Middle East and Central Asia
October 2010 Regional Economic Outlook Highlights
International Monetary Fund

With the global economy on the mend, prospects for the Middle East and Central Asia region have improved.[1] Almost every country in the region is projected to grow faster in 2010 and 2011 than in 2009. Given this pickup in growth, most of the region's countries plan to exit from fiscal stimulus by 2011, while maintaining an accommodative monetary policy stance for some time. However, some countries may need to tighten macroeconomic policies earlier, given signs of inflationary pressures or lack of fiscal space.

As the region recovers from the Great Recession, policy attention should center on strengthening banking sectors and addressing medium-term challenges. In the MENAP oil exporters, further efforts at financial sector development and economic diversification top the agenda. In the MENAP oil importers, raising growth and creating jobs for expanding populations are key. In the CCA, the priority is to resolve banking sector problems, and, in some countries, to reduce external debt and current account deficits.

MENAP Oil Exporters: Well-Placed to Focus on Medium-Term Challenges

MENAP oil exporters' fiscal and external balances will improve markedly in response to rising oil prices (up from US$62 per barrel in 2009 to US$76 in 2010 and US$79 in 2011) and oil production levels. The combined external current account surplus of these countries is expected to increase to US$120 billion in 2010 and US$150 billion in 2011 from US$70 billion in 2009. In the Gulf Cooperation Council (GCC) alone, the improvement is estimated at about US$50 billion from 2009 to 2011.

Oil GDP growth—projected at 3½–4½ percent in 2010 and 2011—is likely to stay below precrisis levels. Moreover, while external financing conditions have improved, domestic credit is picking up only slowly, and investment demand is subdued. As such, growth in non-oil activity remains lackluster at 3¾–4½ percent, indicating a need for continued policy support through 2011 in most countries.

Most countries with fiscal space—mainly the GCC, Algeria, and Libya—target additional fiscal stimulus in 2010 and 2011. But some, including Saudi Arabia, are seeing inflation picking up, which may call for a tempering of stimulus in 2011. Iran, Sudan, and Yemen have less fiscal space and have already embarked on fiscal consolidation. In most countries, monetary policy remains expansionary to revive private-sector credit growth, although some central banks are starting to unwind their quantitative easing.

Over the medium term, all oil producers—to differing degrees—will need to pursue fiscal consolidation to safeguard the sustainable use of hydrocarbon revenues, while promoting diversification and employment creation. Measures to support these goals include reorienting spending toward social and development needs, revisiting energy subsidies, and diversifying the revenue base.

Banking system development requires continued attention. Nonperforming loans remain elevated in a number of countries. Regulatory frameworks and supervision should be strengthened in line with global efforts to reduce regulatory cyclicality, strengthen liquidity and capital buffers, address systemically important

[1] The Middle East and Central Asia region comprises Middle East, North Africa, Afghanistan, and Pakistan (MENAP) oil-exporting countries; MENAP oil-importing countries; and the Caucasus and Central Asia (CCA).

institutions, and enhance bank resolution practices. Saudi Arabia's countercyclical provisioning provides an example of successful implementation of such macroprudential policies.

MENAP Oil Importers: Adjusting to New Global Growth Patterns

MENAP oil importers have weathered the global recession well, and are close to their long-term growth trend. Most countries are set to grow by 3½–5½ percent in 2010–11. Pakistan suffered from devastating floods in July/August, which will hold back growth this year.

The region has also remained resilient to recent turbulence in global financial markets. Private-sector credit is picking up, though banks in some countries still need to address elevated nonperforming loan ratios.

Governments across the region are appropriately withdrawing stimulus in 2010 and 2011, and gearing fiscal policy toward further reducing government debt.

Over the next decade, the Maghreb and Mashreq alone will need to create more than 18 million jobs to absorb new labor market entrants and eliminate chronic and high unemployment. This would require an average annual growth rate of over 6 percent—given the labor market's weak responsiveness to growth—compared with the 4½ percent achieved in the last decade.

The key to addressing these challenges is to raise competitiveness. Governments need to strengthen business environments and enhance the functioning of labor markets by improving educational outcomes and ensuring that wages better reflect market conditions. In addition, at a time when the region's traditional trading partners in Europe are growing more slowly, MENAP oil importers should view fast-growing emerging market economies not only as competitors for export markets, but also as partners for profitable collaboration along global supply chains.

Caucasus and Central Asia: Challenges beyond the Crisis

Growth is projected to rebound to 4–6 percent in 2010 and 2011 in most CCA countries, but it will take time for disposable income to recover to precrisis levels. The exceptions are Uzbekistan and Turkmenistan, where growth is expected to reach about 10 percent, and, on the other side, the Kyrgyz Republic which suffered a growth setback due to the political and ethnic conflict in spring 2010.

Most CCA countries are exiting from fiscal stimulus in 2010 or 2011. For the oil and gas importers, this move should help restore policy room to respond to future shocks. Fiscal consolidation—in particular in Armenia and Georgia—is also needed to address high external debt levels and current account deficits, some of which are the result of the policy response to the crisis. Turkmenistan and Uzbekistan continue to provide fiscal stimulus in 2010, despite strong growth (and already high inflation in Uzbekistan).

Monetary policy has limited effectiveness in the CCA economies, as witnessed in 2008–09. This is mainly because of low financial market development and high dollarization. A number of countries are implementing reforms to strengthen the monetary policy tool kit, for example, by developing government securities markets. Countries should also allow for greater exchange rate flexibility to promote dedollarization.

Banking sectors in a number of CCA countries are not yet out of the woods. Nonperforming loans are high or rising in Kazakhstan, the Kyrgyz Republic, and Tajikistan. These countries need to adopt comprehensive and transparent resolution strategies to restore banking sector health. They will also need to enforce stricter lending standards to safeguard asset quality, which, along with macroeconomic stability, will put banking sectors on a sounder footing.