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Middle East and Central Asia Department

Learning to Live with Cheaper Oil

Policy Adjustment in Oil-Exporting Countries of
the Middle East and Central Asia

*IMF staff team led by
Martin Sommer*

Middle East and Central Asia Department

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*Martin Sommer, Greg Auclair, Armand Fouejieu, Inutu Lukonga,
Saad Quayyum, Amir Sadeghi, Gazi Shbaikat, Andrew Tiffin,
Juan Trevino, and Bruno Versailles*

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Preface

This paper was prepared by the IMF's Middle East and Central Asia Department under the general guidance of Masood Ahmed, director of the department. The project was directed by Aasim M. Husain, deputy director, and led by Martin Sommer, deputy chief of the Regional Studies Division. Contributors to this report include Greg Auclair, Armand Fouejieu, Inutu Lukonga, Saad Quayyum, Amir Sadeghi, Gazi Shbaikat, Andrew Tiffin, Juan Trevino, and Bruno Versailles. Neil Hickey provided editorial support and Joe Procopio managed the report's production. Hanan Altimimi Bane assisted with formatting and document preparation, with additional support from Esther George.

This report is generally based on information as of April 2016. The macroeconomic assumptions and oil prices are consistent with those in the April 2016 *World Economic Outlook*. Specifically, the average Brent oil price is assumed at \$36 a barrel in 2016 and \$42 a barrel in 2017, gradually increasing to \$51 a barrel in 2021.

The paper focuses on policy challenges facing the countries of the Gulf Cooperation Council (*Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates*), *Algeria*, and oil exporters in the Caucasus and Central Asia (*Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan*). To keep the focus on the impact of lower oil prices, this study does not cover developments in those Middle Eastern and North African (MENA) oil exporters where developments are also, or primarily, driven by conflicts (*Iraq, Libya, and Yemen*) or by the removal of sanctions (*Iran*).

The word *oil* is used interchangeably for both crude oil and natural gas.

Executive Summary

The oil exporters in the Middle East and North Africa (MENA) and the Caucasus and Central Asia (CCA) are facing an exceptionally challenging policy environment. Lower oil prices have reduced growth, opened up large budget and trade deficits, and increased financial stability risks. The proliferation of conflicts in the MENA region continues to cause severe economic damage and significant spillovers for neighbors and beyond. In the Caucasus and Central Asia, the adverse impact of lower oil prices has been compounded by slowdowns in Russia and China. All these challenges could undermine macroeconomic stability and further deepen social and political tensions. Fortunately, most MENA and CCA oil exporters enter this challenging period from a position of strength, having built up large financial buffers during the years of high oil prices. These resources can be drawn down in the coming years to smooth out—but not avoid—the adjustment to lower oil revenues.

In the *Gulf Cooperation Council (GCC) region and Algeria*, ambitious fiscal consolidation measures are being implemented this year, but budget balances will deteriorate in several countries nonetheless, given the sharp drop in oil prices. An additional substantial deficit-reduction effort is required over the medium term to preserve fiscal sustainability and, in the GCC countries, to support the exchange rate pegs. Policymakers need to be mindful of emerging signs of liquidity pressures in their financial systems and the risk of deteriorating asset quality. Deep structural reforms are necessary to improve medium-term prospects and facilitate much-needed diversification in order to create jobs for the growing labor force.

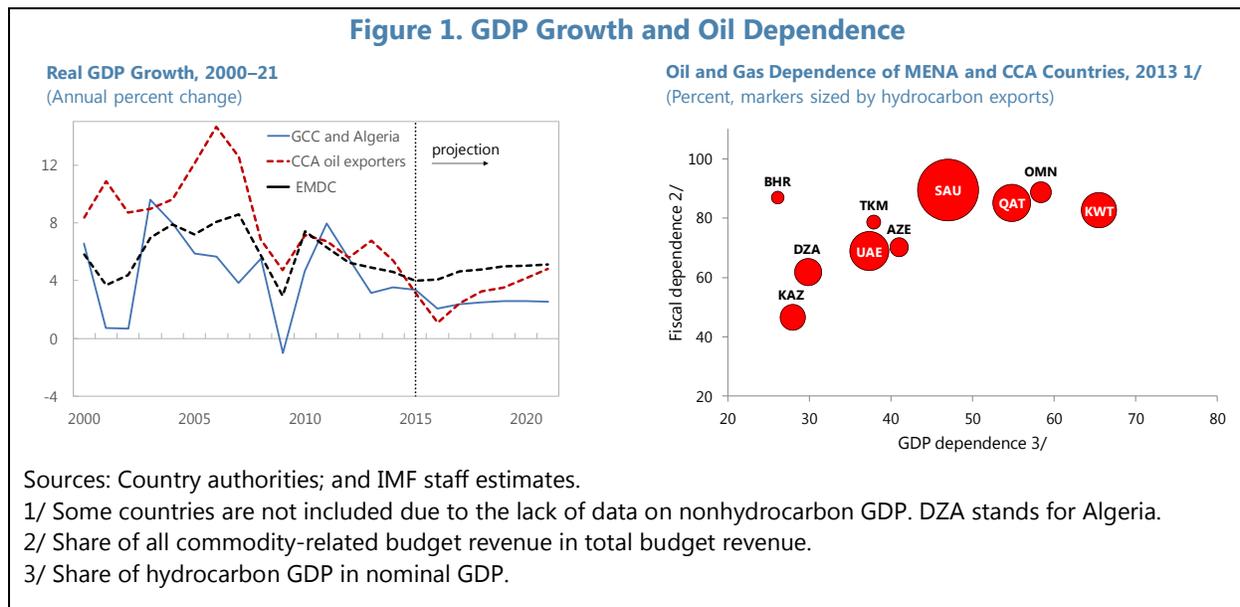
In the CCA countries, economic activity has slowed to a two-decade low. Although currency weakening has helped mitigate the impact of external shocks on economic activity, inflation and financial sector vulnerabilities have risen, in some cases exacerbated by policy uncertainty. Stronger macroeconomic policy frameworks and better financial sector supervision are needed to maintain financial sector stability and weather exchange rate adjustments. Significant fiscal adjustment would help ensure sustainability over the medium term, along with structural reforms to boost potential growth, competitiveness, and job creation.

1

Lower Oil Prices: A Challenging New Reality

Over the past 15 years, MENA and CCA oil exporters enjoyed large external and fiscal surpluses and rapid economic expansion on the back of booming oil prices. Growth averaged almost 5 percent in the *GCC region* and *Algeria* and more than 8 percent in *CCA oil-exporting countries*, compared with 6 percent growth in all emerging markets and developing countries (EMDCs) (Figure 1). Rising public expenditures have played an important role in propelling non-oil growth as policymakers channeled buoyant oil revenues into the economy. At the same time, banks had ample liquidity from deposits of public sector surpluses, which supported private sector credit and activity.

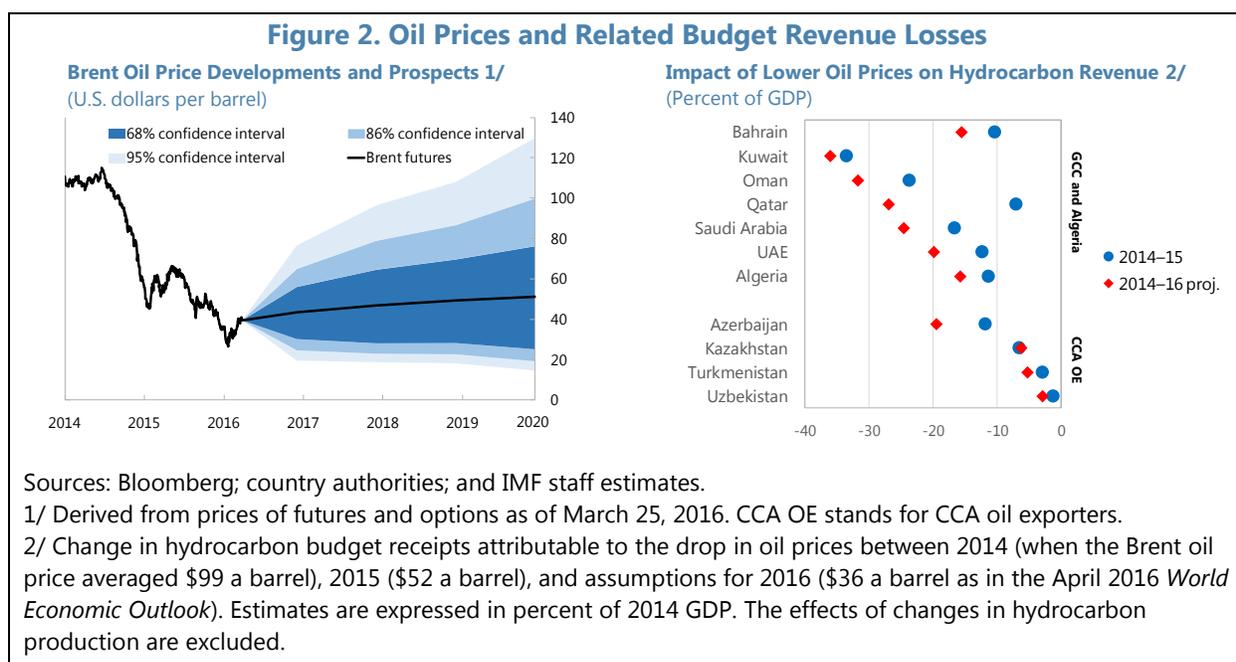
However, as oil prices have plunged by some 60 percent since the middle of 2014, fiscal and external surpluses have turned into deficits and growth has slowed, raising concerns about unemployment and financial sector risks. How should the exporters adjust to the new oil market reality?



Oil and Natural Gas Are Crucial Commodities

The MENA and CCA regions are home to 11 of the world’s top 20 hydrocarbon exporters. These exporters are highly dependent on oil and natural gas in terms of budget revenues, exports, and gross domestic product—especially in the Gulf. Therefore, the oil market remains one of the key drivers of the regional outlook. In particular, lower oil prices are projected to have reduced hydrocarbon budget receipts by more than 10 percent of GDP in *all GCC countries, Algeria, and Azerbaijan* over the past two years (Figure 2).¹

Futures markets predict only a modest recovery in oil prices from about \$45 a barrel at present to about \$50–\$55 a barrel by the end of this decade. However, uncertainty around this price prediction is unusually large. The weak oil price prospects reflect, among other factors, the surprising resilience—at least until recently—of U.S. shale supply, the expectation that Iran will boost its exports while other major exporters maintain high output, and the sluggish global recovery (Husain and others 2015). Meanwhile, the longer-term market impact of a recent proposal by several countries to freeze oil production is unclear.

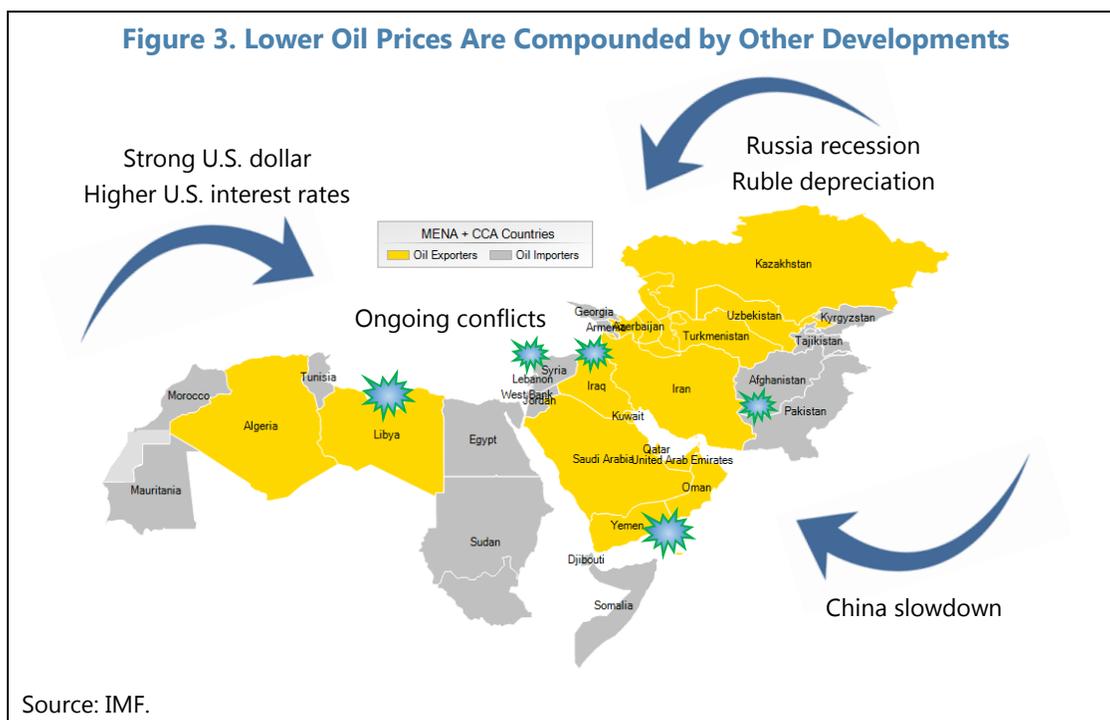


¹ The value of oil and natural gas exports is projected to fall by almost \$450 billion in the *GCC countries and Algeria* in 2016 compared with 2014; the corresponding estimate for the *CCA oil exporters* is \$65 billion. In contrast, the *MENA and CCA oil importers* are collectively projected to save only \$20 billion on oil and gas imports this year compared with 2014.

The Effects of Lower Oil Prices Are Being Compounded by Other Factors

In addition to lower oil prices, MENA and CCA oil exporters are facing a number of other adverse developments (Figure 3):

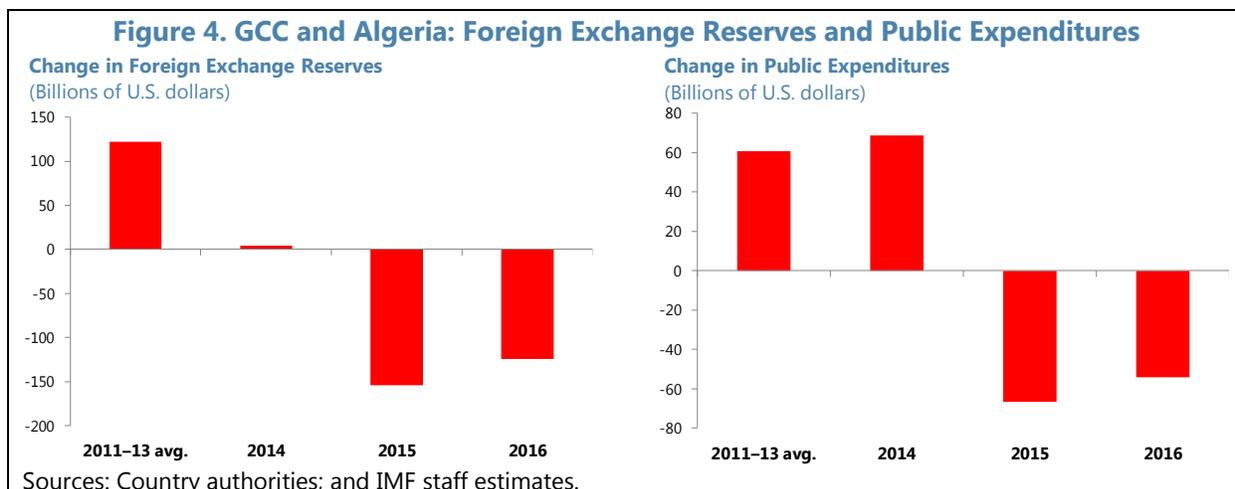
- *Conflicts are spreading and deepening across the MENA region.* Among the oil exporters, *Libya, Iraq, and Yemen* are the most severely affected, with tragic humanitarian effects and massive damage to their economies. These conflicts (including in other MENA countries such as *Syria*) also have significant implications for neighboring countries, particularly *Lebanon and Jordan*, and other regions, including Europe.
- *Further strengthening of the U.S. dollar and normalization of U.S. monetary policy* would have negative repercussions for the region, possibly putting downward pressure on oil prices or increasing funding costs. The risk of higher funding costs is also relevant because all MENA and CCA oil exporters are expected to run budget deficits and will be seeking market financing.
- *Slowing growth in China could impart larger-than-expected spillovers* to both oil exporters and importers in the MENA and CCA regions, including through further downward pressure on commodity prices and reduced trade and investments.
- *Lower oil prices and other factors have pushed Russia into recession and caused the ruble to depreciate.* This has reduced demand for CCA exports and cut remittances and investment into the CCA countries. The perfect storm of adverse external factors (including from China and the United States) has created unprecedented policy challenges for the CCA region. Oil exporters with substantial nonhydrocarbon exports have also been adversely impacted by lower prices of many non-oil commodities.



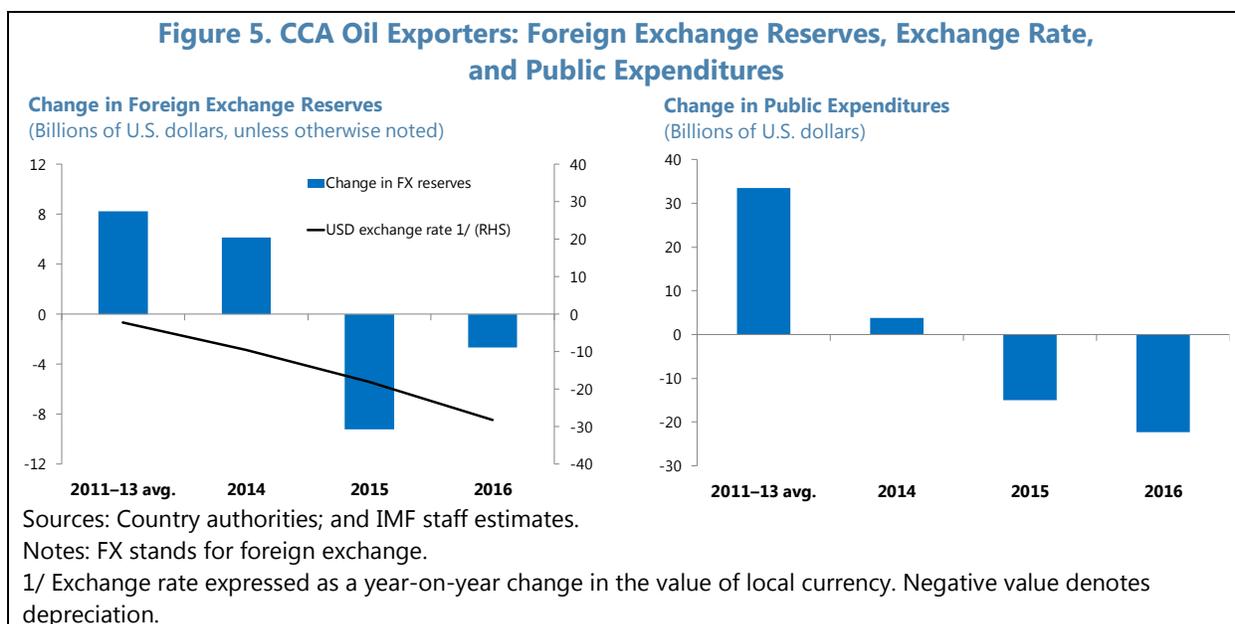
The remainder of this paper focuses on policy challenges facing the countries of the Gulf Cooperation Council (*Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates*), *Algeria*, and oil exporters in the Caucasus and Central Asia (*Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan*). To keep the focus on the impact of lower oil prices, this study does not cover developments in those MENA oil exporters where developments are also, or primarily, driven by conflicts (*Iraq, Libya, and Yemen*) or by the removal of sanctions (*Iran*). The word *oil* is used interchangeably for both crude oil and natural gas.

Initial Policy Responses

In the *GCC region* and *Algeria*, exporters with financial buffers appropriately used these reserves to absorb the initial oil price shock and smooth policy adjustment. This has been reflected in falling foreign exchange reserves (Figure 4). The actual drawdown of financial buffers may have been larger, as some countries also withdrew assets from their sovereign wealth funds. At the same time, most countries have started to rein in budget spending—the break in expenditure trends after 2014 is striking. The fiscal consolidation process will continue and intensify in most countries in 2016. However, due to the further deterioration in oil prices, their fiscal deficits will not, on average, visibly improve this year.



In the *CCA oil exporters*, some of the policy adjustment has been attained through exchange rate depreciation, which has helped ease initial overvaluations due to ruble depreciation and the strong U.S. dollar (Figure 5). Subsequently, the losses of foreign exchange reserves have been smaller in the *CCA region* than in the *GCC and Algeria*, even after accounting for the smaller size of the *CCA* economies. Some *CCA* countries (*Turkmenistan, Uzbekistan*) have managed their currencies more tightly through interventions and administrative controls. Details of fiscal policy responses differ across *CCA* countries, with some countries implementing fiscal stimulus measures, including through off-budget vehicles, but the general pattern at the regional level is similar—expenditures slowed substantially in 2015, and spending restraint will further deepen in 2016.



Economic Growth is Slowing

Real GDP growth slowed last year, with further deceleration projected for this year in both the CCA and MENA regions (Figure 6). Growth is also much lower than had been projected in the October 2014 edition of the IMF's *Middle East and Central Asia Regional Economic Outlook* (IMF 2014), which was based on assumptions of much higher oil prices.

- Growth in the *GCC countries* and *Algeria* is forecast to slow substantially in 2016, as the impact of lower oil prices is felt through tighter fiscal policy, weaker private sector confidence, and tightening of liquidity in the banking systems. This year's growth (2.1 percent) is projected to be well below the 2014 growth rate (3.6 percent), but none of the exporters are expected to fall into recession.
- For *CCA oil exporters*, growth is projected to hit a two-decade low this year: 1.1 percent, compared with 3.2 percent in 2015 and 5.4 percent in 2014. The sharp slowdown is similar in magnitude to growth decelerations in Brazil, Nigeria, and Russia (Figure 6), and reflects a combination of adverse factors—lower oil production, public spending cuts, tight financial conditions, lower external demand, weaker remittances, and policy constraints and uncertainty. *Azerbaijan's* GDP may contract by 3 percent this year, and *Kazakhstan* is forecast to narrowly avoid a recession.

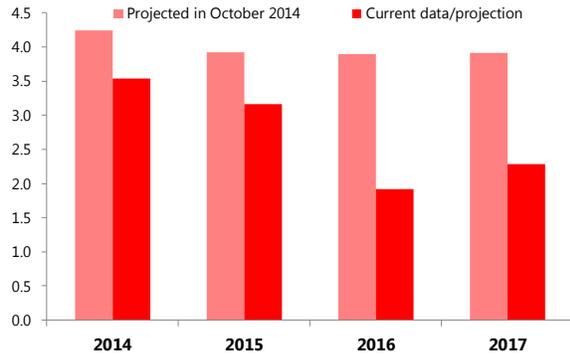
Risks for both groups of oil exporters are tilted mainly to the downside. In addition to the risks related to the external environment mentioned above, two additional considerations—discussed in more detail later in this paper—are worth highlighting:

- Policymakers have adopted a number of welcome budget deficit-reduction measures. However, these could exert either a larger-than-expected drag on growth given tightening financial conditions or, to the contrary, have a smaller-than-expected impact on activity if the measures target unproductive expenditures and tax breaks.
- In the *CCA region*, risks also stem from high vulnerabilities of the banking sector to adverse economic conditions and depreciation of the exchange rate.

Figure 6. GDP Growth and Forecast Revisions

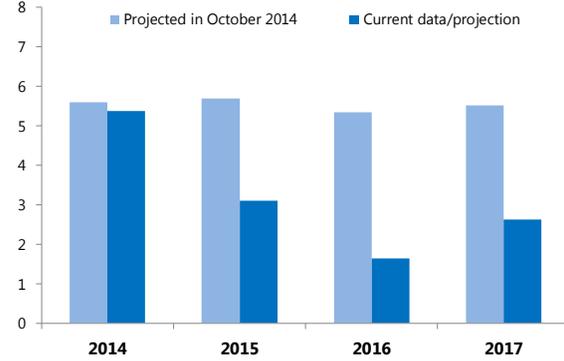
GCC and Algeria's Real GDP Growth

(Annual percent change, PPP GDP weighted average)



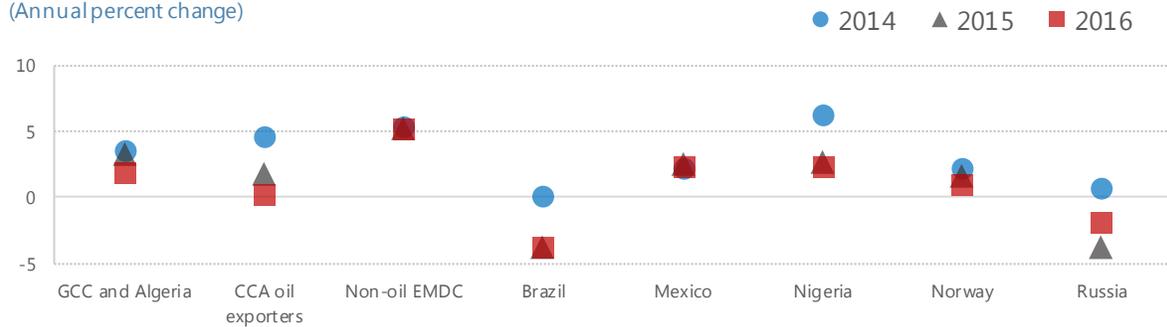
CCA Oil Exporters' Real GDP Growth

(Annual percent change, PPP GDP weighted average)



Real GDP Growth, 2014–16

(Annual percent change)



Sources: Country authorities; and IMF staff estimates.

Note: PPP GDP stands for the purchasing power-adjusted gross domestic product.

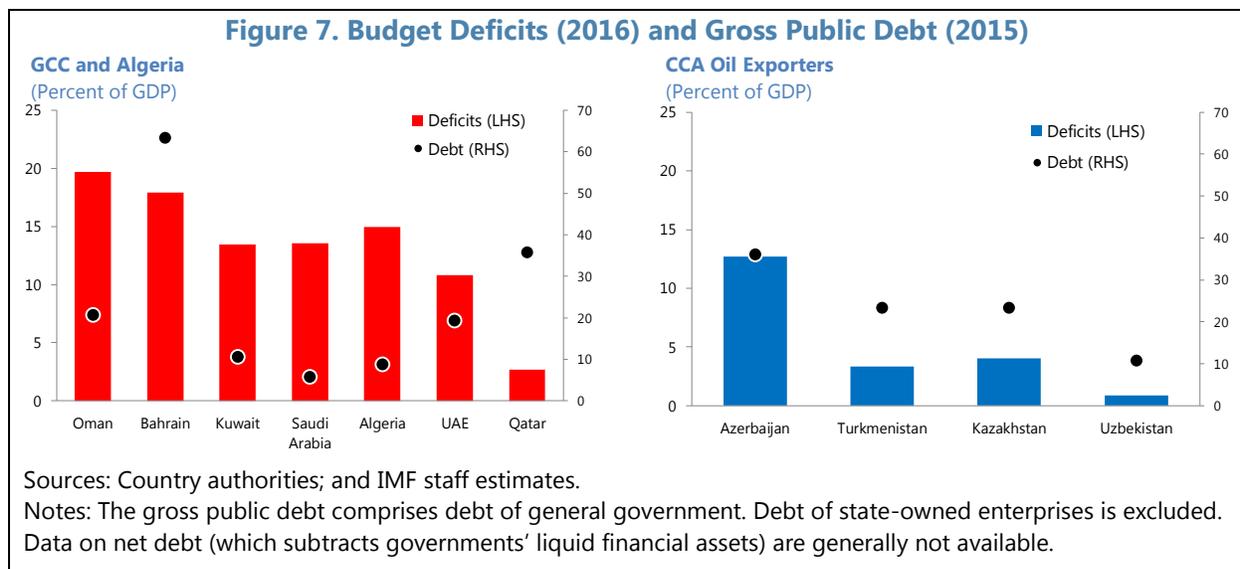
2

Preserving Fiscal Sustainability

Magnitude of the Fiscal Challenge

The steep drop in oil prices has led to a significant deterioration in fiscal balances, despite the deficit-reduction measures adopted so far. This year’s projected budget deficits are particularly high in the *GCC region* and *Algeria* (13 percent of GDP, down from a surplus of 8½ percent of GDP in 2013), reflecting the high reliance of these budgets on oil-related revenues (Figure 7). The budget deficits of *CCA oil exporters* (5 percent of GDP this year, compared with a 3½ percent surplus in 2013) are generally lower, given more developed sources of non-oil revenues and exchange rate depreciation, which increases the local currency value of oil-related receipts.

The starting public debt ratios are low, and accumulated financial savings are sizable in many—but not all—countries, pointing to significant fiscal buffers in the near term. Countries with room to borrow and ample financial savings can afford a more gradual fiscal adjustment, but all countries will need to adjust over time, given the large revenue losses from lower oil prices.



Adopted Adjustment Measures Are Significant

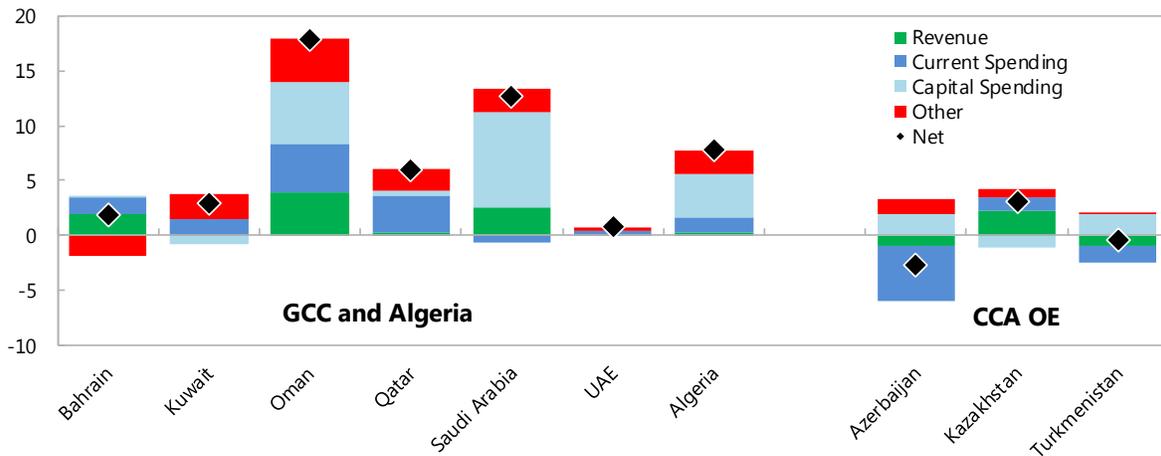
Fiscal adjustment plans for 2016 are sizable, with several MENA and CCA countries announcing ambitious measures of about 4–6 percent of non-oil GDP or even more (Figure 8). Countries with higher deficits have generally initiated larger adjustment plans—Annex I provides country-specific details.

- *Countries have typically focused on spending cuts* because spending increased significantly during the period of high oil prices. Country strategies differ and some of the plans have not yet been spelled out fully, but a number of countries appear to be planning sizable cuts in public investment (including *Algeria, Azerbaijan, and Saudi Arabia*). In contrast, *Qatar* intends to protect its key infrastructure spending ahead of the FIFA 2022 World Cup. *Oman* plans to make a sizable dent in defense, operating expenditures, and workers' fringe benefits. The *United Arab Emirates* has cut transfers to government-related entities, subsidies, and grants. In *Kuwait*, current spending is being curtailed, while capital outlays are expected to uptick further. In general, countries are protecting public employment and wages.
- *Most GCC countries have not yet increased non-oil revenues in a meaningful way*, although several policymakers have announced the introduction of a GCC-wide value added tax (VAT), as well as other fees, charges, and excises. *Bahrain* has started increasing a number of fees, including for health care services, and recently increased tobacco and alcohol taxes. *Oman* has increased corporate taxes and fees this year. *Saudi Arabia* has boosted non-oil receipts, primarily through higher transfers from entities outside the central government budget. There are no plans to introduce personal income taxes in the GCC countries at this time.
- *GCC countries and Algeria have pursued substantial energy price reforms*. Fuel, water, and electricity charges have been raised significantly from very low levels in most of these countries, including *Saudi Arabia*, and some countries have indicated that further price increases will be undertaken over time. However, only the *United Arab Emirates, Oman*, and recently *Qatar* have introduced energy price adjustment mechanisms that will ensure domestic prices move in tandem with international benchmarks. These energy price reforms may either raise revenues or reduce expenditures, depending on country circumstances. In some cases, the gains from energy price hikes may remain off budget if energy sector profits are not transferred fully to the state budget.

Figure 8. Planned Fiscal Adjustment in 2016

Composition of Fiscal Adjustment 1/

(Contribution to the change in non-oil fiscal balance between 2015 and 2016, percent of non-oil GDP)



Sources: Country authorities; and IMF staff estimates.

1/ Fiscal adjustment = deliberate policy measures to improve the fiscal balance; other adjustment = residual item reflecting changes in fiscal balances due to factors such as automatic reduction in subsidies due to lower oil prices, one-off items, and denominator effects from lower GDP base.

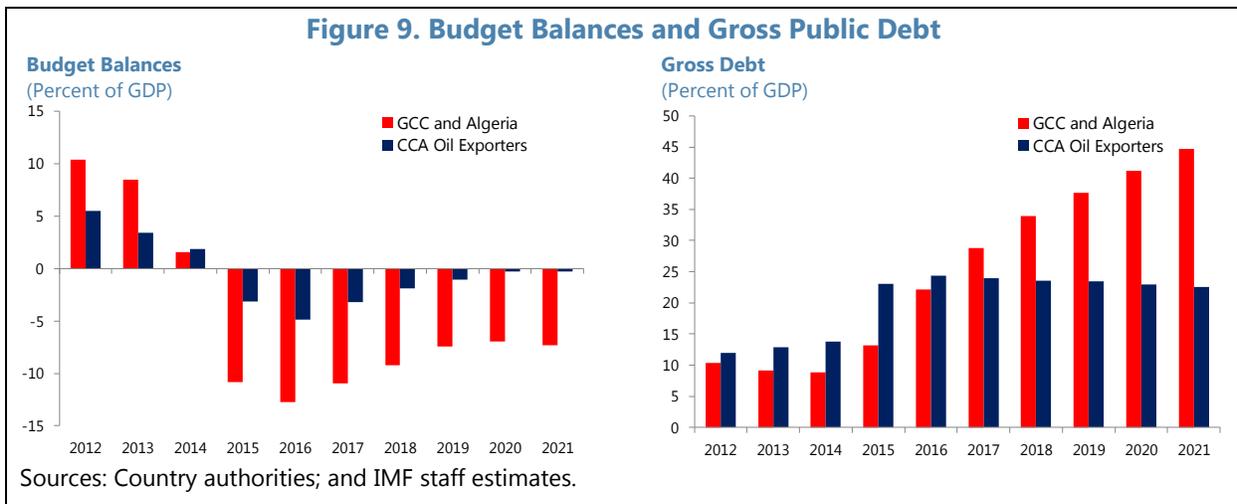
Challenging Fiscal Trajectory Despite Measures

Ambitious consolidation measures are not generally translating into better fiscal positions this year because of the further drop in oil prices. Fiscal deficits are projected to shrink as a percentage of GDP only in *Algeria, Kazakhstan, Oman, and Saudi Arabia*. The medium-term fiscal trajectory remains challenging, especially for MENA oil exporters (Figure 9).

- Even after incorporating the announced measures, fiscal deficits of *GCC countries and Algeria* are still projected to average about 7 percent of GDP in 2021. The cumulative deficits for this country group are expected to reach almost \$900 billion during 2016-21. Gross government debt is projected to increase from 13 percent of GDP last year to about 45 percent of GDP in 2021. This points to a modest average debt load; however, the debt ratio for some countries is forecast to exceed 100 percent of GDP by the end of the decade.
- For the *CCA oil exporters*, the cumulative deficits are much smaller, \$32 billion during 2016-21. The CCA fiscal path appears more favorable, in part because of the lower reliance on oil revenues, but also because of higher planned hydrocarbon production over the medium term (for example, from *Kazakhstan's* Kashagan field). Combined with the assumed consolidation measures, the public debt ratio could remain broadly

unchanged at about 23 percent of GDP. However, for some countries, debt is still projected to rise significantly.

Over the medium term, IMF country teams expect oil exporters to continue curtailing public investment, but also to broaden spending restraint to curb the public wage bill and achieve further subsidy cuts. On the revenue side, the expected increase in oil prices would help ease the adjustment. Box 1 discusses the fiscal adjustment undertaken by MENA countries during the 1980s and 1990s.



Fiscal Buffers Vary Considerably by Country

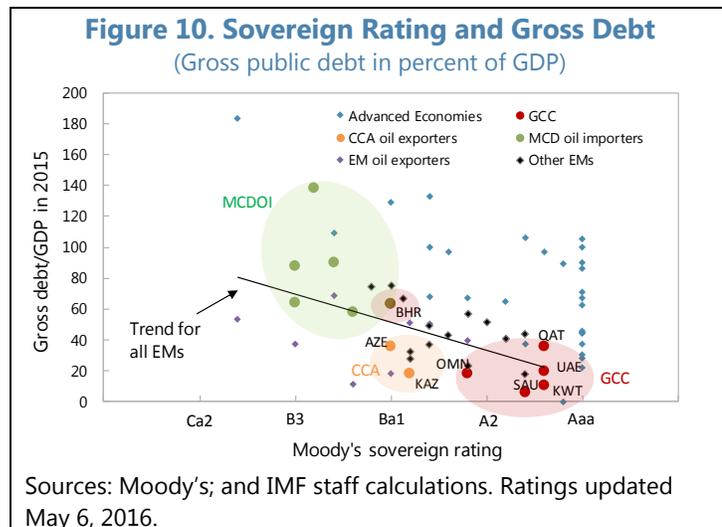
According to estimates by the Sovereign Wealth Fund Institute (SWFI), the *GCC countries* and *Algeria* have saved a combined \$2.5 trillion in their sovereign wealth funds and other savings vehicles. This aggregate figure is much higher than the amount of projected budget deficits over the next five years (\$0.9 trillion). However, this average comparison masks important differences across countries.

A country-level analysis of the SWFI data, combined with various measures of fiscal buffers, suggests that financial savings and debt capacity differ across countries.

- Based on projected spending levels extrapolated from current patterns and policy announcements, many (but not all) *GCC and CCA oil exporters* have substantial fiscal space, with financial savings plus debt capacity exceeding 10 years' worth of projected fiscal deficits. Available fiscal buffers appear particularly large in countries such as *Kazakhstan, Kuwait, Qatar, the United Arab Emirates, and Turkmenistan*, where the estimated buffers can finance more than 20–30 years of projected deficits.

- A review of the past public debt paths shows that debt ratios for several countries peaked at about 100 percent or even higher in the mid-to-late 1990s when oil prices were also in a slump (see Chapter 4 of IMF 2015b). Public debt ratios projected by IMF staff through 2021 are well within these historical norms for many *GCC and CCA oil exporters*, because policymakers have implemented important fiscal consolidation measures, and oil prices are expected to increase somewhat over the medium term.

Despite recent downgrades, *most GCC countries* have ratings similar to those of the best performing advanced economies and their debt ratios are typically below advanced economy peers (Figure 10). The point about relatively low debt ratios also applies to the two rated CCA countries (*Azerbaijan and Kazakhstan*). The fiscal position of oil exporters is also buttressed by large government holdings of corporate assets suggesting that privatization could—in addition to boosting private sector growth—also be used as a temporary source of financing during adjustment (Box 2).



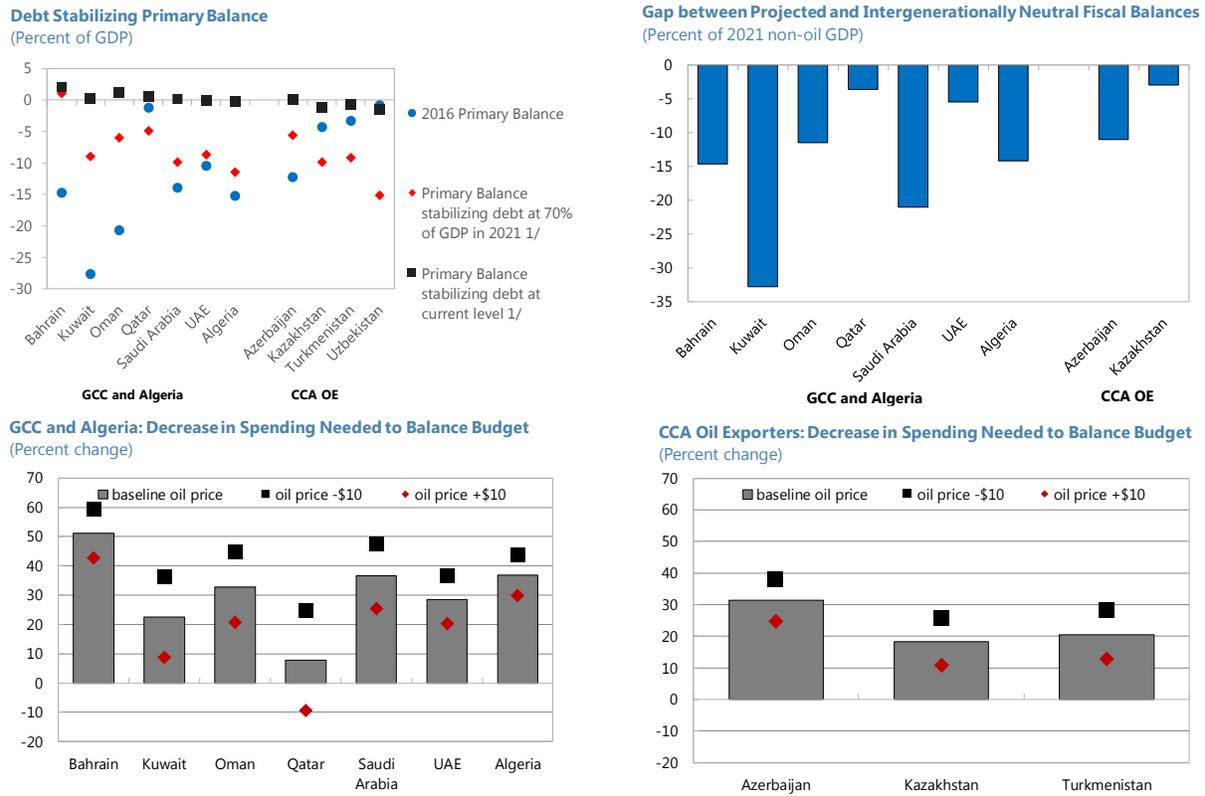
Magnitude of Desirable Fiscal Consolidation

Over time, all MENA and CCA oil exporters will need to adjust to the new reality of lower oil prices. So what is the exact amount of fiscal adjustment these countries need?

The answer very much depends on country-specific circumstances and such detailed assessment is beyond the scope of this paper. For illustration, however, if policymakers decided to balance their books, the *GCC countries and Algeria* would face an adjustment of 10–15 percent of GDP and *CCA oil exporters* about 5 percent of GDP (Figure 11).² These are hefty figures; a recent study (Escolano and others 2014) of large fiscal adjustment episodes over the past 80 years found that the typical (median) sustained adjustment was about 5 percent of GDP,

² Some countries pursue extensive off-budget quasi-fiscal operations by state-owned enterprises, which could further increase the estimates of current fiscal deficits. However, these transactions are difficult to quantify, given data gaps on activities of the state-owned enterprise sector.

Figure 11. Calibrating the Size of Fiscal Adjustment



Sources: Country authorities; and IMF staff estimates.

Notes: The baseline Brent oil price is \$36 a barrel, as in the April 2016 *World Economic Outlook*.

1/ Assumes no drawdown of available financial assets.

with only one-quarter of countries managing to achieve an adjustment of more than 7½ percent of GDP. That said, MENA oil exporters such as *Algeria*, *Libya*, and *Saudi Arabia* achieved similar, or even larger, fiscal adjustments in the past, including through deep spending cuts (Box 1). From another perspective, balancing budgets would, on average, require cutting today’s public expenditures by about one-third in the *GCC countries* and *Algeria*, and about one-quarter in the *CCA oil exporters*. Should the baseline oil price increase by \$10 a barrel, these ratios would drop by an average of about 10 percentage points for the *GCC countries* and *Algeria* and by 5 percentage points for the *CCA countries*.

Figure 11 presents another illustrative alternative scenario in which oil exporters take advantage of their borrowing capacity and allow part of the fiscal deficit to persist, with the debt ratio rising to 70 percent of GDP in 2021—a general benchmark used by the IMF to identify high-risk emerging markets. In this illustrative (but, for most countries, undesirable) framework, the

required adjustment would be about 5–10 percent of GDP smaller than in the baseline, but it would still be sizable for a number of countries.

IMF staff typically recommends setting medium-term fiscal targets that take into account intergenerational equity considerations. In order to save enough exhaustible resources so that spending can be sustained at the same level in real per capita terms even once oil wealth is exhausted, policymakers would need to implement adjustment of some 10–25 percent of non-oil GDP (Figure 11). Additional savings should also be considered to accumulate sufficient precautionary balances against future sharp drops in oil prices.³

Naturally, all these calculations are highly sensitive to assumptions about future oil prices. In the GCC region—where fiscal dependence on oil revenues is particularly high—a \$10 increase in the price of oil reduces the required fiscal adjustment by roughly 4 percent of GDP on average.

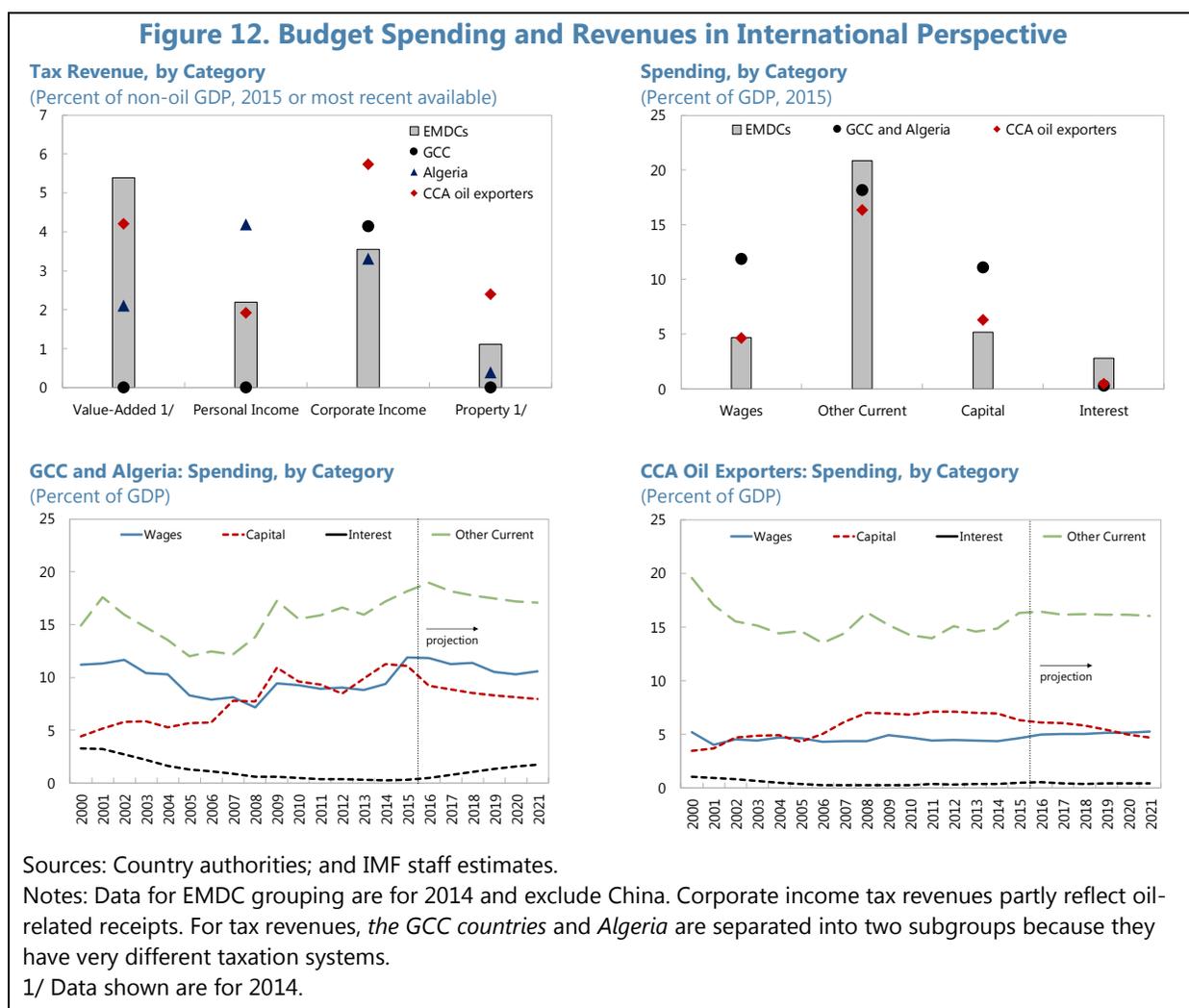
Illustrative Options for Fiscal Consolidation

Implementing further large fiscal adjustment is no easy task. It will require difficult choices and adjustments in the implicit social contract between governments and citizens, not least because spending on items such as wages and social benefits tends to be rigid and difficult to cut. Policymakers will need to implement measures in a way that minimizes the adverse impact on growth, while maintaining social cohesion, including by protecting essential spending on health, education, and other high-return categories, and by protecting the vulnerable segments of population.

³ The October 2015 editions of the *Fiscal Monitor* (IMF 2015c) and *Middle East and Central Asia Regional Outlook* (IMF 2015b) discuss how medium-term fiscal frameworks can support consolidation efforts over time. The main recommendations include formulation of clear medium-term fiscal objectives to anchor decisions related to annual budgets, identification of accompanying policy measures including contingency plans, and a strong communication strategy to secure buy-in for the planned policies. Among MENA and CCA oil exporters, preparations are underway to establish or enhance medium-term frameworks in, for example, *Algeria, Bahrain, Kazakhstan, Kuwait, Oman, Qatar, Saudi Arabia*, and the *United Arab Emirates*. Increasing fiscal transparency and moving off-budget entities onto the budget would also be highly desirable. Bova, Medas, and Poghosyan (2016) discuss the role of institutional quality in reducing pro-cyclicality of fiscal policy in resource-rich countries.

A useful perspective on the desirable composition of budget revenues and expenditures in MENA and CCA oil exporters can be gleaned from a comparison with other EMDCs (Figure 12).

- On the revenue side, the *GCC countries* have room to raise receipts in all areas, from both indirect taxes (VAT, property) and direct taxes (personal and corporate income taxes). Non-oil taxation is much more developed in the *CCA region*, but these countries have room to reduce exemptions and strengthen collections.
- On the spending side, the *GCC countries* and *Algeria* spend much more on public sector wages and capital expenditures compared with the other EMDCs and there is scope for scaling back, including by raising the efficiency of public investments. *CCA countries* spend somewhat more than the EMDC average on capital expenditures.



As an example of options available to GCC policymakers, a broad-based 5 percent VAT would raise about 1½ percent of GDP in the *GCC region*. Increasing public investment efficiency could save about 2 percent of GDP, and additional savings could be made by cutting non-essential investments.⁴ There would be additional opportunities to save on current and capital expenditures, which increased significantly during the period of high oil prices (Figure 12).

Growth Impact of Fiscal Consolidation

Policymakers have embarked on significant fiscal consolidation. What does this imply for growth? Standard estimates of fiscal multipliers suggest that fiscal adjustment to a persistent \$10 oil price reduction should temporarily reduce overall real GDP growth by about ½ percentage point in the GCC region and ¼ percentage point in the CCA (see Box 1.1 in IMF 2015b).

At the same time, Figure 13 suggests that the relationship between growth and public spending may vary considerably over time. In particular, the large increase in government spending after the Arab Spring might have had a limited impact on growth. Conversely, spending reductions aimed at inefficient expenditures could have a lower-than-usual multiplier, reducing imports and private saving rather than private domestic demand. Given the large run-up in government expenditures during the oil price boom, policymakers should be able to identify wasteful expenditures that could be cut without adversely affecting growth. This task would, of course, become more challenging over time as fiscal consolidation advances.

On the other hand, it should be acknowledged that fiscal consolidation is being implemented amid tightening financial conditions, which could exacerbate the drag of fiscal policy on growth. Uncertainties in the face of a very large drop in oil prices could reduce private sector confidence, further dampening economic activity.

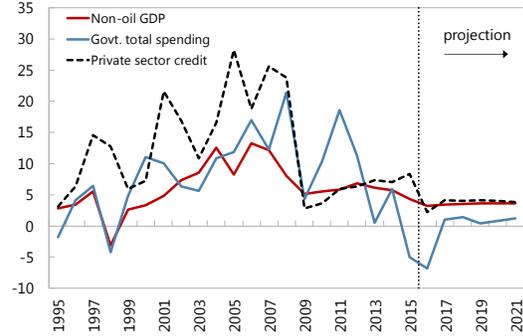
On balance, the IMF country teams forecast a notable slowdown in growth, but do not envisage an outright recession in most countries. Of course, much will depend on how the planned fiscal tightening is implemented, and to what extent the fiscal drag is muted by exchange rate depreciation, if any.

⁴ See Albino-War and others (2014) for policies to improve efficiency of public investment in MENA and CCA countries. Roudet and others (2016) discuss the relationship between investment and growth. Alreshan and others (2015) and Rodriguez, Pant, and Flores (2015) discuss options for raising budget revenues and energy reforms.

Figure 13. Links between Growth, Public Spending, and Credit

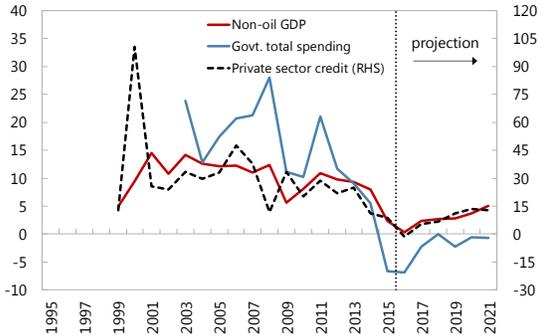
GCC

(Percent annual change, simple average)



CCA Oil Exporters 1/

(Percent annual change, simple average)



Sources: Country authorities; and IMF staff estimates.
1/ CCA excludes Uzbekistan.

3

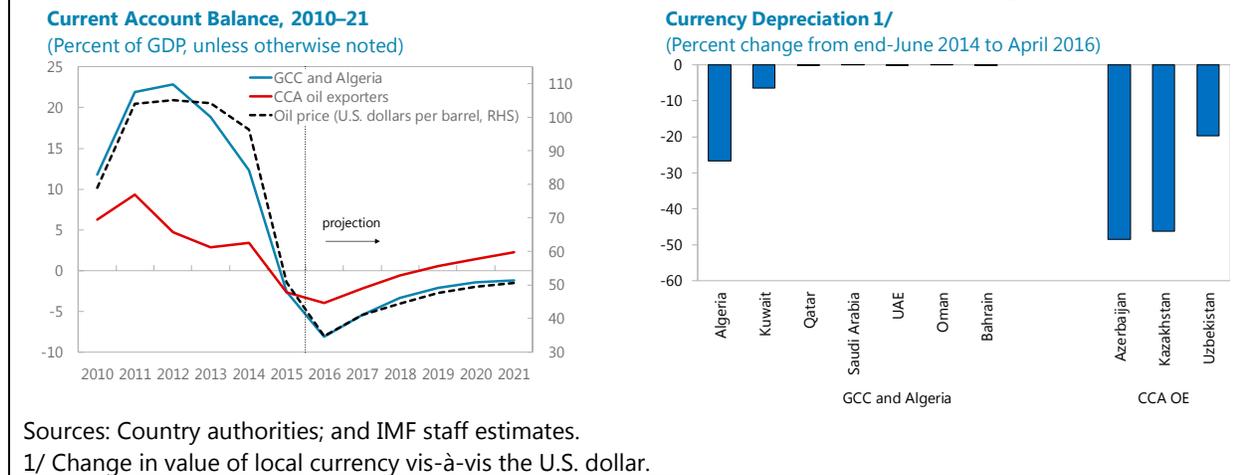
Maintaining External and Financial Stability

Exchange Rate Policy Options

Oil exporters have taken diverse approaches to their exchange rate regimes. The *GCC countries* have decided to maintain their pegs, while the *CCA countries* and *Algeria* have allowed their currencies to depreciate in response to lower oil prices. Both approaches can be feasible, but supportive policies are necessary to manage related risks:

- Preserving a peg at its long-established exchange rate can continue to provide a helpful nominal anchor for policymakers, especially in countries that are highly undiversified (such as some in the *GCC*). However, when a country faces prolonged fiscal and external deficits, policy adjustment must come from fiscal consolidation measures. To maintain confidence under a fixed exchange rate regime facing a persistent adverse shock, large financial buffers and/or the initiation of a credible adjustment through direct fiscal measures are critical.
- In contrast, exchange rate depreciation can help facilitate fiscal and external adjustment, especially in countries with more diversified economies. But possible adverse side effects (in particular, higher inflation and financial stability risks) need to be addressed, especially in the context of dollarized economies. Oil exporters that decide to introduce more exchange rate flexibility will need to substantially modernize their monetary policy frameworks, develop more liquid money and foreign exchange markets, and strengthen communication.

Figure 14. Current Account Balances and Exchange Rate Changes

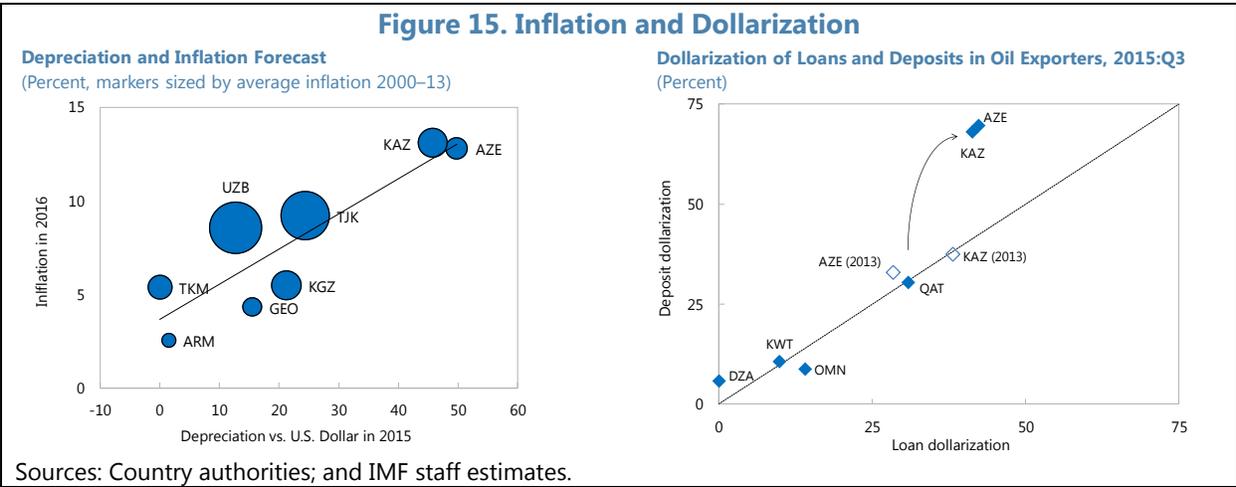


Experience of CCA Countries and Algeria

As current account balances have swung into deficit, the *CCA countries* intervened in foreign exchange (FX) markets to prevent devaluations in recognition of the stability risks due to dollarized bank balance sheets. Eventually, however, both *CCA oil exporters* and *Algeria* allowed their currencies to depreciate to help achieve policy adjustment to lower oil prices (Figure 14). In addition to the depreciation, *Kazakhstan* has also introduced substantially more FX flexibility.

- The short-term fiscal gains from depreciation can be significant because the weaker currency raises the local-currency value of oil and other exports. However, the fiscal gains will last only if fiscal expenditures, in particular public wages, do not increase in tandem with the exchange rate depreciation. In other words, fiscal gains arise only to the extent that fiscal expenditures are reduced in foreign currency terms.
- Currency depreciations have heightened inflationary pressures especially in *Azerbaijan* and *Kazakhstan*, where this year's inflation is projected to reach double digits for the first time in more than 15 years (Figure 15). Depreciation has also put pressure on bank balance sheets, because of currency mismatches and unhedged borrowers. Dollarization in the *CCA* has been high, and has recently increased further amid uncertainty about the future direction of local exchange rates.

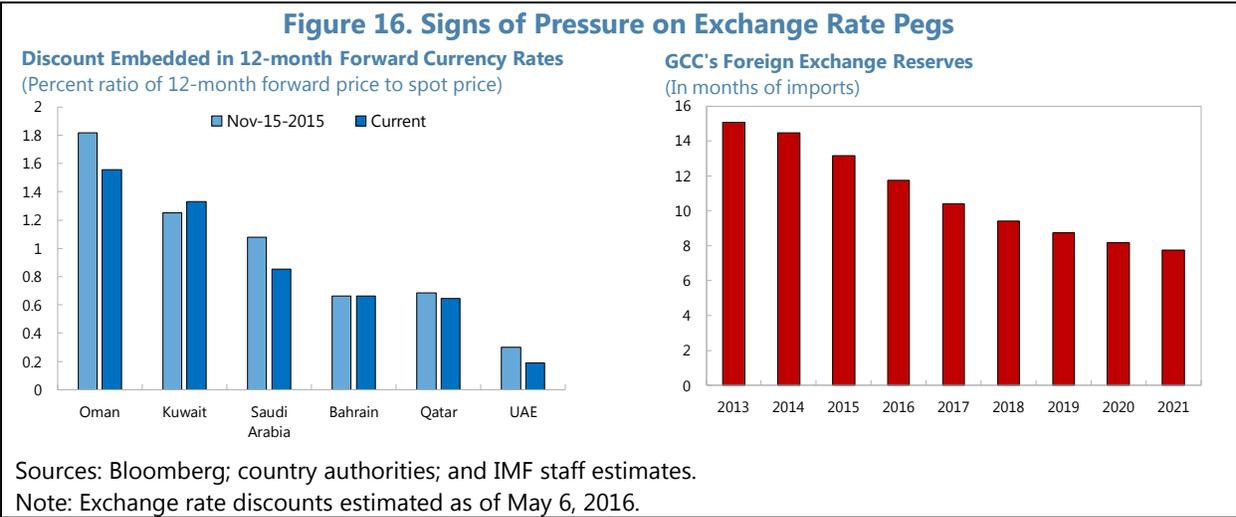
Where relevant, modernization of monetary policy frameworks and institutions will be a key component of implementing floating exchange rate policies. Desirable modernization includes, among other things, clarifying monetary policy objectives, increasing operational independence of central banks, deepening analytical capabilities, and improving effectiveness of the interest rate instrument. Financial supervision should be enhanced, together with measures to ensure adequate liquidity, provisioning, and capital, especially where balance sheet risks stem from sizable dollarization and high nonperforming loan (NPL) levels.



The GCC Exchange Rate Policy

The GCC countries have maintained their long-standing exchange rate pegs underpinned by substantial net foreign assets. This strategy will require sustained fiscal consolidation through direct expenditure cutbacks and non-oil revenue increases.

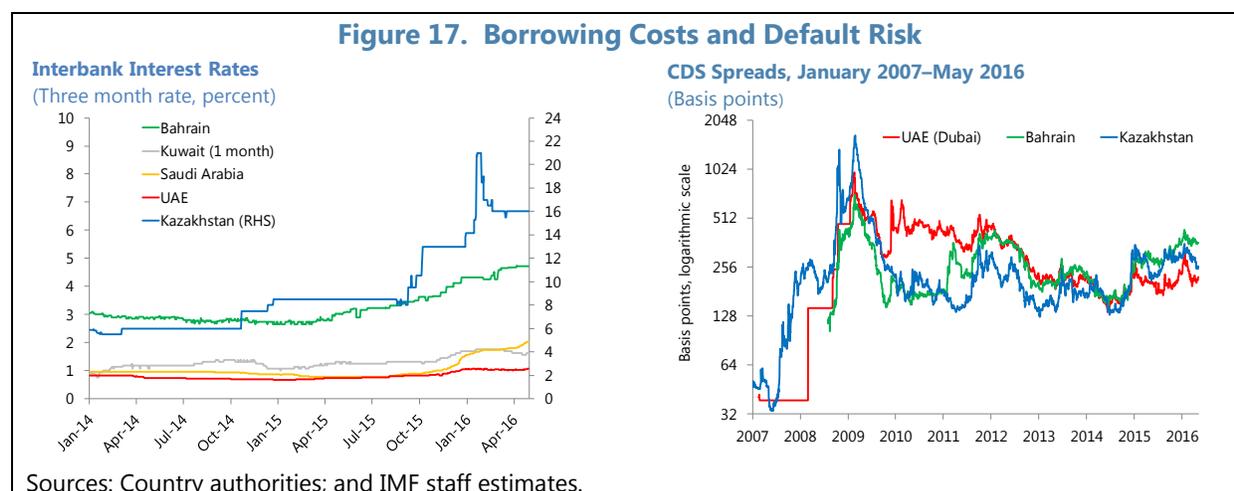
Given lower oil prices and expectations of large fiscal and external deficits for years to come, there are some signs of pressure on the GCC pegs in the foreign currency forward markets (Figure 16). That said, these forward markets are relatively illiquid and most GCC countries continue to have significant buffers for now. However, these buffers would clearly erode over time in the absence of additional fiscal consolidation measures and if oil prices remain low, as implied by futures prices.



Lower Oil Prices Have Pushed up Borrowing Costs and CDS Spreads

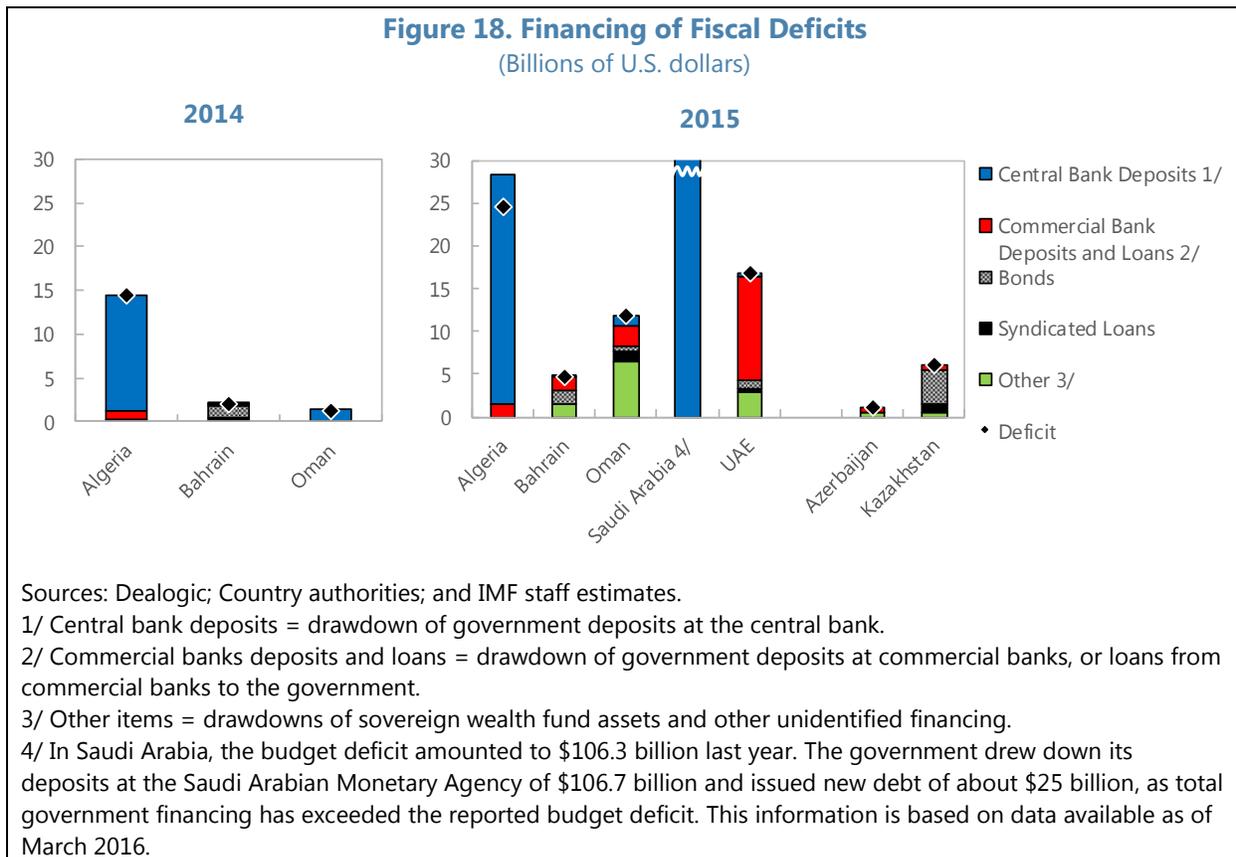
The prospect of persistently low oil prices has fundamentally altered the fiscal outlook of hydrocarbon exporters. As a result, government bond yields and sovereign credit default swap (CDS) spreads have increased in several countries, although they have fallen recently as oil prices increased from their early-2016 lows. In the *GCC countries*, interbank rates have increased following the U.S. Fed rate hike—consistent with the GCC fixed exchange rate regimes—although in some GCC countries, interbank rates have increased by a larger amount than the Fed hike owing to tighter domestic liquidity. In a couple of *CCA countries*, higher interbank rates also reflect monetary policy tightening to address inflationary and depreciation pressures (Figure 17). Some credit rating agencies have revised down the sovereign credit ratings of several MENA and CCA oil exporters, including *Bahrain, Kazakhstan, Oman, and Saudi Arabia*.

Budget deficits are being financed with a mix of asset drawdowns and debt issuance (Figure 18). Many governments withdrew some of their deposits from the local banking system, central bank, or sovereign wealth funds. In some cases, governments also borrowed from local banks. The use of international bonds (for instance, in *Bahrain, Kazakhstan, Qatar, and the United Arab Emirates—Abu Dhabi*) and syndicated loans (*Oman, Qatar, and Saudi Arabia*) have been less frequent until recently.



After significant withdrawals of financial savings last year, some countries may issue more debt this year. The exact composition of financing is highly uncertain, but if policymakers decided to finance half of their deficits by issuing debt, the total issuance would reach close to \$100 billion, given the sizable projected deficits. When considering the right financing strategy, policymakers need to strike a balance between drawing down buffers, issuing domestic debt—thus helping catalyze the development of domestic capital markets, but potentially crowding out private investment—and borrowing abroad. The preferred financing mix will depend on country circumstances. Annex II summarizes the key policy trade-offs.

Figure 18. Financing of Fiscal Deficits
(Billions of U.S. dollars)



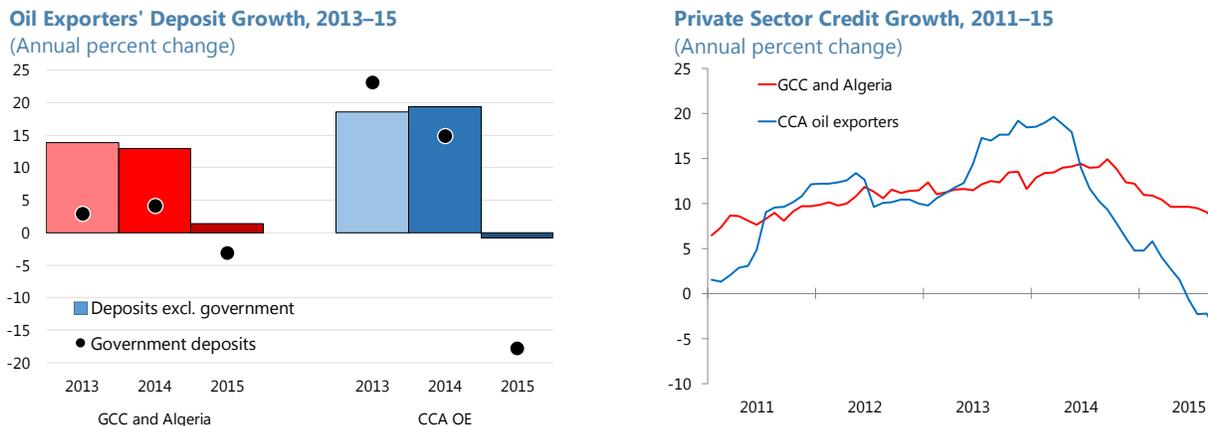
Lower Oil Prices Are Reducing Bank Liquidity, Dampening Credit Growth

Until recently, many oil-exporting countries enjoyed excess liquidity in the domestic financial system. Liquidity, however, has been tightening in many countries amid lower export receipts. In many cases, governments withdrew their deposits and/or borrowed from local banks. In several countries, capital outflows have contributed to a reduction in financial sector liquidity as well—this resulted from weaker domestic fundamentals, a bout of global risk aversion, and higher U.S. monetary policy rates.

Consequently, credit growth has slowed (Figure 19). This slowdown has been especially sharp in CCA countries where banks have been buffeted by exchange rate depreciations and, in some cases, more NPLs. While some of the reduction in bank credit growth reflects weaker economic conditions and lower demand for loans, the drop in liquidity is likely to constrain credit supply and thus undermine the ability of the private sector to pick up the slack from a downsizing public sector, creating negative consequences for growth and job creation.

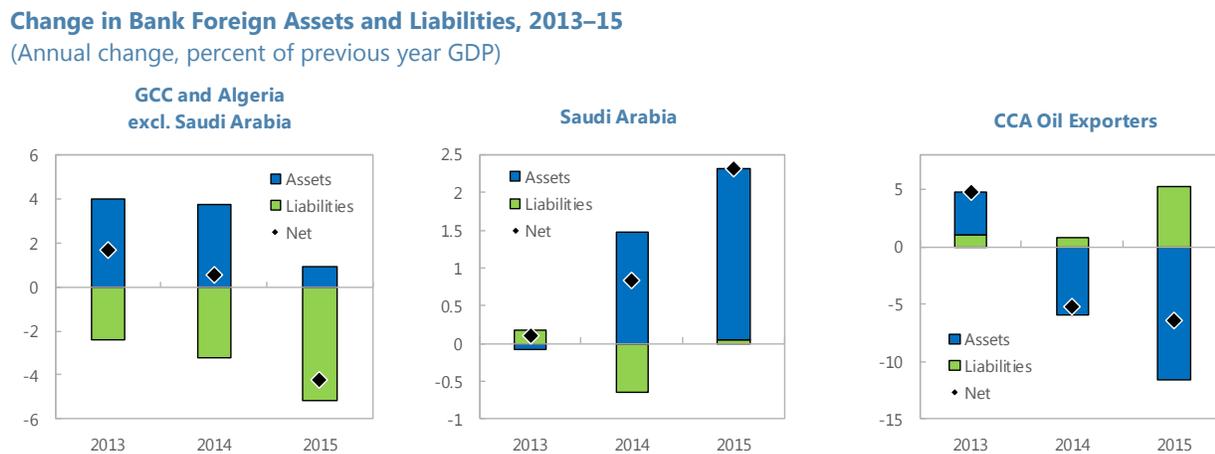
In order to help finance continued credit provision, banks in most countries have tapped foreign sources of funds (Figure 20). In the *GCC countries* (excluding *Saudi Arabia*) and *CCA oil exporters*, the increase in net foreign liabilities was about 5 percent of GDP last year. In *Qatar*, the increase was almost 10 percent of GDP. A notable exception to this trend is *Saudi Arabia* where local banks invested some of their surplus liquidity abroad, including in other GCC countries.

Figure 19. Commercial Bank Deposits and Private Sector Credit



Sources: Country authorities; and IMF staff estimates.
Note: CCA deposits and credit are adjusted for exchange rate changes.

Figure 20. Cross-Border Activities of Banks



Sources: Country authorities; and IMF staff estimates.
Note: CCA foreign assets and liabilities adjusted for exchange rate changes. An increase in assets is denoted with a plus sign, while an increase in liabilities is denoted with a minus sign.

Policymakers have adopted diverse responses to tightening liquidity, such as easing their loan-to-deposit ratios (*Saudi Arabia*), reducing reserve requirements (*Azerbaijan*), cancelling several government bill auctions (*Qatar*), and planning to reactivate dormant central bank lending facilities (*Algeria*). Many governments can assist central banks in boosting liquidity by transferring some of their foreign assets into the local banking system, or by financing a larger share of budget deficits through foreign borrowing and foreign asset drawdowns.

Lower Oil Prices Pose Financial Stability Risks

As economic activity slows and CCA currencies depreciate, NPLs are likely to rise from current low levels, eroding capital buffers. However, this trend has not yet been observed clearly, because NPLs tend to accumulate with a lag (Chapter 6 in IMF 2015b, and Kinda, Mlacha, and Ouedraogo 2016). Benign aggregate NPLs may also mask emerging stress in individual banks, which may have system-wide implications later on. There may also be measurement issues—for example, some countries report as NPLs only the delinquent portion of a loan, rather than the total amount. During previous episodes of financial stress, the fiscal costs of contingent liabilities from the financial sector proved to be sizable. Looking at the health of non-financial corporations, analysis based on data for publicly traded companies suggests that, on average, the corporate sector entered the period of lower oil prices with solid profitability and balance sheets, although the bottom quartile of corporations had low profits relative to interest payments to lenders, and these profits are set to decelerate further as the economies slow (Figure 21).

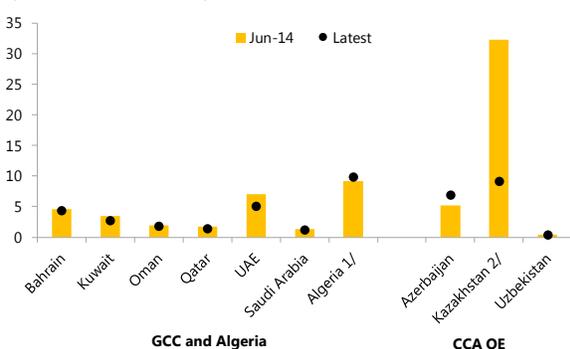
Financial Sector Policy Priorities

In the short term, policies should be geared toward mitigating rising liquidity, credit, and exchange risks. There is a particular need to ensure coherence in fiscal and monetary operations to avoid amplifying liquidity shocks, improve liquidity-forecasting capabilities at central banks, ensure effective liquidity-assistance frameworks, enforce open-position limits, and ensure appropriate loan classification and provisioning. Annex III summarizes the key measures adopted so far to address risks from lower oil prices. More generally, because oil-related macro-financial risks are mostly transmitted through the real economy, policies that promote growth and external and fiscal sustainability will help safeguard financial stability. The design of macro policies should take into account any potential financial stability risks, especially in dollarized banking systems. Many countries would benefit from enhancing financial sector surveillance, including through more frequent and rigorous stress testing. Financial sector reforms to strengthen supervision, insolvency, and crisis management frameworks, corporate governance, and crisis management frameworks would be highly desirable. Macroprudential frameworks should be enhanced as well (Callen and others 2015). The CCA countries will need to address bank vulnerabilities, especially dollarization.

Figure 21. Nonperforming Loans, Contingent Liabilities, and Corporate Vulnerabilities

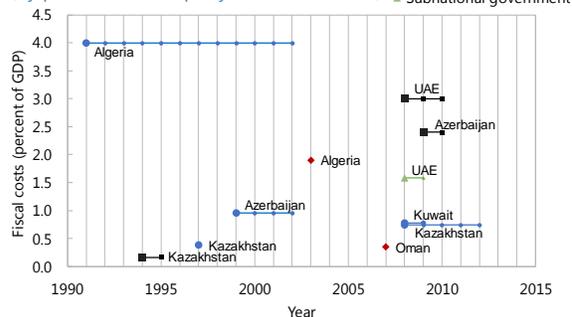
Non-Performing Loans of Banks

(Percent of total loans)



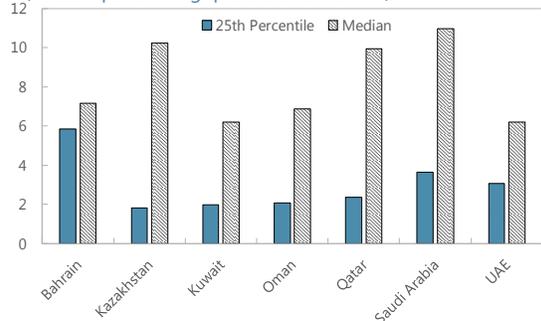
Fiscal Costs of Contingent Liabilities: by Subcategories and Year, 1990–2015

(By percent of GDP per year and duration)



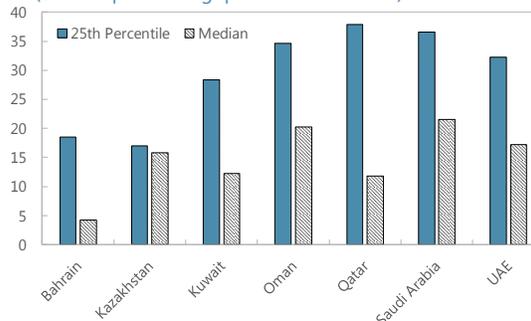
Interest Coverage Ratio of Corporate Sector, 2014

(Bottom performing quartile and median)



Debt to Assets Ratio of Corporate Sector, 2014

(Bottom performing quartile and median)



Sources: Country authorities; Bova and others (2016b); and IMF staff estimates.

1/ Algeria base year is December 2014.

2/ The value of nonperforming loans has decreased in Kazakhstan due to their transfer to special-purpose vehicles.

3/ Interest coverage ratio = corporate profits before interest and taxes divided by interest payments.

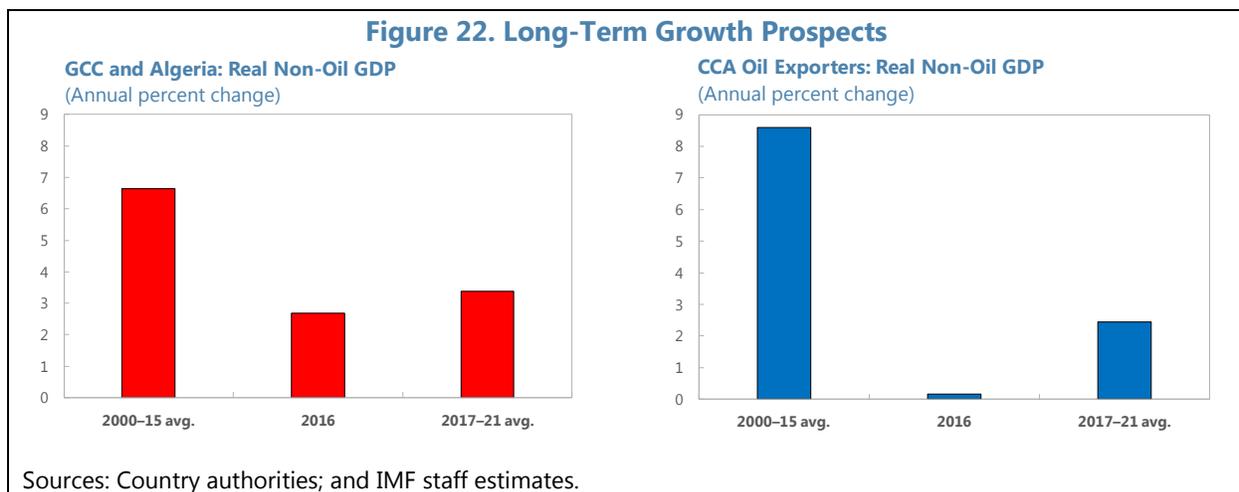
Note: SOE denotes state-owned enterprises.

4

Generating Jobs and Growth

Growth Will Remain Well Below Historical Trends

The steep and persistent decline in oil prices has sharply worsened the growth outlook, and the need to diversify away from oil has become even more critical. In the *GCC region* and *Algeria*, non-oil GDP growth is expected to average only one-half of the recent trend (3½ percent during 2017–21, compared with 6½ percent during 2000–15), as headwinds from lower oil prices will persist and fiscal consolidation will need to continue for many years (Figure 22). In the *CCA oil exporters*, non-oil growth will be a mere one-quarter of the previous trend (2½ percent during 2017–21, down from 8½ percent during 2000–15), reflecting the compounding of the impact of lower oil prices with other adverse factors, as discussed in Chapter 1.

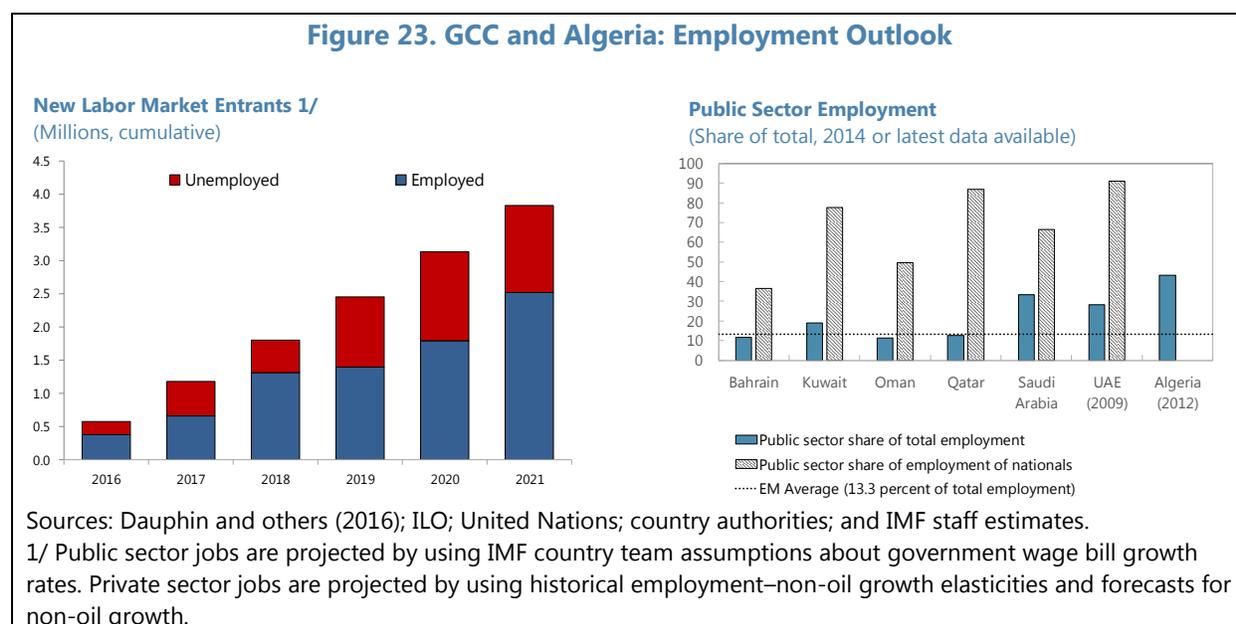


The region’s traditional growth model based on redistribution of oil revenues through the government budget and public sector employment is no longer sustainable, and new sources of growth and fiscal revenue will need to be found. Most MENA and CCA oil exporters have adopted long-term strategies to support diversification, private sector development, and non-oil growth—*Oman* and *Saudi Arabia* recently unveiled their long-term policy plans. Progress has been gradual, and the role of the private sector in generating jobs and growth will need to be deepened much further. The transformation of oil-exporting economies is no easy task and will

be a long-term project. It will require a sustained push for reforms and well thought out communications.⁵

Low Growth Will Push Up Unemployment

Anemic growth will have important ramifications for the various social contracts of these oil exporters, especially in the *GCC countries* and *Algeria*, which have young, rapidly growing populations. The United Nations estimates that 3.8 million people will enter the labor force in this region by 2021. In light of budget pressures, the public sector will not be able to absorb all the new labor market entrants. As a result, IMF estimates suggest that unemployment could increase by 1.3 million people by 2021 (Figure 23). A similar exercise for all the MENA oil exporters (including *Iran*, *Iraq*, *Libya*, and *Yemen*) suggests that unemployment could increase by 3 million, compared with the projected rise in the labor force by 10 million people.⁶



⁵ See Callen and others (2014) and Dauphin and others (2016) for a more detailed analysis of MENA countries. Cherif, Hasanov, and Zhu (2016) discuss how Indonesia, Malaysia, and Mexico fostered diversification. IMF (2015a) discusses macroeconomic performance following structural reforms and summarizes recent IMF work on macro-structural issues. The IMF organized a conference on diversification of oil-exporting countries in 2014 (the conference materials are available at <http://www.imf.org/external/np/seminars/eng/2014/mcd/>). Abiad and others (2014) suggest that public investment can play an important positive role in fostering development, provided such investments are well targeted and fiscally prudent. Warner (2014) cautions about the mixed tracked record of developing countries in boosting long-term growth through public investment booms.

⁶ These calculations assume that the relative share of domestic and expatriate workers follows historical trends.

Key Impediments to Growth and Job Creation

Diversification from oil will require further improvements in the business environment, stronger incentives to develop the private sector (including by reducing public–private sector wage gaps), and better aligning education and skills to market needs. Nationals should be encouraged to seek private sector employment, and firms encouraged to develop business models that do not depend on government-driven activities. Fostering financial development and inclusion is especially important for channeling resources toward productive activities. Providing meaningful opportunities and making growth inclusive would help allay social pressures, especially as an increasing number of young people are entering the labor market.

Table 1. Global Competitiveness Report Rankings

| | 2015–2016 | 2006–2007 | Change |
|---------------------------|-----------|-----------|--------|
| GCC and Algeria | | | |
| Bahrain | 39 | 48 | 9 |
| Kuwait | 34 | 30 | -4 |
| Oman ¹ | 62 | 42 | -20 |
| Qatar | 14 | 32 | 18 |
| Saudi Arabia ¹ | 25 | 35 | 10 |
| United Arab Emirates | 17 | 37 | 20 |
| Algeria | 87 | 77 | -10 |
| CCA Oil Exporters | | | |
| Azerbaijan | 40 | 62 | 22 |
| Kazakhstan | 42 | 50 | 8 |

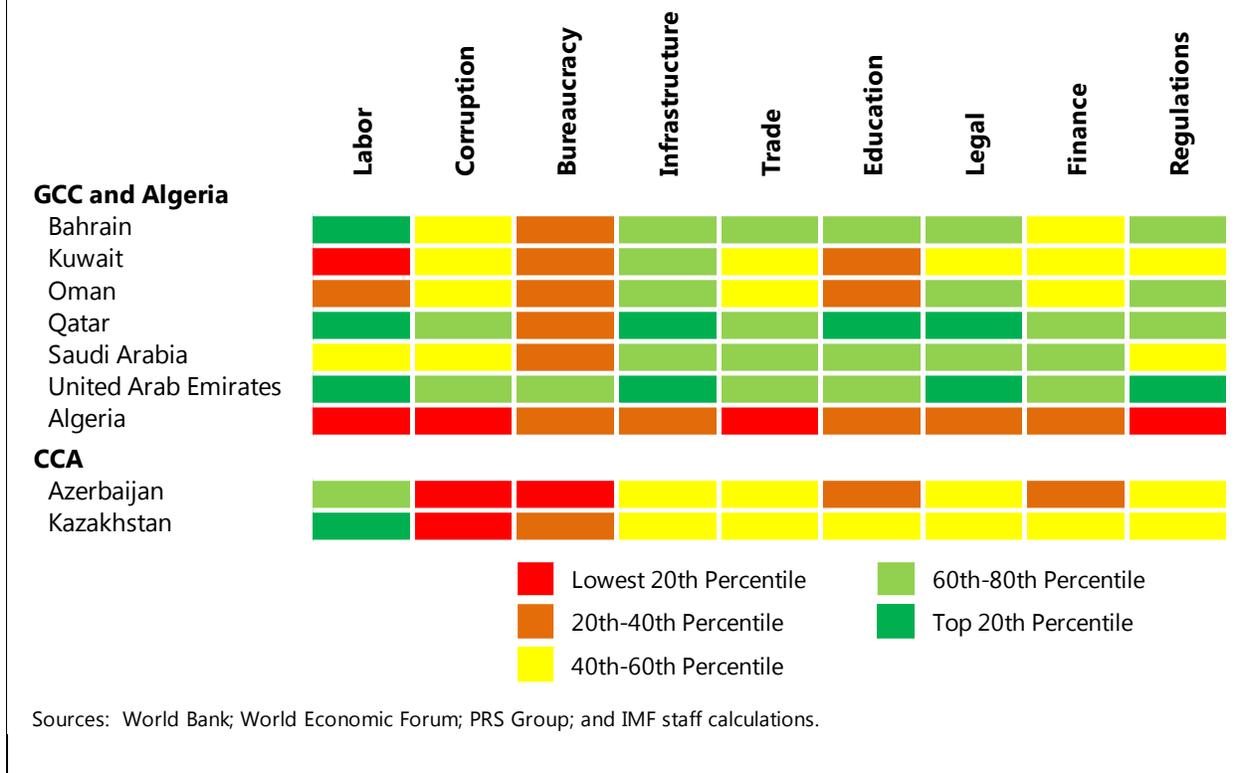
Source: Global Competitiveness Report data.
1/ Earliest entry corresponds to 2007–2008.

Table 1 illustrates the progress made by a number of MENA and CCA oil exporters in improving their business environment over the past decade. The figure suggests that some exporters are already doing quite well, but at the same time, several oil exporters have further considerable scope to boost their competitiveness. Figure 24 provides an additional insight into the specific areas suitable for further reforms:⁷

- The *GCC countries* generally benefit from high-quality infrastructure, but are hindered by bureaucracy and remaining gaps in legal and regulatory frameworks. The quality of education could also be improved further.
- Institutional quality could be enhanced in *CCA oil-exporting countries* and *Algeria* in a number of areas, including reducing corruption, improving contract enforcement, and expanding access to finance. Infrastructure is also relatively less well developed than in the *GCC region*.

⁷ See Mitra and others (2016) for further details.

Figure 24. Structural Reform Priorities
(Relative Country Rankings)



The government remains the dominant force in many MENA and CCA oil-exporting economies. Privatization of state-owned enterprises holds the promise of improving productivity and efficiency, while at the same time raising temporary financing for budgetary shortfalls—*Kazakhstan, Kuwait, Oman, and Saudi Arabia*, for instance, have indicated tentative plans to privatize selected state assets. Box 2 discusses the experience of GCC countries with privatization and highlights the key policy considerations.

In sum, a deepening of structural reforms is essential to promote diversification and non-oil sector growth in order to create jobs for the growing workforce. Job creation and growth in the oil-exporting countries in the region will also have important positive spillovers for trading partners, which will benefit from higher trade and remittances (De and others 2015).

5

Takeaways

Lower oil prices and other major shocks have hit the MENA and CCA regions with serious and persistent impacts. Sizable policy adjustment is needed in all major areas: fiscal, external, financial, and structural.

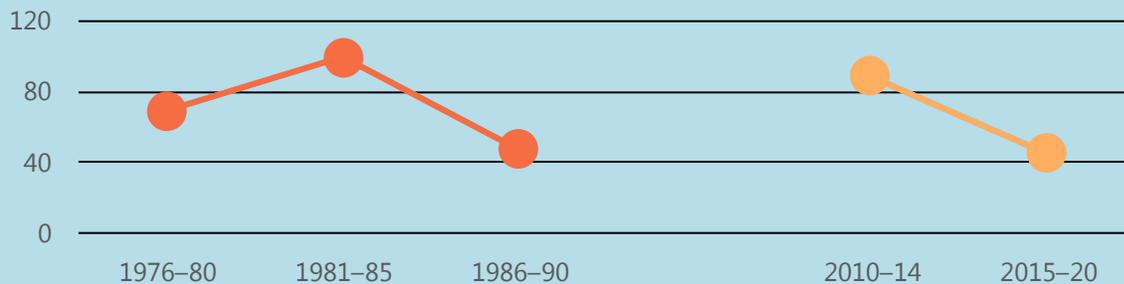
The good news is that policymakers have started responding to this new reality, and substantial progress has already been made, especially with respect to fiscal consolidation. But the fiscal outlook remains challenging despite the consolidation measures adopted so far, and additional sustained policy effort will be needed over a number of years. Policymakers will need to be proactive in addressing the challenges posed by lower oil prices for the financial system, and should step up structural reforms to boost medium-term growth prospects.

Lower oil prices have created wide-ranging demands for the IMF's engagement. The IMF can help through advice, technical assistance and training, and—if needed—financial support. Recent examples of technical and analytical assistance include advice on medium-term fiscal frameworks, the pace and composition of fiscal consolidation, energy price reform, revenue administration, and financial sector and exchange rate policies. In addition to these bilateral interactions, the IMF is also intensifying its engagement with country authorities through regional initiatives such as the GCC Meetings, Arab Forums, and CCA peer-to-peer events.

Box 1. Experience of MENA Oil Exporters during the 1980s and 1990s

The recent drop in oil prices has strong parallels with the price decline in 1986. Oil prices dropped many times over the past 30 years, but most of these price falls were associated with weakening global demand, following U.S. recessions (1990–91 and 2001); the Asian crisis (1997–98) and the global financial crisis (2008–09). The most recent price decline, however, also reflects a substantial—and potentially long-lived—shift in supply (Husain and others 2015). Like the 1986 episode, the recent price drop followed a period of rapid growth in supply sources. In addition, the drop also followed on from a shift in policy by key producers, especially those from OPEC. Consequently, the drop in global oil prices is expected to be protracted.

Average Oil Price 1/ (2010 U.S. dollars)



1/ Average of Brent, WTI, and Dubai oil prices.

Sources: WEO; World Bank WDÍ; and IMF staff calculations.

The 1980s: A Cautionary Tale

For many countries, the 1986 oil price drop illustrates the consequences of not having sufficient fiscal space. In most oil exporters, the revenue associated with the two positive oil price shocks in the 1970s was matched by a widespread and deliberate increase in spending. This was particularly true for many MENA exporters, where infrastructure and development needs were evident, and where, it was hoped, such public investment and social spending would spread the benefits of the oil windfall more broadly, laying the groundwork for future growth. However, this also applied to exporters outside the region, ranging from developing countries such as Mexico and Venezuela to more advanced-market economies, such as Norway.

As oil prices started to decline in the early 1980s, public finances for many exporters came under strain even before the price drop in 1986. In part, this reflected growing expenditures. For key OPEC exporters, it also reflected falling export volumes, which were in turn part of an effort to maintain prices in the face of growing non-OPEC supply. Ultimately, the trigger for the abrupt price fall in 1986 was a policy shift by OPEC producers, who expanded production to arrest their declining market share.

Nonetheless, some exporters (especially in the GCC region) entered the mid-1980s with the benefit of fiscal buffers. Like most other exporters, the Gulf states used the proceeds of the 1970s oil boom to embark on a substantial expansion of public expenditure, with priority given to investment in basic infrastructure and an expansion of social spending. Given their small populations and the sheer size of the windfalls, however, spending in these countries was generally accompanied by a parallel increase in official reserves. Moreover, given the small size of their non-oil economy at the start of the 1970s, the growth rate of this sector throughout the 1970s and 1980s was sizable—which helped bring down the scale of fiscal balances expressed as a proportion of non-oil GDP. Still, with declining (OPEC) output volumes throughout the early 1980s, reserve

(continued)

accumulation generally eased. That was especially so in Saudi Arabia, which bore the largest portion of the output reductions, and whose continued spending resulted in fiscal deficits financed by a drawdown of reserves.

The Gulf exporters met the price drop of 1986 with a mix of funding and adjustment. In general, the key funding vehicle was a drawdown in reserves—for Saudi Arabia, where reserves had already declined, this was augmented by the issuance of domestic debt starting in 1988, and continuing until the late 1990s. On the adjustment side, most Gulf exporters reduced public investment significantly, while generally leaving social spending untouched (see Chapter 4 in IMF 2015b). The net effect was a material slowdown in the pace of real non-oil growth, dropping from an average of about 5 percent in the first half of the 1980s to zero in the second half. Without the space afforded by pre-existing buffers, this outcome may have been worse—accumulated surpluses from the past (and access to finance) allowed the Gulf countries to continue to run persistent fiscal deficits into the late 1980s, obviating the need for a potentially disruptive movement in exchange rates.

The 1990s: Increased Prudence and Buildup of Buffers

Following the experience of the 1980s, many countries attempted to expand their fiscal space. The oil price booms of the 1970s, followed by the shocks of the 1980s, highlighted the two-way volatility and unpredictability of oil prices. The following decade saw the increasing use of institutional arrangements to shield fiscal policy decisions from oil price volatility.

Key among these was the increased use of oil stabilization funds. These help smooth out the impact of fluctuations in the international price of oil, stabilizing government expenditures by helping shield the fiscal authorities from pressure to boost spending whenever revenues increase. From the establishment of the Kuwait Investment Authority in 1953, the number of sovereign wealth funds (SWFs) increased gradually through the following decades, including Abu Dhabi in the 1970s and Oman in the 1980s. The interest picked up notably in the 1990s, with Norway's Government Petroleum Fund (GPF) serving as a key example of good practice. Established in 1990, partly in response to the country's experience in the 1980s, the GPF started accumulating resources in 1996, and provided material help to the authorities to cope with the 1998 price decline that followed the Asian crisis.

Some governments started hedging oil price risks in financial markets, but so far, interest in this strategy has remained modest. Mexico, in particular, started using financial risk-management tools in 1990 to secure a price that could be used as the basis for the following year's budget. Beyond Mexico, however, the use of hedging instruments has been relatively modest. The most important constraint is the political difficulty in explaining foregone gains during an upturn. Ecuador, for example, bought a number of put options in 1993 that, together with an additional swap arrangement, helped secure a floor price for the year. When prices turned out to be significantly higher, the government was criticized harshly for the "losses" associated with the hedging strategy.

Box 2. Privatization in the GCC Region

Several GCC countries (Kuwait, Oman, and Saudi Arabia) have recently announced plans to step up their privatization programs. While motivated in part by fiscal considerations, these announcements should be viewed in the context of a broader, long-standing, reform agenda—many of the region’s oil exporters have historically included privatization as a key part of their efforts to liberalize and diversify their economies, and have tailored their privatization plans to coincide with parallel institutional and legal reforms. However, implementation has often moved slowly, particularly in GCC countries where supporting institutional frameworks have sometimes been lacking, and where privatization programs have often focused on already-successful enterprises. Nonetheless, GCC divesture programs have, in the past, managed to generate significant receipts from only a handful of high value operations.

Government ownership in the economy remains substantial for most GCC countries. The region is home to some of the world’s largest national oil companies (NOC)—the Saudi oil company ARAMCO is the largest such enterprise in the world. The net present value of NOCs’ future oil revenues amounts to 350–700 percent of GDP. Most of the NOCs in the GCC countries are well run and enjoy a high degree of operational independence. Case studies, however, suggest that there is still scope for increased productivity in the upstream sector, and that private participation in both the upstream and downstream sectors would reduce rent seeking, enhance transparency, and clarify fiscal linkages.

Outside the hydrocarbon sector, GCC countries have a number of key enterprises that might gain from privatization. Compared with other countries in the region, where the state has a stake in hundreds of poor-productivity firms, potential candidates in the GCC are concentrated in a few critical sectors, which have been largely untouched by previous privatization efforts. In particular, the state still dominates the provision of utilities, some of which remain dependent on government support—in addition to the implicit assistance they receive from subsidized fuel.

Not all state-owned enterprises (SOEs) in the GCC are inefficient, however, and the relative benefits of privatizing high-performing firms are not always straightforward. Many of these firms have been corporatized and partially privatized in recent years, and several rank among the region’s most productive and successful enterprises (for example, Saudi SABIC and MAADEN, Emirates Airlines, Dubal and Etisalat, and Bahraini Betlco). Indeed, investment income from these firms is substantial. The decision on whether further divestment is warranted, therefore, often reflects a range of asset- and liability-management considerations, which depend on the circumstances of each individual country.

International evidence suggests that privatization is associated with improved macroeconomic performance (Davis and others 2000). Micro-level case studies find that privatized firms typically become more efficient and profitable, and tend to increase their capital spending. The impact of restructuring on employment is sometimes negative in the short term, but the longer-term impact is mostly positive owing to an expansion of operations. On the fiscal side, privatization has generally had a positive impact on revenue, while also resulting in a marked decline in transfers. The consolidated accounts of the SOE sector generally show a sizable decline in these firms’ overall deficits, and a drop in the implied cost of quasi-fiscal operations.

GCC: Government Ownership in Listed SOEs (US\$ Billions)

| | Share in listed SOEs | |
|--------------|----------------------|----------------|
| | Value | Percent of GDP |
| Bahrain | 2.4 | 7.9 |
| Kuwait | 6.9 | 5.7 |
| Oman | 2.9 | 4.9 |
| Qatar | 42.8 | 23.1 |
| Saudi Arabia | 129.1 | 19.8 |
| UAE | 77.2 | 21.8 |

Sources: Bloomberg; and IMF staff calculations.

(continued)

International experience also points to a number of good practices in designing privatization programs (Megginson and Netter 2001; Chong and Lopez-de-Silanes 2004):

- i. The privatization process should be carefully designed and sequenced and have a clear timetable.
- ii. Firms should be carefully deregulated and re-regulated, with strengthened governance frameworks.
- iii. Although pre-privatization restructuring may increase the sale price and help smooth the impact on employment, it nonetheless represents a major cost and is best left to the private sector. Indeed, in some cases pre-privatization restructuring has been counterproductive, lengthening the privatization process and lowering the final sales prices.
- iv. Restrictions on foreign direct investment and other conditions—including on redundant workers—generally results in substantial price discounts and lower post-privatization performance.
- v. The transparency of the process strongly shapes the number of bidders and the sale price.
- vi. Auctions and initial public offerings are more transparent and generate higher returns than bilateral sales.
- vii. Negotiated deals may allow the authorities to achieve their social objectives or exclude unwanted buyers, but constraints on the new owner can lead to lower revenues, which the authorities might otherwise have used to strengthen social safety nets.
- viii. Privatization through large-scale IPOs is associated with rapid growth in national stock markets.

Further privatization in the GCC oil exporters could have a substantial impact on their public finances, not only from the boost in revenues, but also through permanent changes in taxes, transfers, and dividends.

- Privatization proceeds represent an uncertain and one-off revenue stream that should be recorded transparently and subject to oversight.
- The availability of these proceeds should not delay needed fiscal adjustment, or promote a level of spending that jeopardizes fiscal sustainability.
- The use of the proceeds (such as financing the deficit, paying down debt, or building buffers) should be framed around the preservation of the government's net wealth (GNW) and should generally be determined by asset- and liability-management considerations.
- Using privatization proceeds to finance the deficit or repay debt can reduce debt service costs, especially when borrowing needs are great. Some countries have earmarked part of the proceeds to cushion the social impact of higher prices or worker layoffs.
- Using the proceeds to finance additional capital expenditure does not have to reduce GNW if done efficiently, where the expected rate of return on new assets is greater than that on financial assets. Privatization in this case simply entails a change in the composition of government assets. Additional investment, however, has implications for recurrent government spending.
- Improved tax policy and administration can offset the permanent impact of foregone SOE income.

Privatization could have other implications that require a policy response. The macroeconomic impact will depend on the origin of the buyer, the degree of capital mobility, whether receipts from privatization are saved or spent, and the exchange rate regime. In particular, managing large receipts may have implications for local liquidity, and capital inflows may impact the real effective exchange rate. Macroeconomic policy can be framed to minimize these effects. Concerns about job losses should be addressed ideally in the context of an overall policy to enhance employment in the private sector and other labor market policies such as severance payments, public works programs, and retraining opportunities.

Annex I. Recently Announced Fiscal Measures in MENA and CCA Oil-Exporting Countries (as of March 2016)

| MENA | |
|---|---|
| Algeria | A public sector hiring freeze instituted in 2015 and still in place. The 2016 budget laws call for a 9 percent cut in spending (mainly capital expenditures), while a subsidy reform was initiated by raising prices on fuel, electricity, and natural gas. |
| Bahrain | In 2015, fees and charges for government services increased, while a meat subsidy was cancelled. Natural gas prices are being gradually increased over 2015–21. In 2016, the price of diesel, kerosene, and gasoline products (January); tobacco and alcohol taxes; and electricity and water tariffs (March) all increased. Current expenditure streamlined. |
| Kuwait | Fuel subsidy reform in 2015: diesel and kerosene prices were increased (saving 0.3 percent of GDP), while non-essential current spending was curtailed. In March 2016, the cabinet announced a wide-ranging set of economic and financial reforms. In addition to initiatives aimed at enhancing the role of the private sector through financial, labor market, and other reforms that will help reshape the government’s role, reforms include the following fiscal measures: (1) introduction of value added and corporate profit taxes, (2) re-pricing of some commodities and public services, (3) reforms of the civil service (including wages), and (4) privatization of state-owned assets and a greater role for public private partnerships. |
| Oman | Measures announced in January 2016: (1) increase in fuel prices, (2) reduction in defense spending, (3) reduction in capital spending (related to development projects and hydrocarbon production), (4) increase in corporate income tax, (5) higher fees for government services, and (6) reduction in government workers’ allowances, other remunerations and operating expenses (including transportation allowances, business travel, hospitality spending). |
| Qatar | The 2016 budget suggests government spending will continue being restrained this year. Authorities have recently increased some utility and energy prices (water and electricity charges in September 2015, and gasoline prices in January 2016). |
| Saudi Arabia | In 2015, authorities increased transfers of investment income from the Public Investment Fund and the Human Resource Development Fund. In addition, they introduced spending controls for both current and capital spending, and the announced fiscal packages were under-executed (saving 0.5 percent of GDP). In 2016, the government raised prices of energy products (saving about 1¼ percent of GDP), while planning to further curtail spending. |
| UAE | Tariffs for water and electricity were raised in January 2015, saving ½ percent of GDP. Policymakers have also cut grants and transfers to government-related enterprises. |
| CCA | |
| Azerbaijan | In 2016, authorities have increased mineral royalty tax rates, raised the threshold on the simplified tax, upgraded checks on tax evasion and increased administrative measures (expected savings are 0.5 percent of GDP). The authorities have significantly cut public infrastructure spending, while increasing transfers to vulnerable populations to partially compensate for the adverse impact of devaluation on real incomes. |
| Kazakhstan | In 2014, authorities embarked on a three-to-five-year stimulus plan to modernize critical infrastructure and promote lending to small and medium-sized enterprises, \$12 billion (5¾ percent of GDP) of which is financed through buffers and \$7 billion (3 percent of GDP) in international development bank loans. No new measures have recently been announced. |
| Turkmenistan | Authorities have raised import duties, placed limits on car and food imports, and cut investment spending (by over 20 percent in 2015) and utility subsidies—more capital spending cuts are envisaged in 2016. Public salaries have been increased, while social spending was reduced. |
| Uzbekistan | The authorities recently announced a new public investment program, amounting to \$41 billion during 2015–19 (11 percent of GDP). |
| Sources: National authorities; and IMF staff estimates. | |

Annex II. Policy Trade-Offs in Devising Budget Deficit-Financing Strategies

| Options | Cost and Risk Characteristics | Benefits | Policy Issues |
|--------------------------------------|---|---|--|
| <p>Sovereign wealth funds</p> | <ul style="list-style-type: none"> • If large deficits persist, buffers could diminish, investor sentiment could shift, and borrowing costs could increase. • Losses could be incurred if assets are liquidated in unfavorable market conditions. | <p style="text-align: center;">1. Drawdown of Own Resources</p> <ul style="list-style-type: none"> • Could ease pressures on domestic liquidity. • Funds are readily available, contingent on market conditions. | <ul style="list-style-type: none"> • Need a decision-making structure to determine how much, when, and what assets to sell. • Fiscal rules governing sovereign wealth funds. |
| <p>Bank deposits</p> | <ul style="list-style-type: none"> • Could tighten liquidity in the banking system and exert pressures on interest rates. • Contingent on the surplus liquidity in the banking system, the government could crowd out the private sector. • Net costs could be very high if government deposits are small in relation to financing need. | <ul style="list-style-type: none"> • Financing costs for the government are low, particularly since the deposits likely yield low interest. • Funding is readily available because it is not constrained by investor appetite for risky assets. | <ul style="list-style-type: none"> • Coherence in monetary and fiscal operations is needed to minimize liquidity shocks. |

| 2. External Borrowing | | | |
|--|---|---|--|
| Issuance of sovereign bonds | <ul style="list-style-type: none"> • Cost of borrowing can be high if market sentiment shifts due to uncertainties about the trajectory of oil prices and if the sovereigns are downgraded. • Access is contingent on market sentiment and liquidity conditions in the global market. • Increases currency exposure and exchange rate vulnerability for countries with flexible exchange rates. • Large financing needs could lead to re-emergence of debt vulnerabilities. | <ul style="list-style-type: none"> • Eases pressure on domestic liquidity conditions. • Debt is marketable and can be traded in a secondary market so investor appetite might be higher than for domestic bonds. • Can attract investors seeking to diversify their portfolios, given that the countries have not been in the markets regularly. • Pre-financing when market conditions are favorable could reduce borrowing costs. | <ul style="list-style-type: none"> • Need to develop debt management strategy. • Need legal and financial advisory services necessary to achieve a successful issuance. • Need to monitor issuance by sovereigns with similar credit ratings and establish effective investor-relations programs. |
| Sovereign bond issuance for on-lending to government-related entities | <ul style="list-style-type: none"> • Central government assumes the counterparty risks of government-related entities. | <ul style="list-style-type: none"> • Could reduce borrowing costs for the government-related entities. | <ul style="list-style-type: none"> • Legal framework is needed to govern the transaction. |
| Sukuk | <ul style="list-style-type: none"> • Usage for budgetary purposes could be constrained or would require complex structuring. • Issuance costs could be higher than for conventional bonds. • Market for loans not as developed as that of international bonds. | <ul style="list-style-type: none"> • Investor demand could be high because it offers diversification opportunities. | <ul style="list-style-type: none"> • Legal framework to issue Sukuk is needed, as is identification of permissible assets. |
| Commercial bank loans, including syndicated loans | <ul style="list-style-type: none"> • Eases pressure on domestic liquidity conditions. • Greater flexibility to influence terms depending on negotiating power. | | |

| | | | |
|--|---|--|--|
| <p>Bilateral loans, including project loans</p> | <ul style="list-style-type: none"> • Project loans tied to specific project use, thus less fungible. • Disbursement highly dependent on progress of project. | <ul style="list-style-type: none"> • Could finance public investment programs. | <ul style="list-style-type: none"> • Institutional framework for monitoring projects is needed. |
| <p>3. Domestic Borrowing</p> | | | |
| <p>Treasury bills</p> | <ul style="list-style-type: none"> • Exposes government to rollover risks given the short duration. | <ul style="list-style-type: none"> • Instruments are denominated in domestic currency, so there is no currency risk. • Could attract capital inflows from foreign investors wishing to participate. • Provides banks with short-term liquid assets and facilitates their liquidity management. • Medium- to long-term instruments issued in domestic currency, so reduces rollover and currency risk. • Can facilitate domestic debt market development and provides a reference benchmark for private sector issuance. • Provides alternative investment opportunities for financial institutions, and for banks the zero-risk weight can improve the capital-adequacy ratio. • Could attract capital inflows from foreign investors wishing to participate. | <ul style="list-style-type: none"> • Ensure infrastructure for issuance and calendar. |
| <p>Treasury bonds</p> | <ul style="list-style-type: none"> • If domestic liquidity conditions tighten, the domestic cost of borrowing could be higher than in international capital markets. • In tight liquidity conditions, could crowd out private sector. • Islamic banks, which account for a significant market share of banking systems in the GCC, cannot participate. | <ul style="list-style-type: none"> • Ensure infrastructure for issuance and calendar. • Develop medium-term debt management strategy. | |

| | | | |
|--|---|--|---|
| Sukuk | <ul style="list-style-type: none"> • Could require complex structuring if it is to be used for budgetary purposes since an underlying asset is required. | <ul style="list-style-type: none"> • Provides investment opportunities for Islamic banks and facilitates liquidity management in the Islamic banking segment. | <ul style="list-style-type: none"> • Need a legal framework to issue Sukuk and to identify permissible assets. |
| Retail instruments | <ul style="list-style-type: none"> • Administrative or market rates. • Could crowd out banks in the funding market. • More costly distribution arrangements. | <ul style="list-style-type: none"> • Could tap into high-net-worth clients. • Widens investor base for the government. | <ul style="list-style-type: none"> • Need an institutional framework for issuance. |
| Commercial bank loans, including syndicated loans | <ul style="list-style-type: none"> • Could crowd out the private sector. • The secondary market for loans is not as developed as that for bonds. | <ul style="list-style-type: none"> • Government could negotiate good terms. | |

Annex III. Financial Sector Policies to Address Risks from Lower Oil Prices

Selected Policies Implemented since June 2014 to Mitigate Adverse Impact of Low Oil Prices

| | GCC and Algeria | | | | | | | CCA Oil Exporters | | | |
|---|-----------------|-----|-----|-----|-----|-----|-----|-------------------|-----|-----|-----|
| | BHR | KWT | OMN | QAT | SAU | UAE | DZA | AZE | KAZ | TKM | UZB |
| Financial Sector Policies | | | | | | | | | | | |
| Policies to ease liquidity pressures in banks | | | | | | | | | | | |
| Traditional measures 1/ | √ | | | √ | √ | | √ | √ | √ | | |
| Unconventional measures 2/ | | | | | | | | √ | √ | | |
| Policies to maintain solvency of the banking system | | | | | | | | | | | |
| Recapitalization of banks 3/ | | | | | | | √ | √ | | | |
| Purchase of NPLs | | | | | | | | √ | √ | | |
| Termination of licenses | | | | | | | | √ | | | |
| Strengthening prudential measures and frameworks | | | | | | | | | | | |
| Microprudential regulations | | √ | | | √ | | | | | | √ |
| Macroprudential measures | | √ | | | √ | | | | | | √ |
| Crisis management | | | | | | | | | | | |
| Forbearance | | | | | | | | | | | |
| FX Open position | | | | | | | | √ | | | |
| Capital requirements 4/ | | | | | | | | √ | | | |
| Provisioning on restructured loans | | | | | | | | √ | | | |
| Macro Policies with Direct Impact on Banking System Liquidity or Asset Quality | | | | | | | | | | | |
| Exchange rate policies | | | | | | | | | | | |
| Intervention to stem depreciation | | | | | | | | √ | √ | √ | √ |
| Devaluation and/or allowing depreciations | | | | | | | √ | √ | √ | √ | √ |
| Administrative controls on FX transactions | | | | | √ | | | √ | | √ | √ |
| Other measures | | | | | 5/ | | | | | | |
| Interest rate policy | | | | | | | | | | | |
| Increases in interest rates 6/ | √ | √ | | | √ | √ | | √ | √ | | |
| Declines in interest rates | | | | | | | | √ | | | √ |
| Administrative controls | | | | | | | | √ | | | |
| Fiscal (Deficit Financing Options) | | | | | | | | | | | |
| Drawdown of SWF or other external assets | | √ | √ | √ | √ | √ | √ | | | | |
| External borrowing | √ | | √ | √ | | | | | √ | | |
| Domestic borrowing | √ | √ | | √ | √ | | | | | | |
| Drawdown of local bank deposits | | | | √ | | √ | | | | | |
| Arrears to domestic government suppliers | | | √ | | | | | | | | |

1/ Traditional measures include reducing reserve requirements (Azerbaijan), increasing loan to deposit ratio (Saudi Arabia), reducing the amount and frequency of T-bill auctions (Qatar), engaging in currency swaps (Kazakhstan), and raising deposit insurance (Azerbaijan). Algeria announced reactivation of refinancing facilities, but continued its liquidity absorption operations during 2014-15.

2/ Unconventional measures refers to the placement of deposits at commercial banks including by sovereign wealth funds (Azerbaijan), pension funds (Kazakhstan), and directed lending through commercial banks (Turkmenistan).

3/ This included use of public funds for recapitalization (Algeria) and consolidation of banks (Azerbaijan).

4/ Forbearance on capital has included reducing capital requirements and allowing banks to operate below statutory capital requirements (Azerbaijan).

5/ The authorities requested local banks to stop selling option contracts on foreign exchange forwards.

6/ In the GCC countries that increased interest rates, these policy changes followed an interest rate hike by the U.S. Federal Reserve.

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