

## 4. Fiscal Adjustment to Lower Oil Prices in MENA and CCA Oil Exporters

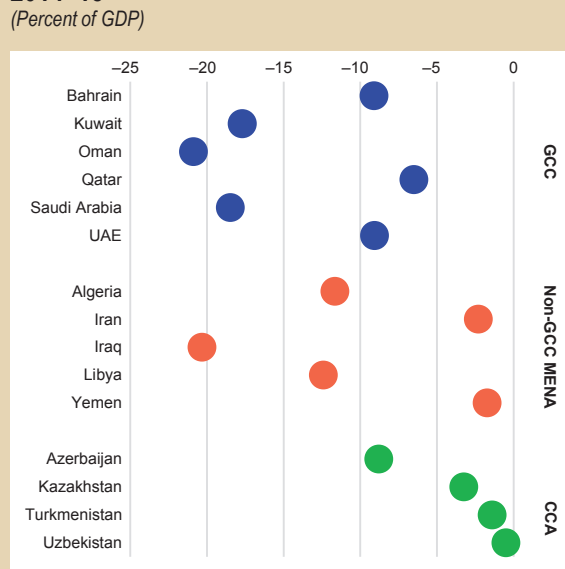
*Facing a significant and persistent drop in oil prices, oil-exporting countries in MENA and CCA regions have started a process of fiscal adjustment. Although many countries have accumulated sizable buffers that will permit deficit reduction to take place gradually, faster progress is now needed in developing specific plans that would put fiscal positions on a stronger footing. Priorities include streamlining expenditures, increasing non-oil taxation, and gradually rebuilding buffers in the context of comprehensive tax, energy pricing, and public investment management reforms. These objectives should be supported by binding medium-term fiscal frameworks and a strong communication strategy.*

Sharply lower oil prices have significantly affected the fiscal prospects of oil exporters across MENA and the CCA.<sup>1</sup> The Brent oil price is projected to average \$53 a barrel in 2015, down from almost \$110 a barrel in the first half of last year. Exporters' fiscal balances have turned from sizable surpluses to large deficits, with MENA and CCA export revenues dropping by \$360 billion and \$45 billion, respectively, this year alone.

The impact on oil exporters will vary substantially (Figure 4.1). Countries that are highly dependent on oil exports—especially the GCC countries, Algeria, Iraq, and Libya—will face a drop in fiscal revenues of 10–20 percentage points of GDP. In contrast, countries with relatively low oil receipts—such as Iran and Yemen—will lose only about 2 percentage points of GDP, although their weaker starting positions mean that even this smaller drop will be arduous.<sup>2</sup> Among the CCA countries, Azerbaijan and Kazakhstan will be the hardest hit, with Uzbekistan and Turkmenistan facing less of an impact because of their specific long-term natural gas contracts.<sup>3</sup>

Figure 4.1

### Impact of Lower Oil Prices on Fiscal Balances, 2014–15 (Percent of GDP)



Source: IMF staff calculations.

Note: Change in fiscal balances due to the projected drop in oil prices between 2014 and 2015. UAE = United Arab Emirates.

Prepared by Greg Auclair, Saad Quayyum, Martin Sommer (team lead), Andrew Tiffin, and Bruno Versailles, with contributions from Alberto Behar and Ben Piven.

<sup>1</sup> In this chapter, the word *oil* is used interchangeably for both crude oil and natural gas.

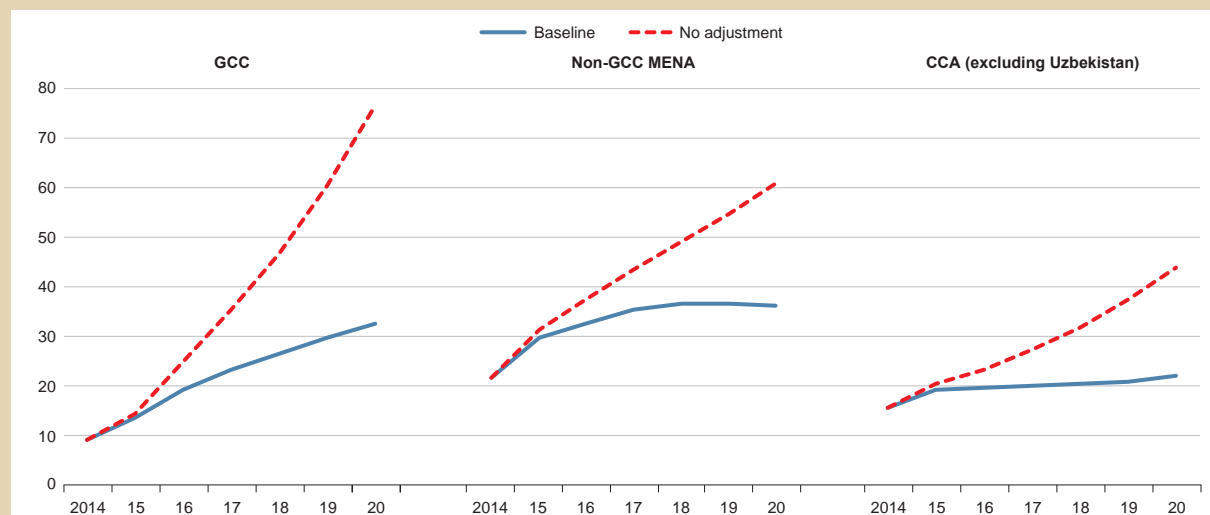
<sup>2</sup> The limited impact of lower oil prices on Iran's budget is partly due to a one-off increase in the share of oil revenue allocated to the budget, with correspondingly lower allocation to the National Development Fund.

<sup>3</sup> Natural gas prices have generally declined in line with oil prices in most markets (albeit with a lag). There are notable exceptions owing to the geographical segmentation of the natural gas market and proprietary nature of long-term supply contracts. Several CCA countries, for example, have benefited from fixed-price contracts for their pipeline gas. In the case of Uzbekistan, the redirection of natural gas exports from Russia to China—which pays a higher price—has helped to offset the adverse effect of lower international oil prices.

Figure 4.2

**Projections of Public Debt under Alternative Scenarios**

(Percent of GDP)



Sources: National authorities; and IMF staff calculations.

Note: "Baseline" refers to a scenario based on IMF staff's assessment of likely policies by country authorities; "no adjustment" assumes that the 2014 non-oil deficit persists into the medium term.

For oil exporters, the main policy issue is fiscal adjustment and rebuilding buffers over the medium term. The Brent oil price is projected to recover only modestly to about \$66 a barrel by the end of the decade, with MENA and CCA export receipts remaining \$345 billion and \$30 billion, respectively, below the 2014 level, even in 2020. In the absence of adjustment, fiscal balances will remain in deep deficit in most countries, with public debt ratios rising rapidly (red lines in Figure 4.2). Under the IMF's baseline projections—incorporating likely adjustment policies as discussed below and removing temporary factors<sup>4</sup>—medium-term fiscal prospects look more favorable than in the no-adjustment scenario. Even under the IMF baseline scenario, however, public debt ratios will continue to rise in many GCC and CCA exporters (blue lines in Figure 4.2). In a number of countries, medium-term fiscal balances will fall well short of the levels needed to ensure that an adequate portion of the income from exhaustible oil and gas reserves is saved

<sup>4</sup> For example, the medium-term baseline projections exclude recent transitory spikes in security-related spending and expenses on foreign aid in some countries.

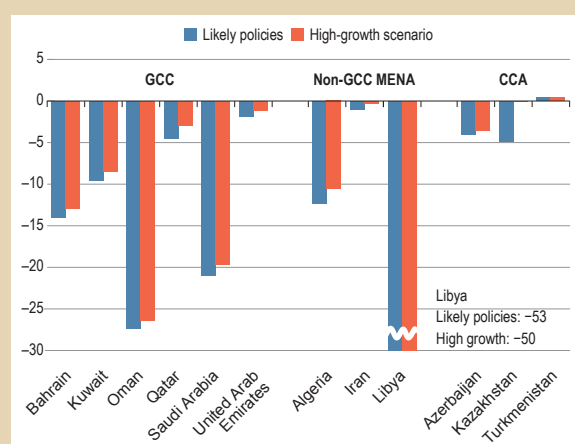
for future generations (Figure 4.3). Bahrain, Oman, and Saudi Arabia have medium-term fiscal gaps of some 15–25 percentage points of non-oil GDP, while conflict-torn Libya has a gap of more than 50 percent of non-oil GDP.<sup>5</sup> Iran, Qatar, the United Arab Emirates, and the CCA oil exporters have fairly small gaps of—at most—5 percent of non-oil GDP. But clearly, these estimated gaps are conditional on assumptions about adopted deficit reduction measures in the IMF baseline, and so they understate the overall amount of needed fiscal adjustment.

<sup>5</sup> This is the gap between the medium-term projection of the non-oil fiscal balance and its desirable level from a Permanent Income Hypothesis (PIH) model. Any net-present-value calculation is subject to caveats about sensitivity to assumptions such as interest rates, population growth, and policymakers' objectives (for example, policymakers could be assumed to target stable real spending, or real spending per capita, in the long run). The point estimates of fiscal gaps should therefore be interpreted with caution. The basic PIH benchmark could be considered as too ambitious for countries with large infrastructure needs (IMF 2012), but too weak for countries exposed to large commodity price uncertainty (see the October 2015 *Fiscal Monitor*).

Figure 4.3

### Gap between Projected Fiscal Balances and Desirable Policies

(Percent of non-oil GDP)



Source: IMF staff calculations.

Note: Difference between the projected medium-term non-oil primary balance and the non-oil primary balance recommended by the Permanent Income Hypothesis. The high-growth scenario assumes higher non-oil growth by 1 percentage point annually.

## Lessons from Previous Oil Price Drops

The sustained oil price drop during the 1980s offers a cautionary tale. Two sharp oil price hikes in the 1970s prompted a broad-based increase in government spending, based on expectations that public investment and increased social spending would lay the groundwork for future growth. As a result, MENA exporters were ill-prepared to cope with an abrupt fall in oil prices; public finances came under strain as prices declined during the early 1980s, doubly so after the oil price dropped steeply in 1986.<sup>6</sup> Producers that

<sup>6</sup> Oil prices stabilized about two-thirds below their 1980 peak and remained low with brief interruptions until the 2000s. The price drop was driven by large increases in non-Organization of the Petroleum Exporting Countries supply and sluggish demand—both of which were strong responses to the previously high oil prices. Demand was also muted by substantial increases in energy taxation in some countries in response to the oil shocks of the 1970s.

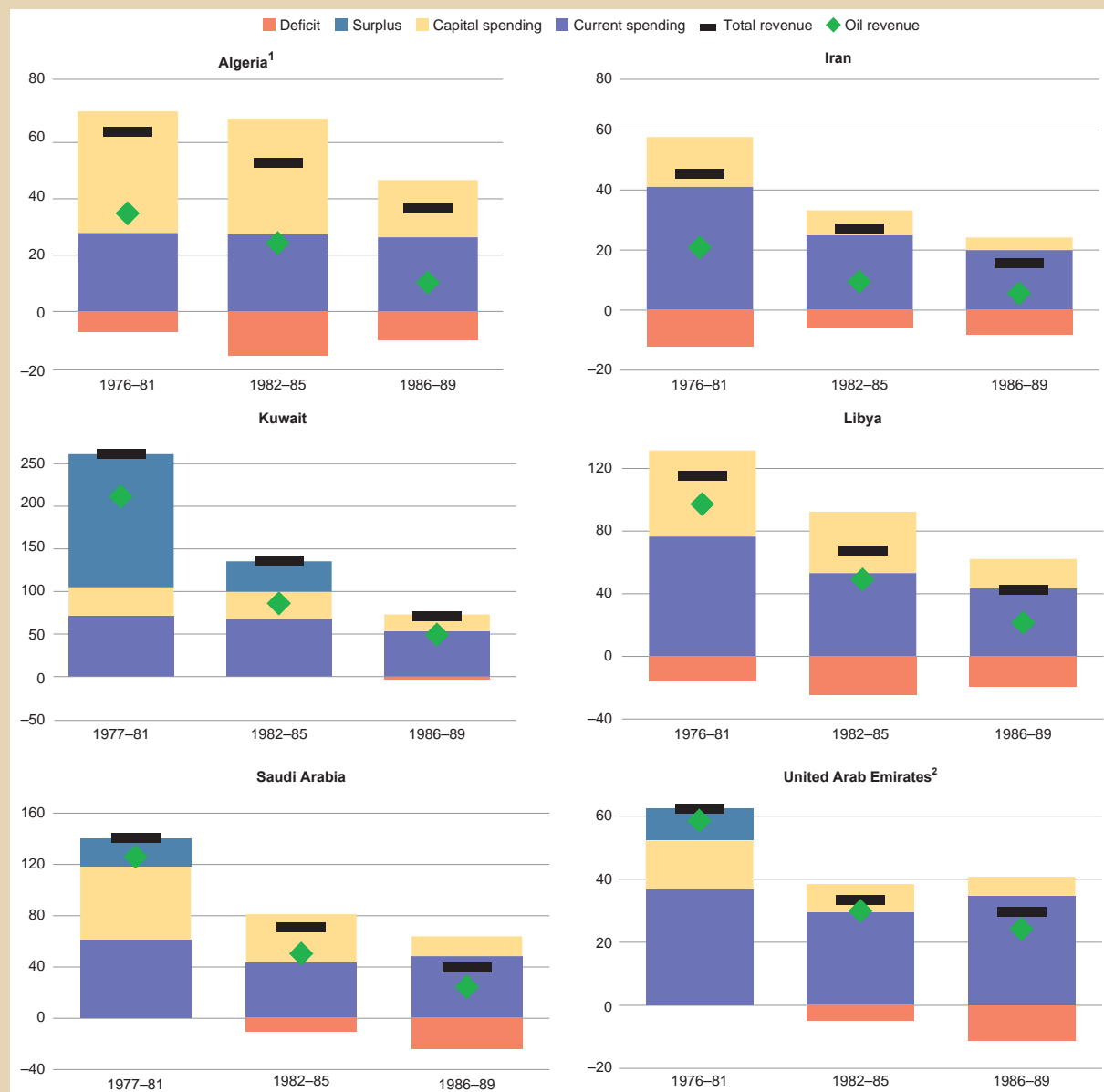
were restraining oil production in an effort to prop up international prices, such as Saudi Arabia, saw even larger declines in oil receipts. Even as they drew down buffers and accumulated debt, policymakers were forced to substantially reduce public investment, particularly after 1986. Current spending, in contrast, was curbed to a much smaller degree (Figure 4.4). Efforts to raise non-oil revenues were generally limited. Countries such as Saudi Arabia and the United Arab Emirates ran budget deficits for some 15 years, significantly increasing public and external debt. The overall fiscal dynamics of MENA exporters did not improve until oil prices finally recovered in the 2000s.<sup>7</sup>

The events of the 1990s and 2000s highlight the importance of gradually rebuilding fiscal buffers. Taking a lesson from the boom-and-bust cycle of the previous two decades, oil exporters enhanced institutional arrangements to mitigate the effects of oil price volatility including by setting up oil-stabilization and sovereign wealth funds. Moreover, in contrast to the 1980s, the two oil price drops of 1998 and 2008–09 proved to be short-lived. Nonetheless, policy responses differed across the two episodes. In 1998, a prolonged period of low oil prices left MENA oil exporters with limited buffers, so that many were forced to tighten fiscal policy. By 2008–09, these buffers had been replenished, allowing for more countercyclical policies (Figure 4.5).

<sup>7</sup> Growth and social development slowed substantially, partly because of the unfavorable composition of fiscal adjustment (Diwan and Akin 2015). Many other countries around the world were similarly ill-prepared for lower oil prices during the 1980s, prompting abrupt fiscal and external adjustments (for example, Norway, Mexico, and Venezuela). In a number of oil exporters including Saudi Arabia, real GDP per capita was lower at the end of the 1990s than during the 1970s.

Figure 4.4

### Fiscal Policy Responses during the 1970s and 1980s (Percent of non-oil GDP)



Sources: Haver Analytics; IMF, International Finance Statistics and country reports; and IMF staff calculations.

<sup>1</sup>Capital spending includes advances and loans to public enterprises.

<sup>2</sup>Current spending includes loans and grants.

## Adjustment Policies at Present

The recent drop in oil prices points to some parallels with the 1980s. Many MENA and CCA countries have ramped up current and capital spending over the past decade, lifting fiscal breakeven oil prices well above the current oil price

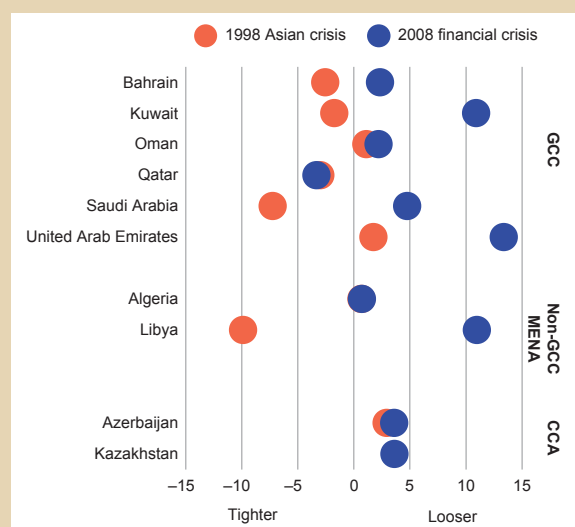
(see Chapter 1).<sup>8</sup> Also, as in the 1980s, lower oil prices are expected to persist for the foreseeable future (Husain and others 2015). Just to balance budgets, the average required adjustment is

<sup>8</sup>The fiscal breakeven oil price is defined as the oil price that balances the government budget.

Figure 4.5

### Fiscal Policy Responses during the 1990s and 2000s

(Percent of non-oil GDP)



Sources: IMF, World Economic Outlook database; World Bank, World Development Indicators database; and IMF staff calculations.  
Note: The circles denote average changes in the non-oil primary balance as a share of non-oil GDP during 1998–99 and 2008–09.

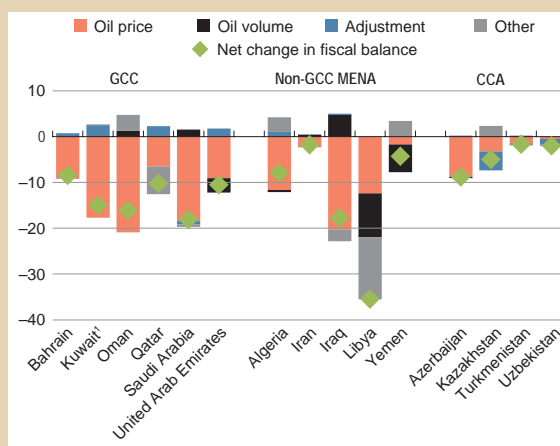
12–13 percent of GDP in MENA countries, and 3½ percent of GDP in the CCA.<sup>9</sup> As discussed above and in the October 2015 *Fiscal Monitor*, ensuring that adequate resources are saved for future generations, and accumulating precautionary buffers to reduce risks from highly persistent oil price swings, would require an even larger adjustment. These are all hefty figures—a recent study by 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, while only one-quarter of analyzed countries managed to achieve an adjustment of more than 7½ percent of GDP. That said, MENA oil exporters such as Algeria, Libya, and Saudi Arabia managed to achieve similar, or even larger, fiscal adjustments in the past, including through deep spending cuts (Figure 4.4).

<sup>9</sup> Saudi Arabia is expected to run a deficit of more than 20 percent of GDP this year. Only Kuwait and Qatar will have a surplus this year, after accounting for estimated income from their sovereign wealth funds.

Figure 4.6

### Dissecting the Deterioration in Fiscal Balances between 2014 and 2015

(Percentage points of GDP)



Sources: National authorities; and IMF staff calculations.

<sup>1</sup>Data for Kuwait are on a fiscal year basis.

Note: Adjustment = deliberate policy measures to increase or decrease the fiscal balance; Other = 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.

The adjustment plans adopted so far are modest compared to the scale of the fiscal challenge:

- Only one half of MENA and CCA oil exporters have adopted significant adjustment measures this year. Policymakers intend to draw on buffers where available and streamline nonessential spending. Headline fiscal deficits will be partly reduced by lower subsidies on account of lower oil prices and a phase-out of one-off expenditures from previous years (see Chapter 1). Active consolidation measures, such as tax increases and spending cuts (for example, lower investment, hiring freezes, or energy price reform), exceed 1 percentage point of non-oil GDP only in Algeria, Kuwait, Iraq, Qatar, and the United Arab Emirates (Figure 4.6, Table 4.1). Several exporters such as Kazakhstan, Saudi Arabia, and Uzbekistan have engaged in net fiscal stimulus in 2015.<sup>10</sup>

<sup>10</sup>This fiscal expansion was mostly driven by higher public investment in Kazakhstan and Uzbekistan, partly prompted by adverse spillovers from a slowdown in Russia. In Saudi Arabia, the expansion was driven by the January and April 2015 stimulus packages.

Table 4.1. Recently Announced Fiscal Measures in MENA and CCA Oil-Exporting Countries

(As of end-June 2015)

GCC	
Bahrain	Authorities announced gradual increases in gas prices (from April 2015) and employee medical insurance and visa fees (from early 2015). Savings amount to about ½ percent of GDP in both 2015 and 2016. In May 2015, the Cabinet approved saving measures in the amount of BD396 million, equivalent to about 3½ percent of GDP; implementation dates were not established.
Kuwait	Fuel subsidy reform: diesel and kerosene prices were increased (saving ½ percent of GDP), while nonessential current spending has been curtailed.
Oman	The 2015 budget includes a reduction in defense spending. Capital spending is protected.
Qatar	Qatar continues its policy of restraining current expenditures, while maintaining a medium-term cap on public investment.
Saudi Arabia	Large fiscal spending packages were announced in January and April 2015.
United Arab Emirates	Tariffs for water and electricity were raised in January 2015, saving ½ percent of GDP. Other planned measures for 2015 include a reduction in capital transfers to Abu Dhabi government-related entities.
Non-GCC MENA	
Algeria	In 2015, a public sector hiring freeze was instituted. A supplementary 2015 budget law was adopted in July that cut capital spending by 2¼ percent.
Iran	The 2015/16 budget aims to limit the drop in oil revenue by (1) increasing the share of oil exports that goes to the budget, (2) depreciating the official exchange rate (by 10%), and (3) increasing the value-added tax rate, reducing tax exemptions, and improving tax collection efforts.
Iraq	The 2015 budget includes increases in non-oil taxes and aims to contain spending, including by reprioritizing capital expenditures and stricter cash management of current spending.
Libya	Political and security turmoil has severely restricted the scope for policy action. The central bank has been withholding payments across the board to safeguard reserves.
Yemen	The reform agenda is on hold because of the security situation.
CCA	
Azerbaijan	Authorities raised import duties slightly and envisage an underexecution of the budget by between 10 percent and 15 percent in 2015, mainly effected by a reduction in nonpriority capital expenditures.
Kazakhstan	Authorities have embarked on a three- to five-year stimulus plan to modernize critical infrastructure and promote small and medium-sized enterprise lending, \$12 billion (5¼ percent of GDP) of which is financed through buffers and \$7 billion (3 percent of GDP) in multilateral development bank loans.
Turkmenistan	Authorities used a low natural gas price in the 2015 budget. Half of the investment for rural areas projected for 2016 could be turned into an expenditure contingency.
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.

- *Medium-term plans are yet to be articulated clearly.* GCC policymakers generally envisage substantial cuts in public investment, in many cases by not initiating new projects, while non-GCC MENA countries are projected to reduce subsidies and transfers. These assumptions have already been incorporated into IMF baseline forecasts (Figure 4.7). Revenue measures will be limited and are likely to feature more prominently in the non-GCC MENA region. CCA countries—which have smaller adjustment needs than those in MENA—have identified very limited fiscal consolidation measures to date (Table 4.1).

## Desirable Fiscal Policy Actions

Most countries need to plan for a sizable medium-term fiscal adjustment to secure fiscal

sustainability and intergenerational equity, while rebuilding space for countercyclical policies over time. Those with fiscal space (including borrowing capacity; Box 4.1) can adjust more slowly so as to cushion the adverse impact on growth in the near term, especially if their non-oil economies are weakening. Medium-term adjustment plans—including clear policy objectives and contingency scenarios—should nonetheless be spelled out as soon as possible. Countries without available buffers and market access have no choice but to adjust quickly, irrespective of their cyclical position. For these countries, specific measures should be chosen in a way that minimizes the adverse short-term macroeconomic impact, while enhancing equity and medium-term growth prospects (Husain and others 2015).

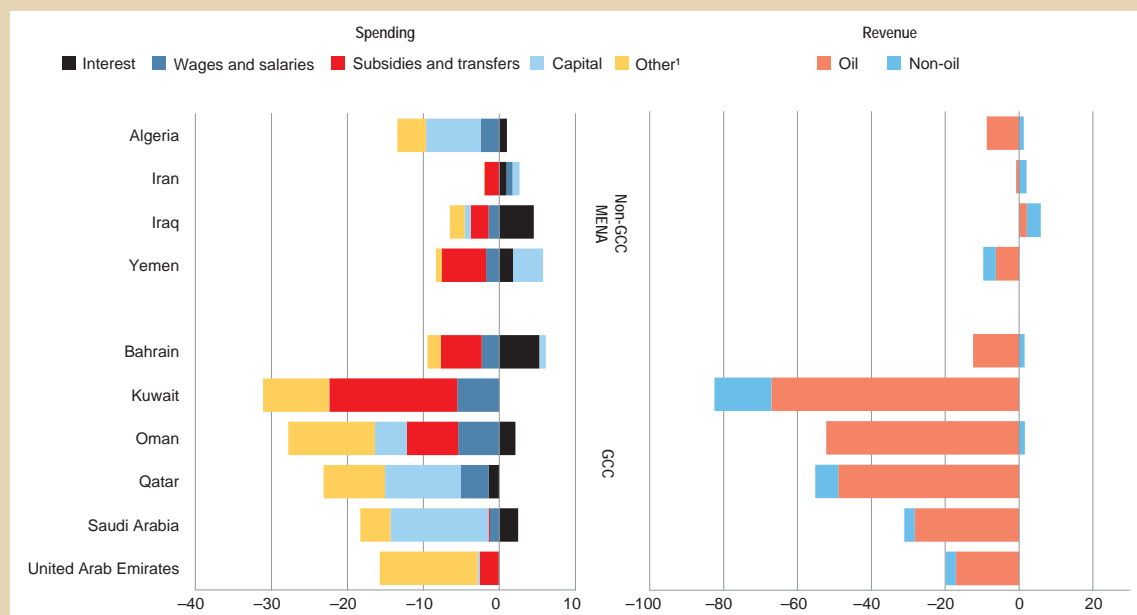
Consolidation should be as growth friendly and equitable as possible, underpinned by a medium-term



Figure 4.7

**Change in Spending and Revenue between 2014 and 2020**

(Percentage points of non-oil GDP)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

<sup>1</sup>Includes subsidies and transfers for Algeria and Qatar.

fiscal framework. Key elements include fair taxation (broader bases, greater income tax progressivity, wider use of value-added tax [VAT], and higher property taxes; Jewell and others 2015); an emphasis on cuts to current, rather than capital, expenditures; and energy price reforms (Coady and others 2015). The medium-term framework should take into account intergenerational considerations, and should be accompanied by additional reforms to increase the coverage and transparency of fiscal accounts (October 2015 *Fiscal Monitor*).

- *Raising non-oil revenue.* Only Iran and Iraq have adopted significant new revenue measures. The recent intensification of work by GCC countries on a regional VAT framework is welcome, but further progress is needed to firm up specific plans, including a timetable for implementation. For example, a 5 percent broad-based VAT could raise roughly 1–2 percent of GDP in revenues. The CCA countries that already have substantial non-oil taxation should reduce exemptions and strengthen collections.

- *Curbing current spending.* There is space to reduce current spending given the run-up in wage, administrative, and security-related expenditures over the past decade (Figure 4.8). These items are often the hardest to address politically, and have made budgets more rigid and difficult to adjust. Wages have grown particularly quickly relative to non-oil GDP in Algeria, Kuwait, and Oman, while Bahrain has significantly increased social benefits. Bringing current noninterest spending back to pre-boom levels would save more than 3 percent of GDP in the GCC region. Health, education, and other essential social spending should be protected. Complementary civil service reforms, and creating incentives for workers to seek private sector employment, would be highly desirable.
- *Streamlining public investment, while increasing its efficiency.* Albino-War and others (2014) found that, on average, MENA and CCA infrastructure projects could achieve the same results with 20 percent less spending, through

## Box 4.1

## Fiscal Space in Oil-Exporting Countries

The large and sustained drop in oil prices has increased fiscal vulnerabilities in MENA and CCA oil-exporting countries. The issue of fiscal space has become critical as oil exporters decide how quickly to adjust their fiscal policies to the new reality of persistently lower oil prices. This box considers several alternative measures of fiscal space.

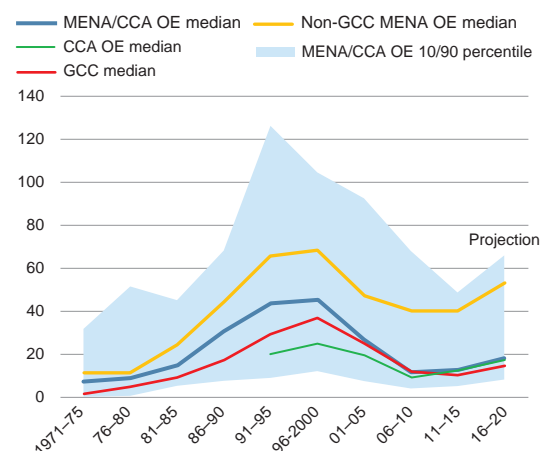
A good starting point is the size of governments' financial assets—commonly referred to as “fiscal buffers.” In general, countries with larger buffers can afford to maintain fiscal deficits further into the future, so as to reduce the impact of lower oil prices on growth. On current trends, however, all non-GCC MENA oil exporters are already projected to run out of liquid financial assets in the next three years (see Chapter 1). In contrast, CCA oil exporters have at least 15 years' worth of available financial savings,<sup>1</sup> while GCC countries are split evenly between countries with relatively large buffers (Kuwait, Qatar, and the United Arab Emirates—more than 20 years remaining) and countries with relatively smaller buffers (Bahrain, Oman, and Saudi Arabia—less than five years).

Additional perspective is provided by a review of past public debt trajectories. MENA and CCA oil exporters accumulated most debt in the mid-to-late 1990s, when the median debt ratio increased to almost 50 percent of GDP, with several countries' debt ratios peaking at about 100 percent or even higher (Figure 4.1.1). Public debt ratios projected by IMF staff through 2020 are well within these historical norms for most MENA and CCA oil exporters, though these projections already assume some fiscal adjustment. Under the alternative “no-adjustment” scenario presented in this chapter, the debt ratios would be within historical norms for the next several years, but would be rising rapidly, especially in the GCC region.

Sovereign ratings also convey information about public debt and fiscal space. Typically, the higher the country's public debt, the lower the sovereign rating and borrowing capacity. Almost all GCC countries (except Bahrain) have ratings similar to those of the best-performing advanced economies, but their debt ratios are considerably below advanced economy peers by some 20–40 percentage points of GDP (Figure 4.1.2).<sup>2</sup> A similar conclusion holds for the two rated CCA countries (Azerbaijan, Kazakhstan). This fairly upbeat assessment, however, should be contrasted with the situation of several non-GCC MENA oil exporters that face security-related challenges and geopolitical risks, do not have sovereign ratings, and are cut off from funding markets (Iran, Libya, Yemen).

Further granularity can be obtained from analysis of the “distance-to-debt limit.” This concept extends an approach developed by Ostry and others (2010) and Ghosh and others (2013) and is updated regularly by Moody's. The fiscal

Figure 4.1.1  
Public Debt Ratios, 1970–2020  
(Debt in percent of GDP)



Sources: National authorities; and IMF staff calculations.  
Note: CCA OE = CCA oil exporters excluding Uzbekistan, for which debt data are unavailable.

Prepared by Martin Sommer and Bruno Versailles, with support from Greg Auclair.

<sup>1</sup> Based on available data for Azerbaijan, Kazakhstan, and Turkmenistan.

<sup>2</sup> Generally, undiversified oil-exporting countries should be expected to maintain lower debt ratios than similarly rated diversified peers given the inherent risks from highly volatile revenues.



## Box 4.1. (continued)

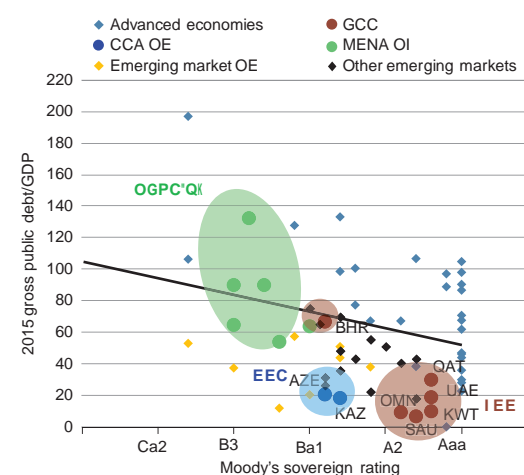
space is defined as “the difference between a nation’s sovereign-debt-to-GDP ratio and the limit beyond which the nation will default unless policymakers take fiscal steps that are outside of anything they have done historically” (Moody’s Analytics 2011, p. 2). Moody’s assessment of fiscal space for advanced economies can be mapped to the MENA and CCA oil exporters by matching sovereign credit ratings. On this basis, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates appear to have fiscal space similar to that of Norway. Oman belongs to the intermediate group with the United Kingdom, while Azerbaijan, Bahrain, and Kazakhstan are all at a level where their debt position is considered more vulnerable in comparison with other rated borrowers.

In sum, the fiscal space varies considerably across the MENA and CCA regions. Some oil exporters have very limited fiscal space because of their small savings, security-related challenges, and geopolitical factors. Others have ample savings, low debt ratios, access to international markets, and developed financial systems. Oil exporters have additional options to finance fiscal deficits, including borrowing against their oil reserves and selling ownership stakes in both oil and non-oil industries. Table 4.1.1 combines all of the above considerations and suggests that Kuwait, Qatar,

Figure 4.1.2

### Sovereign Ratings and Public Debt

(2015 gross public debt as a percent of GDP)



Sources: National authorities; and IMF staff calculations.

Note: OE = oil exporters; OI = oil importers. Country abbreviations are International Organization for Standardization (ISO) country codes.

Table 4.1.1. Alternative Measures of Fiscal Space

	Fiscal space									
	Large	Medium	Limited	Small	Data not available					
	Fiscal buffers			Financing needs			Borrowing capacity			Overall assessment
	Years to exhaust fiscal buffers	Years to exhaust fiscal buffers and reach 70 percent of GDP in debt	Hydrocarbon reserves in percent of 2014 GDP	Fiscal balance in percent of GDP, 2015	Government-debt-to-GDP ratio, 2015	Government-debt-to-GDP ratio, 2020	Government-debt-to-bank-assets ratio, 2014	Moody's rating as of mid-2015	Debt limit, Moody's <sup>1</sup>	
<b>GCC</b>										
Bahrain	Green	Green	Green	Red	Yellow	Red	Green	Green	Yellow	Yellow
Kuwait	Green	Green	Green	Red	Yellow	Red	Green	Green	Yellow	Yellow
Oman	Yellow	Yellow	Green	Red	Yellow	Red	Green	Green	Yellow	Yellow
Qatar	Green	Green	Green	Red	Yellow	Red	Green	Green	Yellow	Yellow
Saudi Arabia	Yellow	Yellow	Green	Red	Yellow	Red	Green	Green	Yellow	Yellow
United Arab Emirates	Green	Green	Green	Red	Yellow	Red	Green	Green	Yellow	Yellow
<b>Non-GCC MENA</b>										
Algeria	Yellow	Yellow	Yellow	Red	Yellow	Red	Green	Green	Yellow	Yellow
Iran	Yellow	Yellow	Yellow	Red	Yellow	Red	Green	Green	Yellow	Yellow
Iraq	Red	Red	Green	Red	Yellow	Red	Yellow	Green	Yellow	Yellow
Libya	Red	Red	Green	Red	Yellow	Red	Yellow	Green	Yellow	Yellow
Yemen	Red	Red	Red	Red	Yellow	Red	Yellow	Green	Yellow	Yellow
<b>CCA</b>										
Azerbaijan	Green	Green	Yellow	Yellow	Yellow	Red	Green	Green	Yellow	Yellow
Kazakhstan	Green	Green	Yellow	Yellow	Yellow	Red	Green	Green	Yellow	Yellow
Turkmenistan	Green	Green	Yellow	Yellow	Yellow	Red	Green	Green	Yellow	Yellow
Uzbekistan	Yellow	Yellow	Red	Yellow	Yellow	Red	Yellow	Green	Yellow	Yellow

Sources: Moody's Analytics; national authorities; and IMF staff estimates.

<sup>1</sup> The estimates for MENA and CCA oil exporters are obtained by regressing credit ratings of advanced economies onto the “distance-to-debt limit” estimates by Moody's. Regression coefficients are then used in conjunction with credit ratings for MENA and CCA oil exporters to estimate the “distance-to-debt limit.”

**Box 4.1. (continued)**

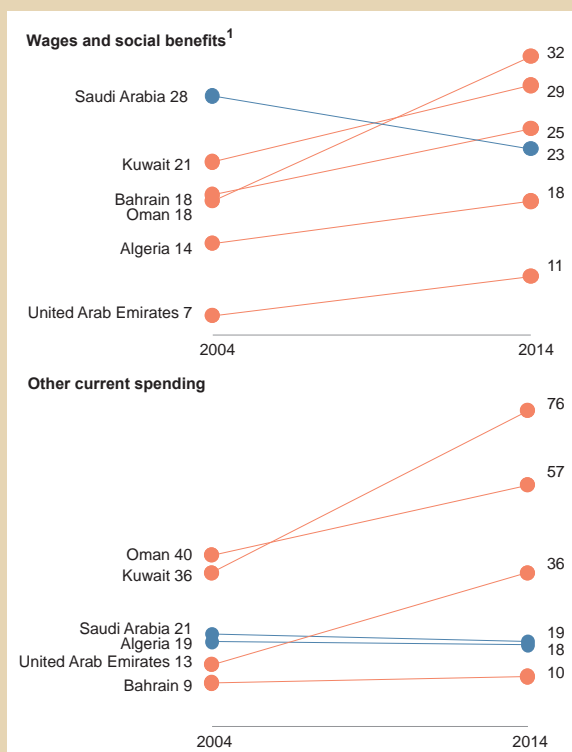
Turkmenistan, and the United Arab Emirates have a high degree of fiscal space. Countries with limited or small fiscal space include Bahrain, Iraq, Libya, and Yemen.

The degree of fiscal space will determine the pace of desirable policy adjustment, but over time all oil exporters will need to adjust to the new low oil price environment. Countries without fiscal buffers have no choice but to adjust in the short term, irrespective of their cyclical position. Countries with fiscal buffers are right to use them to smooth their policy adjustment to support growth, but still need to pursue fiscal consolidation over the medium term because oil prices are expected to remain low. There is no room for complacency even if fiscal buffers appear strong. When public debt quickly rises to high levels, credit to the private sector could get crowded out, with adverse effects on non-oil growth. Specific plans should be made now to adjust fiscal policies and rebuild buffers over the medium term.

Figure 4.8

**MENA Oil Exporters: Selected Spending Categories**

(2004–14, percent of non-oil GDP)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

<sup>1</sup>In Kuwait excludes social benefits.

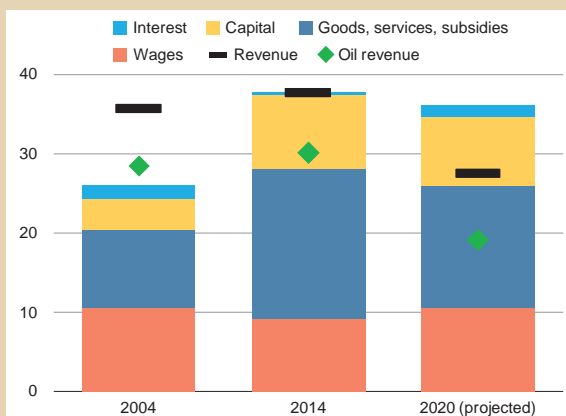
more efficient use of resources. Raising investment efficiency could thus save some 2 percentage points of GDP. The scope for savings could be even higher, as this estimate is based on an average over two decades, while public investment has increased rapidly in recent years (Figure 4.9). Any additional streamlining beyond efficiency improvements should be based on a thorough review of needs. Indeed, several non-GCC MENA oil exporters with large infrastructure gaps resulting from military conflicts should actually *increase* public investment once the security situation allows. Over time, all countries need to develop a comprehensive public investment management framework to improve spending efficiency; in this regard, Qatar has made important progress.

- *Medium-term frameworks.* Several countries have established macro-fiscal units (for example, Kuwait and Qatar),<sup>11</sup> and preparations are

<sup>11</sup> The macro-fiscal units are tasked with preparing a consistent set of macroeconomic and budget revenue and spending projections. Well-functioning macro-fiscal units are a prerequisite for establishing effective medium-term fiscal frameworks.

Figure 4.9

### GCC: Composition of Revenue and Spending (2004–20, percent of GDP)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

under way to establish or enhance medium-term frameworks in other oil exporters, such as Algeria and Kazakhstan. The fiscal frameworks should specify the key medium-term objectives and accompanying policy measures including contingency plans, and should anchor decisions related to annual budgets. Fiscal frameworks should be accompanied by a strong communication strategy to secure buy-in for the difficult, though necessary, choices, while maintaining policy credibility in the context of large and persistent budget deficits.

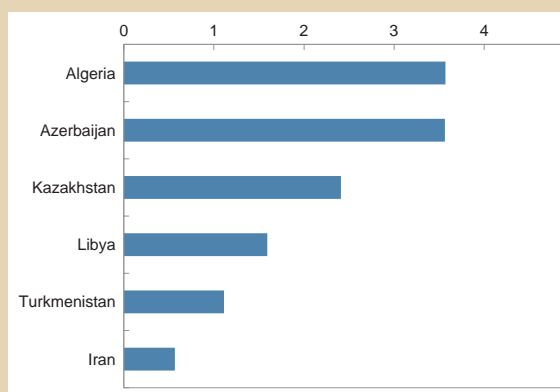
## Complementarities with Other Policies

The burden of fiscal adjustment can be eased through other policies, especially exchange rate and structural policies:

- Some MENA and CCA countries allowed their exchange rates to depreciate. This step has eased the need for fiscal adjustment, by facilitating higher local currency receipts from oil sales (for example, in Algeria, Azerbaijan,

Figure 4.10

### Impact of Exchange Rate Depreciation on Oil Revenues (2015, percent of GDP)



Sources: National authorities; and IMF staff calculations.

Note: Calculated based on a change in the exchange rate between June 2014 and September 2015.

Iran, and Turkmenistan; Figure 4.10).

Nonetheless, large exchange rate adjustments can have adverse balance sheet effects on dollarized economies such as those of the CCA. Moreover, the effectiveness of depreciation as an adjustment mechanism varies across countries depending on the degree of diversification, responsiveness of exports and imports (including migrant labor) to exchange rate changes, and balance sheet effects. Where exchange rate depreciation is not appropriate, an even greater emphasis on fiscal adjustment is warranted. In particular, GCC countries should maintain their currency pegs, but aid both fiscal and external adjustment by formulating adequate medium-term fiscal consolidation plans early on.

- Structural policies to boost growth will also facilitate fiscal adjustment (see Figure 4.3). Although structural reforms are highly desirable, they take time to bear fruit. To reap the fiscal benefits, oil exporters would need to enhance their non-oil taxation frameworks, which are generally underdeveloped in MENA, and especially in the GCC countries.

Financing deficits through debt issuance would support financial market development. Exporters with ample fiscal space can issue debt that, by establishing key pricing benchmarks, would help with developing the local corporate debt market (Box 4.2).<sup>12</sup> In particular, highly rated GCC countries tend to have low debt ratios relative to their peers (Box 4.1). Norway, for example, has about 30 percent of GDP in public debt despite substantial wealth in its sovereign wealth fund. That said, policymakers will need to monitor liquidity in local financial markets to ensure that government borrowing does not crowd out private investment. Clear communication about debt issuance plans would help financial markets prepare. Some countries with large deficits may need to borrow externally. In this context, risks to external financing may become elevated in the near term, including those from the euro area and spillovers from normalization of U.S. monetary policy.

## Conclusions

MENA and CCA oil exporters are only just beginning to tackle the associated fiscal challenge posed by a sizable and persistent drop in oil prices. Much more progress is needed to formulate and implement significant medium-term fiscal adjustment. Countries with fiscal space are using their buffers appropriately, but medium-term plans to put fiscal finances on a stronger footing

are lacking, including in those countries with the largest adjustment needs. Some countries without fiscal space have started to meet some of their funding needs through monetary financing, which creates inflation risks. Some non-GCC countries could also benefit from exchange rate depreciation, which would facilitate the needed fiscal adjustment and improve the competitiveness of their non-oil export sectors. In devising adjustment policies, attention should be paid to growth and distributional effects.

Medium-term policies to deal with lower oil prices include formulating medium-term frameworks to secure fiscal sustainability and intergenerational equity, gradually rebuilding buffers, lowering the rigidity of budget spending, increasing fiscal transparency through greater disclosure, and moving off-budget entities onto the budget, especially in the energy sector. Contingency plans are crucial, given the uncertainty over longer-term oil prices. Policymakers should also strengthen diversification efforts to boost non-oil growth and revenues.

The IMF can help through advice, technical assistance and training, and—if needed—financial support. Technical assistance and training can be provided in many relevant areas, including formulating medium-term fiscal plans; conducting expenditure reviews; designing of tax, energy pricing, and public investment management reforms; and developing communication strategies.<sup>13</sup> Many of these areas are also priorities for MENA and CCA oil-importing countries, which should take advantage of lower oil prices to rebuild buffers and enact important reforms (Box 4.3).

<sup>12</sup> Policymakers have taken diverse approaches to date. Bahrain, Iraq, and Yemen have issued debt. Oman and Saudi Arabia have mostly drawn down buffers, although Saudi Arabia has recently issued sovereign debt for the first time since 2007. Similarly, the CCA countries with ample buffers and relatively small deficits are mainly drawing down assets. On average, debt issuance is expected to cover 22 percent of deficit-financing needs in the GCC region this year, compared with 62 percent in non-GCC MENA and 54 percent in the CCA.

<sup>13</sup> The IMF offers courses on macroeconomic management in resource-rich countries (<http://www.imf.org/external/np/INS/english/pdf/catalog2015.pdf>), including a free online course on energy subsidy reform (<https://www.edx.org/course/energysubsidy-reform-imfx-esrx-0>).

## Box 4.2

### Developing and Deepening Local Currency Debt Markets in the GCC

The choice of how fiscal deficits are financed could provide an opportunity for GCC countries to develop their local debt markets, including sovereign issuance of long-term Islamic instruments. Developing deep and liquid domestic debt markets can strengthen the resilience of these economies to adverse shocks, facilitate the conduct of monetary policy by improving the monetary transmission mechanism and the implementation of Basel III liquidity norms, and help advance diversification agendas by expanding the availability of long-term financing. An actively traded government bond market in the GCC region could provide a base from which to price local currency corporate bonds and help address maturity mismatches that restrict long-term bank lending.

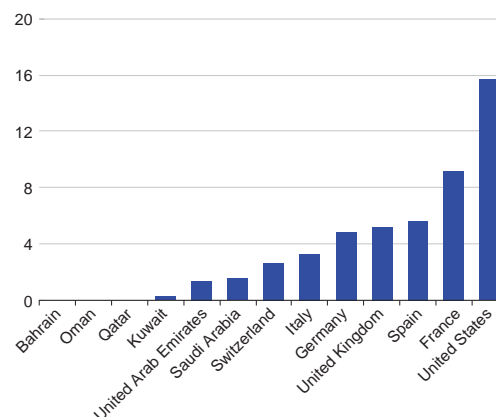
The GCC countries' domestic debt markets are at an early stage of development and much needs to be done to advance the agenda (Figure 4.2.1). The domestic corporate bond market is almost nonexistent. In July 2015, Saudi Arabia, for example, issued its first sovereign bonds since 2007 to local banks to finance its fiscal deficit, and Oman and Kuwait are planning a Sukuk issuance. That said, the local currency debt issuance in the GCC countries has yet to translate into adequate secondary market liquidity, and only Qatar has made systematic progress in the development of its government securities market in recent years (Figure 4.2.2).

Establishing a liquid and well-functioning market for long-term government and corporate debt requires proactive and coordinated efforts from government, central banks, other regulatory bodies, and market participants. Key steps and conditions include:

- Initially concentrating on developing the short end of the yield curve by building a liquid Treasury bill market where issuances are backed by liquidity forecasting with a transparent price-clearing mechanism.
- Achieving a diversified domestic and foreign institutional investor base (including pension, insurance, and mutual funds) that can shift financial intermediation from banks to capital markets by increasing the demand for long-term financial assets.
- Creating an efficient institutional infrastructure—including a credible rating system, good corporate governance standards, transparency in reporting requirements, and the adoption of international accounting standards—to help foster market discipline.
- Make pricing transparent and improve microstructures—such as effective trading mechanisms, and custody and settlement systems—to enhance liquidity and efficiency, while reducing trading costs and volatility.

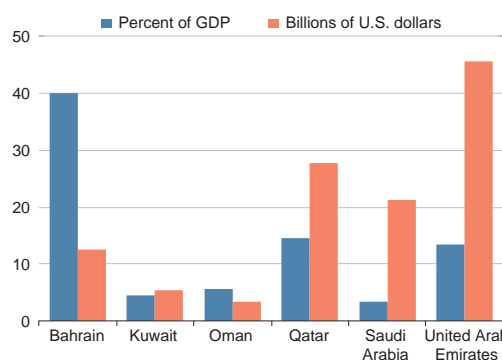
Prepared by Prasad Ananthakrishnan.

Figure 4.2.1  
Domestic Debt Issuance by Nonfinancial Corporations, 2014  
(Percent of GDP)



Sources: National authorities; and IMF staff estimates.

Figure 4.2.2  
GCC Government Domestic Debt Stocks, 2015



Sources: National authorities; and IMF staff estimates.

Note: Debt stock is composed of Treasury bills and government bonds; 2015 data are last month available.

## Box 4.3

## Fiscal Adjustment in Response to Lower Oil Prices in Oil Importers

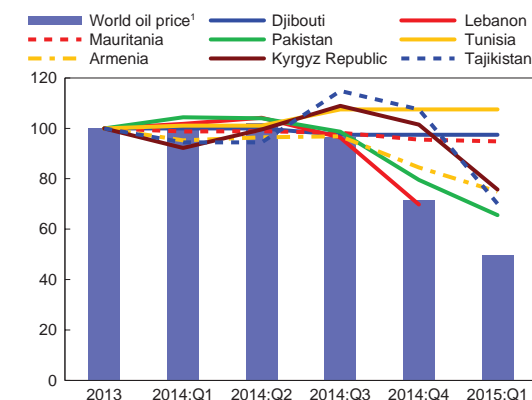
For most oil-importing countries in the MENAP and CCA regions, windfall gains from the recent decline in oil prices have been muted by the effects of concurrent adverse shocks. Lower oil prices generally imply higher real disposable income and lower production costs for an oil-importing country, leading to higher consumption and investment growth. However, recent oil price-related gains have been partly offset by other factors for most MENAP and CCA oil importers. The CCA was negatively affected by spillovers from Russia, a key economic partner in the region. Many non-oil commodity producers, including Armenia, Mauritania, and Tajikistan, saw their export unit values deteriorate, because of declining prices for metal and cotton. Data so far do not show a decline of remittances and foreign aid from GCC countries, but this remains a significant risk for a number of oil importers in the Mashreq and Pakistan. It could also translate into slower export demand because the GCC is a significant trading partner as well. In some cases, these negative shocks more than offset the positive effects from lower oil prices on growth, at least in the short term.

Although lower oil prices imply current account gains for MENAP and CCA oil importers,<sup>1</sup> the impact on fiscal balances is mixed. Regulation of domestic energy prices implies that some of the real income gains from lower oil prices accrue to the fiscal or quasi-fiscal sectors, rather than end users. In fact, MENAP and CCA oil importers have generally had a relatively low pass-through from world to retail oil prices (Figure 4.3.1). However, while some countries are seeing fiscal and/or quasi-fiscal gains from savings on energy subsidies, in others these gains are outweighed by losses from ad valorem fuel taxes (Pakistan, Kyrgyz Republic—Figure 4.3.2). In some CCA countries, pass-through has been limited because fuel import prices were set under long-term international contracts with Russia, and because of gasoline import supply constraints (notably in the Kyrgyz Republic). Countries enjoying fiscal windfall gains should decide how much

Figure 4.3.1

## World Oil Price and Retail Fuel Prices

(Index, 2013 = 100)



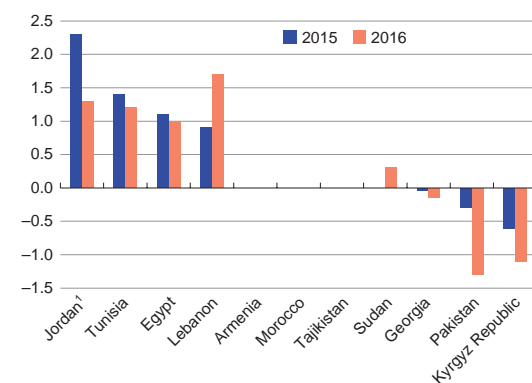
Sources: National authorities; and IMF staff calculations.

<sup>1</sup>Simple average of Dated Brent, West Texas Intermediate, and the Dubai Fateh spot prices.

Figure 4.3.2

## Impact of Lower Oil Prices on Fiscal Balances

(Percent of GDP)



Sources: National authorities; and IMF staff estimates.

Note: The first-round impact of the oil price change in the APSP oil price between 2014 (\$96.25) and the World Economic Outlook database assumptions for 2015 (\$51.62) and 2016 (\$50.36), keeping oil/gas production and other factors constant at the 2014 level.

<sup>1</sup>For Jordan, estimates include a state-owned electricity company.

Prepared by Gohar Minasyan.

<sup>1</sup> The current account balances of CCA oil importers were also adversely affected by lower remittances from and exports to Russia—partly owing to lower oil prices. These second-round effects are not considered here.



**Box 4.3 (continued)**

of them to save based on the existing vulnerabilities and cyclical risks. Locking in windfall gains, reducing public debt, and strengthening policy buffers should be priorities when vulnerabilities are significant, but where output gaps are large, the windfall should be spent.

Getting energy prices right has been a longstanding policy priority for most MENAP and CCA countries, and low oil prices provide a unique window of opportunity to push ahead with reform. Fully liberalizing domestic energy prices or adopting automatic pricing formulas, and reforming state-owned enterprises in the energy sector can be easier and politically less costly in an environment of low international oil prices. Savings from these reforms can then be used to finance targeted transfers to socially vulnerable groups and growth-enhancing spending. Because low energy prices are deeply entrenched in many economies in the Middle East, targeted mitigation measures and an effective communication strategy would be required to make reforms successful. It is encouraging that energy pricing reform is on the agenda in most countries while some countries, including Jordan, Morocco, and Pakistan, have already implemented measures (Table 4.3.1). Some CCA countries (such as Armenia) are expected to use the opportunity to increase fuel excises. However, if short-term fiscal incentives are not well aligned with the long-term energy pricing reform agenda, lower oil prices may jeopardize reform. In particular, lower oil prices temporarily ease the fiscal burden of subsidies, which may create incentives for governments to delay the implementation of energy pricing reform, as appears to be the case in Egypt.

**Table 4.3.1. Subsidy Reform Progress in Selected Countries**

	<b>Egypt</b>	<b>Jordan</b>	<b>Mauritania</b>	<b>Morocco</b>	<b>Tunisia</b>	<b>Pakistan</b>
Budgetary Subsidy Reform	The five-year plan to eliminate electricity subsidies is on track. There have been slippages on fuel subsidy reform.	Completed. Conditional cash transfers in case of oil prices exceeding US\$100 per barrel will be maintained.	Gasoline subsidies have been eliminated.	Liquid natural gas subsidies have been eliminated.	Reform to eliminate energy subsidies has started but progress has been slow.	Reforms to reduce electricity subsidies are on track.
SOE Reform	There has been no tangible progress in reforming the EGPC and EGAS.	On track to achieve electricity cost recovery by 2018.	No reform plans for the energy sector SOEs.	No reform plans for the energy sector SOEs.	Cross-subsidies between energy sector companies have been eliminated.	Authorities have devised a plan to address arrears in the power sector SOEs.

Sources: National authorities; and IMF staff calculations.

Note: EGAS = Egyptian Natural Gas Holding Company; EGPC = Egyptian General Petroleum Corporation; SOE = state-owned enterprise.

