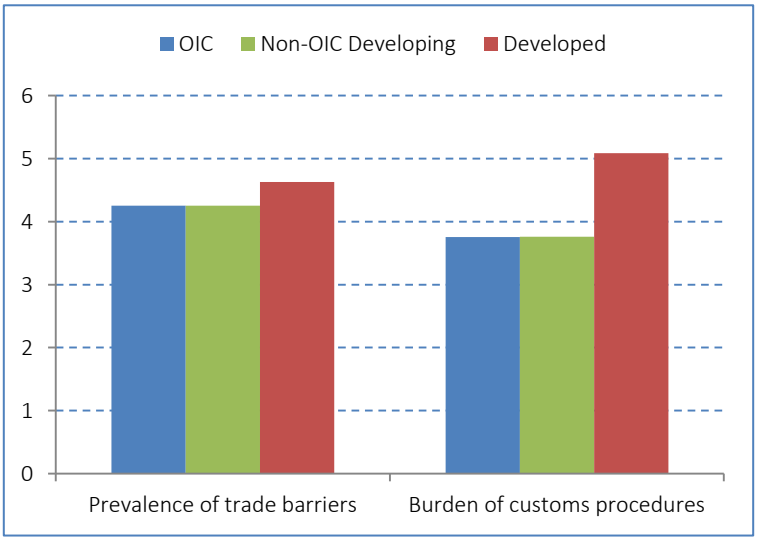
On the other hand, a well-functioning system of contract enforcement and dispute resolution must be in place and widely accessible. Good enforcement procedures improve predictability in commercial relationships and reduce uncertainty by guaranteeing investors that their contractual rights will be maintained by law. When procedures for enforcing commercial transactions are rigid and burdensome or when contractual disputes cannot be resolved in a timely and cost effective manner, many potential investment projects will not be undertaken and economies will rely on less efficient commercial practices. The expropriation laws and review processes also need to be well-defined and explicit limits and channels.

Figure 5.2 shows the performance of OIC countries in two indicators of investment regulation in comparison with other country groups. Strengths of property rights and intellectual property rights are measured within the range of [1 - 7], with 7 being the strongest one. While OIC countries and non-OIC developing countries show similar protection levels, developed countries significantly outweigh the levels in developing countries. By improving levels of property rights and intellectual property protection, OIC countries can create a better environment for private investors.

Trade policy

Trade policies are important in investment decisions due to its impact on the market size for goods and services offered by firms. Rising trade in intermediate goods, falling trade barriers and growing integration into global production chains played important roles in raising the importance of trade policies on investment climate. In addition to enlarging the market potential, trade liberalization is said to improve allocative efficiency and productivity. On the other hand, governments use various trade policy instruments, such as tariffs, quotas, subsidies etc., to promote investment in targeted sectors. Trade policy measures to stimulate private investment are, however, not limited to these restrictive instruments. Custom procedures, international trade agreements, trade facilitation measures and clear trade policy strategies play all significant roles in influencing private investors.

Figure 5.3
Trade Policy Indicators



Source: World Economic Forum, Global Competitiveness Report 2014-2015.

Private sector likes simplified procedures that can significantly reduce costs of custom compliance, and regulatory and administrative procedures. Unnecessarily complicated procedures make it harder for countries to reap the efficiency gains resulting from global supply chains, potentially discouraging investment. Systematic analysis

should be made to evaluate to what extent trade policies raise the cost of inputs for production and thereby avoid sourcing inputs at competitive world prices. It must be ensured that protectionist trade policies do not distort resource allocation and damage the overall investment climate. Policies that favour certain industries should be devised in a way that they do not crowd out investment in more productive activities.

Predictable, consistent and transparent trade policies reduce the risks for investors. Multilateral and preferential trade and investment agreements increase investor sentiments and attract more investment. Such agreements expand the market potential, allow for greater economies of scale and reduce costs. Therefore, governments should be predictable in entering new agreements to promote adjustments to changing competitive conditions. The promotion of investment in specific industries through trade policies also should be transparent and consistent with existing international obligations.

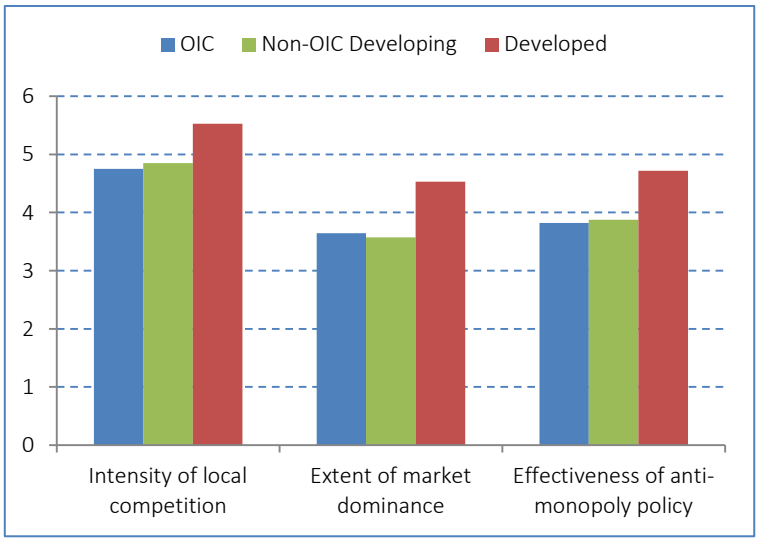
Figure 5.3 shows the performance of OIC countries in two trade policy indicators, namely prevalence of trade barriers and burden of customs procedures. Prevalence of trade barriers measures the level of restriction on imported goods due to non-tariff barriers, with index value 7 indicating no limitation. OIC countries again show similar performance in import restrictions and efficiency of custom procedures compared to non-OIC developing countries, but weaker performance compared to developed countries. In order to attract more private investment, OIC countries can reduce the barriers to trade in a way that does not harm the national economy and improve the efficiency of customs procedures for better trade policy environment.

Competition policy

A competitive environment encourages risk-taking and investment. Therefore, competition is essential for a dynamic business environment in which firms are willing to take risks and invest. Evidence also suggests that industries facing greater competition experience faster productivity growth, because competition allows more productive firms to enter and gain market share at the expense of less productive ones. Competition provide stimulus for innovation in products and processes. Investor confidence, and hence investment, increases in an environment where there is ample opportunity for innovation, productivity growth and higher profits, and competition contributes to that.

Creating and maintaining a competitive environment requires a rigorous and well-structured competition law and an effective competition authority that enforces this law. Economic policies should be in line with the principles of competition and avoid any unfounded restriction. Competition

Figure 5.4
Competition Policy Indicators



Source: World Economic Forum, Global Competitiveness Report 2014-2015.

authorities must have the adequate resources, political support and independence to conduct their job properly. Incumbent firms can sometimes discourage investment by abusing their market power. Competition authorities should effectively address anti-competitive practices by such firms, including state-owned enterprises, that damage investment climate. The demonstrated willingness of competition authorities to avert and punish anticompetitive practices can have a significant positive effect on the investment climate.

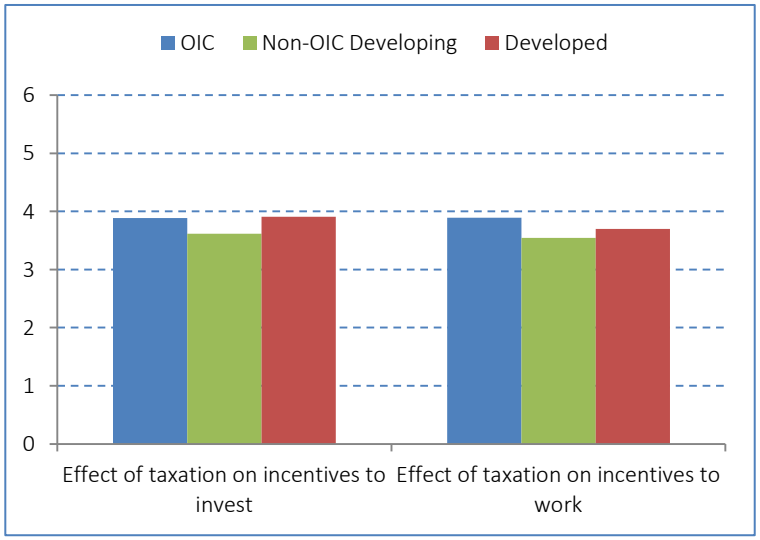
Competition authorities should periodically evaluate the costs and benefits of industrial policies that provide direct or indirect support to different industries to achieve certain objectives. Such policies often include state involvement through financial assistance or restriction on foreign involvement, trade barriers and exemption from competition laws. Prolonged support of certain firms or industries may result in higher prices and lower productivity due to lack of competitive pressures.

Figure 5.4 shows the performance of OIC countries in three competition policy indicators, namely intensity of local competition, extent of market dominance and effectiveness of anti-monopoly policy. Once again, OIC countries show similar performance with non-OIC developing countries, but weaker performance compared to advance countries. OIC countries can attract more private investment by improving competitive environment and effectiveness of anti-monopoly policies.

Tax policy

Tax incentives are one of the instruments used by policy makers to stimulate private investment. If there are some underlying problems with overall investment environment, such as poor infrastructure or lack of skilled labour, it is easier for governments to provide tax incentives than investing in addressing these problems. Governments do not need to make actual spending while providing tax incentives, which makes the policy instrument politically easier, but governments forego significant fiscal revenues. If expected benefits do not exceed the costs, overall welfare may be deteriorated. The whole process of tax incentives should be based on solid assessments of costs-benefits and implementation process should be clear and transparent in encouraging private investment.

Figure 5.5
Tax Policy Indicators



Source: World Economic Forum, Global Competitiveness Report 2014-2015.

Tax policy should be supportive to investment. While providing certain incentives to investors, tax system should be able to raise revenues to strengthen the key enablers of investment ranging from human capital development to infrastructure development. In order to maintain the balance between these two objectives, policy makers should regularly assess the adequacy of fiscal revenues to cover the costs of key

public investments and the level of tax burden on corporate profits to determine if the tax system is supportive of private investment. At the end, if framework conditions and market characteristics for investors are relatively weak, a low tax burden may have only limited effect on investment decisions.

Figure 5.5 shows the performance of OIC countries in two tax policy indicators, namely effect of taxation on incentives to invest and effect of taxation on incentives to work. Taxes in OIC countries do not reduce the incentives to invest and work as they do in non-OIC developing countries. This shows that current tax policies in OIC countries are relatively more investor friendly than the policies in other country groups.

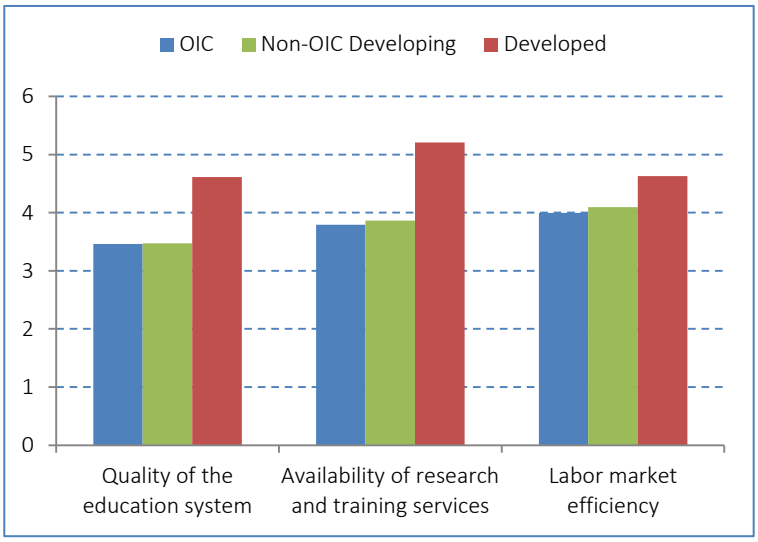
Human resource development policies

Human resource development policies concern the quality of the labour force and the regulation of the labour market. Quality of labour force reflects the outcomes of educational attainment, training programmes and physical health conditions of the people. Skilled and adaptable labour force provides an important stimulus for investors in making their decisions, as they show quick adaptation capability to new processes and technologies. Due to multiple dimensions involved in developing human resources, it must be consistent with a country's broader development and investment policies. Policy makers should tackle low human resource development by developing comprehensive strategies that considers all dimensions within the implementation capacity of the country.

Human resource development policies must therefore be adaptable and regularly updated to respond to the changing skill needs of enterprises so that to ensure investments are productive and growth-enhancing. High-skilled labour force is a key factor in a country's competitiveness to attract investment.

Figure 5.6 shows the performance of OIC countries in three indicators of human resource development policies, namely quality of the education system, availability of research and training services and labour market efficiency. Labour market in OIC countries is not as effective as in advanced economies and labour force in OIC countries are apparently lacking quality education and research and training services. In order to encourage private investors, OIC countries can employ polices that improve the human capital.

Figure 5.6
Indicators of Human Resource Development Policies



Source: World Economic Forum, Global Competitiveness Report 2014-2015.

Investment financing

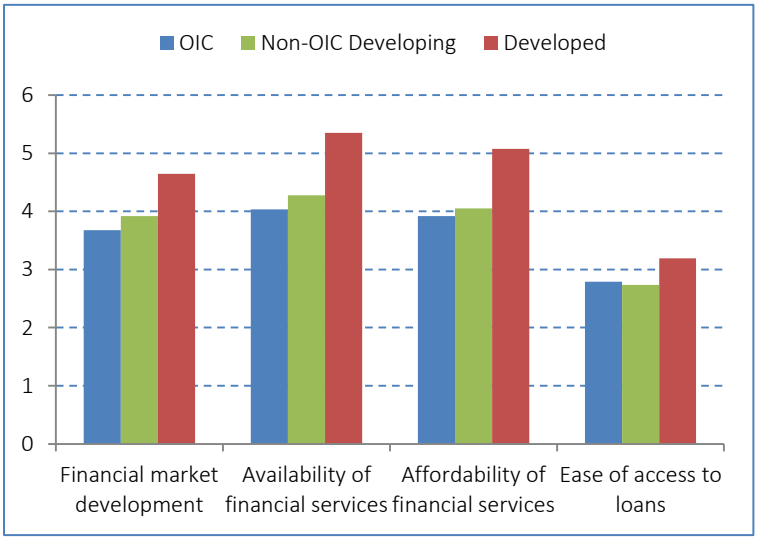
When it works as it should, financial sector plays a critical role in allocating resources to most productive uses, but it can be quite harmful if not properly regulated. Financial sector should enable firms to make use of promising investment opportunities by providing necessary funds.

Small but innovative firms particularly need external finance to expand their businesses. By facilitating entry of such firms to market, financial sector can help to increase competition and efficiency in the market. Governments should establish framework conditions for the efficiency and proper functioning of the financial system. Greater competition generally contributes to developing more efficient banking institutions and helps to enhance financial deepening.

There are typically two kinds of challenges for investment financing. One is financing long term investments and the other is financing innovative SMEs. Financing long-term investments is especially challenging task, given the longer time horizons of such projects, the greater uncertainty regarding investment returns and the illiquidity of certain types of investments. Governments should also encourage lenders to provide financing to innovative SMEs that typically lack sufficient collateral.

Figure 5.7 shows the performance of OIC countries in four indicators of investment financing, namely financial sector development, availability and affordability of financial services, and ease of access to loans. In first three indicators, OIC countries show the poorest performance compared to other country groups. In ease of access to loans, they show slightly better performance compared to non-OIC developing countries. Therefore, by further developing financial markets and enhancing availability of financial services, OIC countries can improve the investment climate for private participants.

Figure 5.7
Indicators of Investment Financing



Source: World Economic Forum, Global Competitiveness Report 2014-2015.

5.2 Encouraging Private Participation in Infrastructure Investment

A well-functioning and efficient infrastructure is highly instrumental for economic and social development. It increases living standards, attracts more businesses and supports the production process of agricultural and manufactured goods by reducing costs. It also helps economic integration and facilitates trade as it eases the access to goods and services. Better transport and communication links make it easier for many countries to access international markets, which is particularly of significant importance for landlocked countries. Infrastructure projects also have a stimulus effect in the economy and they are very likely to increase employment, not just for short term construction purposes but also for the longer term, as infrastructure facilities are believed to draw more companies in their areas. Moreover, infrastructure projects create a demand for skilled labour and intermediary materials to be used as inputs. Responding to this demand, initiatives such as labour training or local production of intermediary materials can be undertaken, which will further benefit the economy in the long term.

Bearing the above mentioned advantages in mind, today's developed nations had been investing in infrastructure for many decades. However, lack of infrastructure still remains a major challenge in developing countries. Some of the biggest challenges to investment in infrastructure in these countries include lack of government resources, inefficiency of state owned enterprises, unskilled labour and low levels of technology. To remedy this problem, private companies are increasingly given infrastructure projects by different contract types, varying according to the necessities of the particular project and country.

On the other hand, the choice between public and private provision of infrastructure services should be guided by an objective assessment of what best serves the public interest. Factors to be taken into account include the current levels of service delivery and the condition of assets, affordability to households and companies, coverage of networks, operational efficiency, long-term maintenance of assets as well as social and environmental sustainability. The decision also needs to be guided by the timeframe in which improvements are required and the sources of finance that are available.

Private participation does not necessarily require a partnership with public sector. When governments open the market for private investment, investors can decide whether or not to invest in certain sectors based on their assessment of project profitability. On the other hand, there is also an increasing interest in cooperation between public and private sectors to promote development within a country. Public Private Partnerships (PPPs) involve collaboration between public and private sector to fulfil a long-term goal, usually for a social and economic infrastructure project that will lead to the development of an area or region. In practice, such partnership agreements are mainly used to finance the building and operation of hospitals, schools, roads, rail networks and airports.

PPPs can be attractive to both the government and the private sector. For the government, private financing can support increased infrastructure investment without immediately adding to government borrowing and debt, and can be a source of government revenue. At the same time, better management in the private sector and its capacity to innovate can lead to increased efficiency and bring better quality and lower cost services. For the private sector, PPPs present business opportunities in areas from which it was in many cases previously excluded as well as expansion of products and services beyond their current capability (IMF, 2004b). PPPs, therefore, enable the public sector to benefit from entrepreneurial dynamism, extended financing opportunities in an environment of budgetary constraints, innovative and efficient management styles of the private sector who contributes their own capital, skills and experience.

There are four broad types of PPP modalities: management contracts, lease contract, concessions, and build-operate-transfer (BOT) schemes and its many variants. Table 5.1 illustrates how these different forms of project delivery vary in terms of asset ownership, risk transfer, contract duration, and the share of responsibilities among public and private parties. There are many other variants of PPP agreements including, but not limited to, build-own-operate (BOO), build-develop-operate (BDO), design-build-finance-operate (DBFO), build-own-operate-transfer (BOOT), where private sector designs, builds, owns, develops, operates, manages, buys, leases, renovates and/or modernizes an asset in accordance with the agreements with the public sector. The issue of public-private partnerships is comprehensive and they can be an important tool in leveraging private

investment as well. For the sake of brevity, however, the analyses in rest of this subsection will be limited to the private participation in infrastructure investment.

Table 5.1: Forms of PPP Delivery: Differences in asset ownership, risks, and contract duration

Contract type and duration	Asset ownership	Capital investment	Commercial risk	Responsibility for O&M	Service and payment to private provider
Service contract (1-3 years)	Public	Public	Public	Public & Private	Definitive fee paid for technical service by government to private provider
Management contract (3-8 years)	Public	Public	Public	Private	Private sector manages operation of government service and receives direct fees from government
Lease contract (5-10 years)	Public	Public	Private	Private	Private sector manages, operates and/or maintains a public service to specified standards; user fees charged and rent paid to government for use of facility
Concessions and PPPs (BOTs, BOOs etc.) (10-30 years)	Public & Private	Private	Private	Private	Private sector manages, operates, maintains and/or invests in infrastructure to specific outputs and standards; fees charged to users; may also pay concession fee to government

Source: OECD (2015c).

The World Bank Private Participation in Infrastructure (PPI) Database provides information on the private sector participation in infrastructure investment for 138 developing countries, 49 of which are OIC member countries. This subsection analyses the tendency of private participation in infrastructure in 49 OIC countries[7] over the last 25 years (between 1990 and 2014) and compares the figures in OIC countries with non-OIC developing countries to make assessments on total investments and deal types. However, it should be noted that the average performance of non-OIC developing countries are highly influenced by four leading emerging economies, namely Brazil, Russia, India, and China (BRIC countries). High infrastructure investment in these countries induces marked differences in the amount of private participation in infrastructure and number of projects. For that reason, the average performance of OIC countries is compared with non-OIC developing countries by further disaggregating them between non-OIC countries excluding BRIC and BRIC countries, whenever appropriate.

According to the database, there are four major areas for infrastructure investment, which are also accordingly considered in this report. These are energy, transport, telecom, and water and sewage. These infrastructure investments are also classified under four contract types, including management and lease contracts, concessions, greenfield projects, and divestitures. Management and lease contracts leave the operation and management of a state owned facility to a private entity while the state still remains the decision maker. Concessions also leave the management to a private entity; however the private entity bears an important part of investment risk. Greenfield projects take place when a private entity or a public-private joint venture builds a new project and then operates it for a fixed period. Divestitures on the other hand are privatization projects, they

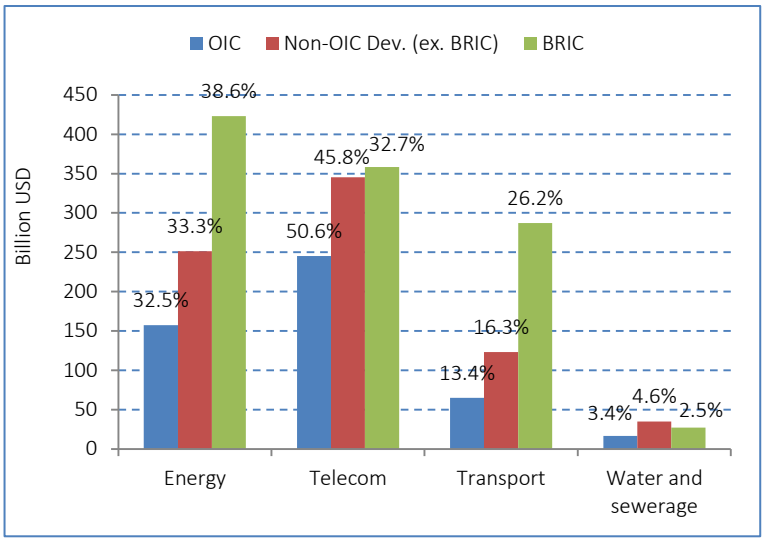
[7] The data are not available for Bahrain, Brunei, Kuwait, Libya, Oman, Qatar, Saudi Arabia, United Arab Emirates. The database also does not cover developed countries.

occur when private companies buy shares of a state owned enterprise (see World Bank, 2015 for detailed descriptions).

Figure 5.8 and 5.9 shows the total value and number of private investment in infrastructure in OIC countries in comparison with non-OIC developing countries during the period 1990-2014. Energy infrastructure covers natural gas and electricity generation, transmission and distribution. Between 1990 and 2014, 507 private participation in energy infrastructure projects reached contractual or financial closing in 49 OIC countries, comprising of investment commitments of US$ 157.4 billion. Energy sector accounted for 32.5% of all private investment in OIC countries.

Figure 5.8

Total Value of Private Investment in Infrastructure (1990-2014)

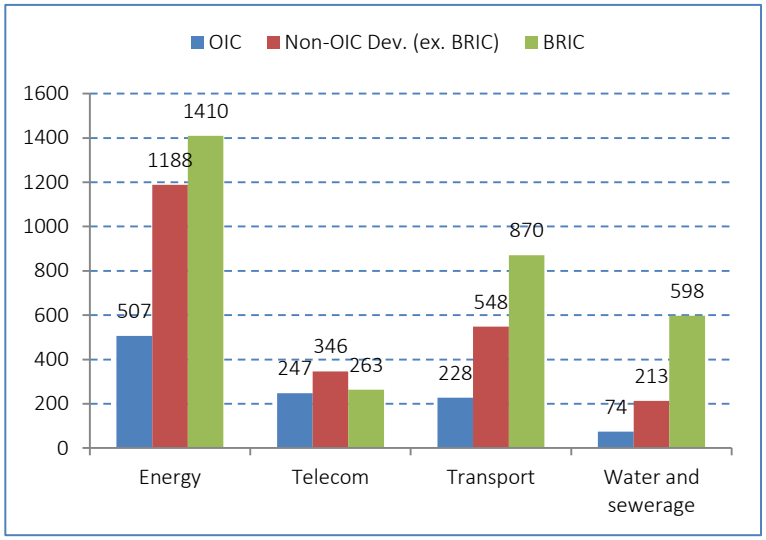


Source: World Bank Private Participation in Infrastructure (PPI) Database.

Telecom infrastructure involves fixed or mobile local telephony, domestic long distance telephony, and international long-distance telephony is quite significant bearing in mind the strong role IT technology and e-commerce has in business. Between 1990 and 2014, telecom infrastructure projects with private activity reached contractual or financial closing in OIC member countries, covering investment commitments of US$ 245.2 billion through 247 projects. With over 50% share, the sector accounted for the largest private participation in investment in OIC countries.

Figure 5.9

Total Number of Private Investment in Infrastructure (1990-2014)



Source: World Bank Private Participation in Infrastructure (PPI) Database.

Transport infrastructure consists of airport runways and terminals, railways, toll roads, bridges, highways, tunnels, port infrastructure, terminals, superstructures, and channels. It plays a significant role in economic development through improving the freight industry and transfer of agricultural, manufacture products, raw and intermediary materials. During the period of 1990-2014, 228 private transport infrastructure projects took place in OIC countries, involving investment commitments of US$ 65.1 billion and accounting 13.4% of total investments.

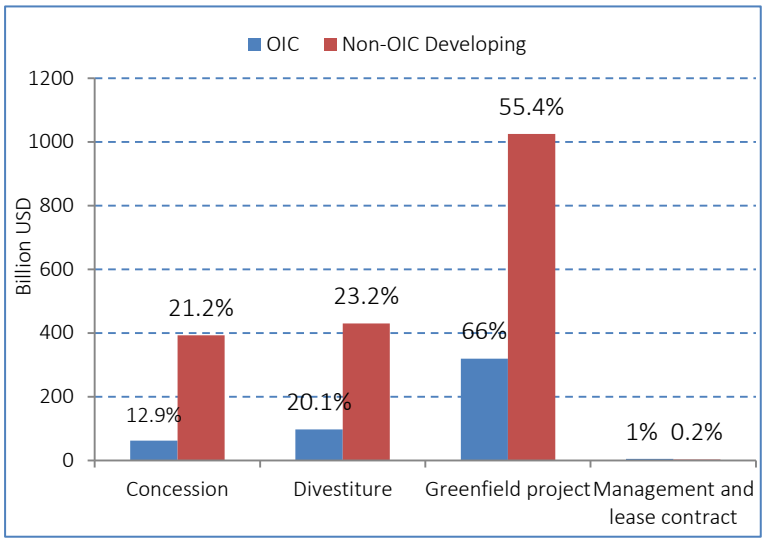
Making possible drinkable water generation, distribution, sewage collection and treatment; water and sewage infrastructure is not only a substantial element in determining the achievement of agricultural and manufacturing activities but also essential to providing the decent life standards for human and economic development. During the period 1990-2014, 74 private water and sewage infrastructure projects reached contractual or financial closing in OIC countries, comprising investment commitments of US$ 16.5 billion since 1990.

Overall, in 49 OIC countries, 1,056 privately funded infrastructure projects took place, making up US$ 484.2 billion between 1990 and 2014. In all sectors, 89 non-OIC developing countries have larger amount and number of investment by private sector, which can naturally be explained by the greater number of countries involved in the calculations. However, the interesting observation is that four BRIC countries outperform OIC countries in terms of value and number of projects in all sectors and they again outperform other non-OIC developing countries except the value of investment in water and sewage and number of investment in telecom.

In terms of project type, almost two-thirds of all investments have been made through greenfield projects by investment commitments of US$ 319.4 billion, meaning that most of the projects were newly initiated, having no prior infrastructure to build on (Figure 5.10). With the increasing of economic decentralization and privatisation policies, divestiture contracts were the second most widespread deal type in private participation involving investment of US$ 97.3 billion, 20.1% of total investments in OIC countries. In non-OIC developing countries, greenfield investments have also accounted for bulk of investments with over 55% share.

Figure 5.10

Private Investment in Infrastructure by Project Type (1990-2014)



Source: World Bank Private Participation in Infrastructure (PPI) Database.

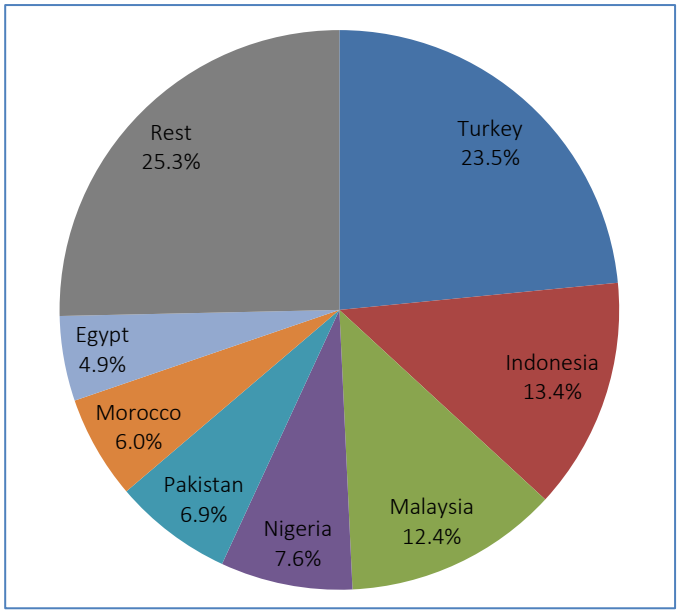
Among the 49 countries, Turkey, Indonesia and Malaysia have been the leading OIC countries through conducting 390 infrastructure projects, with total value of private investment reaching US$ 238 billion and accounted for %49 of total OIC investment (Figure 5.11). Having higher income levels, human capital and better conditions for doing business have promoted private investments in infrastructure. Many OIC countries, located mostly in sub-Saharan Africa and central Asia, on the other hand, lag behind their peers in terms of private investment in infrastructure. Out of 49 OIC member countries, 30 countries reported no private infrastructure projects at all for water and sewage, followed by 20 in transport, 11 in energy and 5 in telecom. Comoros, Djibouti, Gabon, Mauritania, Suriname and Turkmenistan had no private activity in three out of four categories.

In encouraging private investment, OECD (2007) outlines general principles for private sector participation in infrastructure investment. These principles, which are also completely relevant for OIC countries, can be categorized under five main areas:

i. Decision to involve the private sector on the provision of infrastructure services
ii. Ensuring an enabling policy framework for investment
iii. Clarifying goals, strategies and capacities
iv. Making the public-private co-operation work
v. Encouraging responsible business conduct

The decision to involve the private sector has to be guided by an assessment of the relative long-term costs and benefits and availability of finance. Embarking on privately financed infrastructure projects as a way of improving the asset bases without properly evaluating the longer-term economic, financial and social consequences almost invariably causes further problems. Moreover, careful assessments should be made on how to finance the projects and how the end-users are affected in case of shortfalls. Therefore, the allocation of potential risks and responsibilities between private and public sector should be agreed based on an assessment of public interest. Risk allocation largely depends on the type of private sector involvement. Full private ownership (divestiture), full public ownership (management or service contracts), and temporary control and investment commitments (concessions) implies various degree of control over infrastructure assets and different risk sharing arrangements. From public sector perspective, fiscal discipline must be safeguarded and private participation should not be used as an opportunity for escaping budgetary discipline.

Figure 5.11
Private Investment in Infrastructure (1990-2014)



Source: World Bank Private Participation in Infrastructure (PPI) Database.

Second, authorities need to ensure an enabling policy framework for investment. A sound enabling environment for infrastructure investment is essential to attract the participation of the private sector. This includes high standards of public and corporate governance, transparency, the rule of law, protection of property and contractual rights. Success of private sector involvement is heavily affected by the quality of the national investment climate. Laws and agreements should be adequately enforced and infrastructure projects should be free from corruption. Privately funded infrastructure projects have usually monopolistic characteristic, which can provide significant opportunity for rent-seeking at all phases, including design, procurement, operation and transfer of assets. Therefore, adequate measures should be in place to ensure transparency and safeguard against corrupt practices. Moreover, the benefits of private participation are enhanced by efforts to create a competitive environment by exposing these areas to competitive pressures, where

elements of natural monopoly are common and competition is scant. Finally, in order to improve the policy environment, access of private sector to capital markets should be facilitated to fund their operation at competitive international rates. In markets where there exist well-functioning domestic capital markets, private sector is more likely to involve in infrastructure investment.

Third, the success of private involvement in infrastructure depends on public acceptance and on the capacities of government to implement the projects. Private participation in infrastructure is unlikely to be successful unless authorities guarantee that the projects are in the public interest and are acceptable to consumers and other stakeholders. Authorities should have the capacity to manage the commercial processes involved, as private participation often involves sophisticated technological, corporate and financial solutions that authorities may not be fully equipped to handle. An important concern for public authorities is the coordination of infrastructure policy, because divergent strategies may be pursued at the national and sub-national levels and infrastructure projects may have important repercussions outside the implementing jurisdiction. Therefore, mechanisms should be in place for cross-jurisdictional co-operation.

A fourth challenge for public authorities and the private sector is to establish a working relationship toward the joint fulfilment of the general public's infrastructure needs. Building trust between the public and private sector is a matter of high priority. Public authorities should communicate clearly the objectives of their policies and put in place consultative mechanisms between the public and

Box 5.1: The Coordination Council for the Improvement of the Investment Environment (YOIKK) of Turkey

Turkey developed its own structure for reforming the investment climate. In order to rationalize bureaucratic procedures and reduce red tape, a comprehensive reform program was launched in 2001 and renewed in 2012. The Coordination Council for the Improvement of the Investment Environment (YOIKK) is established with the aim of rationalizing the regulations on investments in Turkey, developing policies by determining the necessary arrangements that will enhance the competitiveness of the investment environment, generating solutions to the administrative barriers encountered by the domestic and international investors in all phases of the investment process including the operating period.

YOIKK has become a key structure where private sector makes contributions in the process of improving investment climate. The Council conducts its agenda through 10 Technical Committees working on specific issues with participation of both public and private institutions. YOIKK is described as a success story of public-private partnership on international platforms. The reform program consists of 10 Technical Committees working on technical issues and each of the technical committee is chaired by high level bureaucrats. These committees include Company Transactions and Corporate Governance, Employment, Input Supply Strategy (GITES) and Sectoral Licences, Investment Location, Environment and Zoning Permits, Taxes and Incentives, Foreign Trade and Customs, Intellectual Property Rights and R&D, Legislation on Investment Climate and Legislative Procedures, Access to Finance, and Infrastructure.

Turkey's experience in improving the investment environment offers important lessons in terms of creating awareness and changing the mentality of the public and private sector, establishing institutional mechanisms on improving investment environment, diagnosing the investment conditions of the country and detecting major obstacles, and formulating best solutions for investor problems.

See yoikk.gov.tr for more information about Turkey's experience in improving investment climate.

private partners in order to optimise the involvement of the private sector. All relevant information about projects, including the state of existing infrastructure, performance standards and penalties in the case of non-compliance, should be disclosed. Awarding procedure should be fair, transparent and non-discriminating and dispute resolution mechanisms should be in place.

Fifth, governments' expectations regarding responsible business conduct need to be clearly communicated by governments to their private partners. Private sector participants should observe commonly agreed principles and standards for responsible business conduct, including endeavouring for competitive returns and responding to societal expectations. Private enterprises should participate in infrastructure projects in good faith and with a commitment to fulfil their commitments. They should not resort to bribery and other irregular practices to obtain contracts, gain control over assets or win favours. It is also important to engage in dialogue with affected communities and stakeholders early in the planning process in order to give them a genuine chance to be heard and to engage actively with the financiers over the issue of environmental and social consequences of their actions.

5.3 Social Impact Investment

Impact of an investment usually measured in terms of economic value added (such as total value added, value of capital formation and export growth), job creation (such as increase in employment, wages and skills) or sustainable development (such as social, environmental and development impact indicators). Depending on the development context, some indicators may have greater relevance for different countries. At early stages of development, contribution to GDP and job creation may be more relevant but at more advanced stages skills development and technology improvements may gain greater relevance. Social and environmental development needs equally rely on the development context in which societies are living.

A growing number of individuals, foundations and institutional investors have become interested in finding investments that deliver both a social and a financial return. Such investments are generally called as social impact investment (SII), responsible investment (RI), socially responsible investing (SRI) or corporate social responsibility (CSR), which will be used interchangeably in this subsection despite some differences in definitions. Traditionally, investors are used to make their decisions based on careful analysis of risks and returns of investment projects. Proponents of social impact investment claim that "by bringing a third dimension, **impact**, to the 20th century capital market dimensions of risk and return, impact investing has the potential to transform our ability to build a better society for all" (SIITF, 2014). This new approach is built mainly on the beliefs that investment in some cases can be more effective than donations in helping the poor and social motivations harnessed to financial ones can sometimes do perform more effectively.

Broadly speaking, social impact investment (SII) is the provision of finance to organisations with the explicit expectation of a measurable social, as well as financial, return (OECD, 2015d). SII involves private investment that contributes to the public benefit. Although, socially responsible investing has origins dating back several centuries, social impact investment began to emerge about a decade ago (Saltuk et al, 2013). A growing number of "responsible investors" started to seek socially responsible and sustainable investments and subsequently a social impact investment market has grown over the past decade to develop approaches for financing solutions to social

issues. Today, a growing number of companies are focusing on environmental and social issues or practicing CSR.

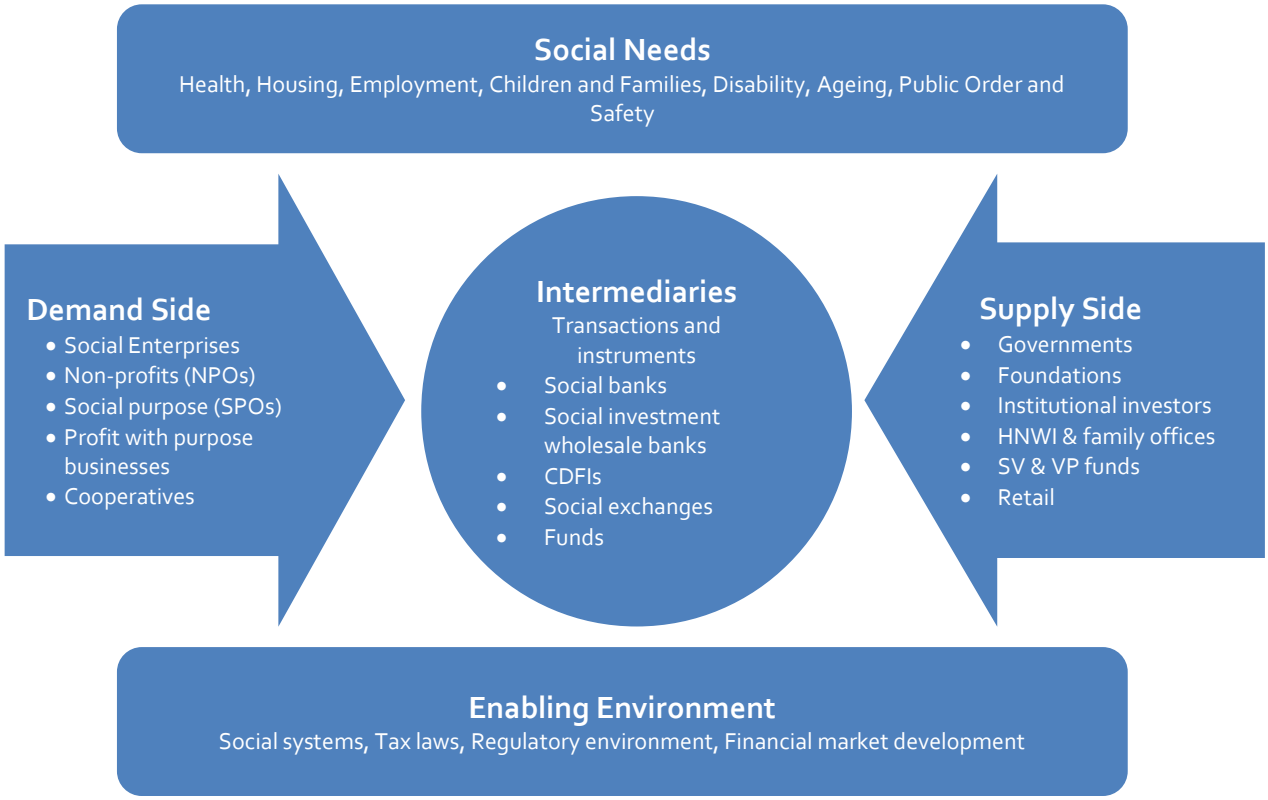
Responsible investment requires that investors pay attention to the wider contextual factors, including the stability and health of economic and environmental systems and the changing values and expectations of the societies of which they are also part. Therefore, social impact investors seek market-based solutions to the world's most pressing challenges in sectors such as sustainable agriculture, affordable housing, affordable and accessible healthcare, clean technology, and financial services, (GIIN, 2015). Despite the difficulties in measuring size of the market, mainly due to the lack of clear definitions and the diversity of sectors and approaches across geographies, the social impact investment market potential has been estimated to be significant (OECD, 2015d).

Social impact investment framework drawn by OECD (2015d) consists of investors (supply side), social ventures (demand side) and intermediaries (including transactions and financing instruments) (Figure 5.12). The enabling environment, including framework conditions (e.g. social systems, tax and regulation), also can play a critical role in the social impact investment market and must be taken into consideration when looking at the SII ecosystem. Progress in the SII market will depend on different stakeholders working together to build critical mass by developing the market, tools and practice.[8]

There is also the responsible investment (RI) approach that explicitly acknowledges the relevance

Figure 5.12

Social Impact Investment Market Framework

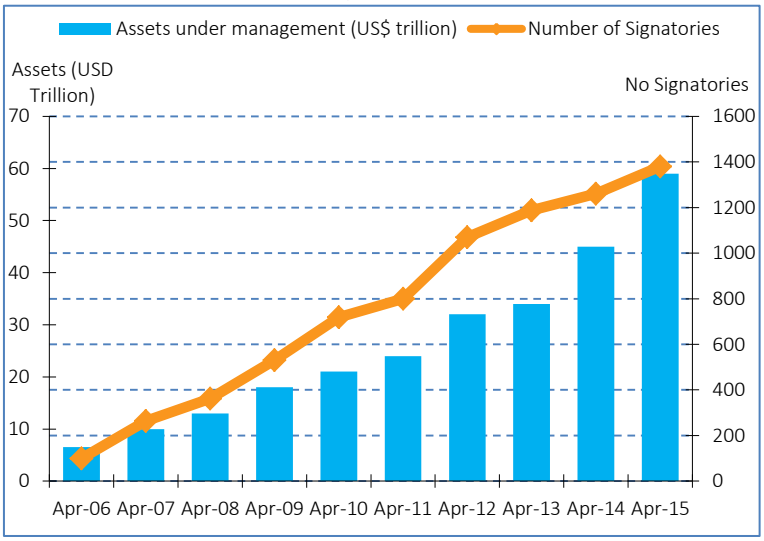


Source: OECD (2015d).

[8] See OECD (2015d) for more detailed discussion on the role of different actors.

to the investor of environmental, social and corporate governance (ESG) factors[9], and of the long-term stability of the market as a whole. It recognises that the long-term sustainable returns are dependent on stable, well-functioning and well governed social, environmental and economic systems (PRIA, 2015). The UN Principles for Responsible Investment is a joint initiative of the UN Environment Programme Finance Initiative and the UN Global Compact with the aim of incorporating ESG issues into mainstream investment decision-making and ownership practices. Since its launch in 2006, the PRI Initiative has been instrumental in raising awareness about responsible investment among the global investment community, increasing the level of transparency around the activities and capabilities of its signatories and fostering collaboration between them, and supporting their engagements with companies and policymakers on ESG issues. Assets under management by PRI signatories now stand at more than $59 trillion, up from $4 trillion at the PRI's launch in 2006 (Figure 5.13).

Figure 5.13
Growth in Responsible Investment



Source: PRI Association.

Similarly, OECD has *Guidelines for Multinational Enterprises (MNEs)*, which is the most comprehensive voluntary corporate responsibility instrument addressed by governments to multinational enterprises – i.e. those operating from and in the 39 adherent countries to the OECD Declaration on International Investment and Multinational Enterprises. The OECD Guidelines are recommendations by governments to multinational enterprises (MNEs) operating in and from the territories of the 39 countries that adhere to the Guidelines. The Guidelines are designed to contribute to a favourable investment climate, to promote the positive contributions multinational enterprises can make to economic, environmental and social progress, and to ensure that MNEs act in harmony with the policies of the countries in which they operate and with societal expectations. They establish non-binding principles and standards covering such areas as human rights, disclosure of information, anti-corruption, taxation, labour relations, environment, competition and consumer protection (OECD, 2011).

[9] Examples of environmental issues include biodiversity loss, climate change impacts, renewable energy, energy efficiency, resource depletion, chemical pollution, waste management, depletion of fresh water and changes in land use. Examples of social issues include activities in conflict zones, distribution of fair trade products, health and access to medicine, workplace health safety and quality, labour standards in the supply chain, human capital management, and freedom of association. Examples of governance issues include executive benefits and compensation, bribery and corruption, shareholder rights, business ethics, independent directors, risk management, stakeholder dialogue, lobbying, and disclosure (PRIA, 2015).

In this context, OIC countries can develop their regulatory infrastructure to accommodate more "responsible investment" in addressing the various socio-economic and environmental challenges. The key drivers in addressing social needs are the service delivery organisations. These organisations can include community organisations, charities or non-profit organisations, social enterprises, and social impact-driven businesses. In some countries, only non-profit organisations are considered "social", but rules can be changed to include for-profits organizations with a targeted social purpose. There is also need to support investors to allocate certain amount of their resources to investment projects with various impacts on social, economic and environmental areas. Intermediaries and an efficient intermediation system also play a pivotal role in developing the social impact investment ecosystem and necessary measures should be taken to encourage and incentivize the actors for effective functioning of the responsible investment system.

SECTION 6

Trends and Policies in Attracting **Foreign Direct Investment**

With the rise of globalization, foreign direct investment (FDI) has been increasingly seen as an important stimulus for productivity and economic growth both for developing and developed countries. Although there is no consensus, many scholars have found that the benefits of FDI outweigh its side effects. UNCTAD (2015b) claims that FDI is a critical source for financing development in developing countries, whose inward FDI stocks are expected to quadruple by 2030. Positive effects of FDI on development (e.g. employment generation, technology diffusion, and economic growth etc.) have led many developing countries to follow pro-FDI policies in order to induce more FDI inflows (Brenton et al., 1999).

Since FDI is a type of physical investment, it is expected to widen the stocks of physical capital in host countries (i.e. capital widening effect). Usually multinational companies bring advanced technology and effective managerial systems along with their capital to host countries for profit maximization (OECD, 2002). This basic yet important reasoning about the technology diffusion/transfer implies that as FDI increases total factor productivity levels tend to go up, which ultimately increases per capita income levels and spurs development over the long-run (see info box).

Against this backdrop, this section overviews FDI trends and policies observed in OIC member countries in a comparative perspective. It first starts with an overview on FDI inflows and stocks performance of OIC member countries, and then looks at intra-OIC FDI trends in order to assess the opportunities to improve intra-OIC FDI flows by using the UNCTAD bilateral FDI database. Finally, it examines the current FDI policies and institutional framework in OIC countries in order to

explore policy issues for improving the investment climate to attract more value adding international investment.

6.1 Flows, Stocks and Potential of Foreign Investment

This section provides an assessment of FDI inflows and stocks in OIC member countries by using a dataset that covers the period 1993-2014. It subsequently provides an analysis on FDI potential and performance in OIC member countries, and the stance of Greenfield investments in the OIC group.

6.1.1 FDI Flows and Stocks

According to the UNCTAD, FDI is the category of international investment in which an enterprise resident in one country (the direct investor) acquires an interest of at least 10% in an enterprise resident in another country (the direct investment enterprise) (UNCTAD, 2010). Less technically, the volume of FDI inflows is the sum of actual FDI realized in a given period in a host country. The figures on FDI inflows in a given year can give an overall idea about the actual investment climate in a country from foreigners' perspective. If FDI inflows into a country are increasing over time, it is an indication of an overall improvement in host country institutions and economy that attracts more FDI.

Figure 6.1 presents the evolution of FDI inflows in the world for the period 1993-2014. According to Figure 6.1 (left), all country groups experienced a significant increase in their FDI inflows figures since the 1990s, mainly thanks to the globalization wave and the collapse of the Soviet Union that allowed many countries to integrate more with the world economy. As a result, FDI inflows in the OIC group increased from around US$ 16.4 billion in 1993 to US$ 132.3 billion in 2014 (a 8.1

Box 6.1: FDI and Technology Transfer, 2014

Countries benefit from new technologies brought by FDI at varying degrees. The index developed by the World Economic Forum measures the extent to which countries benefit from FDI and technology transfer. Accordingly, it is found that OIC countries, on average, benefit to a lesser extent from technologies that foreign investors bring with FDI compared with non-OIC developing countries and developed countries. However, the simple average of OIC countries (4.3) is not too far away from the world average (4.5). Overall, the figure suggests that OIC member countries benefit from FDI in terms of new technologies. However, there is ample room for improvement where OIC countries can better utilise FDI for technology transfer.

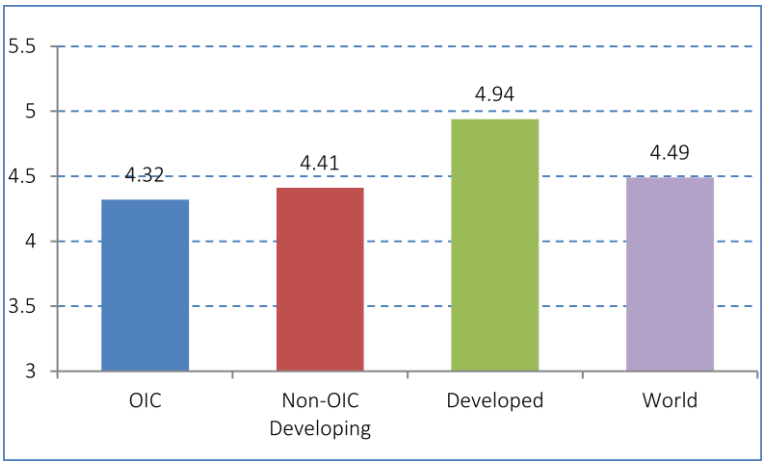
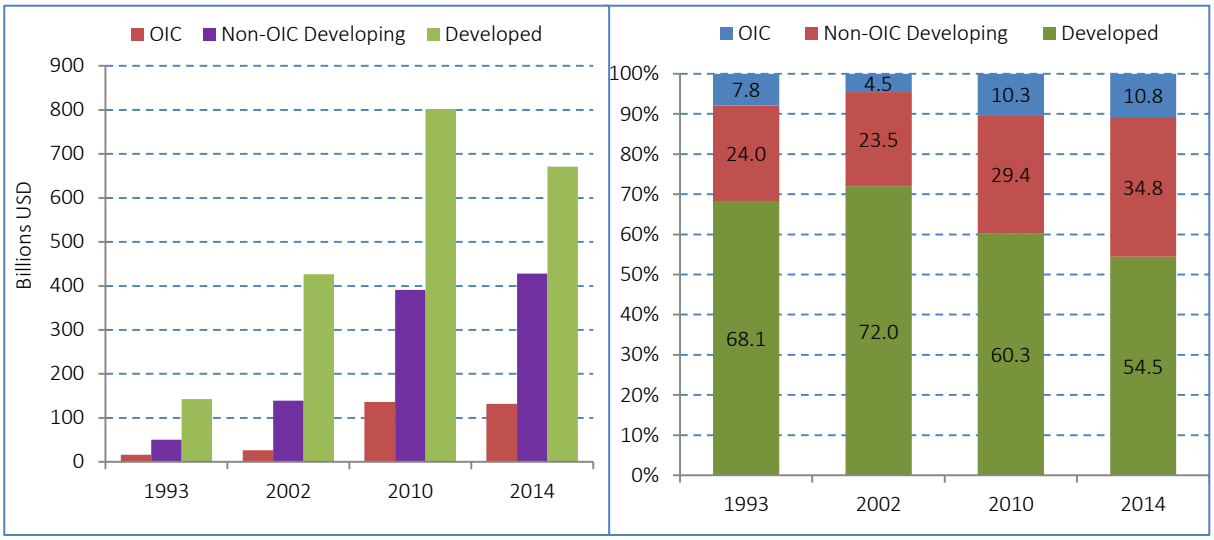


Figure Source: World Economic Forum, Global Competitiveness Index Database. Note: 1 = worst, FDI does not bring any new technology at all; 7 = best score, FDI brings new technology to a great extent and FDI is a key source of new technology.

fold increase). As a result, the share of OIC member countries in the world FDI inflows climbed from 7.8% in 1993 to 10.7% in 2014 (Figure 6.1, right). Non-OIC developing countries similarly witnessed a remarkable continuous increase in FDI inflows during the period under consideration and their share in the world FDI inflows jumped from 24% in 1993 to 34.7% in 2014. After reaching

Figure 6.1

FDI Inflows in the World (left) and Share of Country Groups in the World FDI Inflows (right)



Source: UNCTAD FDI Database

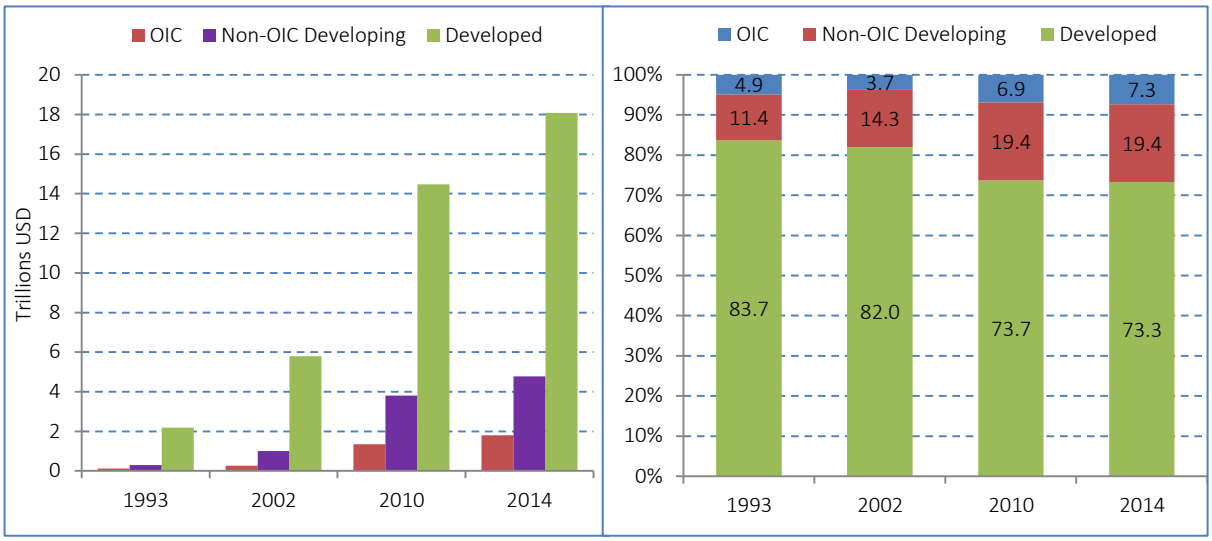
US$ 802.2 billion (a peak) in 2010, FDI inflows into developed countries started to decline and reached US$ 670.9 billion as of 2014. Accordingly, their share in the world FDI inflows dropped from 60.3% in 2010 to 54.5% in 2014.

All these figures reflect an important change in the trend of FDI inflows worldwide. It is clear that, over the last two decades, foreign investors have started to invest more in developing countries rather than in developed countries. This is mainly stemming from the nature of developing countries which have dynamic and progressive population and rapidly-growing economies. On the other hand, developed countries face serious challenges such as aging population (i.e. contraction in aggregate demand), old infrastructure and sluggish economic growth that divert investors to developing economies.

Figure 6.2 displays the change in FDI inward stocks in country groups between 1993 and 2014. According to Figure 6.2 (left), FDI inward stocks in the OIC group increased from US$ 127 billion in 1993 to US$ 1,802 billion in 2014. Non-OIC developing countries and developed countries also accumulated more FDI inward stocks during the same period. As shown in Figure 6.1, over the last two decades developing countries including OIC member countries started to attract more FDI inflows and ultimately their FDI inward stocks boosted. As a result, the share of non-OIC developing countries and OIC countries in the world FDI inward stocks increased. The share of the OIC group jumped from 4.9% to 7.3% between 1993 and 2014. In the same period, the share of non-OIC member countries increased from 11.4% to 19.3%. Naturally, the share of developed countries in the world FDI inward stocks reduced from 83.7% in 1993 to 73.3% in 2014.

Figure 6.2

FDI Inward Stocks in the World (left) and Share of Country Groups in the World FDI Inward Stocks (right)



Source: UNCTAD FDI Database

6.1.2 FDI Potential and Performance

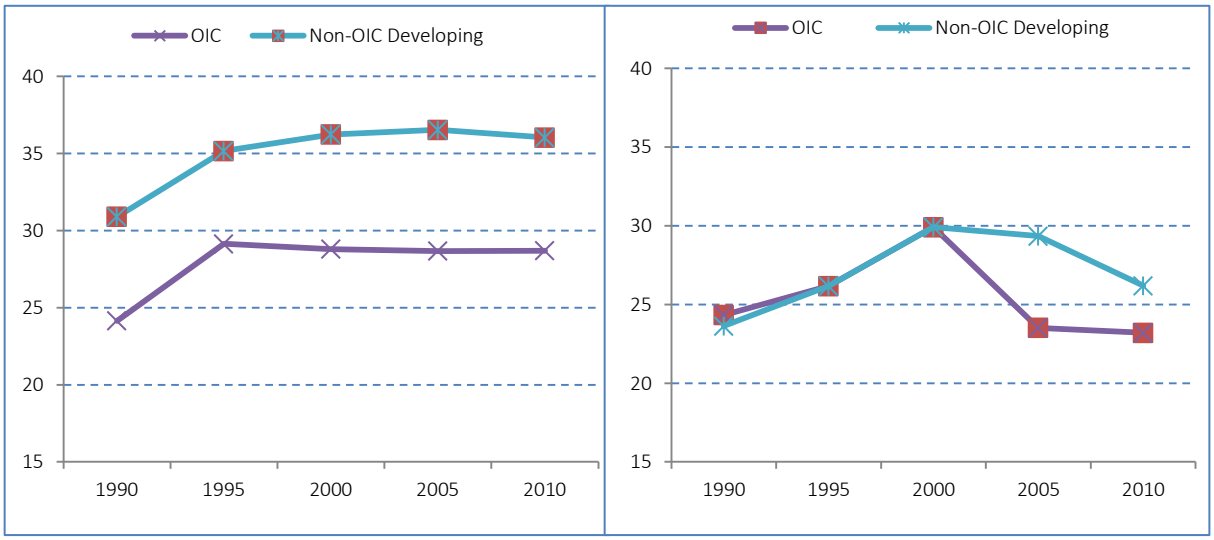
This sub-section examines the trends in FDI flows in the group of OIC countries in a comparative perspective by using two unique indices developed by the UNCTAD: FDI potential and performance indices. In addition to the figures presented in the previous sub-section on FDI flows and stocks, these two indices can reflect a realistic picture of FDI potential and performance of OIC member countries by considering several other factors such as GDP growth and share in the world FDI flows into account.

FDI Potential Index

The FDI potential index is constructed by the UNCTAD to measure the FDI potential of countries (UNCTAD, 2012). The literature on determinants of FDI claims that investors take both economic and institutional factors into account before finalizing their decisions on FDI. Therefore, one should take these two dimensions into account. In this context, the FDI potential index of the UNCTAD covers 12 sub-items that encompass different aspects of a host country. These quantifiable sub-items are the following, which are mostly confirmed as the robust determinant factors of FDI in host countries in different empirical studies (e.g. Vijayakumar, 2010; Ali et al., 2010): GDP per capita, the rate of GDP growth over the previous 10 years, the share of exports in GDP, average number of telephone lines per 1,000 inhabitants, commercial energy use per capita, the share of R&D spending in GDP, the share of tertiary students in the population, country risk, the world market share in exports of natural resources, the world market share of imports of parts and components for automobiles and electronic products, the world market share of exports of services, and the share of world FDI inward stock. The FDI potential index data are obtained from the UNCTAD-FDI Annex database over 5-year intervals. The last observation year was 2010. An increase in the index value is treated as an improvement in the FDI potential.

Figure 6.3 (left) presents the average values between 1990 and 2010 in the FDI potential index for OIC and non-OIC developing countries. In 1990, the OIC average was 24.1, whereas the average of non-OIC developing countries was 30.9. Between 1990 and 1995, both country groups increased

Figure 6.3
FDI Potential Index (left) and FDI Performance Index (right)



Source: SESRIC Staff Calculations from UNCTAD WIR Reports

their FDI potential remarkably. After 1995, the FDI potential index of OIC and non-OIC developing countries followed a relatively stable pattern. By the end of 2010, the average of non-OIC developing countries was measured as 36.4 and the OIC average was calculated as 28.7.

FDI Performance Index

The FDI performance index is developed by the UNCTAD to measure a country's relative position in the world in terms of FDI performance. Formally, it is the ratio of a country´s share in global FDI flows to its share in global GDP and can be calculated as follows:

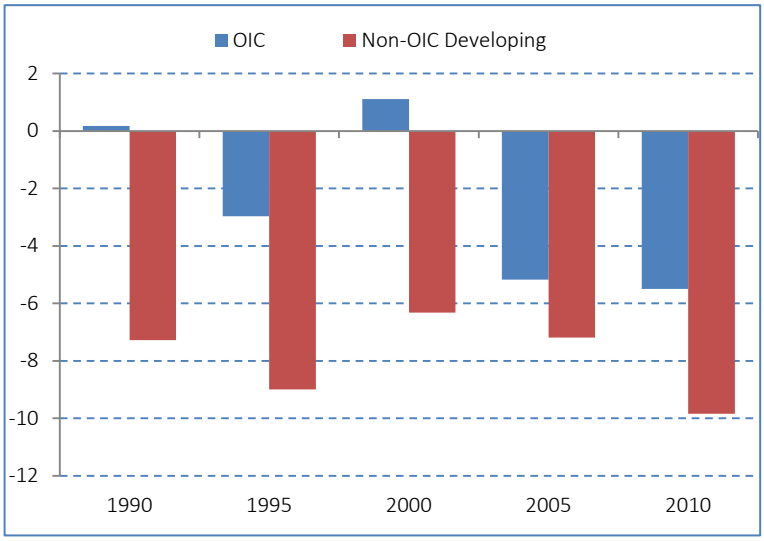
$$FDI\ Performance\ Index_i = \frac{FDI_i/FDI_{world}}{GDP_i/GDP_{world}}$$

An increase in the index value indicates a a positive development in the FDI performance (SESRIC, 2014c). According to Figure 6.3 (left), in 1990, on average, the FDI performance of the OIC countries was measured as 24.3. In the same year the average of non-OIC developing countries was calculated as 23.6. This implies that the OIC countries' FDI performance was slightly better than non-OIC developing countries in 1990. Until 2000, both country groups increased their FDI performance by following a similar trend line and the average values of the FDI performance index climbed to 29. After 2000, they experienced significant decreases in their index scores, and therefore their average values declined dramatically. However, the magnitude of decrease seen in the OIC average was far more remarkable than the magnitude of decrease observed in the average of non-OIC developing countries, possibly stemming from loose pro-FDI policies, restrictive policies to investors, economic instability, poor infrastructure, and low quality institutions. By the end of 2010, the average of non-OIC developing countries was measured as 26.1 and the OIC average was calculated as 23.2.

Based on the FDI potential and performance indices, Figure 6.4 displays the FDI gap and surplus values in OIC and non-OIC developing countries. If the difference between the FDI performance and FDI potential indices is positive, it is called "FDI surplus". Having FDI surpluses is usually

associated with higher economic growth rates that enhance development. Surpluses mainly stem from the existence of good governance and sound macroeconomic policies as well as stability. If the difference between the FDI performance and FDI potential index scores is negative it is labelled as "FDI gap" that the volume of FDI inflows that a country attracts is below than the level that it can attract. The existence of a FDI gap implies that a country is underperforming than its FDI potential that is the result of problems related to business environment such as complex rules and regulations for initiating a business to limited access to electricity.

Figure 6.4
FDI Gap and Surplus



Source: SESRIC Staff Calculation from UNCTAD WIR Reports. Note: The values shown are equal to the difference between FDI Performance and FDI Potential Index values.

According to Figure 6.4, OIC member countries generated FDI surpluses in 1990 and 2000, whereas non-OIC developing countries experienced FDI gaps over the whole period. FDI surplus of the OIC countries in 2000 turned to a gap in 2005. The magnitude of the FDI gap increased from 5.1 in 2005 to 5.5 in 2010 in the OIC countries. These figures imply that the volume of FDI inflows that OIC countries attract is usually less than the amount that their FDI potential suggests. Policies how to improve the FDI performance of OIC countries will be discussed in next sections in details.

6.1.3 Greenfield Investments

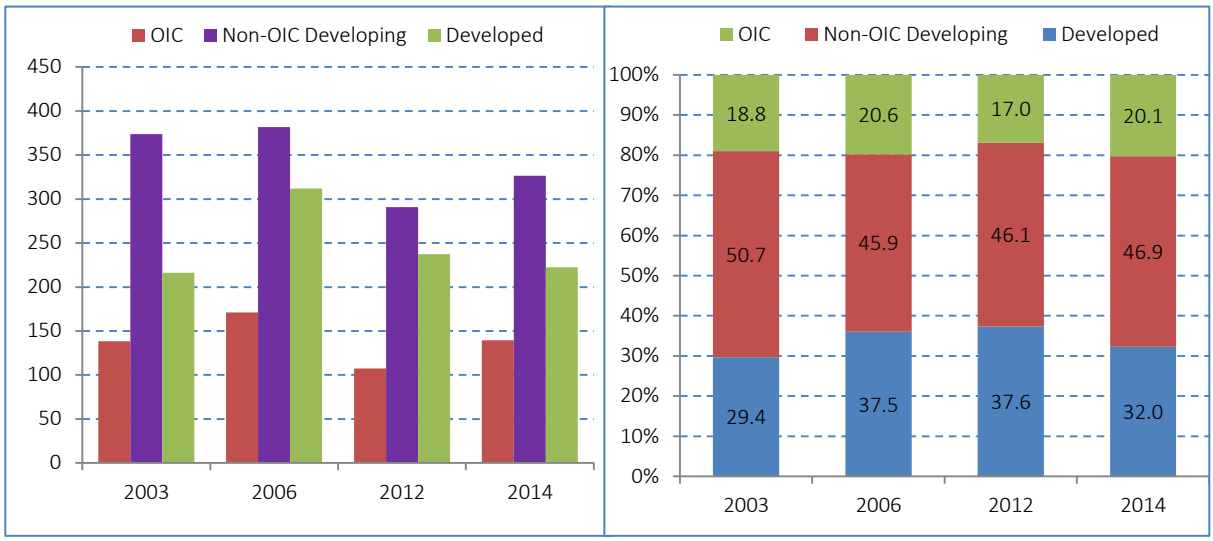
When FDI leads to the establishment of a totally new facility, it is described as a greenfield investment that boosts the capital base in a host country (i.e. capital-widening). Basically, when foreign investors buy a share (at least 10%) of an existing company in the host country it is classified as mergers & acquisitions (M&A) according to the literature.

Since greenfield investment requires a greater initial capital investment in order to establish and run a new company in a host country, the rise in the host country capital stocks stemming from FDI would be substantial. In this regard, the effects of FDI vary depending on the type of FDI (greenfield versus M&A). Host countries are expecting a greater valued-added generation, more job creation and ultimately faster economic growth stemming from greenfield FDI. Therefore, not only the volume of FDI inflows matters, but also the type of FDI.

In this context, Figure 6.5 displays the value of announced greenfield FDI projects in the world between 2003 and 2014. According to Figure 6.5 (left), while the value of announced greenfield FDI projects was US$ 138 billion in 2003, it only increased to US$ 140 billion in 2014 in the OIC group. In non-OIC developing countries the same figure went down from US$ 374 billion to 326 billion between 2003 and 2014. In developed countries, greenfield FDI projects amounted US$ 222 billion in 2014. Given these figures, the share of OIC group in the world FDI greenfield projects increased

Figure 6.5

Value of Announced Greenfield FDI Projects in the World (left) and Share of Country Groups in the World FDI Greenfield FDI Projects (as %)



Source: UNCTAD FDI Database

from 18.8% to 20.1% between 2003 and 2014. In 2014, non-OIC developing countries group took the lion share that 47% of all greenfield FDI projects in the world realized in non-OIC developing countries. By 2014, the share of developed countries was measured as 31.9%. The figures imply that on average, developing countries attract the vast majority of FDI greenfield projects worldwide. However, the average performance of OIC member countries was relatively poorer compared with non-OIC developing countries. Therefore, policy-makers in the OIC group not only need to seek ways to boost overall FDI inflows but also need to attract more greenfield FDI projects.

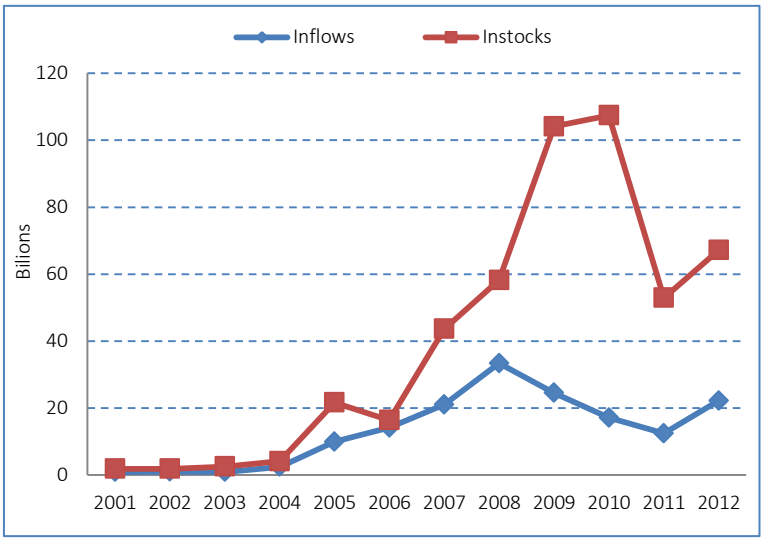
6.2 Intra-OIC Foreign Direct Investment Trends

Intra-OIC FDI inflows and instocks (i.e. inward stocks) reflect the directed investment from one source OIC country to another host OIC member country. As in other dimensions of the economic integration among OIC countries (e.g. intra-OIC trade and tourism), intra-OIC FDI trends can be a good indicator to assess the level of economic integration among OIC countries. A higher volume of intra-OIC FDI inflows implies the existence of stronger economic ties among OIC countries. In a similar fashion, an increased volume of intra-OIC FDI inward stocks indicates improvement among intra-OIC economic cooperation stemming from FDI originating from OIC countries.

Figure 6.6 presents the trends on the intra-OIC FDI inflows and instocks between 2001 and 2012. According to Figure 6.6, between 2001 and 2004 both intra-OIC FDI inflows and instocks followed a stable pattern. Only after 2004 both inflows and instocks started to climb up until the global economic crisis. Intra-OIC FDI instocks reached its peak value in 2010 by hitting US$ 107.4 billion. By 2012, it went down to US$ 67.2 billion. Intra-OIC FDI inflows peaked up in 2008 with US$ 33.3 billion. In 2012, intra-FDI inflows reached US$ 22.1 billion. As of 2012, both intra-OIC FDI inflows and instocks were lower than their peak values in 2008 and 2010, respectively.

Between 2001 and 2012 intra-OIC FDI inflows and instocks figures improved, despite having booms and busts. This reflects an improved economic integration among OIC countries. Nonetheless, it is fair to claim that these figures are being far from their potential. Figures on intra-OIC FDI inflows and instocks were stagnating lower than their peak values by 2012. Therefore, more policy-interventions are needed to reduce intra-OIC investment barriers. These interventions should not be only limited with the free movement of capital across the borders of OIC member countries but also need to address the restrictive visa regimes applied to citizens of OIC countries by other OIC countries since foreign investors usually look for eased movement of human capital across borders (i.e. limited or no restriction on transfer of labour). OIC countries need to get a common understanding that there is a great potential in terms of intra-OIC FDI flows, which can boost economic growth and trigger development in OIC countries. However, existing barriers in OIC countries ahead of investors in terms of institutional quality, visa regimes, restrictions on profit and capital transfers etc., limits the level of economic cooperation among OIC member countries.[10]

Figure 6.6
Intra-OIC FDI Inflows and Instocks



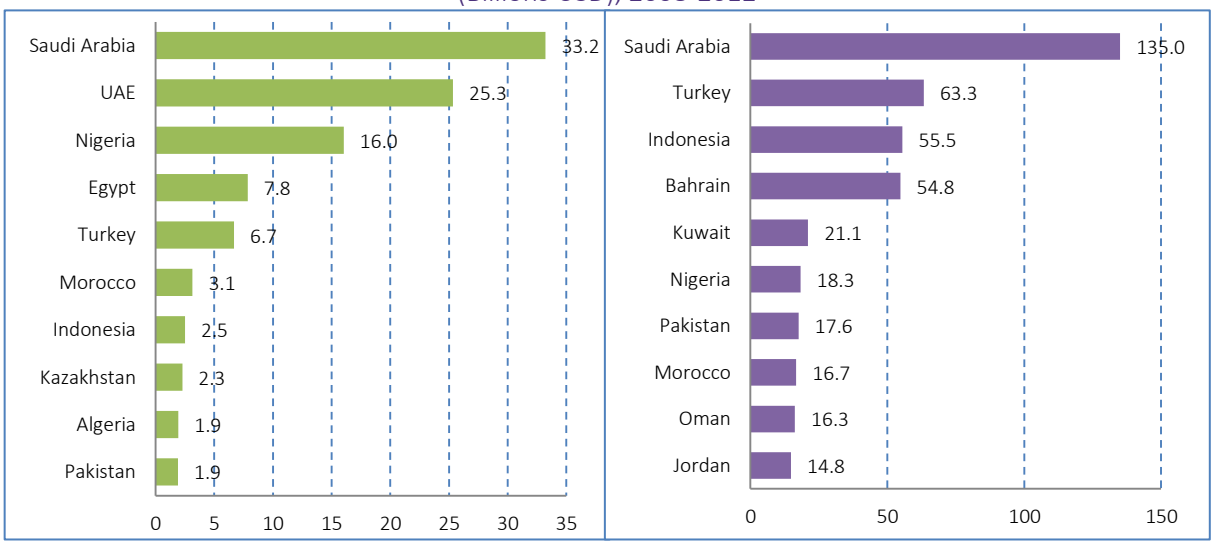
Source: UNCTAD FDI Database

At the individual country level, Figure 6.7 presents top-ten OIC member countries in terms of intra-OIC FDI inflows and instocks during the 2008 and 2012 period. Saudi Arabia and the United Arab Emirates were the two leading OIC member countries in terms of intra-OIC FDI inflows. Saudi Arabia alone attracted FDI flows equal to US$ 33.2 billion between 2008 and 2012 from other OIC member countries. With this performance, FDI inward stocks of Saudi Arabia originating from other OIC member countries reached US$ 135 billion in the same period. This makes Saudi Arabia the top-performer OIC member country in terms of intra-OIC FDI inward stocks between 2008 and 2012. Saudi Arabia was followed by Turkey and Indonesia with intra-OIC inward stocks amounting US$ 63.3 billion and 55.5 billion, respectively.

The intra-OIC FDI figures provide some clues on the unequal distribution of intra-OIC FDI flows and stocks. A group of few OIC countries benefited relatively more than other member countries from intra-OIC FDI. The volume of intra-OIC FDI inflows recorded by the top four performer OIC countries (Saudi Arabia, United Arab Emirates, Nigeria and Egypt) between 2008 and 2012 represented 75.2% of all intra-OIC FDI inflows seen in the same period. In a similar vein, the top four performer OIC countries (Saudi Arabia, Turkey, Indonesia, and Bahrain) hosted 79.1% of all intra-OIC FDI inward stocks accumulated between 2008 and 2012 in the OIC group. Therefore, the positive trends seen in intra-OIC FDI figures have not been stemming from an overall improvement

[10] These barriers are analysed in details in the next section with data.

Figure 6.7
Top Performing OIC Countries in terms of Intra-OIC FDI Inflows (left) and Instocks (right) (Billions USD), 2008-2012



Source: UNCTAD FDI Database

in intra-OIC cooperation rather it is a result of increased economic integration among some OIC countries.

These figures indicate that the OIC countries did not yet achieve a desirable level of intra-OIC FDI flows. For instance, during the period 2008-2012 intra-OIC FDI inflows only represented 18% of the total FDI inflows realized in Turkey, although it is one of the top-three FDI attracting countries in the OIC region in terms of the volume of total FDI inflows (from all over the world). This statement also holds true from the OIC investor country perspective. For instance, only 12% of FDI flows originating from Malaysia went to other OIC countries, although Malaysia is one of the leading countries in the OIC region in terms of the total volume of FDI outflows. Overall, it is clear that intra-OIC FDI is still far below its potential (SESRIC, 2014c; UNCTAD, 2013). The success on reaching the potential in intra-OIC FDI flows depends on the determination of policy-makers of OIC countries to adopt some concrete policy measures for reducing trade and investment barriers, abolishing/easing visa regimes, and facilitating capital transfers among OIC member countries.

6.3 Policy Measures for Attracting Value Adding Investment

Understanding the main determinants of FDI is critically important in order to develop and implement policy measures for attracting value adding FDI. According to the literature, gravity model of international trade is applicable to FDI. According to the gravity model, in a two-country world, FDI between countries A and B is positively associated with the size (e.g. GDP, per capita GDP, market size) of countries A and B, and it is negatively associated with the physical distance between countries A and B (e.g. geographical distance between capital cities, financial centres, free economic zones) (Chakrabarti, 2001). On the other hand, the eclectic theory, also known as the OLI paradigm, claims that FDI is determined by three sets of advantages: ownership advantage in the host country (O), location advantage of the host country (L), internalization advantage via the host country (I). According to the insights from the eclectic theory, international trade openness of a host country is an important factor for potential foreign investors.

With the rise of institutional economics, scholars started to work with different sets of institutional variables in exploring the determinants of FDI especially after the pioneering study of North (1991). According to these scholars, institutional factors, in addition to economic factors such as market size and trade openness, determine investment decision of multinational companies significantly (Tintin, 2013).

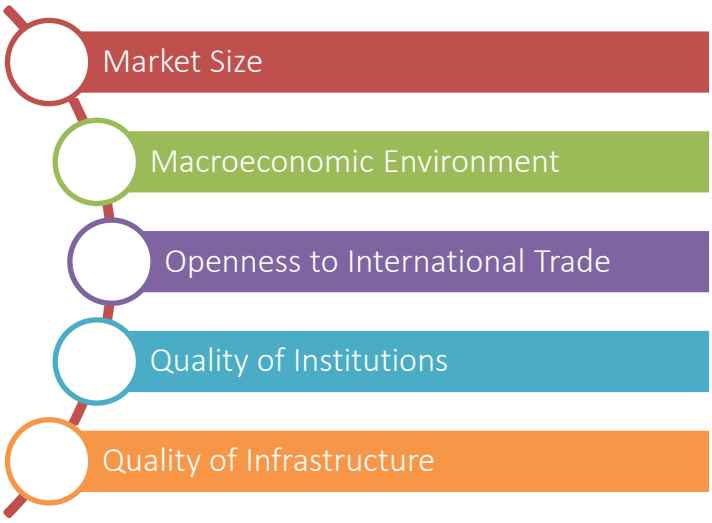
Figure 6.8 is constructed based on a literature review on the determinants of FDI by benefiting from Faeth (2009), Blonigen (2005) and Lim (2001). Accordingly, most commonly confirmed factors in the literature that significantly affect FDI decision of multinational companies are the market size, macroeconomic environment, openness to international trade, quality of institutions and infrastructure of host countries.

In the light of the above discussion, the rest of this section provides a detailed analysis on FDI policies and institutional framework in OIC countries by using several internationally comparable indices and indicators.

6.3.1 Enlarging Market Size and Improving Macroeconomic Environment

A larger host country market size associates with more FDI inflows and the reason is two-fold. First, a larger market size implies a higher number of potential customers for multinational companies (i.e. foreign investors) that can boost their sales volume and profits. Second, in a host country with a larger market size, foreign investors can enjoy economies of scale that reduces the production and operation costs remarkably.

Figure 6.8
Determinants of Foreign Direct Investment



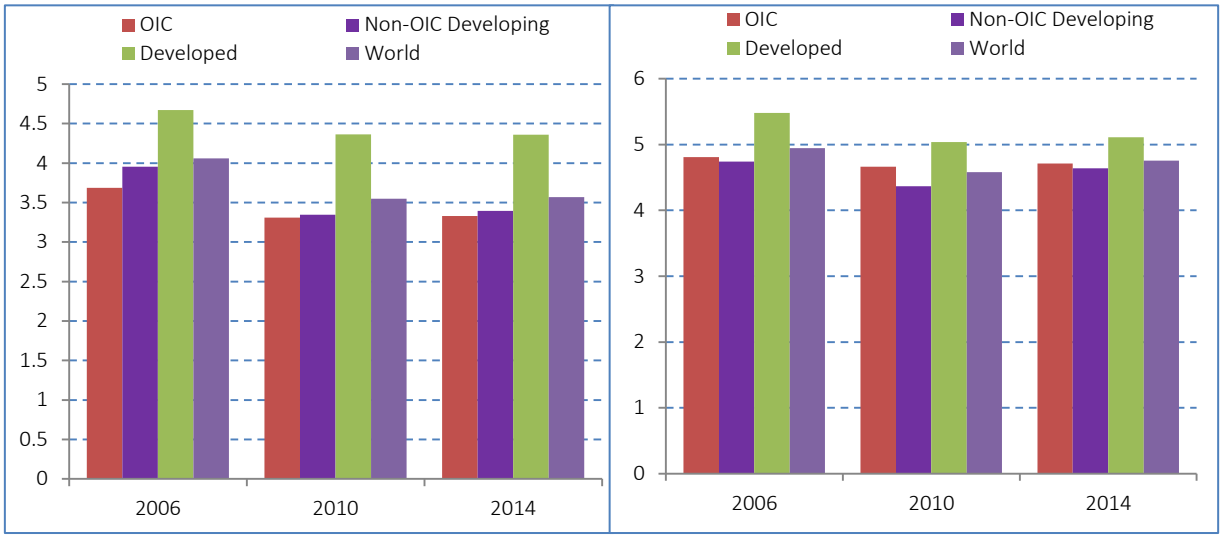
As indicated in Figure 6.8, an important determinant for FDI is the existence of a sound macroeconomic environment. A country with sound and stable macroeconomic environment usually attracts significant amount of FDI inflows. Foreign investors look for an economy management and system that are competent enough to cope with any shocks and able to minimize the impacts on businesses. Therefore, foreign investors tend to invest into host countries in which the stance of macroeconomic environment is predictable (i.e. less volatile), core macroeconomic indicators are promising (e.g. high growth potential, less inflation pressure), and the economy management is far from being populist.

Figure 6.9 shows the average market size (calculated based on domestic and foreign market size, GDP size, exports as a percentage of GDP) and the stance of macroeconomic environment (calculated based on government budget balance, gross national savings, inflation, general government debt, and country credit rating) in different country groups. According to Figure 6.9

(left), the average market size in the OIC group decreased from 3.68 in 2006 to 3.33 in 2014. In the same period, both non-OIC developing countries and developed countries also experienced a decrease in their market size scores. As a result, the value of the average global market size decreased from 4.06 to 3.57. In terms of macroeconomic environment, the OIC average lagged behind the world average in 2014. It dropped from 4.81 in 2006 to 4.67 in 2010, but climbed back to 4.71 in 2014 (Figure 6.9, right). Between 2006 and 2014, the world average reduced from 4.95 to 4.76. It is clear that in 2014, the macroeconomic environment in OIC countries, on average, was less competitive and less attractive for foreign investors as compared with 2006. Moreover, the average market size in the OIC group is smaller in 2014 compared with 2006 that raises concerns for foreign investors.

Figure 6.9

Market Size (left) and Macroeconomic Environment (right)



Source: World Economic Forum, Global Competitiveness Index Database. Note: 1 (worst)-7 (best).

6.3.2 Improving Quality of Institutions and Infrastructure

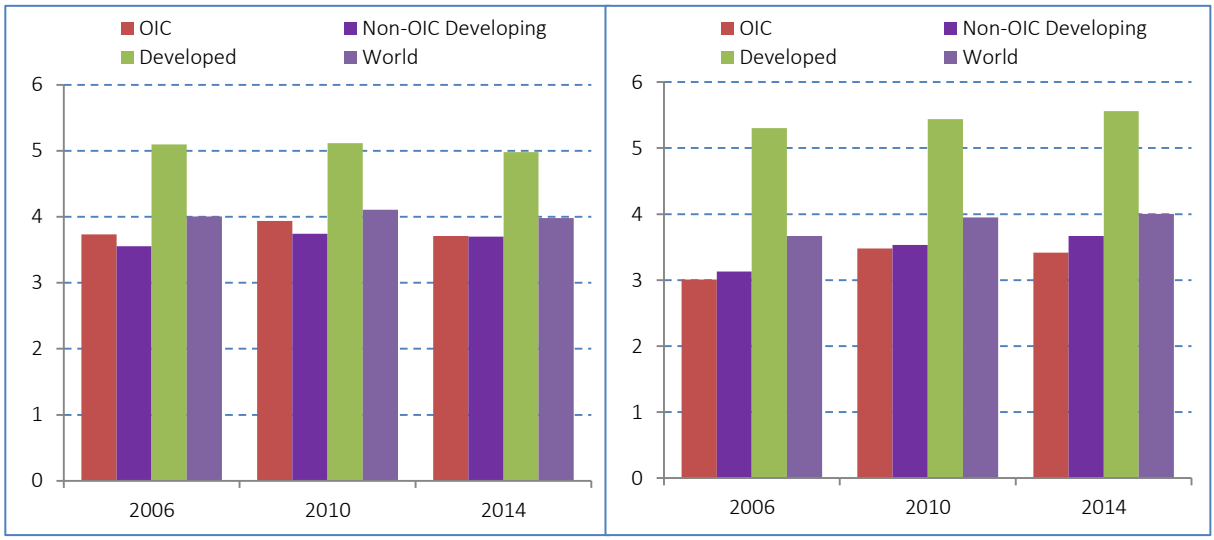
As shown in Figure 6.8, foreign investors look for host countries in which the quality of institutions and infrastructure are developed enough to run their businesses with predictable profit margins. Many foreign investors decide to invest in other countries to save from production costs. However, the production costs are not only depending on the cost of labour. Other factors such as the cost of capital (i.e. interest rate), transportation and energy costs, the installation costs, the number of procedures to start a business, and protection of property rights are all affecting the decision of foreign investors while selecting a country to invest in. Overall, from a foreign investor's perspective, efficiency of such factors can be tracked under two categories: quality of institutions and quality of infrastructure. A foreign investor tends to invest in a country where the quality of infrastructure is reliable and allows the foreign investor to run the business without any interruption during its operations. For instance, a flawed electricity infrastructure or a rail network system with unpredictable delays and extra costs in a host country affect the decision of a foreign investor negatively. On the other hand, the existence of corruption in the business and public circles and prolonging period to start a foreign subsidiary due to a high level of bureaucracy in a host country also indicate the existence of problems related with the overall quality of institutions.

The existence of such a problematic business environment raises costs of production and services that discourage foreign investors.

Figure 6.10 displays the stance of quality of institutions (measured by 21 indicators from property rights to judicial independence) and infrastructure (measured by 9 indicators from road & railroad quality to number of subscribers to fixed telephone lines) across country groups between 2006 and 2014. According to Figure 6.10 (left), the quality of institutions in the OIC group, on average, deteriorated and the average score went down slightly from 3.73 to 3.71 between 2006 and 2014. In the same period, both non-OIC developing countries and developed countries also experienced a decrease in their scores on the quality of institutions. As a result, the world average on the quality of institutions also slightly dropped from 4.01 to 3.98. Given the slowly changing nature of institutions, it is not fair to expect a significant improvement in a couple of years. However, the overall deterioration is a discouraging factor for investment and it should be well taken into consideration by policy-makers in the OIC countries and other countries in upcoming years.

Figure 6.10

Quality of Institutions (left) and Quality of Infrastructure (right)



Source: World Economic Forum, Global Competitiveness Index Database. Note: 1 (worst)-7 (best).

Unlike the negative trend observed in the quality of institutions, the average scores on the quality of infrastructure showed a positive trend between 2006 and 2014 both worldwide and in the OIC group (Figure 6.10, right). The average of the OIC countries went up from 3.01 to 3.41 where the world average increased from 3.67 to 4.0 during the period under consideration. Despite the overall improvement in the quality of infrastructure in the OIC group, the average of the OIC countries (3.41) was still lagging behind the average of non-OIC developing countries (3.67) and the world average (4.0) in 2014.

6.3.3 Enhancing Openness to Trade

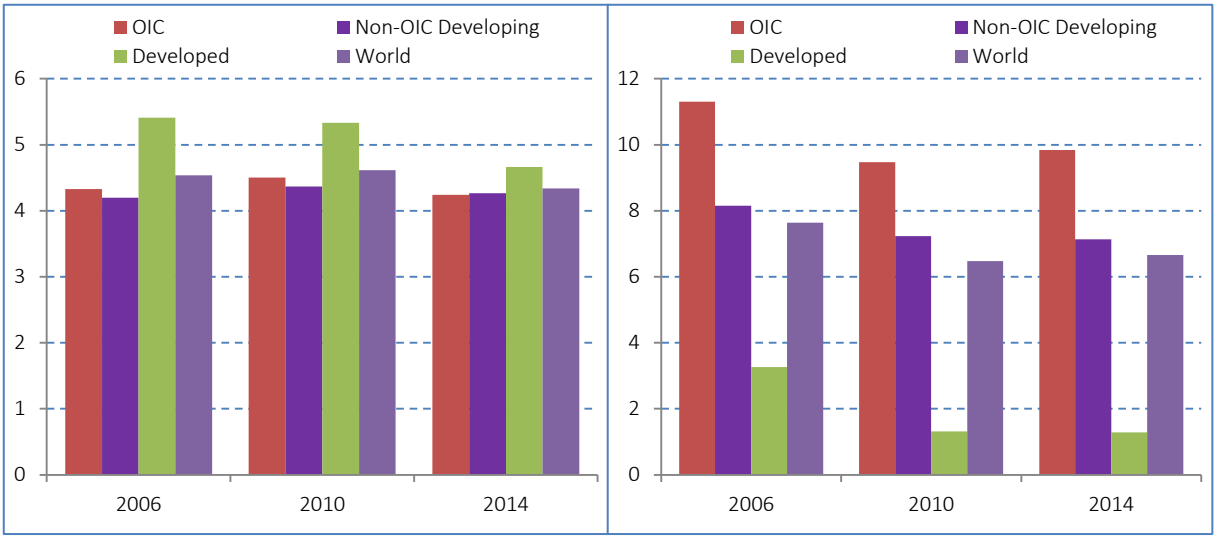
According to the literature, more open economies are more integrated to international markets and, thus, more likely to attract investment from multinational companies. A foreign subsidiary company usually imports variety of raw materials and intermediate goods from international markets, and may export final goods to these countries. The level of interconnectedness to the

world in terms of international trade is very important from a foreign investor's eye. Therefore, a high level of openness to trade (e.g. low duty taxes and simplified and standard duty procedures) is most likely to be associated with more FDI inflows.

The openness to trade is displayed in Figure 6.11 by two indicators, namely prevalence of trade barriers and tariff rates. On average, prevalence of trade barriers (tariffs and non-tariff barriers) in the OIC countries decreased from 4.33 in 2006 to 4.24 in 2014. While the world average also dropped from 4.54 to 4.34 in the same period, non-OIC developing countries, on average, witnessed an increase from 4.20 to 4.26 (Figure 6.11, left). In a similar fashion, the average tariff rates in the OIC group decreased from 11.3% to 9.8%, where the world average decelerated from 7.6% to 6.7%. As of 2014, average tariff rates in OIC countries was the highest compared with the world average and the averages of other country groups. In a nutshell, the figures display that OIC member countries successfully reduced several trade barriers and became more open to international trade. In this context, increased openness to international trade constitutes a great opportunity for the OIC group to attract more foreign investment.

Figure 6.11

Prevalence of Trade Barriers (left) and Tariff Rates (right)



Source: World Economic Forum, Global Competitiveness Index Database. Note: 1 (worst)-7 (best).

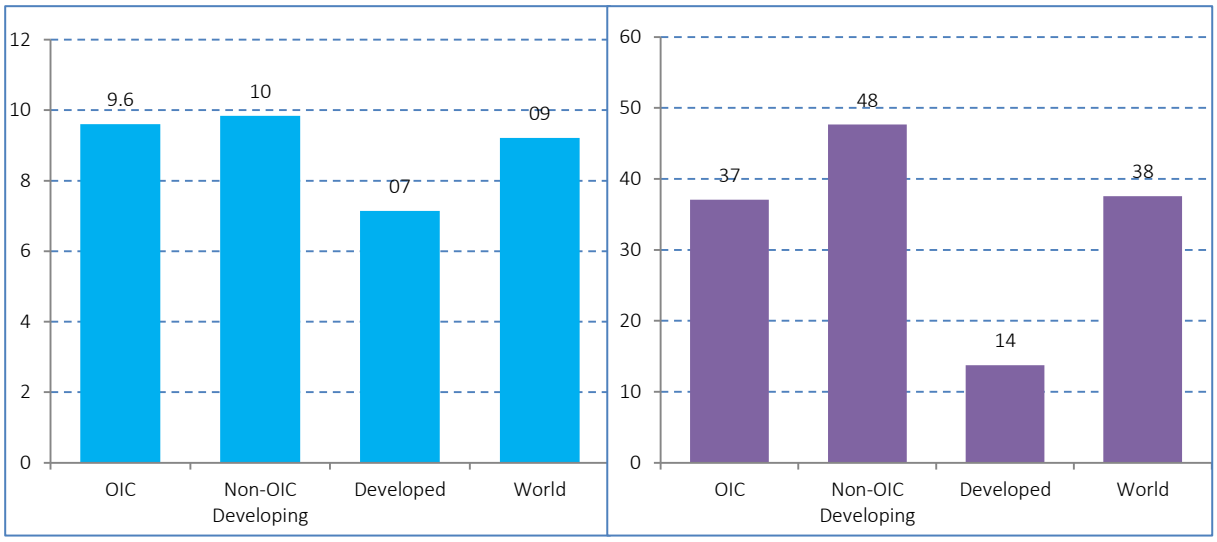
6.3.4 Developing Regulatory Framework for FDI

Formal procedures to start a foreign subsidiary business constitute an important barrier for foreign investors to invest into a host country. Therefore, they tend to invest more in countries where the number of procedures to start a business (as a foreign subsidiary) requires less time and efforts. In countries with underdeveloped regulatory framework for FDI, official procedures to start a foreign subsidiary company and run such a company are usually time-consuming and include unpredictable cost items that affect foreign investors' decision negatively. Moreover, foreign investors need to do regular international financial transactions between their branches and the headquarters in different locations. Therefore, foreign investors also prefer countries which have almost no restrictions on international capital inflows and outflows. In this regard, foreign investors look for host countries where the overall regulatory FDI framework is less restrictive both in terms of capital transfers and installation procedures and time.

Figure 6.12 (left) shows that the average number of procedures to start a foreign subsidiary in the OIC countries is 9.6 whereas it is 7.1 in developed countries. The world average is estimated at 9.2, which is lower than the average of the OIC group. On the other hand, in OIC member countries, on average, it takes 37.1 days to start a foreign subsidiary whereas foreign companies in non-OIC developing countries need 47.6 days to start their businesses. However, in developed countries, on average, foreign investors can form and start their operations only after 13.8 days (Figure 6.12, right). Overall, the existing formalities in the OIC member countries seem to be cumbersome for foreign investors in order to start their businesses. Since OIC member countries compete both with developed countries and non-OIC developing countries to attract more FDI, required time to form a foreign subsidiary in OIC member countries needs to be shortened by reducing the number of formal procedures to start a foreign subsidiary.

Figure 6.12

Average Number of Procedures Required to Start a Foreign Subsidiary (left) and Average Number of Days Required to Start a Foreign Subsidiary (right), 2012



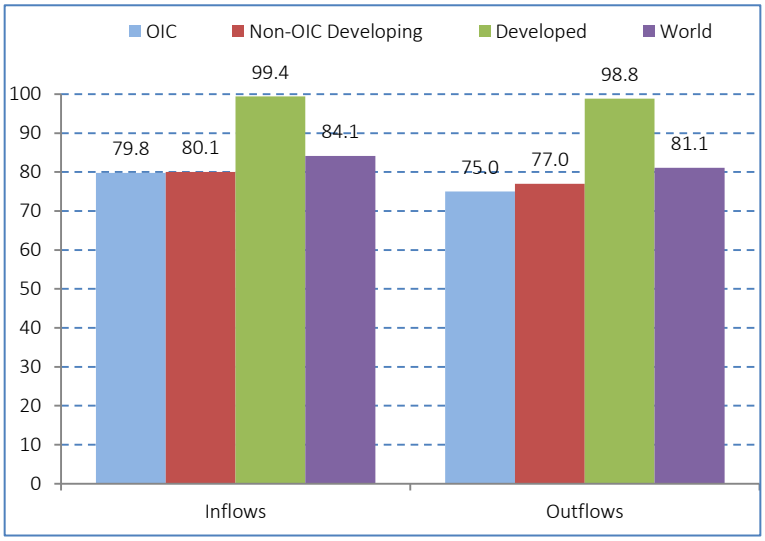
Source: UNCTAD FDI Database

Another factor that affects the investment decision of foreign investors is the existence of restrictions on foreign capital transfers that includes restrictions on initial capital, loan, principal and interest payments. As shown in Figure 6.13, OIC member countries have the most restrictive environment both in terms of capital inflows and outflows with average scores of 79.8 and 75.0, respectively. Developed countries provide the most enabling environment to foreigners in terms capital transfers both in inflows and outflows. Therefore, OIC member countries need to undergo reforms to eliminate restrictions on capital transfers in order to host more foreign investors that are expected to contribute economic growth through various economic benefits to the host country.

As discussed above, overall rules that govern FDI in a host country matter for foreign investors. If the existing rules related with the business environment and FDI are providing a restrictive environment, foreign investors are discouraged to invest in a host country. In this regard, Figure 6.14 presents an indicator developed by the World Economic Forum that measures to which extent rules governing foreign direct investment (FDI) encourage or discourage foreign investors. A score

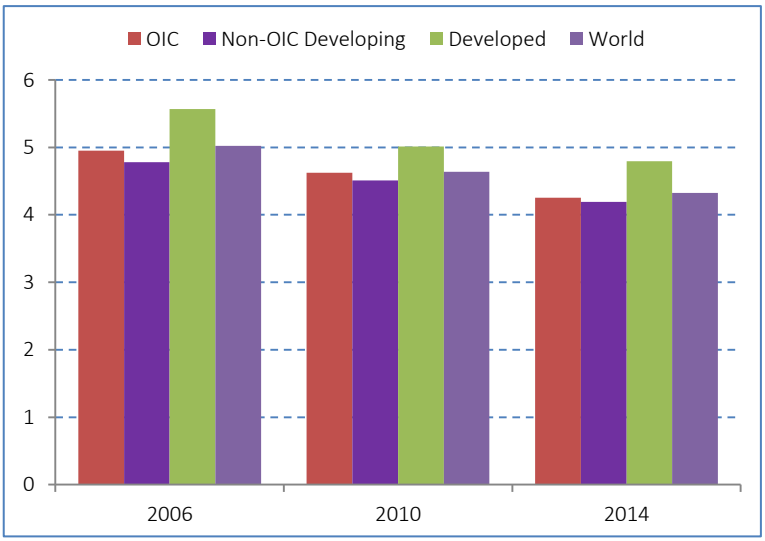
of maximum 7 in the index implies that the existing rules for FDI in a host country strongly encourage foreigners to invest. Accordingly, the average of the OIC group was calculated as 4.2 in 2014. This implies that the rules governing FDI in OIC member countries, on average, are discouraging for foreign investors compared with the average of developed countries (4.8) and the world average (4.3) in 2014. Moreover, the overall rules that govern FDI in OIC member countries became more discouraging over time where the average of the OIC group decreased from 4.9 in 2006 to 4.2 in 2014. This indicates that the new rules and regulations related with foreign investors in OIC countries tend to be more discouraging/restrictive, which are expected to affect FDI inflows negatively.

Figure 6.13
Restrictions on Foreign Capital Transfers (initial capital, loan, principal and interest payments), 2012



Source: World Bank, Investing Across Borders Database. Note: 0 (worst); 100

Figure 6.14
Business Impact of Rules on FDI



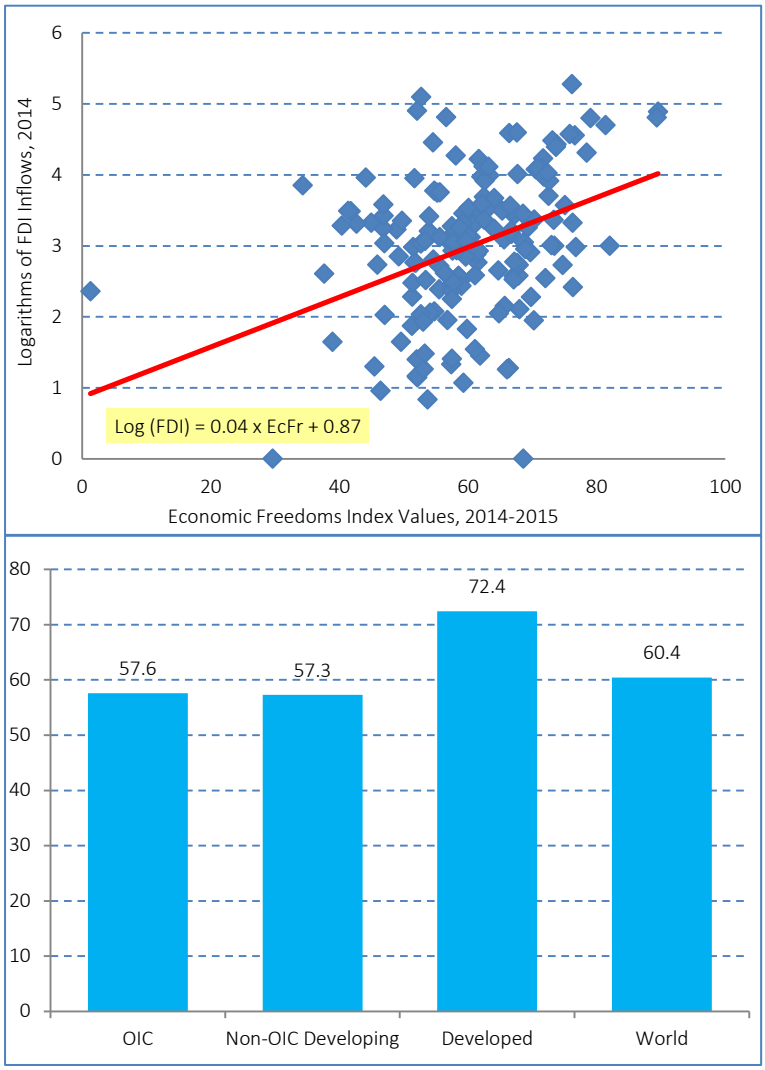
Source: World Economic Forum, Global Competitiveness Index Database. Note: 1 (strongly discourage FDI) - 7 (strongly encourage FDI).

6.3.5 Boosting Economic Freedoms and Fighting with Corruption

As mentioned in section 6.3.2, foreign investors look for a host country with effective and well-functioning institutions, which are expected to affect their profit and operations positively. In this regard, higher economic freedoms in a country, as measured by the economic freedoms index developed by the Heritage Foundation, imply the existence of more developed institutions that their operations can go on smooth, predictable and less-costly. The economic freedoms index covers ten sub-dimensions: business freedom, trade freedom, fiscal freedom, government spending, monetary freedom, investment freedom, financial freedom, freedom from corruption, labour freedom and property rights. A country with higher economic freedoms is expected to provide a good protection in terms of property rights and have a less restrictive regulatory environment for investors. More economic freedoms imply the existence of high quality of institutions in a country, and therefore should be associated with more FDI inflows.

Figure 6.15

Economic Freedoms vs. FDI Inflows (top) and 2015 Economic Freedoms Index Scores across the World (bottom)



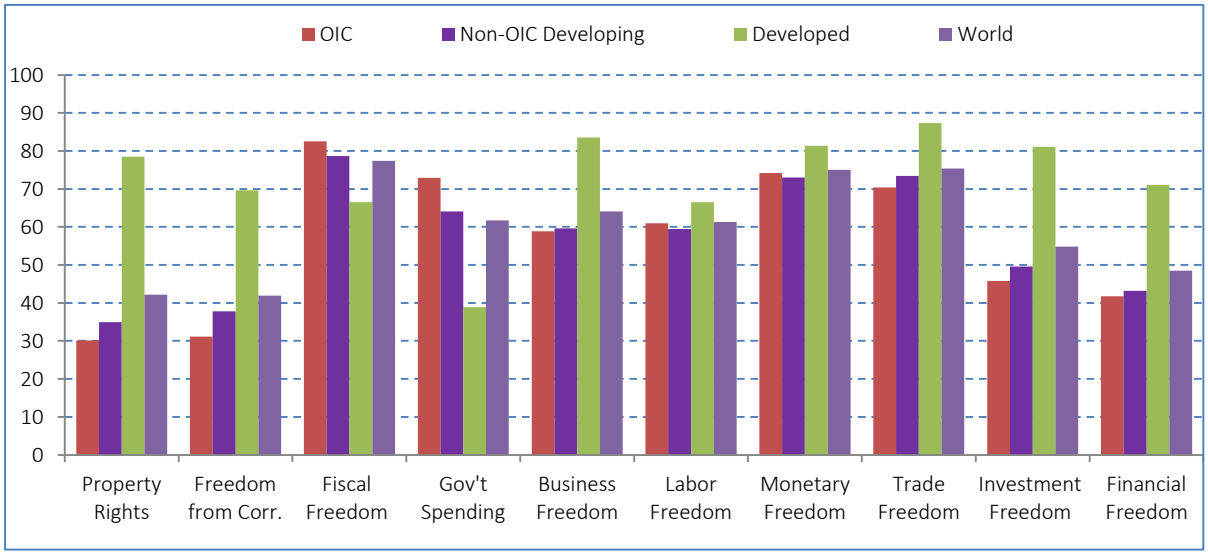
Source: SESRIC Staff Calculations based on the dataset obtained from the Heritage Foundation and UNCTAD. Note: 0 (least free) and 100 (most free).

Figure 6.15 (top) illustrates the correlation between the economic freedoms index values and global FDI inflows for the period 2014 and 2015. Obviously, there exists a statistically significant and positive correlation between economic freedoms and FDI inflows. The regression result reveals that on average a 1 point increase in the score of economic freedoms index is associated with an increase of 0.04% in FDI inflows. In other words, a country with a volume of average annual FDI inflows of US$ 1 billion can see an increase about US$ 40 million due to a 1 point increase in the score of economic freedoms index. In this context, Figure 6.15 (bottom) presents the average economic freedoms index scores for country groups for 2015. According to this, the OIC and non-OIC developing countries, on average, have very similar index scores that are measured as 57.6 and 57.3, respectively. On the other hand, the world average was measured as 60.4 and the average of developed countries is calculated as 72.4. The OIC group lags behind the world average and the average of developed countries. This suggests that policy-makers in OIC member countries need to work on a reform agenda in order to create a better climate for businesses by enhancing economic freedoms.

Figure 6.16 provides some clues to policy-makers in the OIC group from where to start reforms to enhance economic freedoms. According to Figure 6.16, it seems that OIC member countries, on average, are facing serious challenges related to property rights and corruption where their average scores were measured as 30.1 and 31.1, respectively. This implies that, on average, property rights are not very well protected in OIC member countries. This hinders innovation activities and discourage foreign companies to spend on R&D activities and invest into high-tech industries that are generating a higher value-added. Moreover, as seen in Figure 6.17, it seems that many OIC member countries suffer from the existence of corruption at varying degrees where the average score of the OIC group in this sub-dimension is found to be very low.

Figure 6.16

Performance of Country Groups in the Sub-Indices of Economic Freedoms Index, 2015

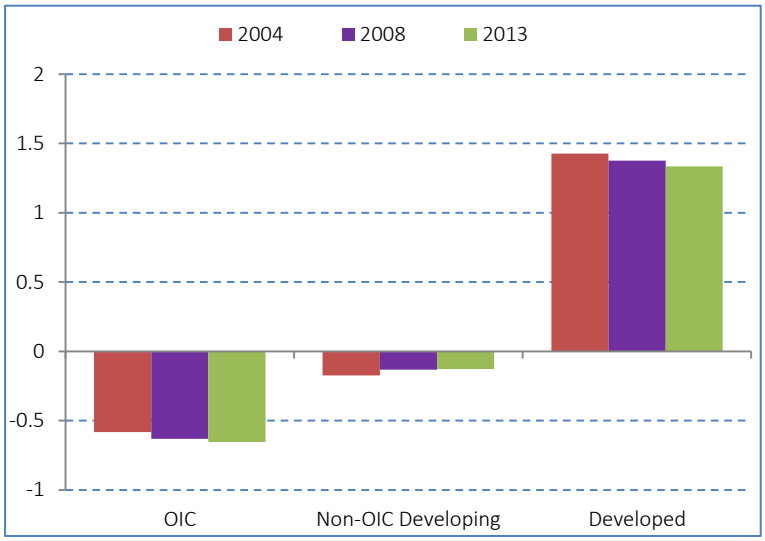


Source: SESRIC Staff Calculations based on the dataset obtained from the Heritage Foundation. Note: 0 (worst score) and 100 (best score).

According to 6.17, compared with other country groups, OIC countries, on average, have a higher degree of corruption during the period 2004-2013. The average level of corruption observed in the OIC group has been even worsened over the years as the average score decreased from -0.58 to -0.65 in 2013. The existence of corruption affects negatively FDI, as predictability goes down where corruption is more widely practised. In order to improve the investment climate and attract more investment, OIC member countries need to address the worsening trend seen in the state of corruption. They may intensify efforts to eradicate corruption through both national polices and cooperation with the international community.

Figure 6.17

State of Corruption across the World and in the OIC Group



Source: World Bank, World Governance Indicators. Note: -2.5 (worst score) and 2.5 (best score).

SECTION 7

Policy Issues for Effective Investment Promotion and Facilitation

Economic and political stability, quality of institutions and infrastructure, human and technological development, and competition policies are some of the major factors that influence the overall investment climate. More broadly, all these factors can be classified under three main features: macroeconomic factors (including political stability), governance, and physical and financial infrastructure. The volume of investments is important, but more important is the quality of investments and payoff received from them. Payoffs can be in terms of increased competitiveness, sustained growth and productive jobs. Empirical studies usually find only weak linkages between volume of investment and sustained growth. For investment to be of high quality, a good investment climate is needed, which supported by the three main features highlighted above.

Given the critical role of investments in promoting growth and development, second part of the report has investigated three major components of investments, namely public investments and how to improve their effectiveness, private investments and how to encourage them, and foreign investments and how to attract more value-adding FDI. Some of the general policy recommendations derived from this part are summarized below.

Enhancing Public Investment Efficiency

Productivity gains are vital to long-term growth, which translate into higher incomes and boost demand. While this can take time, increased investments of good quality can provide the stimulus

to productivity and growth. Yet, debt-fuelled investment can be dangerous if it does not stimulate productivity growth. Properly targeted public investment can help to boost economic activities, stimulate aggregate demand, and raise productivity growth by improving human capital, encouraging innovation, and leveraging private sector investment by increasing returns. Therefore, in times of economic downturn, public investment can play an important countercyclical role (Spence, 2015).

Government may have different justifications in their decisions to involve in the economy, but the nature of involvement affects the people in many aspects. Therefore, public investment choices should be made based on careful evaluation on the expected costs and returns of the alternative options and should be effectively managed when the decision is made. Effectively managed public investment choices can boost the growth and provide stimulus for private sector to leverage their investment. However, poor project selection and mismanagement of investment projects may cause significant waste of resources and limit the prospects for growth.

Many countries in the world are facing major challenges in terms of allocating adequate resources and implementing public investment projects in physical infrastructure as well as human capital development. Due to trade-offs between physical and human capital development as well as conflicts between the interests of present and future generations, prioritization of public investment decisions is never easy. Theoretical and empirical researches also give few insights for optimal public resource allocation across different sectors and across different public investment projects. In principle, the relative allocations within and across programs should focus on increasing productivity and competitiveness, and identify the areas where social returns are the highest and externalities and spillover effects are significant.

The most important concern when it comes to infrastructure investment is the project selection. Selecting projects with the greatest productivity gains and little or no distortions is critical. Therefore, it is vital that countries set up institutions capable of doing adequate planning, cost-benefit analysis and ongoing monitoring and evaluation. If, instead, the focus in on quantity, then it is more likely that higher levels of public investment have undesirable effects such as crowding out private investment with little productivity gains for the economy. In this context, it is important to have strategic objectives for public investment at central and local governance levels, and there must be an established process for preliminary screening of project proposals for compliance to these strategic objectives. Then, there is a need for a formal appraisal process for more detailed evaluation of project proposal. If projects are large scale projects, an evaluation by an external agency would be beneficial.

Setting overall macroeconomic priorities for public spending can be used to increase the effectiveness of public spending in general and to guide public investment decisions. Education, human capital and knowledge, technological investment, innovation, and infrastructure are some of the areas where policy makers generally focus, but priorities within development policy often involve certain sectoral biases (e.g. towards infrastructure or social sector), or contain a wide spectrum of issues. It is not easy for policy makers to optimally allocate public resources across different sectors and across different public investment projects. Having strategic objectives and periodically reviewing the progress towards these goals can be effective instruments to evaluate the effectiveness of different public investment programmes.

In order to realize the selected public investment projects, it is required a fiscal space, i.e. the ability of governments to finance public investment without threatening the sustainability of its financial stance. In principle, the returns on public investment are a crucial indicator for debt sustainability. However, given that the returns on public investment are commonly unknown, there is the risk that additional borrowing worsens debt sustainability. While many countries face fiscal space constraints to finance required investment, some others have plenty of windfall gains waiting for productive investment opportunities. If countries with limited resources improve their business environment and ensure macroeconomic and political stability, the resources in wealthier countries can flow to these countries to finance such investment projects. Moreover, when governments engage in public investments under strict budgetary constraints, projects should be carefully evaluated for their economic and social returns. Inefficiency can be a major concern in the case of large and ambitious investment programmes.

In order to ensure an effective public investment, institutional mechanisms must be reinforced to ensure proper implementation of public investment projects and to develop enough flexibility to adapt to unforeseen circumstances. This also requires developing the standards of good governance and transparency at every stage of project management from selection to procurement and financing. Realizing productive investment projects after their completion requires a good capacity of managing operations and maintenance, and to enforce regulatory measures.

On the other hand, the impact of key public investment programs on the poor should be analysed to identify those which contribute to poverty alleviation objectives cost-effectively. For example, the relationship between program expenditures (e.g., primary education expenditures) and their outcomes (e.g., educational performance), rather than mere trends or international comparisons of expenditure ratios, should be the basis for allocating resources to achieve socially desirable outcomes.

Encouraging Private Investment

There are important drivers of private investment, which include, among others, a solid consumer base or market potential, profitable investment opportunities, economic stability, protection of property rights, good governance and predictability of future economic conditions. While market potential for goods and services is the most critical driver for any investment decision, uncertainties in economic outlook and lack of regulation and coordination may impose greater setbacks for firms contemplating investment with long term expected returns. In order to stimulate large-scale long-term private investments, significant improvements in investment climate should be undertaken. This may include regulatory barriers, financial constraints or lack of resources, such as skilled labour and technology.

As highlighted in section 3, overall investment climate is not at favourable level and there are significant barriers to investment in OIC countries. There are some issues that can be considered in improving the investment conditions for private sector. In improving investment conditions, the most important phase is the identification of barriers to investment. While barriers can be at any possible level where private sector is engaged, identification of barriers at sector level would be a viable approach to start with. An advantage of this approach is to prioritize the sectors with significant potential of productivity gains and growth impacts for the economy and then to develop

a strategy to stimulate investment in these specific sectors. In practice, much of the investment is typically concentrated on energy, transport, construction, tourism and telecommunication and these areas are where governments have greater influence.

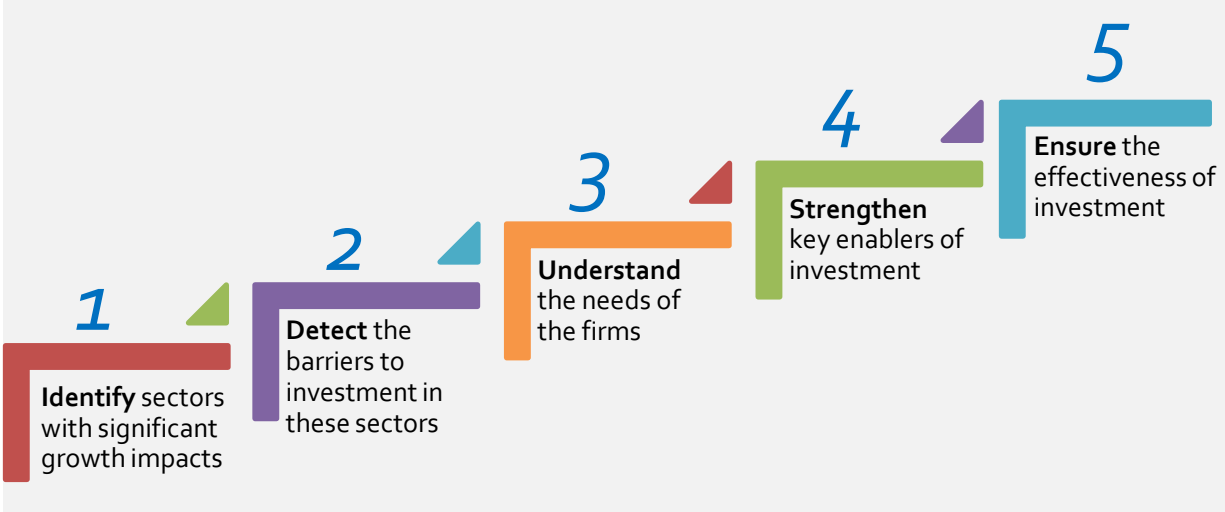
Moreover, investment in one sector usually has positive consequences on other sectors. Promoting water and energy infrastructure accelerates efficiency in agricultural and manufacture production, while improving telecom and transport infrastructure also strengthens economic integration of poor and landlocked areas. Having a bigger industrial sector and higher income levels, on the other hand, promote the density of private infrastructure projects in emerging countries as they increase growth and develop operational performance.

Each sector has different obstacles to private investment. Investment in manufacturing can be constrained by a lack of high-skilled labour and technology. In construction and trade, investment can be constrained by planning regulations and absence of harmonisation of standards. In tourism, a lack of coordination among different service providers (airports, hotels, conference centres etc.) may hinder investment and growth. In transport and communication, government permissions at national and local level may not be easier to obtain.

In addition to sector specific measures to improve investment conditions, firm specific actions should also be taken to encourage private investment. Special incentives should be provided for SMEs, particularly for innovative ones, to support their entry to market and access credit. Moreover, special measures should be taken to strengthen key enablers of investment, such as developing new approaches for the development of necessary skills, access to finance and adequate infrastructure.

Given these three layers of improving investment conditions (economy level, sector level and firm level), a targeted approach for OIC countries can be proposed to optimise their actions in stimulating private investment. Creating a suitable investment climate for private enterprises and then waiting for them to invest in profitable business opportunities is an approach, but for a more directed strategy in fostering development and competitiveness, the following policy interventions, as also depicted in Figure 7.1, would be suggested:

Figure 7.1: Key Steps of Promoting Effective Private Investment



1. Identify sectors with significant growth impacts
2. Detect the barriers to investment in these sectors
3. Understand the needs of the firms
4. Strengthen key enablers of investment
5. Ensure the effectiveness of investment

Identify sectors with significant growth impacts: Based on a solid assessment of all sectors after considering their size, level of international competitiveness, expected productivity gains for the economy, time and resources required to invest, and potential for further investment, policy makers should identify the critical sectors to focus on. The potential for gaining comparative advantage, capacity to utilize any emerging trends and time required to realize the returns to investments are some of the other important issues that need to be taken into consideration in prioritizing the sectors. The existing size and the amount of investment required in the sector are in principle among the most important factors. It should be also noted that investments in some sectors, such as transport and energy, can provide economic benefits in other sectors and this should be considered in decision making process.

Detect the barriers to investment in these sectors: Once the priority sectors are identified, the sector specific barriers should be detected at sufficiently detailed level to foster private investment in that sector. These typically include regulatory gaps, weak enablers, lack of coordination and communication. Table 7.1 provides the potential barriers to investment in these categories. Based on the constraints and challenges faced in the promotion of investment in a specific sector and cost-benefit analysis, policy makers should decide whether or not to invest for prioritizing that sector.

Table 7.1: Barriers to Investment

Regulatory failures	**Regulatory restrictions**	Macroeconomic regulations, including taxes, planning restrictions, product market issues, labour market inflexibilities, or market access constraints that inhibit sector's expansion and investment
	Regulatory framework	Lack of regulatory structures, such as failure to price externalities associated with production, unclear legal situations, or an ineffective competition regime that are conducive to investment
Weak enablers	**Financial capital**	Equity or debt financing is difficult for potential investors to access or is available only at prohibitively high cost
	Human capital	Labour force has insufficient supply of the knowledge and capabilities required for the construction or eventual operation of capital investments
	Infrastructure	Supporting infrastructure for investment, including the transport system, scientific research institutions, energy infrastructure, telecommunications or water networks, is absent or of insufficient quality
	Technology	Critical technology for investment is unproven or not yet at commercial / industrial scale
Coordination problems, information failures	**Coordination problems**	Coordination problems with key stakeholders including inadequate scale, insufficient clustering, weak supply chains, ineffective interaction with public bodies, poor firm-union relations or need for complementary investments
	Information failures	Lack of investor information on the benefits and costs of the opportunity

Source: MGI (2012).

Understand the needs of the firms: While common barriers to investment may be a concern for each firm operating in a sector, these firms may have other requirements to engage in productive investment. The barriers should be identified both for incumbents and potential entrants. Moreover, special needs of firms at different sizes or locations should be well assessed in close cooperation with relevant parties and necessary actions should accordingly be taken. Some firms may require protection from foreign competition to grow. However, it should be recognized that efforts to protect a domestic sector from competition coupled with high subsidies to promote investment can be counterproductive.

Strengthen key enablers of investment: As provided in Table 7.1, financial capital, human capital, infrastructure and technology are among the most important enablers of productive investment. Special strategies should be developed to strengthen these key enablers in order to attract more investment in targeted sectors. Depending on the country-specific contexts, necessary short-term and long-term measures should be taken to facilitate investment.

Ensure the effectiveness of investment: Policy makers should make regular assessment of policy interventions and cost-benefit analyses to make sure that these interventions provide expected outcomes. Moreover, a clear coordination mechanism across the relevant levels of government agencies should be established for effective implementation and follow-up of the policy interventions. Criteria for initiating, continuing and completing the interventions should be explicitly articulated and agencies must have flexibility and resources to respond the changing needs of the market and firms during the implementation. Capabilities of these agencies should be developed by recruiting the people with right skills and experience.

While promoting investment, special attention should be paid to degree of economic diversification. Heavy concentration of economic activities in few sectors makes the economy vulnerable to external shocks. Diversification of production base in industry, services and agriculture sectors will allow further investment by both domestic and international investors and strengthen the sustainability of the economy. Therefore, apart from government-led investment promotion policies, private sector should be given opportunity to invest and grow in any growth-inducing and employment-generating economic activity. This requires once again an investment friendly environment with facilitating regulations, deep financial market, labour force with required skills and capabilities, solid infrastructure, access to technology and knowledge, and effective coordination channels between public authorities and private sector representatives.

Last but not the least, improving coordination among the government and private enterprises and institutions is the main principle for having higher returns from existing infrastructure and developing infrastructure in a country. Efficient infrastructure investments should be prioritized for the high returns they bring. Many OIC countries are less-equipped to develop infrastructure on their own. Therefore, integrating energy, water and transport infrastructure to urban regions with the assistance of more developed countries will be a more efficient option as it would reduce the cost of doing trade and enable people to have access to large markets. Moreover, institutional reforms through improving governance and accountability in state-owned and private enterprises can reduce inefficiency of operational performance in enterprises.

Promoting Foreign Direct Investment

Looking at raw FDI inflows and inward stocks data reveals that compared with the performance of non-OIC developing countries and developed countries, the OIC group increased FDI inflows and stocks the most since the 1990s. However, the positive trends seen in FDI inflows in OIC member countries are far from being sufficient given the high potential of OIC member countries to host even larger amount of FDI. In this context, OIC member countries need to implement effective FDI attraction strategies in order to reach their potential in FDI flows. These strategies are usually being implemented by national FDI promotion agencies worldwide that serve as a one-stop-shop for foreign investors. To this end, forming national FDI promotion agencies may help OIC member countries for those without such a national agency to host more FDI. It is also important for OIC member countries with existing FDI promotion agencies to check their quality and effectiveness in order to improve their performance.

While the share of the OIC group in the world FDI inflows jumped from 4.5% in 2002 to 10.7% in 2014, the share of OIC member countries in the world greenfield FDI projects only increased from 18.8% in 2002 to 20.1% in 2014. Therefore, OIC member countries not only attracted FDI below their potential but also experienced difficulties in hosting greenfield type of FDI projects that are expected to have a higher impact on employment creation and economic growth compared with mergers and acquisitions. In this regard, OIC member countries need to design FDI policies to host more FDI greenfield projects through, inter alia, allocating land for investors, giving incentives or applying tax exemptions for this kind of FDI projects. However, incentives for attracting FDI could turn into a wasteful policy option if not applied properly. In this context, the OECD checklist for FDI incentive policies could provide a road-map for policy-makers in OIC countries (see OECD, 2003).

Foreign investors pay a special attention to the international trade openness of a country before investing. To this end, OIC member countries need to intensify their efforts to ease international trade through, among others, reducing tariff rates, easing and standardization of trade rules and regulations, and taking measures against non-tariff barriers. Another dimension of the trade reforms should target the bureaucrats and professionals who engage into international trade. Training programs would be designed in order to change the mind-sets of bureaucrats and professionals towards having a more pro-trade understanding.

Foreign investors not only bring capital or technology to host countries but also transfer some of their workers from their home countries. To this end, regulations for expatriates need to be revisited in several OIC member countries. Measures that aim to facilitate professional and social life of expatriate workers would enhance FDI flows to member states. Restrictive policies against expatriates such as difficulties on opening bank accounts and getting working permits need to be revisited. Moreover, many investors attach a special importance to the working standards of labour in host countries. In this context, labour market reforms that aim to increase the standards of workers with a view to reach the International Labour Organization (ILO) standards would make a positive impact on FDI flows to member states.

Foreign investors prefer working with workers with some certain skills in host countries. Therefore, targeted policies to upgrade skills of workers would enhance FDI flows to OIC member countries. To this end, vocational education and training programmes needs to be promoted. Policies towards

promoting foreign language education would also increase the number of workers with a foreign language, and therefore would induce more FDI flows.

Overall quality of institutions and infrastructure are important factors that affect the decision of foreign investors. Due to the existence of cross-country differences in terms of quality of institutions and infrastructure within the OIC group, each member country should make a detailed assessment on the quality of their institutions and infrastructure in order to find out priority areas for reforms with a view to hosting more foreign investors.

A very effective way to increase overall FDI flows to OIC member countries is to enhance intra-OIC cooperation (UNCTAD, 2013). A higher volume of intra-OIC FDI inflows also means a higher degree of integration and deeper connection among Muslims living in different countries. Therefore, it is crucial for policy-makers in the OIC countries to take the necessary actions in order to give a boost to intra-OIC FDI inflows through, inter alia, building-up an online and up-to-date OIC investment database, organising regular OIC investment forums and exhibitions, relaxing trade barriers, easing visa rules for investors, and reducing transport costs and taxes levied on it.

Part of the responsibility belongs to businessmen and companies in the OIC countries. They need to be more pro-active in finding and utilizing the potential investment opportunities in other OIC countries. However, policy-makers in the OIC countries need to level the field for investors who are willing to invest in other OIC countries by reducing legal and trade barriers ahead of investors, especially originating from other OIC countries. Establishing a formal mechanism at OIC level to facilitate coordination among the national investment promotion agencies/bodies of the OIC countries can also be helpful to enhance intra-OIC investment. This mechanism can seek, evaluate and list different investment cooperation opportunities in OIC countries. Moreover, this platform can be used to exchange the best practices among the member states on FDI projects and policies.

On the other hand, many OIC countries still experience problems related with overall macroeconomic and institutional environment at varying degrees. The detailed analysis in section 6.3 revealed the stance of problems seen in OIC member countries related with the average market size, macroeconomic environment, the quality of institutions and infrastructure, regulatory framework on FDI, and economic freedoms. Therefore without addressing these policy areas properly, it is not possible for the OIC group to reach its full potential in terms of FDI flows.

The success of the OIC countries in this field is closely linked to the willingness and determination of policy-makers in designing, implementing and following up comprehensive FDI attraction strategies. In this regard, policy-makers in OIC member countries can benefit from international documents and practises. For instance, a key document called the Investment Policy Framework for Sustainable Development (IPFSD), which was launched by the UNCTAD in 2015 in Addis Ababa, can provide some guidance to national policy-makers in OIC member countries on this issue. Overall, IPFSD aims to help policy-makers to design guidelines or action menus in three domains: guidelines for national investment policies, guidance for the design and use of international investment agreements (IIAs), and an action menu for the promotion of investment in sectors related to the sustainable development goals.

Figure 7.2
Policy Interventions to Boost Foreign Direct Investment

Some of the global developments, security concerns in some OIC countries and significant growth recorded in some emerging markets (Brazil, China and India) worked against OIC member countries that diverted some investors into other non-OIC developing countries. Increased fragility in some OIC member countries in recent years and on-going conflicts create an unfavourable environment for foreign investors. Therefore, OIC member countries in fragile regions/conflicts zones need to follow more specific FDI policies in order to continue attracting FDI. Investment Climate (2014) Report of the World Bank provides some clues on how to promote FDI in fragile and conflict-affected countries. The report presents three sets of recommendations to policy-makers:

1. *Being focused:* Try to attract FDI on competitive subsectors or projects rather than into all sub-sectors.
2. *Having empathy with foreign investors:* Approach the investment process from the investor's perspective.
3. *Being vigilant against negative environmental and social effects of incoming investments:* Such an approach would improve the overall operational performance of FDI projects, increase social acceptance, and boost the long-term development impact of FDI on host country.

Overall, given the FDI potential of OIC member countries with their young and dynamic population, OIC member countries are expected to host more FDI inflows in near future. However, the success of OIC member countries on hosting more foreign investors is closely linked to the factors listed in Figure 7.2. As discussed above in details, if OIC member countries invest more into human capital and infrastructure, and complete reforms to improve macroeconomic environment, trade openness, and the quality of institutions by reducing risk factors (i.e. country risks political instability), foreign investors are more likely to boost their investments in OIC member countries that would contribute to development process of OIC member countries in several ways from employment creation to technology diffusion.

REFERENCES

Abiad A., D. Furceri and P. Topalova (2015), "The Macroeconomic Effects of Public Investment: Evidence from Advanced Economies," IMF Working Paper No:1595, May, International Monetary Fund, Washington DC.

Albino-War, M., S. Cerovic, F. Grigoli, J. C. Flores, J. Kapsoli, H. Qu, Y. Said, B. Shukurov, M. Sommer, and S. Yoon (2014), "Making the Most of Public Investment in MENA and CCA Oil-Exporting Countries," IMF Staff Discussion Note 1410, November.

Alfaro, L., and A. Charlton (2007), "*Growth and Quality of Foreign Direct Investment: Is All FDI Equal*?" CEP Discussion Papers, 830, London: Center for Economic Performance, LSE.

Ali, F. A., Fiess, N., and MacDonald, R. (2010). Do Institutions Matter for Foreign Direct Investment?. *Open Economies Review, 21*(2), 201-219.

Antras, P. (2003), "Firms, Contracts, and Trade Structure," *The Quarterly Journal of Economics*, 118(4), 1375-1418.

Anwer M., Sampath R., 1999, "*Investment and Economic Growth.*" Presentation at the Western Agricultural Economic Association Annual Meeting, Fargo, USA. http://ageconsearch.umn.edu/bitstream/35713 /1/sp99an01.pdf

Arslanalp, S., F. Bornhorst, S. Gupta, and E. Sze (2010), "Public Capital and Growth", IMF Working Paper No: 10/175. International Monetary Fund.

Blonigen, B. A. (2005). A Review of the Empirical Literature on FDI Determinants. *Atlantic Economic Journal, 33*(4), 383–403.

BNEF (2015), *Global Trends in Renewable Energy Investment 2015*, Bloomberg New Energy Finance and Frankfurt School-UNEP Centre.

Brenton, P., Di Mauro F., and Lucke, M. (1999). Economic Integration and FDI: An Empirical Analysis of Foreign Investment in the EU and in Central and Eastern Europe. *Empirica, 26*(2), 95-121.

Caballero, R. J. (1999), *"Aggregate Investment Handbook of Macroeconomics,"* Chapter 12, Vol.1, Edited by. J. B. Taylor and M. Woodford. Elsevier Science B.V.

Calderon, C., and L. Serven (2008), "Infrastructure and Economic Development in Sub-Saharan Africa," World Bank Policy Research Working Paper No. 4712.

Cavallo E. and C. Daude (2008), "Public investment in developing countries: a blessing or a curse?" Inter-American Development Bank, Working Paper No: 648, Washington, DC.

Chakrabarti, A. (2001). The Determinants of Foreign Direct Investment: Sensitivity Analyses of Cross-Country Regressions. *Kyklos*, *54*(1), 89-114.

Dabla-Norris, E., J. Brumby, A. Kyobe, Z. Mills, C. Papageorgiou (2011), "Investing in Public Investment: An Index of Public Investment Efficiency," IMF Working Paper WP/11/37, February.

Erden, L. and R. G. Holcombe (2005), "The Effects of Public Investment on Private Investment in Developing Economies," Public Finance Review, Vol. 33 No. 5, pp: 575-602, September.

Esfahani, H., and M. Ramirez, 2003, "Institutions, Infrastructure, and Economic Growth," Journal of Development Economics, Vol. 70, pp. 443-477.

Faeth, I. (2009). Determinants of Foreign Direct Investment: A Tale of Nine Theoretical Models. *Journal of Economic Surveys, 23*(1), 165-196.

Gelb A., S. Tordo, H. Halland, N. Arfaa and G. Smith (2014), "Sovereign Wealth Funds and Long-Term

Development Finance: Risks and Opportunities," CGD Policy Paper 041, May, Center for Global Development, Washington, DC.

GIIN (2015), Global Impact Investing Network website, available at: http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html, accessed 6 July 2015.

Gupta, S., A. Kangur, C. Papageorgiou, and A. Wane. 2014. "Efficiency-Adjusted Public Capital and Growth." *World Development* 57 (C): 164–78.

Heller, Peter S. (2005), "Understanding Fiscal Space," IMF Policy Discussion Papers, March.

Hermes, N., and R. Lensink (2003), "Foreign Direct Investment, Financial Development and Economic Growth," *Journal of Development Studies*, 40(1), 142-153.

Horton Mark, Mohan Kumar, and Paolo Mauro, (2009): The State of Public Finances: A Cross-Country Fiscal Monitor," IMF Staff Position Note 09/21 (Washington: International Monetary Fund).

IFPRI (2007), "Pro-Poor Public Investment Program," International Food Policy Research Institute, Washington, D.C.

ILO (2015), World Employment and Social Outlook 2015, Geneva: International Labour Organization.

IMF (2004a), "Public Investment and Fiscal Policy," Prepared by the Fiscal Affairs Department and the Policy Development and Review Department, March 2014, International Monetary Fund

IMF (2004b), "Public-Private Partnerships", Prepared by the Fiscal Affairs Department, March, available at https://www.imf.org/external/np/fad/2004/pifp/eng/031204.pdf.

IMF (2005), "Public Investment and Fiscal Policy—Lessons from the Pilot Country Studies", April 2005, International Monetary Fund.

IMF (2014), "Making the Most of Public Investment in MENA and CCA Oil-Exporting Countries," Staff Discussion Note SDN/14/10, November 2014.

IMF (2015), Making Public Investment More Efficient, Staff Report, June, International Monetary Fund.

Investment Climate (2014). Promoting Foreign Investment in Fragile and Conflict-Affected Situations, No.22 (April), the World Bank Group.

Janicki, H. P., and Wunnava, P. V. (2004). Determinants of Foreign Direct Investment: Empirical Evidence from EU Accession Candidates. *Applied Economics, 36*(5), 505-509.

Lim, E.-G. (2001), "Determinants of and the Relation between, Foreign Direct Investment and Growth: A Summary of the Recent Literature," IMF Working Paper,01/175, Washington: International Monetary Fund.

Makki, S., and A. Somwru (2004), "Impact of Foreign Direct Investment and Trade on Economic Growth: Evidence from Developing Countries," *American Journal of Agricultural Economics*, 86(3), 795-801.

MGI (2011), *Resource Revolution: Meeting the world's energy, materials, food and water needs*, McKinsey Global Institute.

MGI (2012), *Investing in Growth: Europe's Next Challenge*, McKinsey Global Institute, December.

Misch, F. and Peter W. (2008), **"**The returns on public investment: concepts, evidence and policy challenges" Discussion Paper 25, Deutsches Institut für Entwicklungspolitik, Bonn.

Mizell L. and D. Allain-Dupré (2013), "Creating Conditions for Effective Public Investment - Sub-National Capacities in a Multi-Level Governance Context," OECD Regional Development Working Papers 2013/04.

North, D. C. (1991). Institutions. *Journal of Economic Perspectives, 5*(1), 97-112.

OECD (2002). Foreign Direct Investment for Development; Maximizing Benefits, Minimizing Costs, Paris: Organisation for Economic Co-Operation and Development.

OECD (2003). Checklist for Foreign Direct Investment Incentive Policies, Paris: Organisation for Economic Co-Operation and Development.

OECD (2006), "*Promoting Private Investment for Development: The Role of ODA."* Paris: Organisation for Economic Co-Operation and Development.

OECD (2007), *OECD Principles for Private Sector Participation in Infrastructure*, Paris: Organisation for Economic Co-Operation and Development.

OECD (2011), "OECD Guidelines of Multinational Enterprises 2011 Update," Paris: Organisation for Economic Co-Operation and Development.

OECD (2014), "Recommendation of the Council on Effective Public Investment across Levels of Government," Adopted on 12 March 2014. Organisation of Economic Cooperation and Development: Paris.

OECD (2015a), "Mobilising Private Investment in Clean Energy Infrastructure- What's Happening 2015," Paris: Organisation for Economic Co-Operation and Development.

OECD (2015b), *Policy Guidance for Investment in Clean Energy Infrastructure: Expanding Access to Clean Energy for Green Growth and Development*, OECD Publishing, Paris.

OECD (2015c), *Fostering Investment in Infrastructure: Lessons learned from OECD Investment Policy Reviews*, Paris: Organisation for Economic Co-Operation and Development.

OECD (2015d), *Social Impact Investment: Building the Evidence Base*, Paris: Organisation for Economic Co-Operation and Development.

PRIA (2015), "What is Responsible Investment," Principles for Responsible Investment Association, London.

Rajaram, A., T.M. Le, N. Biletska, and J. Brumby (2010), "A Diagnostic Framework for Reviewing Public Investment Efficiency", World Bank Policy Working Paper, No. 5397 (August), Washington, DC.

Reis, A.B (2002), "On the Welfare Effects of Foreign Direct Investment," *Journal of International Economics*, 54 (2), 411-427.

Saltuk, Y, A. Bouri, A. Mudaliar and M. Pease (2013), "Perspectives on Progress: The Impact Investor Survey", Global Social Finance, J.P. Morgan and the Global Impact Investing Network, London, January.

Samset K., and G. Volden (2013). "Investing for Impact: Lessons with the Norwegian State Project Model and the First Investment Projects That Have Been Subjected to External Quality Assurance." Norwegian University of Science and Technology.

SESRIC (2014a), "Trade Costs in OIC Countries, OIC Outlook Series," February, Ankara.

SESRIC (2014b), *OIC Economic Outlook 2014 – Enhancing Productivity and Competitiveness*, Ankara

SESRIC (2014c), "FDI Potential and FDI Performance of the OIC Countries," OIC Outlook Series, SESRIC, Ankara.

SIITF (2014), *Impact Investment: The Invisible Heart of the Markets*, Social Impact Investment Taskforce, London, September.

Spence, M. (2015). Why Public Investment? Available at: http://po.st/9XS5Ik.

Straub, S., (2008), "Infrastructure and Growth in Developing Countries: Recent Advances and Research Challenges," World Bank Policy Research Working Paper No. 4460.

Sutherland D et al. (2009). Infrastructure investment: links to growth and the role of public policies. Economics Department Working Paper No. 686 ECO/WKP(2009)27.

Tanzi V. and H. Davoodi (1998), "Roads to Nowhere: How Corruption in Public Investment Hurts Growth," Economic Issues 12, International Monetary Fund, Washington DC.

Tintin, C. (2013). The Determinants of Foreign Direct Investment Inflows in the Central and Eastern European Countries: The Importance of Institutions. *Communist and Post-Communist Studies*, *46*(2), 287-298.

UNCTAD (2009), "The role of public investment in social and economic development," Background paper for the High-Level Seminar on the Role of Public Investment in Social and Economic Development, 13–14 July 2009 in Rio de Janeiro, Brazil.

UNCTAD (2010). World Investment Report 2010: Investing in a Low-Carbon Economy, United Nations Conference on Trade and Development, New York and Geneva.

UNCTAD (2012). World Investment Report 2012: Towards a New Generation of Investment Policies, United Nations Conference on Trade and Development, New York and Geneva.

UNCTAD (2013). Strengthening the Links between Intra-OIC FDI and Regional Integration, Global Investment Trends Monitor, No.14, United Nations

Conference on Trade and Development, New York and Geneva.

UNCTAD (2014), *"Economic Development in Africa: Catalysing Investment for Transformative Growth in Africa."* United Nations Conference on Trade and Development, New York and Geneva.

UNCTAD (2015a). Investment Policy Framework for Sustainable Development, United Nations Conference on Trade and Development, New York and Geneva.

UNCTAD (2015b). Financing for Development: FDI can be an Important Source of External Development Financing for LDCs, LLDCs and SIDS, Global Investment Monitor, No.20., New York and Geneva.

Vijayakumar, N., Sridharan P., and Rao, K. (2010). Determinants of FDI in BRICS Countries: A Panel Analysis. *International Journal of Business Science and Applied Management, 5*(3), 1-13.

WEF (2013), *The Green Investment Report - The Ways and Means to Unlock Private Finance for Green Growth*, A Report of the Green Growth Action Alliance, World Economic Forum, Geneva.

World Bank (2004), *"World Development Report 2005: A Better Investment Climate for Everyone."* Washington, DC.

World Bank (2014), *"Doing Business 2015: Going Beyond Efficiency."* Washington, DC.

World Bank (2015) World Bank Private Participation in Infrastructure Database Glossary, Available at http://ppi.worldbank.org/resources/ppi_glossary.aspx

Data Sources

IFPRI Statistics of Public Expenditure for Economic Development (SPEED), 2011

ILO World Employment and Social Outlook 2015 Dataset

IMF Direction of Trade Statistics (DOT) Database, August 2015

IMF World Economic Outlook Database, April 2015

SESRIC BASEIND Database, August 2015

UN Services Trade Database, August 2015

UNCTAD Online Database, July 2015

UNSD National Accounts Main Aggregates Database, August 2015

World Bank Doing Business Database, 2015

World Bank Global Financial Development Database, November 2013

World Bank World Development Indicators (WDI) Database, July 2015

World Economic Forum Global Competitiveness Index Database 2014-2015