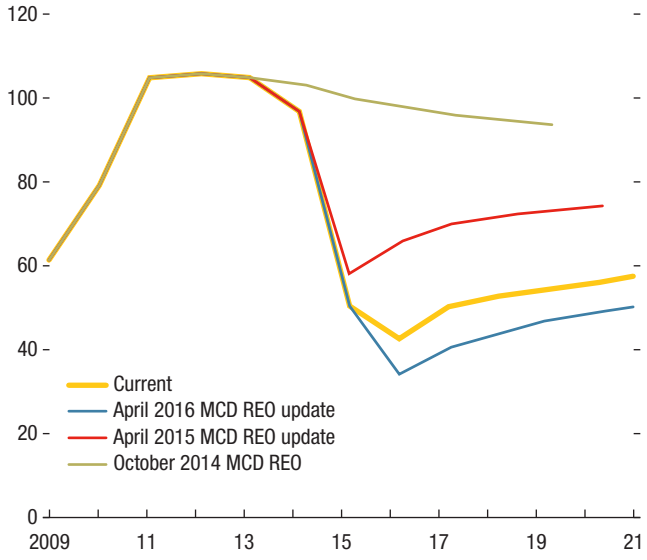
1. MENAP Oil Exporters: Adjustment to Cheaper Oil Continuing

Middle East, North Africa, Afghanistan, and Pakistan (MENAP) oil exporters continue to face an exceptionally challenging environment as low oil prices and conflicts continue to weigh on economic activity, fiscal and external balances, and the financial sector. Many have made progress in fiscal consolidation, yet sustained efforts will be required over the medium term to place public finances on a sound footing. Plans to diversify economies away from oil and create jobs for the rapidly growing populations have also been announced. Such economic transformation will take time. Careful and steady implementation of the diversification plans will be key to their success. In addition, policymakers need to remain vigilant about the financial stability risks, especially tightening liquidity and the risk of deteriorating asset quality.

Figure 1.1. Oil Price[1]
(U.S. dollars a barrel)



Sources: Bloomberg, L.P.; and IMF staff calculations.
Note: MCD REO = *Regional Economic Outlook: Middle East and Central Asia.*
[1]Average of U.K. Brent, Dubai Fateh, and West Texas Intermediate crude oil prices.

Moderate Oil Price Recovery

Oil prices remain the key driver of the outlook for MENAP oil exporters given their high dependence on hydrocarbon budget revenues and exports. Having hit a 10-year low of less than $30 a barrel in January, oil prices have staged a partial recovery to about $40–$50 a barrel, supported by lower output from high-cost oil fields and supply disruptions in Canada and Nigeria, which have outweighed substantial production increases in Iran and Iraq.

However, despite this rebound, the oil market outlook has not fundamentally changed since the April 2016 *Regional Economic Outlook: Middle East and Central Asia* Update (MCD REO Update) Oil prices are assumed to average $43 a barrel in 2016 and $51 a barrel in 2017. Over the medium term, any further oil price recovery is expected to be limited, with futures markets suggesting prices will remain below $60 by 2021 (Figure 1.1). However, considerable uncertainty surrounds the oil price outlook on both the downside and upside, resulting from the global growth risks, sharp swings in the amount of oil supply outages, and ongoing consolidation and efficiency gains in the U.S. shale oil industry.[1]

Weak Growth Outlook, Muted Price Pressures

Overall GDP growth is projected to remain weak, with little change since the April 2016 MCD REO Update—higher-than-expected oil prices will result in smaller budget and external deficits rather than stronger spending. Economic activity in the Gulf Cooperation Council (GCC) region is projected to slow this year despite continued

Prepared by Bruno Versailles (lead author), Mariana Colacelli, Pilar Garcia-Martinez, and Juan Treviño under the supervision of Martin Sommer. Yufei Cai, Sebastian Herrador, Brian Hiland, and Amir Sadeghi provided research assistance.

[1]Husain and others (2015) discuss the fundamental forces driving the oil price outlook and their global implications.

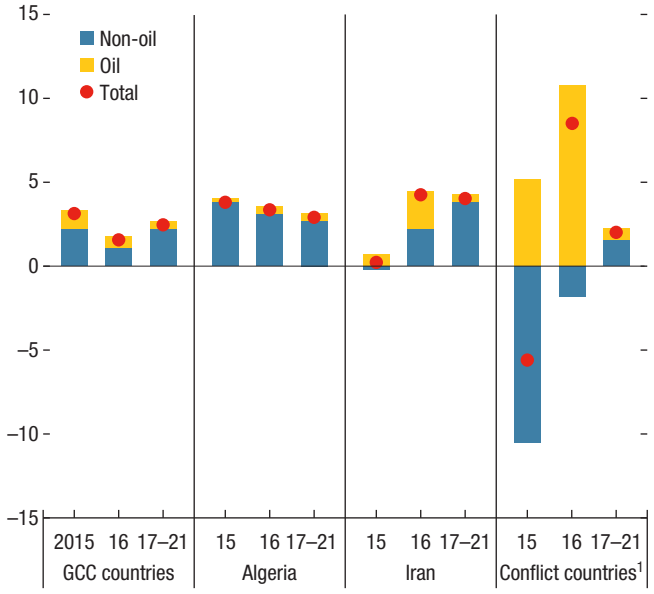
expansion in hydrocarbon output. Non-oil growth is expected to dip from 3¾ percent last year to 1¾ percent in 2016 (Figure 1.2), owing to fiscal consolidation (Box 1.1) and credit constraints due to slowing deposit growth. Next year, non-oil growth is forecast to pick up to 3 percent as the pace of fiscal consolidation eases. Over the medium term, decelerating fiscal consolidation and a partial recovery in oil prices should modestly boost average non-oil growth to about 3½ percent, still well below the 7 percent growth during 2000–14. This sluggish performance will keep a lid on overall growth given the expectations of slow expansion in the hydrocarbon sector. In Algeria, the overall growth slowdown in 2016 will be countered by higher natural gas output, but non-oil growth will remain well below historical norms over the medium term.

Iran's headline growth has been revised up to 4½ percent this year, owing to faster-than-expected increases in oil production and exports following the unwinding of sanctions. Oil output has risen to 3.6 million barrels per day, resulting in positive spillovers to the non-oil economy, although the recovery in oil output is expected to taper sharply next year as production approaches pre-sanctions levels. The growth dividend from the lifting of sanctions is materializing only gradually, with investors remaining cautious, and reintegration into global financial markets and domestic reforms proceeding slowly.

The outlook for countries in conflict (Iraq, Libya, Yemen) remains predicated on an easing of these conflicts (Box 2.1).[2] Despite the recent reduction in ISIL-held territories in Iraq, the medium-term outlook for oil production has been revised down to reflect lower investments in a difficult budget environment and continued security challenges. The recognition by the international community of the Government of National Accord in Libya is yet to translate into improved economic prospects. And a resolution of the conflict in Yemen remains elusive despite ongoing talks.

[2]Rother and others (2016) discuss the macroeconomic implications of regional conflicts.

Figure 1.2. Contributions to Real GDP Growth
(Percentage change)

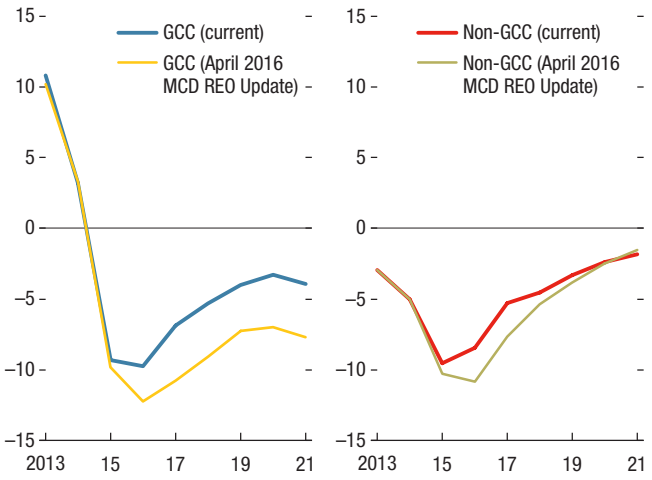


Sources: Country authorities; and IMF staff calculations.
Note: GCC = Gulf Cooperation Council.
[1]Conflict countries include Iraq, Syria, and Yemen. Libya is excluded from conflict countries.

The subdued growth prospects will keep underlying inflation low in the GCC region. Although energy price reforms are expected to temporarily push up headline inflation to about 3½ percent this year, inflation is expected to drop back to 2½ percent in 2017. In Algeria, price pressures are projected to increase further this year, owing in part to the weaker dinar and higher domestic energy prices, before moderating. Iran is making further headway in its disinflation program, bringing consumer price increases to single digits for the first time since 2000. Inflation in Iraq will remain low. Shortages, currency depreciation, and monetization of the fiscal deficit have pushed up inflation in both Libya and Yemen.

Overall, growth risks remain tilted to the downside. In particular, the negative impact of fiscal consolidation and tightening liquidity on growth could be greater than expected (see Box 1.1). Regional conflicts and related adverse spillovers could intensify. A substantial growth

Figure 1.3. Overall Fiscal Balance
(Percent of GDP)



Source: IMF staff calculations.
Note: GCC = Gulf Cooperation Council; MCD REO = *Regional Economic Outlook: Middle East and Central Asia.*

slowdown in China would further reduce commodity prices (Chapter 4), while faster-than-expected tightening by the Federal Reserve could increase global financial market volatility, reducing the availability of international financing, especially for the lower-rated oil exporters. Brexit—the June 2016 U.K. referendum result in favor of leaving the European Union—could worsen these effects through an increase in global risk aversion, even though market reaction has generally been contained (Box 1.2). There is also a double-sided risk to growth over the medium term. Authorities could make faster-than-expected progress in implementing structural reform plans. However, considering the scope of the envisaged economic transformation, such plans could run into domestic obstacles, which could, in turn, lead to reform fatigue.

Further Fiscal Adjustment Needed

Despite higher oil prices and the adoption of consolidation measures, projected fiscal deficits remain large in both the short and medium term (Figure 1.3). Taking into account announced fiscal policy measures, all countries are expected to record fiscal deficits this year, and only Iraq, Kuwait, and the United Arab Emirates are projected to post surpluses by 2021. This year's hydrocarbon budget revenues are projected to be lower by $400 billion compared with 2014. Cumulative fiscal deficits during 2016–21 are forecast to be about $765 billion, down from $1.1 trillion in the April 2016 REO Update.

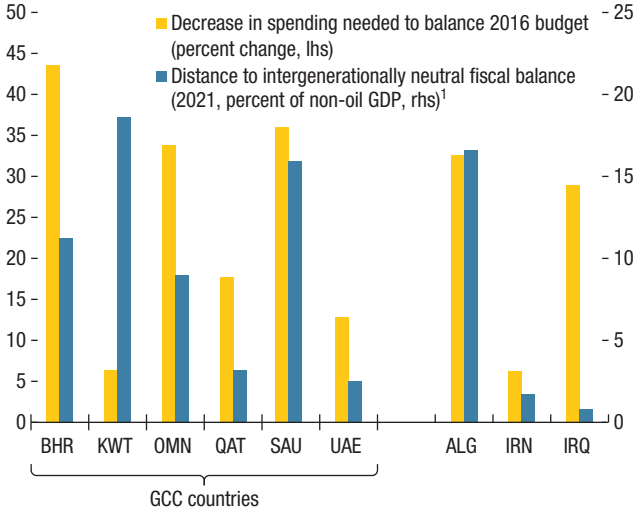
The significant deficit-reduction efforts which began last year are continuing, with the 2016 non-oil fiscal deficit expected to improve by more than 5 percent of non-oil GDP. Fiscal consolidation is particularly fast in Oman and Saudi Arabia, where non-oil deficits are projected to fall by more than 10 percentage points of non-oil GDP. In 2017, the pace of consolidation is expected to ease to about 1½ percent of non-oil GDP.

To help address the large budget deficits, policymakers have adopted a mix of spending cuts and revenue-raising measures. In particular, they have demonstrated resolve in addressing the politically difficult issue of low domestic fuel prices—all GCC countries, for example, have hiked energy prices over the past couple of years (Box 1.3). Some countries have also started—or are planning—to take measures to rein in the public sector wage bill, including through hiring freezes (Algeria, Iraq, Oman) and streamlining benefits (Oman, Saudi Arabia).[3]

Despite the remarkable progress so far, most oil exporters face increasingly difficult policy choices to achieve the significant medium-term fiscal adjustment their economies still need. Eliminating this year's budget deficit would demand an average spending cut of 25 percent. In all MENAP oil exporters, 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 for future generations (as indicated in Figure 1.4 by the estimated distance to the intergenerationally neutral fiscal balance in 2021). Non-hydrocarbon revenues

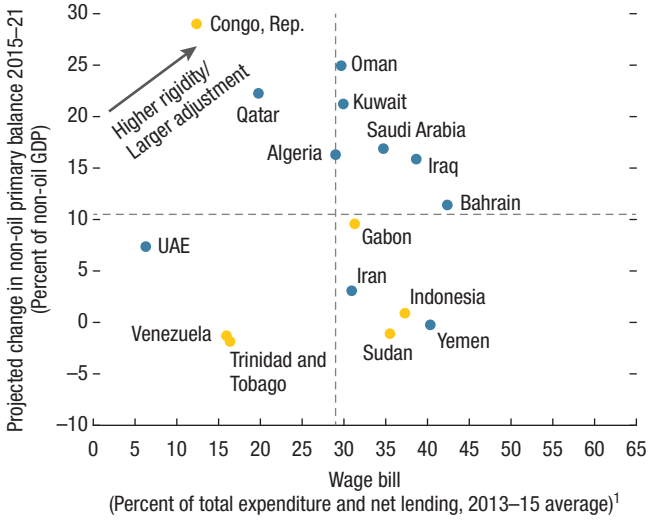
[3]Sommer and others (2015, 2016) discuss the adopted deficit-reduction measures in detail.

Figure 1.4. Illustrative Measures of Fiscal Adjustment



Source: IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes. GCC = Gulf Cooperation Council; lhs = left-hand side; rhs = right-hand side.
[1]This is the gap between the projected nonhydrocarbon primary balance and the desirable fiscal balance based on a permanent income hypothesis, using oil prices based on futures markets.

Figure 1.5. Fiscal Plans and Fiscal Rigidity



Source: IMF staff calculations.
Note: The vertical and horizontal lines dividing the chart into four quadrants correspond to the median of the respective variables.
[1]For Bahrain and the United Arab Emirates (UAE), the concept used is total expense rather than total expenditure and net lending.

have the potential to be increased across the region, especially in GCC countries that continue working toward introducing a value-added tax, having already raised some fees, charges, and excises. Iraq aims to broaden the tax base.[4] Other policy priorities include additional streamlining of current expenditures, including the public sector wage bill, increasing the efficiency of public investment (Albino-War and others 2014, Sommer and others 2015, 2016), and additional energy price reforms, all while protecting the socially vulnerable.

To reduce any adverse impact on growth, countries should phase in these additional deficit-reduction measures gradually. In addition, they should be embedded in a well-defined, medium-term fiscal framework to ensure steady implementation (IMF 2015a).[5] A successful launch of complex projects such as the value-added tax will require enhancements to local capacity. A number of MENAP oil exporters are developing or enhancing their policy frameworks, while improving other aspects of their fiscal institutions. Examples include the establishment of macro-fiscal units in Kuwait, Oman, Qatar, and Saudi Arabia, consolidated medium-term expenditure frameworks for health care and education in the United Arab Emirates, the creation of a debt management and liquidity committee in Oman, and a debt management office in Saudi Arabia, as well as enhancing the capacity of the debt management office in Bahrain. As fiscal consolidation proceeds, policymakers are likely to face headwinds given the high rigidity of public expenditures—for example, public wages account for more than a third of total spending in a number of oil exporters. Countries in the top-right quadrant of Figure 1.5 face the biggest challenge as they are not only planning the largest fiscal adjustment, but also facing a high rigidity of spending.

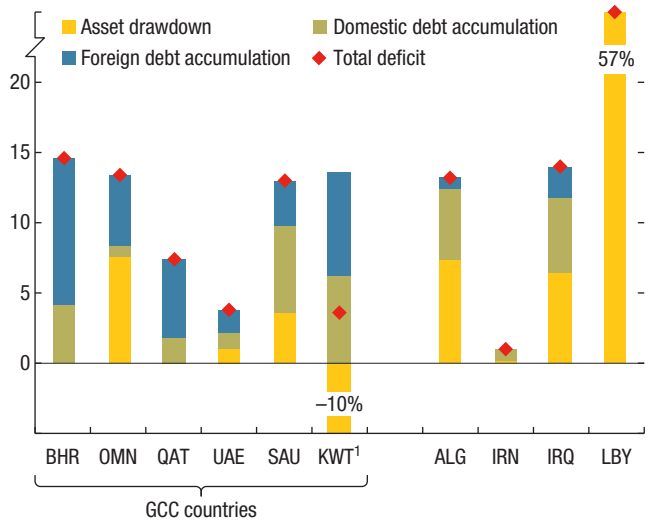
Deficit-financing options—discussed in more detail in Chapter 5—generally include the

[4]Jewell and others (2015) identify fairness-enhancing revenue-raising options for MENAP countries.

[5]More broadly, Lledo and Poplawski-Ribeiro (2013) find that higher quality of fiscal institutions is associated with better implementation of fiscal policy plans.

drawdown of government financial assets and issuance of domestic and foreign debt. After a significant withdrawal of financial buffers last year, a larger portion of the 2016 fiscal deficits (which amount to about $200 billion) is likely to be covered by issuing debt (Figure 1.6). Bahrain, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (Abu Dhabi) have issued bonds and/or obtained syndicated loans in international markets this year. Such diversification of financing sources is appropriate given the greater absorptive capacity of international markets. This strategy will also help ease pressure on domestic banks to finance the deficits. International financing conditions remain broadly favorable for now, but the risks involved with international financing will need to be managed carefully.

Figure 1.6. Projected Financing of Fiscal Deficits
(Percent of GDP, 2016)



Source: IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes; GCC = Gulf Cooperation Council.
[1]Borrowing beyond the size of the deficit implies that the authorities are building buffers.

Financing Current Account Deficits

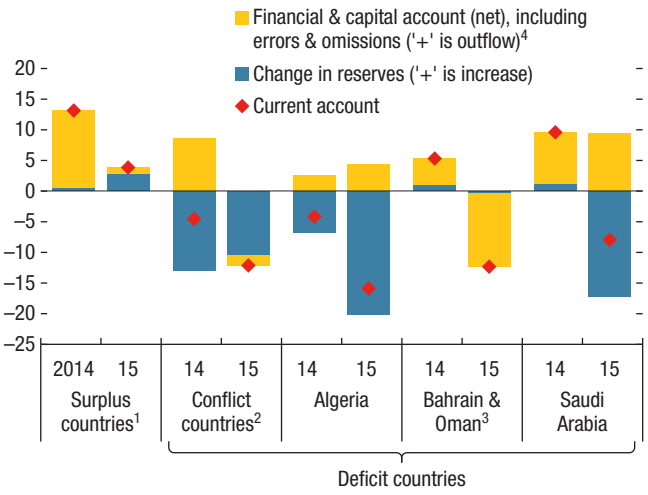
The oil price drop has brought about large export losses—oil-related receipts are projected to fall by about $435 billion this year compared with 2014. Consequently, the aggregate current account balance is projected to turn from a surplus of 8¼ percent of GDP in 2014 to deficits of 4½ percent of GDP in 2016 and 1¾ percent of GDP in 2017. In the GCC countries, the external adjustment to low oil prices should be accomplished through fiscal consolidation given the long-standing currency pegs and relatively undiversified economies. Countries with a more flexible exchange rate regime can attain some of the external adjustment through exchange rate depreciation, particularly diversified oil exporters.

Last year, Algeria and Saudi Arabia used extensive reserves to finance their current account deficits, while some others drew assets from their sovereign wealth funds (Figure 1.7). Conflict countries also drew down their reserves. The increasing international sovereign debt issuance this year, together with the tapping of international markets by government-related entities and the private sector, will help fund the current account shortfalls. Privatization and structural reforms to increase participation by foreign investors in the region would further support capital inflows. Saudi Arabia has announced its intention to sell a stake in Aramco, the world's most valuable oil and gas company, while accelerating capital market reforms to ease access for foreign investors. Oman has drafted a foreign investment law to attract investors. Iraq recently secured official financing from the IMF and other international partners.

Challenging Environment for the Financial Sector

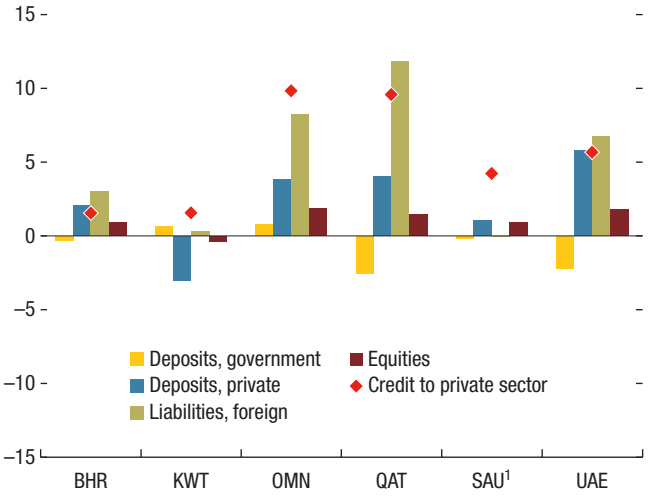
The financial sector has remained resilient following the drop in oil prices, but liquidity has tightened and asset quality is likely to deteriorate. Domestic deposit growth—especially by the government—has slowed significantly, reflecting primarily lower hydrocarbon receipts. The gap between sluggish domestic deposits and robust credit growth has been closed through higher foreign funding, including wholesale. In

Figure 1.7. External Balances
(Percent of GDP)



Sources: Country authorities; and IMF staff calculations.
[1]Iran, Kuwait, Qatar, and United Arab Emirates.
[2]Iraq, Libya, and Yemen.
[3]Weighted average.
[4]Includes transactions by sovereign wealth funds.

Figure 1.8. Trends in Commercial Banking Sector, 2014–15
(Changes in percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.
[1]In Saudi Arabia, government deposits are mostly placed at the central bank.

several GCC countries, rapidly growing foreign liabilities have been the key source of financing for continued credit expansion (Figure 1.8). In Saudi Arabia, robust credit growth has been funded by drawing down excess liquidity held at the Saudi Arabian Monetary Agency and running down foreign assets. Short-term interbank rates have generally increased more than in the United States—the key reference point given the exchange rate pegs or close ties of regional currencies to the U.S. dollar. The slowdown in domestic deposits is likely to constrain credit supply over time and thus undermine the private sector's ability to pick up the slack from a downsizing public sector, with negative consequences for growth and jobs (Box 1.1). Meanwhile, banks remain well capitalized, although profitability pressures have emerged as economic growth is slowing and provisioning for nonperforming loans increases.

Policymakers have adopted diverse responses to tightening domestic liquidity, such as increasing the loan-to-deposit ratio and placing government entity deposits in commercial banks (Saudi Arabia), relaxing reserve requirements (Algeria, Oman), and strengthening capacity to manage and forecast liquidity (Algeria). To help boost liquidity where needed, governments could consider transferring some of their foreign financial assets into the local banking system, while continuing to raise budget-deficit financing from international markets.

In the short term, policies should continue to be geared toward mitigating liquidity and credit risks where necessary. Of particular need is ensuring coherence in fiscal and monetary operations to avoid further tightening of domestic liquidity, improving liquidity-forecasting capabilities at central banks, ensuring effective liquidity-assistance frameworks, enforcing open-position limits, and ensuring appropriate loan classification and provisioning. Sufficient capital buffers need to be maintained to manage high-concentration risks, especially since low oil prices can put balance sheets under additional pressure (see IMF 2014 and Lukonga and Souissi 2015 for details). Many countries would benefit from further enhancing their financial sector surveillance, including more frequent and rigorous stress testing. Macroprudential frameworks should

continue to be enhanced where necessary by clarifying mandates for macro-financial stability, strengthening interagency coordination, formalizing and refining of the policy toolkit, and developing the market infrastructure for effective policy implementation (IMF 2015b). On the regulatory front, the continued progress in the implementation of Basel regulations across the region is welcome.

Accelerating Diversification and Private Sector Development

In light of the new oil market realities and the downsizing of the public sector, countries need to accelerate structural reforms to diversify their economies away from hydrocarbons and boost the role of the private sector. These reforms—that will inevitably take time to implement successfully—will also be crucial for securing employment opportunities given the rapidly growing labor force.

Most oil exporters have formulated strategic development plans, including Saudi Arabia's recent Vision 2030. These plans typically anticipate that several strategic sectors such as logistics, tourism, energy, financial services, health care, and manufacturing will help generate the much-needed private sector jobs and growth. Policymakers have made some progress in increasing the role of the private sector, including through public-private partnerships (PPPs) in Kuwait and Oman; other countries (for example, Saudi Arabia) are expected to follow. Several countries are developing privatization plans (ongoing in Iran, while Kuwait, Oman, and Saudi Arabia are in the planning stages). Small and medium enterprises (SMEs) have been promoted for job-creation potential across the GCC. Moreover, several countries are modernizing their investment and labor laws (Algeria, Bahrain, Oman, Qatar, and Saudi Arabia). Foreign direct investment inflows have been decreasing in recent years; reducing red tape and stronger institutional quality would help attract more foreign investments (IMF 2016).

All of these plans need to be developed into actionable measures, sequenced, and implemented. Importantly, risks and unintended consequences of reforms need to be identified and addressed. For example, the PPPs should be supported by robust regulatory frameworks that ensure cost-effectiveness and limited fiscal risks, with monitoring to ensure service delivery. A strong legal and institutional framework for privatization would ensure a transparent and competitive environment. Increasing the role of credit bureaus would strengthen lenders' ability to properly monitor the credit risk of SMEs. Upgrades to labor regulations should include feedback from the private sector.

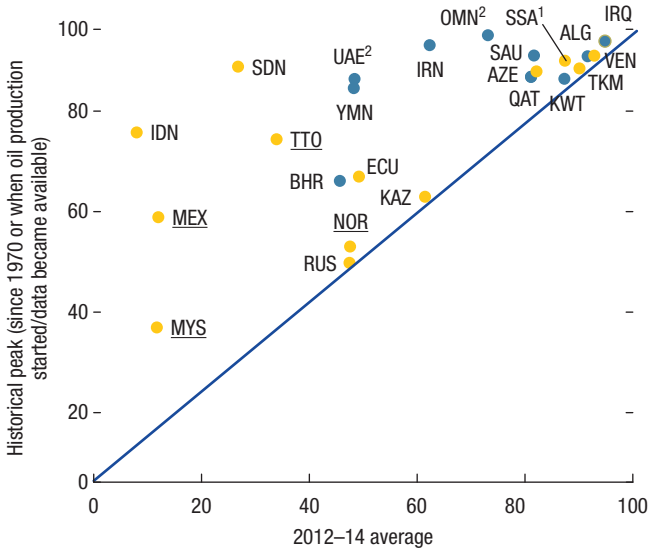
Despite this progress, further measures to improve business environments and to diversify and expand the role of the private sector are urgently needed.[6] The successful cases of Indonesia, Malaysia, and Mexico suggest that reducing commodity dependence takes time (Cherif, Hasanov, and Zhu 2016). In the GCC region, the United Arab Emirates has had some success in diversifying its export base through financial, transport, and business services, as well as through tourism, while Bahrain has increased the roles of financial services and food processing (Figure 1.9).

Labor market policies deserve special attention, with the large youth population facing the biggest challenge, given the expected slowdown in public sector hiring that has traditionally been the employer of first resort for nationals. A focus on labor market policies is particularly important in the GCC region, where businesses consistently rank restrictive labor regulations and inadequately educated workforces as their biggest barriers.[7] These challenges have prevented the private sector from significantly expanding its national workforce at a time when the growth of nationals employed by the public sector has been slowing (Figure 1.10). The ongoing reforms include

[6]Mitra and others (2016) identify three policy areas to boost MENAP's growth prospects: improving the business environment, enhancing workers' talent, and developing financial markets.

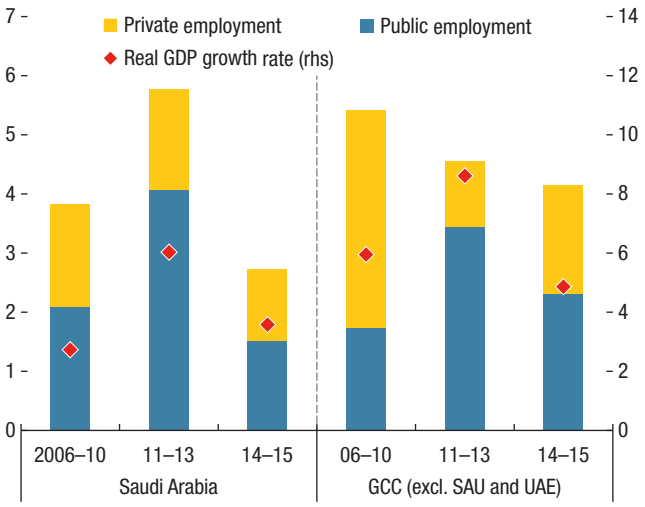
[7]See, for example, the Global Competitiveness Index (World Economic Forum 2015).

Figure 1.9. Diversification of Exports
(Oil exports as percent of total exports)



Sources: Country authorities; and IMF staff calculations.
Note: Countries underlined saw oil production decline by more than 30 percent over the past 10 years. Country abbreviations are International Organization for Standardization (ISO) country codes.
[1]SSA is the average of Angola, Republic of the Congo, Equatorial Guinea, Gabon, and Nigeria.
[2]Excludes re-exports.

Figure 1.10. Employment of GCC Nationals
(Contributions to employment growth)



Sources: Country authorities; IMF staff calculations.
Note: GCC = Gulf Cooperation Council; SAU = Saudi Arabia; UAE = United Arab Emirates; rhs = right-hand side.

public sector hiring freezes (Iraq, Oman), plans for greater mobility of foreign workers among employers (Qatar, Saudi Arabia), and increases in fees on foreign work visas (Bahrain, Oman, Saudi Arabia). Narrowing the gap between public and private sector wages would make private sector employment more attractive for nationals. Complementary active labor market policies, in place throughout the region, have been found, when well designed, to improve labor market outcomes (Box 2.2 discusses what makes such programs successful).

Training programs are particularly important as they help make growth more inclusive, thus helping to alleviate social pressures (see Box 2.2). As diversification accelerates and the economy shifts away from hydrocarbon industries, new skills will be needed to succeed in the private sector, for new and existing workers alike. Upgrades to education, training, and retraining programs should focus on reducing skill mismatches, taking into account the upcoming private sector needs.[8]

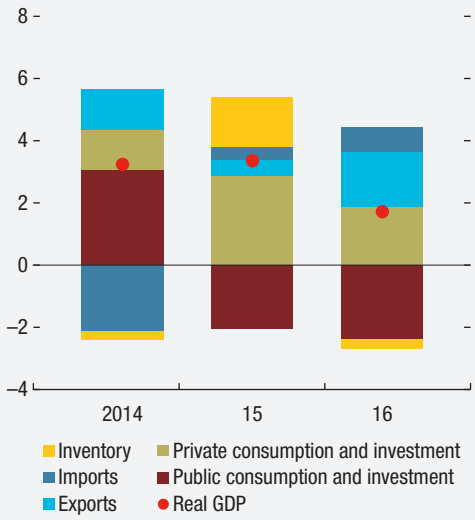
[8]Malaysia's successful diversification, for example, was accompanied by government programs that provided continuous skill upgrades for workers, while Mexico's success in the automobile industry was helped by the local training of engineers, combined with government incentives for firms to provide further training for workers abroad.

Box 1.1. GCC Countries: How Sharp Will the Growth Slowdown Be?

Most Middle East, North Africa, Afghanistan, and Pakistan (MENAP) oil-exporting countries have begun to adjust budget policies to the new reality of persistently low oil prices. Deficit-reduction measures have been particularly significant in the Gulf Cooperation Council (GCC)—the average non-oil deficit is projected to fall by about 20 percent of non-oil GDP during 2014–16. While fiscal consolidation is needed to ensure fiscal sustainability, attain intergenerational equity, and rebuild buffers, it will inevitably weigh on growth.

How much could growth slow? The GCC's non-oil growth is projected to halve from 5½ percent in 2014 to 1¾ percent this year, while Saudi Arabia's non-oil growth has recently turned negative on a year-over-year basis for two consecutive quarters. Lower public consumption and investment may subtract more than 2 percentage points from the estimated GCC growth outturn in 2015 and projections for 2016 (Figure 1.1.1). Last year, this drag was largely offset by resilient private consumption and investment, as well as by higher hydrocarbon production.[1] This year, however, the adverse growth impact will be felt more strongly, although higher exports—especially due to stronger-than-expected petrochemical output in Saudi Arabia—and lower imports will partly soften the drag.

Figure 1.1.1. GCC: Contributions to Real GDP Growth, 2014–16
(Percentage points of GDP)



Sources: National authorities; and IMF staff estimates.

An econometric model of GCC growth suggests that there is a large degree of uncertainty about the central forecasts (Figure 1.1.2).[2] Growth could be either stronger or weaker than currently projected. On the downside, an adverse feedback loop between budget spending cuts and tightening credit conditions could reduce the private sector's ability to pick up the slack created by the shrinking public sector. On the upside, growth headwinds could be smaller than projected if the composition of fiscal consolidation is favorable.

To boost the growth outlook and create jobs, the fiscal adjustment should be implemented in a growth-friendly way and accompanied by these supporting policies:

- *Use appropriate fiscal measures*. Spending cuts should be targeted toward expenditures with the smallest adverse impact on growth, such as those resulting mostly in lower imports and savings. However, the adverse impact of spending cuts on growth could increase over time as governments run out of "low-hanging fruit" and confront the need to curb core expenditures, such as the public sector wage bill, which might reduce consumption. Introducing a value-added tax and property taxes, eliminating exemptions, and increasing excises are

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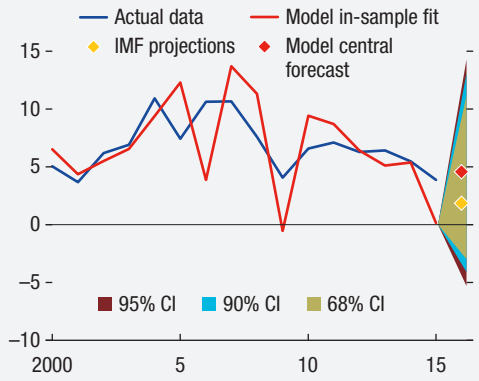
[1]Fiscal consolidation has been fastest in Oman and Saudi Arabia—about 25 percent of non-oil GDP during 2014–16. In Oman, smaller defense-related imports and an automatic reduction in on-budget energy subsidies due to lower international oil prices have accounted for nearly one-half of this adjustment. In Saudi Arabia, reduced purchases of land for infrastructure projects have contributed significantly. All these measures likely have zero or a very small direct impact on growth.

[2]The model includes real non-oil GDP, fiscal expenditures, oil prices, credit growth, and controls for the global financial crisis and the post-Arab Spring period. A fixed-effect panel regression is estimated using data for all six GCC countries during 1990–2015.

Box 1.1. *(continued)*

Figure 1.1.2. GCC: Real Non-Oil GDP Growth
(Percent, PPP weighted)



Source: IMF staff calculations.
Note: CI = confidence interval for the model forecast; GCC = Gulf Cooperation Council; PPP = purchasing power parity.

likely to carry a smaller adverse growth impact than other alternatives.

- *Avoid sharp cuts*. Spreading deficit-reduction measures over time would be desirable, to allow the private sector to adjust.

- *Keep bank credit flowing*. Policymakers can ease the risk of a double whammy from tighter fiscal policies and credit conditions by ensuring adequate liquidity in the financial system; for instance, by reducing required reserves and increasing the loan-to-deposit ratio, where appropriate.

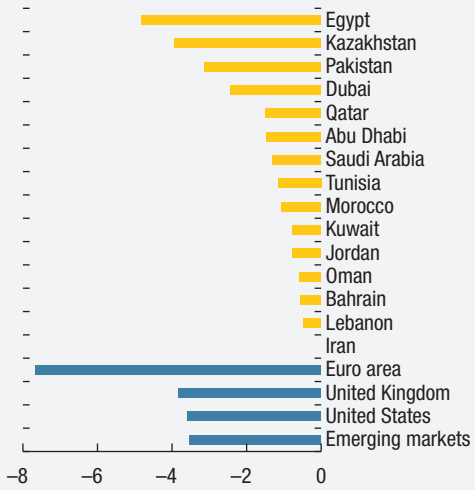
- *Look for new growth opportunities*. Deep structural reforms would, over time, support private sector activity and attract foreign investment, thus weaning the GCC economies off their over-reliance on oil and public spending. In Oman, for example, a focused development plan, the prioritization of public investment, and the draft foreign investment law have all helped to boost private sector confidence. In Bahrain, the upcoming expansions of an aluminum smelter and oil refinery are expected to support growth.

Box 1.2. The Impact of Brexit on MENAP and the CCA

Brexit, the June 2016 U.K. referendum result in favor of leaving the European Union (EU), has so far had a limited impact on the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) and Caucasus and Central Asia (CCA) regions. The regions' financial markets weakened immediately after the Brexit result, in line with global developments. This included a 5 percent drop in oil prices. Stock markets posted losses of 1–5 percent (Figure 1.2.1; Egypt, GCC, Kazakhstan, Pakistan) and five-year credit default swap spreads widened by 10–25 basis points. Currencies weakened only marginally (by 1½ percent in Algeria, Kazakhstan, and Morocco, and by 5 percent in Georgia) and there was no significant impact on forward currency spreads in the GCC, which peg to the U.S. dollar.

However, Brexit has increased uncertainty about global economic prospects. Quantifying the economic impact of Brexit is challenging at this stage, not least because of considerable uncertainty about the nature of future trade arrangements between the United Kingdom and the EU, and the likelihood of any cascading effects from Brexit on the willingness of other countries to remain in the EU. Negotiations between the United Kingdom and the EU are expected to be protracted, raising economic, political, and institutional uncertainty. This is likely to take a toll on confidence and investment, with repercussions on trade and financial market conditions—particularly in advanced Europe—and key commodity prices (Box 1, July 2016 World Economic Outlook Update).

Figure 1.2.1. Stock Market Response to Brexit Vote
(Percent change, June 23–26, 2016)



Sources: Bloomberg, L.P; Haver Analytics.

Bilateral economic linkages between most MENAP and CCA countries and the United Kingdom are limited—including through trade (Figure 1.2.2), remittances, the banking system (Figure 1.2.3), and foreign direct investment (FDI). An exception is the reliance of some banks in Bahrain, Egypt, Qatar, and the United Arab Emirates on wholesale borrowing from the United Kingdom, which may become an issue in the event of a spike in funding costs.

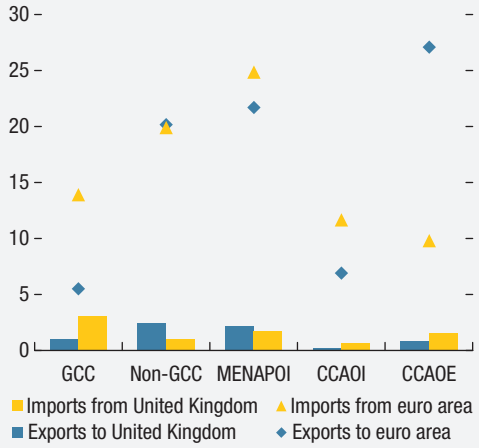
A sharp increase in global risk aversion could push up external financing costs for MENAP and CCA countries and banks. Countries with vulnerable fiscal positions (Egypt) or those expected to tap international markets in the coming months to finance their budget deficits (for example, Egypt, Pakistan, and Saudi Arabia), as well as banks relying on offshore funding (especially in Bahrain and the United Arab Emirates), are also vulnerable through this channel. Cross-border exposures to European banks are sizable for Morocco and Tunisia.

A growth slowdown in the euro area stemming from Brexit would also have a significant impact on the MENAP and CCA regions. Ties to the euro area are strong through trade, remittances, FDI, and tourism, especially for MENAP oil importers in the Maghreb region (Morocco, Tunisia) and the CCA.

Prepared by Pritha Mitra and Juan Trevino, with research assistance from Hong Yang.

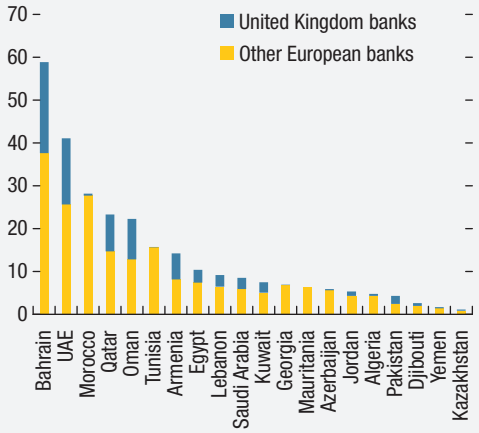
Box 1.2. *(continued)*

Figure 1.2.2. Trade with the United Kingdom and the Euro Area, 2012–14
(Percent of total exports or imports, respectively)



Source: IMF, Direction of Trade database.
Note: CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.

Figure 1.2.3. Claims on United Kingdom and European Banks, 2016:Q1
(Percent of recipients' GDP)



Source: Bank for International Settlements.
Note: Countries that have less than 1 percent exposure are excluded (Afghanistan, Iraq, Kyrgyz Republic, Libya, Sudan, Tajikistan, and Turkmenistan). UAE = United Arab Emirates.

A further decline in oil prices owing to slower global growth is another key channel through which the MENAP and CCA regions could be affected—especially the oil exporters. The decline in exports could further deteriorate fiscal balances and ultimately reduce growth prospects. Oil importers in the MENAP and CCA regions could be affected because of decreased import demand or remittances from oil exporters in the region (especially the GCC) or Russia.

Dollar appreciation, triggered by safe haven flows amid increased global risk aversion, is likely to weaken export competitiveness, especially for countries with diversified (non-commodity) exports whose currencies have limited flexibility against the dollar. Dollar appreciation would also raise the servicing cost of external dollar-denominated debt, particularly for the CCA. International reserves and investment portfolios of sovereign wealth funds will be affected by valuation changes.

All in all, Brexit could weaken the outlook for the MENAP and CCA regions to the extent that it increases global risk aversion and reduces global growth and commodity prices.

Box 1.3. Progress in GCC Energy Price Reforms

Faced with dwindling oil revenues, the GCC region has been implementing energy price reforms as a means of reducing spending. All of the GCC countries have seen an increase in energy prices; most increases have occurred since oil prices began dropping in mid-2014, although the depth and breadth of the reforms have varied significantly across countries. The 2016 January–July average prices for diesel in the United Arab Emirates and Oman, and for natural gas in Bahrain and Oman, are very close to or above U.S. price levels (Table 1.3.1). Saudi Arabia initiated substantial energy price reforms in late 2015, and plans to gradually raise domestic prices further over the next five years. Qatar has also started price reforms, but in both Qatar and Saudi Arabia, domestic prices are still well below international levels. In Kuwait, a significant increase in gasoline prices took effect in September this year, and electricity prices are also expected to increase next year (Table 1.3.4). Besides energy price reforms, many GCC countries have begun to implement policies to improve energy efficiency and are exploring the feasibility of generating electricity through renewable sources.

Table 1.3.1. Prices for Energy Products: GCC and the United States
(Average January–July 2016 or latest available)

	Gasoline	Diesel	Natural Gas	Electricity
	(U.S. dollars per liter)		*(U.S. dollars per MMBtu)*	*(U.S. dollars per KWh)*
Bahrain	0.38	0.32	2.75	0.04
Kuwait	0.19	0.39	1.50	0.01
Oman	0.42	0.43	3.00	0.04
Qatar	0.35	0.37	0.75	0.05
Saudi Arabia	0.22	0.10	1.50	0.10
United Arab Emirates	0.41	0.43	0.75	0.12
GCC average	0.33	0.34	1.71	0.06
GCC maximum	0.42	0.43	3.00	0.12
U.S. prices	0.51	0.45	2.18	0.10

Sources: Prices for GCC countries come from country authorities and are averages for 90 and 95 octane gasoline. U.S. gasoline (average for mid and high grade) and diesel prices come from the U.S. Energy Information Agency (EIA) and are adjusted for taxes. Natural gas price for the United States is the Henry Hub spot price. Electricity tariffs for the United States include taxes and come from EIA.
Note: GCC = Gulf Cooperation Council; MMBtu = 1 million British thermal unit; KWh = kilowatt hour.

Higher energy prices will help slow the region's rapid growth in energy consumption and will support fiscal adjustment. Energy consumption per capita in the GCC is not only high, but is also rising rapidly (in Qatar, Saudi Arabia, and the United Arab Emirates, in particular). The average estimated implicit cost of low energy prices for the six GCC countries based on 2016 prices ranges from 0.8 percent of GDP for the United Arab Emirates to over 7 percent of GDP for Kuwait (Table 1.3.2). The explicit cost of energy subsidies in the budget for the GCC region varies considerably across countries, but averages about 1 percent of GCC GDP (Table 1.3.3). The recent energy price reforms will support fiscal adjustment through the reduction in budget costs from explicit energy subsidies and/or through higher revenues from the domestic sale of energy products.

The GCC countries need to continue to ensure the success and sustainability of their energy price reforms. To this end, effective communication campaigns would be important to explain the rationale, objectives, and benefits of these reforms, inform the public of the pace of price increases, and introduce clear and transparent compensation measures to offset the impact of price increases on low-income households. A 2013 IMF study

Prepared by Malika Pant.

Box 1.3 *(continued)*

Table 1.3.2. GCC Implicit Energy Cost Estimates[1]
(Percent of GDP)

	2014	2015	2016
Bahrain	7.4	5.4	3.6
Kuwait	7.5	8.0	7.2
Oman	7.1	4.6	2.8
Qatar	5.0	4.5	3.5
Saudi Arabia	9.3	7.3	4.2
United Arab Emirates	2.4	1.3	0.8
GCC	6.7	5.3	3.4

Source: GlobalPetrolPrices.com; GCC countries' government agencies; International Energy Agency; U.S. Energy Information Administration; World Bank Commodity Price data; IMF staff calculations.
Note: GCC = Gulf Cooperation Council.
[1] The implicit cost of energy products—including gasoline, diesel, natural gas, and electricity—is estimated using the price gap methodology (2016 prices are averages for January–July 2016 or latest available) IMF (2015).

Table 1.3.3. GCC Explicit Energy Cost Estimates in the Budget[1]

	Billions of U.S. dollars	Percent of GDP
Bahrain	1.1	3.5
Kuwait	7.8	6.8
Oman	0.8	1.3
Qatar	1.2	0.7
Saudi Arabia	0.0	0.0
United Arab Emirates	…	…
GCC[2]	10.9	1.1

Sources: Country authorities; and IMF staff estimates.
Note: GCC = Gulf Cooperation Council.
[1] 2016 budget numbers are used for Bahrain and Oman; 2015 budget numbers are used for others. For Qatar, 2015 staff estimates are based on historical data.
[2] GCC total excludes United Arab Emirates.

covering major energy price reform episodes (during the period from early 1990s to 2010s) finds that, in most of these cases, countries relied on mitigating measures to protect the poor: targeted cash transfers or an expansion of existing social programs. In Armenia, Indonesia, and Jordan, transfer programs helped gain support for the reforms. Mitigating measures to help the productive sector included a gradual adjustment in prices (for instance, for natural gas in Bahrain), and financial support to selected enterprises to reduce energy intensity (Iran). Once prices have been raised, the introduction of an automatic pricing formula—as seen in Oman, the United Arab Emirates, and, more recently, Qatar, and, as announced, in Kuwait—may reduce the risk of the reforms being unwound while ensuring that changes in international prices are reflected in domestic prices in a timely manner.

Box 1.3 *(continued)*

Table 1.3.4. Recent Updates on Energy Price Reforms in the GCC

	Pre-oil price drop (before mid-2014)	Post-oil price drop (after mid-2014)
Bahrain	The gas price for existing industrial customers was increased by 50 percent, starting in January 2012, from $1.50 to $2.25 per MMBtu, while the price for new industrial customers remained at $2.50 per MMBtu (prices for new customers were increased from $1.30 to $2.50 in April 2010).	In March 2015, the authorities announced annual increases of $0.25 per MMBtu in the gas price for industrial users starting on April 1, 2015, until the price reaches $4 per MMBtu by April 2021. In March 2015, the authorities increased the fuel price in marine stations. The electricity and water tariff structure was adjusted for non-domestic users, increasing tariffs for higher consumption levels (October 2013). In January 2016, the authorities raised the retail price of gasoline by nearly 60 percent. Price increases for diesel, kerosene, liquified propane gas, and electricity and water tariffs are being phased in gradually by 2019. Bakeries and fishermen are exempt from the diesel and kerosene price increase, while a majority of Bahraini households and small businesses are exempt from higher electricity and water tariffs.
Kuwait	…	Kuwait doubled the price of diesel in January 2015. Authorities have approved and announced an increase in gasoline prices of about 70 percent, on average, effective September 2016. Additionally, a government committee will revise the new gasoline prices every three months depending on international oil prices. A law was recently passed by parliament to reform water and electricity subsidies. The new tariffs will become effective in May 2017.
Oman	In January 2015, the industrial price for natural gas doubled, following a 2013 agreement.	In 2016, the authorities implemented fuel subsidy reform, linking prices to international ones, with monthly revisions to consumer prices. Water tariffs were increased in March 2016 for government, commercial, and industrial users. There is also a proposal to increase electricity tariffs for these users.
Qatar	Qatar raised the pump prices of gasoline by 25 percent and of diesel by 30 percent in January 2011. Diesel prices were again raised in May 2014, by 50 percent.	In October 2015, water and electricity prices were raised and tiered according to consumption. In January 2016, gasoline prices were increased again by 30 percent. Authorities have set up a committee that makes recommendations on whether prices should be adjusted, based on global markets and regional developments, and prices were increased again slightly by 4 percent in August.
Saudi Arabia	Saudi Arabia increased the average price of electricity sold to non-individual users by more than 20 percent on July 1, 2010.	In December 2015, the authorities announced an increase in fuel prices (ranging from 10 percent to 134 percent increase) across most major energy and water products for businesses or households.

Source: Country authorities.
Note: MMBtu = 1 million British thermal units.

Box 1.3 *(continued)*

	Pre-oil price drop (before mid-2014)	Post-oil price drop (after mid-2014)
United Arab Emirates	The United Arab Emirates increased gasoline prices in 2010 to the highest level in the Gulf Cooperation Council. Dubai raised water and electricity tariffs by 15 percent in early 2011.	In August 2015, the United Arab Emirates reformed its fuel pricing policy by adopting a mechanism to adjust monthly gasoline and diesel prices against international prices. With this reform, gasoline prices were increased by 25 percent and diesel prices were reduced by 29 percent. Abu Dhabi is developing a comprehensive electricity and water consumption strategy, which led to an increase in tariffs in January 2015 (by 170 percent for water and by 40 percent for electricity). Water and electricity tariffs were increased again by 14–17 percent in January 2016. The authorities are planning to gradually phase out the remaining electricity, water, and gas subsidies, while protecting lower-tier consumers.

Source: Country authorities.
Note: MMBtu = 1 million British thermal units.

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MENAP Oil Exporters: Selected Economic Indicators

	Average 2011–12	2013	2014	2015	Projections 2016	2017
Real GDP Growth	**5.4**	**2.0**	**2.7**	**1.6**	**3.3**	**2.9**
(Annual change; percent)						
Algeria	3.7	2.8	3.8	3.9	3.6	2.9
Bahrain	5.1	5.4	4.4	2.9	2.1	1.8
Iran, I.R. of	4.3	–1.9	4.3	0.4	4.5	4.1
Iraq	…	7.6	–0.4	–2.4	10.3	0.5
Kuwait	5.5	0.4	0.6	1.1	2.5	2.6
Libya	7.1	–13.6	–24.0	–6.4	–3.3	13.7
Oman	3.8	3.2	2.9	3.3	1.8	2.6
Qatar	12.4	4.6	4.0	3.7	2.6	3.4
Saudi Arabia	4.3	2.7	3.6	3.5	1.2	2.0
United Arab Emirates	5.0	4.7	3.1	4.0	2.3	2.5
Yemen	3.0	4.8	–0.2	–28.1	–4.2	12.6
Consumer Price Inflation	**7.5**	**10.4**	**5.8**	**5.5**	**4.7**	**4.2**
(Year average; percent)						
Algeria	3.8	3.3	2.9	4.8	5.9	4.8
Bahrain	1.5	3.3	2.7	1.8	3.6	3.0
Iran, I.R. of	16.3	34.7	15.6	11.9	7.4	7.2
Iraq	17.0	1.9	2.2	1.4	2.0	2.0
Kuwait	3.2	2.7	2.9	3.2	3.4	3.8
Libya	5.4	2.6	2.8	14.1	14.2	12.5
Oman	2.8	1.2	1.0	0.1	1.1	3.1
Qatar	4.5	3.1	3.4	1.8	3.0	3.1
Saudi Arabia	2.1	3.5	2.7	2.2	4.0	2.0
United Arab Emirates	4.5	1.1	2.3	4.1	3.6	3.1
Yemen	11.6	11.0	8.2	39.4	5.0	18.0
General Gov. Overall Fiscal Balance	**6.7**	**4.3**	**–0.7**	**–9.5**	**–9.2**	**–6.2**
(Percent of GDP)						
Algeria	3.9	–0.9	–8.0	–16.8	–13.3	–9.5
Bahrain[1]	0.0	–5.4	–5.8	–15.1	–14.7	–11.7
Iran, I.R. of[2]	1.9	–2.2	–1.2	–2.0	–1.1	–1.0
Iraq	…	–5.8	–5.6	–13.7	–14.1	–5.1
Kuwait[1]	28.5	34.3	28.1	1.5	–3.6	3.2
Libya	12.7	–4.0	–40.3	–52.5	–56.6	–43.8
Oman[1]	9.2	4.7	–1.1	–16.5	–13.5	–10.3
Qatar	9.3	22.2	15.0	5.4	–7.6	–10.1
Saudi Arabia	8.2	5.8	–3.4	–15.9	–13.0	–9.5
United Arab Emirates[3]	11.1	10.4	5.0	–2.1	–3.9	–1.9
Yemen	–2.7	–6.9	–4.1	–10.6	–11.3	–5.5
Current Account Balance	**13.4**	**15.1**	**8.3**	**–3.8**	**–4.4**	**–1.8**
(Percent of GDP)						
Algeria	13.5	0.4	–4.4	–16.5	–15.1	–13.7
Bahrain	6.3	7.4	4.6	–3.1	–4.7	–3.8
Iran, I.R. of	4.9	7.0	3.8	2.1	4.2	3.3
Iraq	…	1.4	–0.8	–7.2	–10.8	–3.6
Kuwait	32.8	39.9	33.3	5.2	3.6	8.4
Libya	24.4	13.5	–27.8	–42.1	–47.4	–36.9
Oman	9.1	6.7	5.7	–17.5	–21.3	–17.6
Qatar	20.0	29.9	23.5	8.2	–1.8	0.0
Saudi Arabia	16.7	18.2	9.8	–8.3	–6.6	–2.6
United Arab Emirates	12.5	19.1	10.0	3.3	1.1	3.2
Yemen	0.2	–3.1	–1.7	–5.5	–6.1	–2.8

Sources: National authorities; and IMF staff estimates and projections.

Note: Variables reported on a fiscal year basis for Iran (March 21/March 20).

[1]Central government.

[2]Central government and National Development Fund excluding Targeted Subsidy Organization.

[3]Consolidated accounts of the federal government and the emirates Abu Dhabi, Dubai, and Sharjah.