# 1. MENAP Oil Exporters: Increasing Diversification, Reducing Reliance on Oil-Funded Spending

*Intensified conflicts in Iraq and Libya have led to a downward revision in the 2014 growth projections for the MENAP oil exporters by ¾ of a percentage point compared with the May 2014* Regional Economic Outlook *Update. At 2½ percent, growth in the oil exporters is expected to edge up only slightly from last year, supported by recovery in Iran and continued solid growth in the GCC countries. Growth is expected to strengthen to about 4 percent next year, assuming that security improves and oil production in non-GCC countries, particularly Libya and Iraq, recovers. In the current security environment, these projections are subject to heightened uncertainty. Declining oil revenues and rising government spending are weakening fiscal positions. Consolidation would build resilience against oil price declines and help countries share their oil wealth with future generations. Some non-GCC countries face the pressing need to draw on their savings over the near term to meet essential expenditures. Reducing the dependence of sustained economic growth on rising oil prices requires structural reforms that promote economic diversification and inclusive growth.*

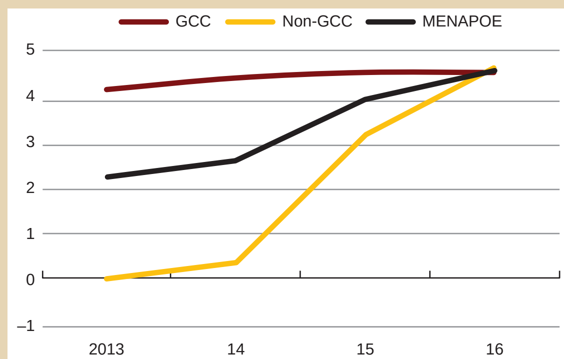
## Rising 2015 Growth Depends on Improving Security

Economic growth is expected to edge up only by ¼ of a percentage point to 2½ percent this year. Growth projections have been revised down by ¾ of a percentage point relative to the May 2014 *Regional Economic Outlook* (REO) Update projections, mainly reflecting declining activity in Iraq and Libya owing to intensified conflicts. The contrast in economic performance between GCC and non-GCC countries in 2014 sharpened because the conflicts have caused additional setbacks to oil production in Iraq and Libya, while economic activity in GCC members has been stronger than expected as these countries compensated for shortfalls in oil production in non-GCC countries and, also, increased their fiscal spending (Figure 1.1). Growth is projected to strengthen to about 4 percent in 2015, driven by an expected turnaround in non-GCC oil production, which is contingent on improvements in security.

Figure 1.1

**Growth to Rise on Delayed Non-GCC Recovery**

*(Real GDP, annual percentage change)*




Sources: National authorities; and IMF staff calculations.

- GCC countries are expected to record growth of 4½ percent in 2014 and 2015. Oil production is projected to rise slightly beyond the current (already high) levels as these countries respond to supply disruptions outside the GCC. Growth in the non-oil sectors will remain high at about 6 percent in 2014 and 2015. Rising government capital expenditure and public sector salaries, along with ample private sector credit expansion in many countries, are supporting domestic consumption and investment. Public infrastructure megaprojects, especially in Qatar, Saudi Arabia, and the United Arab Emirates, are expected to continue to fuel strong expansions in tourism, transport, construction, and wholesale/retail trade.

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- By contrast, deteriorating security conditions in some non-GCC countries have led to a 2¼ percentage point downward revision in the non-GCC growth forecast for 2014 to ¼ percent, despite a return to positive growth in Iran. Militants' occupation of important cities in northern Iraq is expected to reduce Iraq's GDP by 2¾ percentage points in 2014 (Box 1.1), ongoing political turmoil and conflict have again disrupted Libya's oil production, and Yemen is enduring sabotage of oil facilities as well as a drought. Iran's economy is beginning to show signs of recovery following the sanctions-induced 2012–13 recession, but the recovery remains fragile. Non-GCC growth could rise to about 3 percent in 2015, provided security conditions allow a rebound in oil production in Iraq, Libya, and Yemen. This assumption is subject to considerable uncertainty, however, as discussed below.

Softening international food prices will help contain inflation despite rising economic growth rates. This is consistent with patterns in recent years, when faster economic growth did not trigger higher inflation (Figure 1.2).

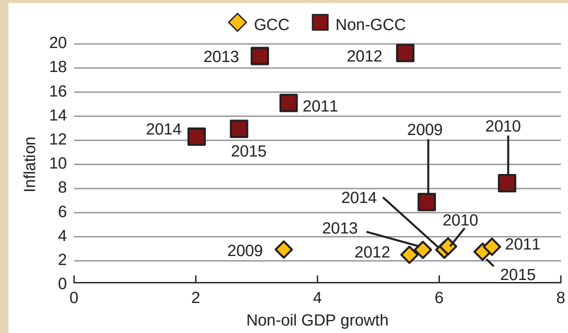
- In the GCC countries, pegged exchange rates, a benign global inflationary environment, reliance on imports, and employment of abundant migrant labor in the nontradable sectors are expected to keep inflation close to 3 percent despite rising housing costs and rapid credit growth in some countries. Real exchange rates have been relatively stable (Figure 1.3).

- In many non-GCC countries, higher inflation has been driven by shortages induced by supply shocks caused by conflict, trade disruptions, or adverse weather. Real exchange rate appreciation has been the result in many countries. As Iran begins to recover from stagflation, a fall in its inflation rate will bring down the non-GCC inflation aggregate to about 12 percent in 2014. However, ceilings on deposit interest rates and subsidy reform in

Figure 1.2

## Faster Growth Has Not Prompted Higher Inflation

*(CPI inflation and non-oil GDP growth, percent)*

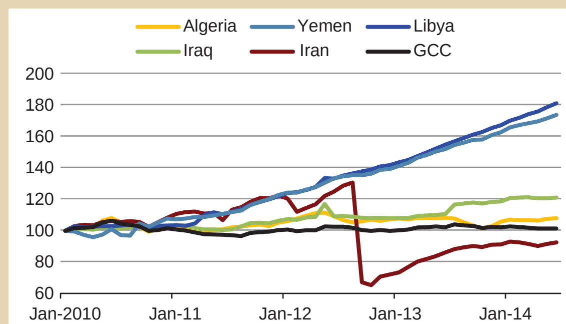



Sources: National authorities; and IMF staff calculations.
Note: CPI = consumer price index.

Figure 1.3

## MENAP Oil Exporters: Real Effective Exchange Rates

*(Index January 2010 = 100)*




Sources: National authorities; and IMF staff calculations.

Iran, a drought and a recent fuel price increase in Yemen, and shortages in Iraq are expected to keep aggregate non-GCC inflation high at about 13 percent in 2015.

Strong macroeconomic fundamentals and institutional changes have drawn capital inflows to the GCC. Credit default swap spreads and long-term yields have been falling since the start of 2014. Similarly, GCC stock markets showed strong gains in the first half of the year, especially in the United Arab Emirates, where the Dubai index rose by more than 50 percent in the first four months before experiencing a correction. The GCC has

**Box 1.1**

## Economic Implications of the Iraq Conflict

**In Iraq, the conflict and humanitarian crisis intensified during the summer.** Islamic State (IS) militants consolidated their control over regions in the north and west and the border with Syria. Their attacks on areas controlled by the Kurdistan Regional Government and their persecution of religious minorities prompted air raids by the United States. As of August, more than 10,000 persons had been killed and approximately 1.8 million Iraqis have been displaced so far in 2014, their numbers adding to the 225,000 Syrian refugees who had fled to Iraq from the ongoing, devastating conflict in Syria (see Box 1 in the May 2014 *Regional Economic Outlook* [REO] Update).

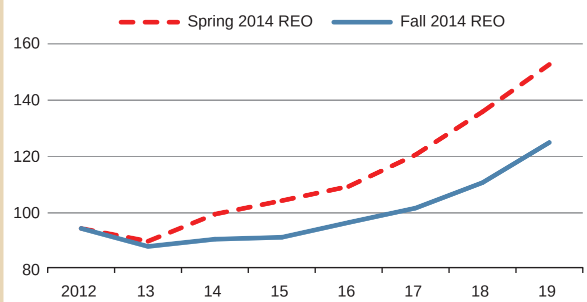
**As a result of the fighting, the economy is likely to contract in 2014.** The conflict has halted the expansion of Iraq's oil production, which is expected to decline slightly to 2.9 mbd, while exports of 2.4 mbd should remain close to last year's level. Non-oil GDP growth will also likely move to negative territory, compared to growth of over 7 percent in 2013, as fighting undermines confidence, disrupts the supply of fuel and electricity, increases trade and distribution costs, and depresses investment. The government budget is under pressure from security spending and the humanitarian crisis, while oil revenues are subdued; however, foreign exchange markets have remained stable despite reports of some deposit withdrawals.

**The crisis is delaying medium-term plans to ramp up oil production.** The near-term impact of the conflict on oil production and exports appears for the moment contained. Higher exports from the southern fields (which are far from the fighting) have so far compensated for the volumes lost to the sabotage of the northern pipeline. However, the deterioration of security will harm the technical and administrative ability to expand oil production and exports over the medium term (Figure 1.1.1). Oil production is now expected to reach only 4.4 mbd in 2019, compared with the May 2014 REO projection of 5.6 mbd.

Figure 1.1.1

Iraq: Medium-Term Oil Exports

*(Billions of U.S. dollars)*




Sources: Iraqi authorities; and IMF staff calculations.

### Regional Spillovers

**The conflict in Iraq could affect the region through multiple channels:**

- **Security disruptions may weaken confidence.** The conflict in Syria and Iraq could affect security conditions in other countries in the region—primarily Jordan, Kuwait, and Lebanon—depressing domestic consumption, harming tourism, and discouraging domestic and foreign investment.
- **The closure of border crossings is hampering regional trade.** Increasing violence and border shutdowns have blocked trade routes, impeding exports to Iraq from Jordan, Lebanon, and Syria. Iraq's oil exports to Jordan have been halted since January 2014. Turkey's exports to Iraq (about 8 percent of Turkey's total) have slumped in recent months. Turkish exports would be further damaged by the closure of trade routes to the Gulf through Iraq. Iranian exports to Iraq may have compensated for some of the decline in imports from these countries—Iraq has become the largest buyer of Iranian non-oil exports.
- **Further fighting may intensify refugee flows across the region.** The Mashreq region has seen very large flows of Syrian refugees, now numbering about 2.9 million, who are concentrated in Lebanon (1.2 million) and Jordan (more than 600,000); other important destinations are Iraq and Turkey. Humanitarian and economic pressures on these and other countries in the region would be intensified by large refugee inflows from an escalation of hostilities in Iraq.
- **Direct financial linkages are limited.** Several foreign banks are active in Iraq, but their operations are generally small and focused on trade financing.

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**Box 1.1** *(concluded)*

**Global Implications**

**Although the global implications under current baseline projections would be contained, the conflict (should it spread so far as to disrupt oil exports) could lift oil prices and reduce global growth.**

- Barring a drastic intensification of the conflict, the near-term decline in global oil exports is expected to be small: Iraq has been able to keep exports steady, and Saudi Arabia has significant spare capacity to compensate for any remaining shortfalls.
- The medium-term impact is also expected to be contained. Amid likely stagnant demand for OPEC crude over the medium term (November 2013 REO, Annex I), Iraq's smaller than previously expected contributions to expanding OPEC spare capacity will ease downward pressure on other OPEC members' output decisions and on global oil prices.
- By contrast, under a downside scenario that envisions a spread of the conflict to Baghdad and the south, Iraq's oil exports could fall by half (roughly 1½ percent of global oil consumption) from current levels, with only half of that decline offset by higher production from global spare capacity (*World Economic Outlook*, October 2014). In such an event, the oil price could rise substantially, depending, in part, on whether ongoing supply disruptions in other countries keep global oil markets so tight that Iraq's disruption would lead to substantially higher precautionary demand for oil inventories. In the scenario, the oil price is assumed to rise by 20 percent in the first year and return to the baseline as the supply disruption unwinds over three years. The oil price spike could lead to reduced appetite for risk in financial markets because confidence effects could affect global equity prices. The combined effects of higher oil prices and reduced appetite for risk could leave global economic output 1½ percent lower than in the baseline scenario after two years.

been viewed as a relatively safe destination for capital during periods of global financial market volatility (Box 1.2) and regional turmoil.

Banking systems have generally remained sound. In many countries, high capitalization, stable profitability, and low nonperforming loans limit risks. Private sector credit has been expanding faster than economic activity in many countries, which may indicate recovery from the global financial crisis and a welcome sign of capital deepening; however, in some countries, fast credit growth, high loan concentrations, and corporate governance deficiencies warrant vigilance. In most non-GCC countries, banking systems remain underdeveloped and/or affected by broader security issues. Islamic banking has expanded rapidly, particularly in the GCC, but risk management capabilities are still developing and regulatory, and supervisory frameworks are not yet tailored to address risks specifically related to Islamic finance.

## Oil Price Risks Remain Balanced, but Geopolitical Risks Have Risen

Amid persistent downside risks to global oil demand and two-way uncertainty about oil supply (estimated at about 2 mbd or about 2 percent of global oil supply each way), options markets perceive oil price risks as broadly balanced. Although intensified geopolitical risks point mainly to the upside for oil prices, there are also significant downside risks related to higher global supply and lower global demand. With a one-in-three chance that the oil price will be above US$112 or below US$87 in the middle of 2015, countries are vulnerable to oil price declines, as increased government spending has raised breakeven oil prices in most countries (Figure 1.4).

- The difficult and rapidly evolving security situation could lead to further supply disruptions in non-GCC countries, raising

**Box 1.2**

## Capital Flows to GCC Countries

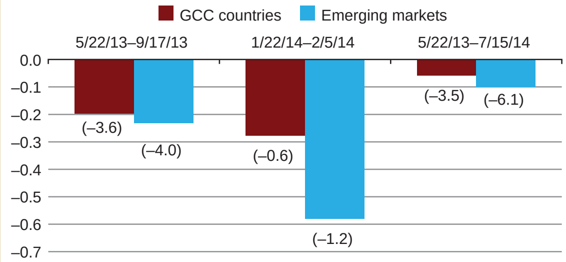
*GCC countries are among the largest recipients of private portfolio flows in the MENAP region. In recent episodes of rising global risk aversion, the GCC countries' strong external positions have led investors to view them more favorably than the broader emerging market asset class.*

Although capital flows to GCC countries have generally been correlated with capital flows to other emerging markets, this relationship has weakened since the U.S. Federal Reserve in May 2013 unveiled plans to taper its asset purchases. Measured by estimated portfolio flows through July 2014, the cumulative impact of tapering and emerging market volatility since May 2013 was less negative for GCC countries. Cumulative outflows during the period amounted to US$780 million (0.05 percent of GDP or 3.5 percent of assets under management [AUM]), compared with cumulative outflows in other emerging markets of US$79 billion (0.35 percent of GDP or 6.1 percent of AUM) (Figure 1.2.1).[1]

Figure 1.2.1

### Net Portfolio Flows[1]

*(One-week equivalent flows, percent of assets under management; cumulative flows in parentheses)*




Sources: EPFR Global; and IMF staff calculations.
[1]Portfolio flows are represented by EPFR equity and bond fund flows.

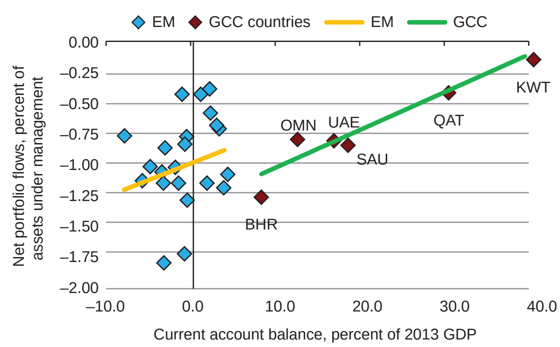
In the period following the tapering announcement, from May to September 2013, weekly bond and equity outflows from GCC countries were broadly in line with weekly outflows from other emerging markets. Pressures eased in September 2013, when the U.S. Federal Reserve surprised markets by delaying tapering, but resumed in late January/early February 2014 triggered by concerns about emerging market fundamentals and vulnerabilities.[2] During the latter period, GCC countries were markedly less affected: portfolio outflows were only half those from other emerging markets. After this period of volatility, outflows continued more slowly into March, but funds flowed back to the GCC and other emerging markets during the second quarter of 2014.

In the period since May 2013, investor sentiment toward emerging markets was at first broadly negative, but investors increasingly began to distinguish more among emerging markets.

In particular, there was no discernible relationship between fundamentals and outflows in the first episode, but countries with stronger fiscal or external positions experienced milder outflows in the second period (IMF *Global Financial Stability Report*, April 2014). The GCC countries stand out from other emerging markets, simultaneously exhibiting much higher external surpluses and smaller outflows of capital (Figure 1.2.2). Moreover, mimicking the pattern within other emerging markets, outflows were lowest among GCC countries where surpluses were highest. The strength in GCC countries' external sectors thus appears to have been an important factor explaining the limited capital outflows during the second period of volatility.[3]

Figure 1.2.2

### Second Period (1/22/14–2/5/14): Net Portfolio Flows[1] and Current Account Balance




Sources: EPFR Global; and IMF staff calculations.
Notes: EM = emerging markets.
[1]Portfolio flows are represented by EPFR bond and equity fund flows.

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[1] Portfolio flows to GCC countries tend to be lower as a percentage of GDP than in other emerging markets, and thus have less of an impact on these economies. The data source (EPFR) covers only a subset of total portfolio flows to the GCC and other emerging markets but is commonly used as a proxy.

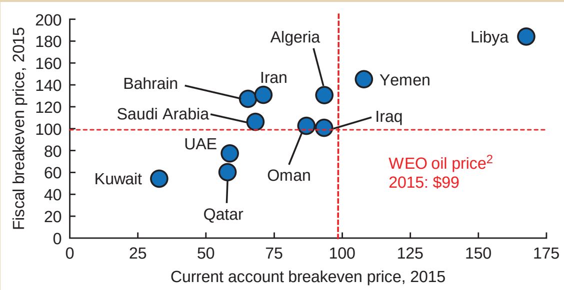
[2] This period covers the most volatile weeks in the early 2014 sell-off, as measured by market-based indicators such as volatility and emerging market bond and equity indexes.

[3] Institutional changes, for example the inclusion of Qatar and the United Arab Emirates in the MSCI Emerging Markets Index in May 2014, are also supporting capital inflows.

Figure 1.4

**Oil Price Uncertainties Increase Vulnerabilities**

*(Breakeven prices, U.S. dollars per barrel)*[1]




Sources: National authorities; and IMF staff calculations.
Note: WEO = World Economic Outlook database.
[1]2013 breakeven prices for Yemen.
[2]Simple average of U.K. Brent, Dubai, and West Texas Intermediate spot prices.

oil prices. Escalation of the civil war in Iraq could disrupt oil exports and even spill over to other oil producers. In Libya and Yemen, the expected recovery in oil production could once again be derailed if the security situation does not improve. In the case of a breakdown of rapprochement between Iran and the P5+1,[1] intensified sanctions could further reduce Iran's oil exports. In a highly unlikely event that all risks materialize simultaneously, about 2 mbd of non-GCC oil supply could be in jeopardy. Moreover, owing to possible additional sanctions on Russia, hydrocarbon prices could face additional upward pressure from actual or feared reductions in Russian oil and gas exports. Price increases could be mitigated if other oil producers in the Middle East, particularly Saudi Arabia, were to step up their oil production in response.[2]

- By contrast, oil prices could face downward pressure from higher-than-expected oil supply. Non-GCC oil output could beat expectations. For example, improvements in Iran's external environment would enable it to export almost 1 mbd more oil than currently expected and could restore non-oil activity sooner, with a significant impact on the region. Iraq and Libya's 2015 oil production could recover more quickly than projected if their security situation improves rapidly. U.S. oil output could again surprise on the upside, and recent changes in regulatory regimes have increased the prospect that other countries could replicate the United States' successful exploitation of unconventional oil and gas resources over the medium term. These possibilities, which combined represent possibly 2 mbd of additional oil supply in the short term, entail downside risks for the region's oil revenues.

- In addition, global oil demand could suffer from lower global growth in the case of a sudden worsening of financial market conditions or a protracted weak recovery.

Risks to the non-oil economy include intensification of conflict and policy inertia. Importantly, a full-fledged civil war in Iraq would acutely damage non-oil activity there and in neighboring countries (Box 1.1).

## Falling Oil Revenues and Rising Government Spending Are Weakening Fiscal Positions

Although countries appropriately supported demand during the global recession, cyclical conditions now warrant a return to fiscal consolidation in some cases, particularly where monetary policy remains accommodative under pegged exchange rates. In the GCC, years of fast growth since the global financial crisis, rising asset prices, rapid credit growth in some countries, and accommodative global monetary conditions call for a return to fiscal consolidation, supported by macroprudential measures to address overheating risks if needed (Arvai, Prasad, and Katayama 2014). Amid oil revenue and other shocks, many non-GCC countries face the immediate and more difficult task of supporting

[1] The P5+1 comprises the five permanent members of the UN Security Council (China, France, Russia, the United Kingdom, the United States) plus Germany.

[2] On several occasions during periods of global oil supply shortages, Saudi Arabia, with its high spare oil production capacity of 2.7 mbd, has responded by increasing production (see Box 4, Chapter 3, 2014 IMF *Spillover Report* [2014a]).

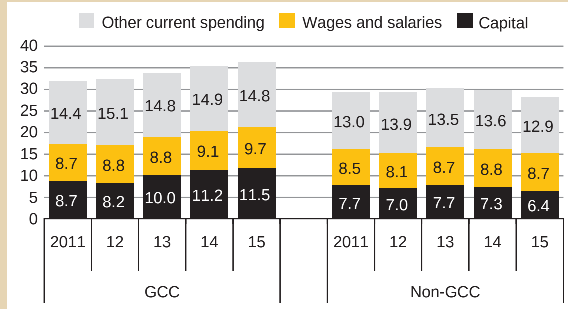
demand with limited resources. For example, Iraq and Libya are, of necessity, drawing on previously accumulated oil wealth to meet essential spending needs, but Algeria should take advantage of its relatively favorable near-term economic outlook and start reducing its deficit. Fiscal consolidation would build resilience against future shocks and help remedy deteriorating fiscal positions:

- Oil revenues have stopped rising, but government spending has not. Although oil supply disruptions have allowed oil prices to stay higher than expected, they have hovered at about US$105 a barrel since 2011, and financial markets continue to predict they will decline over the medium term. In addition, oil production disruptions in most non-GCC countries, maturing fields, and small non-oil receipts combine to reduce revenue by an estimated 3½ percentage points of GDP between 2011 and 2015. In contrast, government spending is forecast to have risen by 7 percent per year in real terms between 2011 and 2015—an increase of 2 percentage points as a share of GDP, much of it on hard-to-reverse current spending items (Figure 1.5).

- Fiscal balances are forecast to deteriorate (Figure 1.6). Notably, Saudi Arabia is expected to run a central government fiscal deficit as early as 2015. In aggregate, after reaching a peak of 7¾ percent of GDP in 2012, the oil exporters' fiscal surplus is expected to be only 1¼ percent in 2015 and to vanish by 2017 (Figure 1.7). Even if oil prices remain at their peak 2014 levels, fiscal balances will deteriorate if policies do not change. Moreover, an unanticipated additional 1 mbd of oil supplied from outside the MENAP region from 2015 onward could, by one estimate, lead to an approximately 12 percent fall in oil revenues, which would likely weaken fiscal balances by 3 percent of GDP.[3]

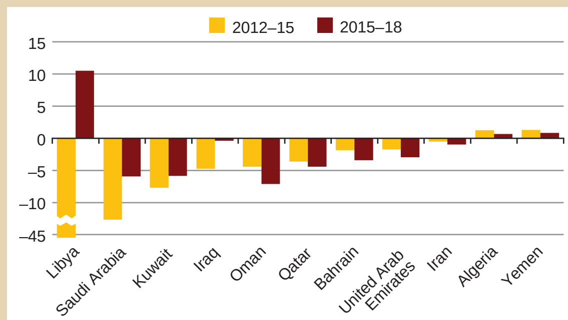
[3] For additional supply from within the region, the negative oil price effect on fiscal balances would likely outweigh the positive effect of higher oil production.

Figure 1.5
## Wages and Capital Raise GCC Government Spending
*(Percent of GDP)*



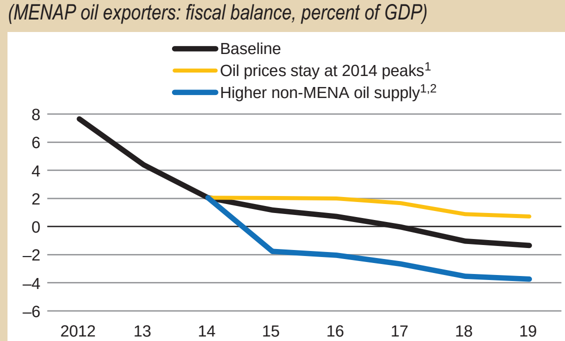

Sources: National authorities; and IMF staff calculations.

Figure 1.6
## Fiscal Positions Are Weakening
*(Change in fiscal balance,[1] percent of GDP)*




Sources: National authorities; and IMF staff calculations.
[1]Central government fiscal balance for Saudi Arabia and Oman.

Figure 1.7
## High Oil Prices Will Not Save Fiscal Positions
*(MENAP oil exporters: fiscal balance, percent of GDP)*

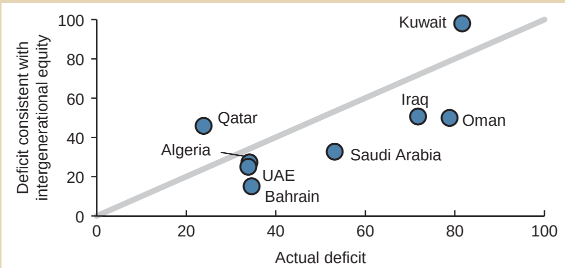



Sources: National authorities; and IMF staff calculations.
[1]Assuming no policy response.
[2]Unanticipated increase of 1 mbd, starting 2015.

Figure 1.8

## Nonhydrocarbon Deficits Are Too High for Intergenerational Equity in Most Countries

*(Nonhydrocarbon primary deficit, percent of nonhydrocarbon GDP, 2013)*

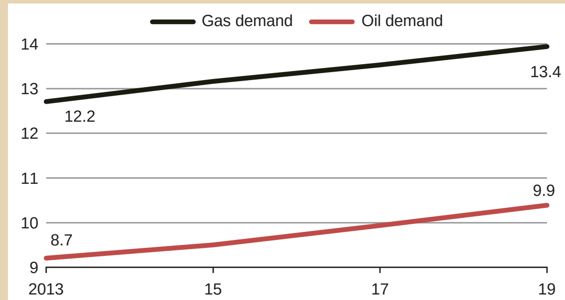



Sources: National authorities; and IMF staff calculations.

Figure 1.9

## Oil and Gas Consumption Are Growing

*(Middle East: oil and gas demand as a share of global demand, percent)*




Source: International Energy Agency.

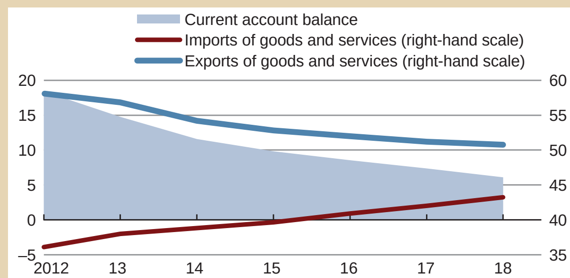
- Although the deterioration in fiscal positions is common among most oil exporters, fiscal positions are generally stronger in the GCC countries. Qatar and Kuwait currently have substantial buffers and long-lasting hydrocarbon resources. So do the United Arab Emirates and Saudi Arabia, but these countries are not yet saving enough wealth for future generations (Figure 1.8). Algeria, Bahrain, Oman, and Yemen have shorter resource horizons and weaker fiscal positions than the above-mentioned countries. Iran, Iraq, and Libya have long resource horizons but have limited financial buffers to support aggregate demand in the face of shocks to oil exports.

Echoing trends in fiscal balances, external current account balances are forecast to decline. Given demographic trends, economic structures, and low domestic energy prices, Middle East oil exporters are expected to sustain gas consumption growth that outpaces the rest of the world (Figure 1.9), restraining hydrocarbon export growth in most cases. With non-oil exports failing to compensate and demand for imports rising, external current account balances are forecast to decline from a peak of 18½ percent of GDP in 2012 to less than half that value in 2016 (Figure 1.10). Surpluses are already too low to accumulate the external wealth needed to pay for the import needs of future generations once oil export revenues dry up.

Figure 1.10

## Current Account Balances Are Falling

*(MENAP oil exporters; percent of GDP)*




Sources: National authorities; and IMF staff calculations.

To strengthen their fiscal positions, most countries need to reform energy subsidies, raise non-oil revenues, and strengthen systems for controlling budget spending.

- Rationalizing energy subsidies while protecting those in need would generate budgetary resources that could be used for strengthening fiscal positions or increasing priority expenditures. Moreover, it would encourage greater energy efficiency. Some countries, notably Yemen, have already made progress in addressing large energy subsidies.

- Non-oil revenues among oil exporters in the MENAP region tend to be lower than those of other oil exporters. Collecting more non-oil revenues can help increase resilience to oil market developments.

- A medium-term fiscal framework, informed by realistic oil price assumptions and supported by new or upgraded macrofiscal units, would more effectively anchor actual spending decisions and mitigate the risk of overruns.

## Growth from Diversification, Not Rising Oil Prices

The favorable short-term growth outlook appears less positive when placed in historical perspective. In 2002–08, for example, non-oil GDP growth rates exceeded 8 percent and coincided with strong employment growth. Oil prices almost quadrupled from US$25 a barrel over the same period. This episode of repeated and large rises in oil prices is unlikely to recur in the future.

Empirical evidence suggests that high rates of GDP growth in commodity exporters are driven much more by concurrent *growth* in commodity prices than by high levels of commodity prices (Gruss, 2014). Regression analysis for MENAP oil exporters suggests that the relationship of non-oil GDP growth to oil price growth is five times stronger than it is to oil price levels (Figure 1.11). Rising oil prices tend to prompt higher government spending, raising non-oil GDP growth, but only in the short term (Husain, Tazhibayeva, and Ter-Martirosyan 2008).

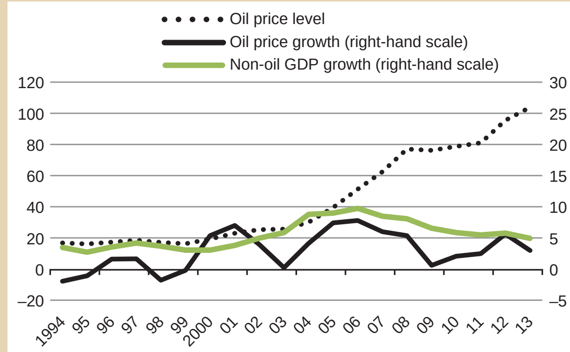
On current policies and in the absence of rapid and sustained oil price rises, medium-term non-oil GDP growth can only be supported at the cost of unsustainable fiscal policies. Non-oil growth is in most cases concentrated in service sectors that rely on demand generated by oil revenues; moreover, in many cases, productivity in the non-oil economy has been declining (Annex I). The existing model will not be able to generate enough jobs to absorb the growing population into the workforce, making more urgent the need to generate inclusive growth based on diversification and private sector job creation.

In the GCC, the business environment is favorable by international standards, infrastructure gaps are small, and the efficiency of high capital spending is comparable with that in other countries (Annex II).

Figure 1.11

GDP Growth Relies on Rising Oil Prices

*(Brent oil price and non-oil GDP three-year moving averages)*

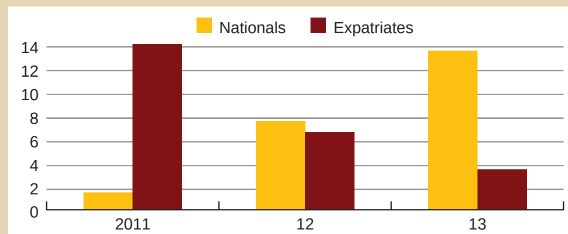



Sources: National authorities; and IMF staff calculations.

Figure 1.12

Signs That Labor Market Reforms Are Bearing Fruit?

*(GCC[1] private sector employment, percent change)*




Sources: National authorities; and IMF staff calculations.
[1]Bahrain, Kuwait (data to June 2013), Oman, and Saudi Arabia (data to June 2013).

Moreover, labor market reforms in Saudi Arabia[4] and elsewhere are under way (Figure 1.12). To build on this progress, further measures can include:[5]

- ***Improving education quality.*** Although enrollment rates and education spending are high, education quality is low by global standards. Improved education provision and coordination with employers to provide

[4] "Saudi Arabia: 2014 Article IV Consultation," IMF Country Report No. 14/292 (Washington, 2014).

[5] For a detailed assessment of policies to support diversification in the GCC, see Cherif and Hasanov (2014), and the proceedings of the conference "Economic Development, Diversification, and the Role of the State" in Kuwait, April 2014 (http://www.imf.org/external/np/seminars/eng/2014/mcd/).

on-the-job training can—over time—encourage firms to hire nationals in the private sector and raise productivity. Well-designed active labor market policies can be equally important.

- ***Restraining growth in public wage bills and incentivizing GCC men and women to seek private sector jobs.*** The public sector pays high wages and is the employer of first and last resort, which creates distortions by raising nationals' reservation wages for private sector employment. Moreover, as discussed earlier, public sector hiring is a fiscally unsustainable job creation mechanism, yet wage bills are high by international standards (Figure 1.13) and are rising as a share of GDP (Figure 1.5). Steps to increase female labor force participation (see Box 1.3, November 2013 *Regional Economic Outlook*) and conditioning unemployment assistance on active job search or training could also increase the pool of nationals available to firms.

- ***Reducing distortions that lead to excessive reliance on foreign labor.*** In certain fields, carefully targeted and temporary wage subsidies can help reduce the business cost of hiring nationals instead of expatriates. Improving the enforcement of existing migrant rights and increasing their mobility within host countries could enhance productivity by facilitating more efficient allocation of workers to vacancies, help somewhat to reduce the difference in cost between hiring domestic and foreign workers, and make growth inclusive by improving migrants' living standards.

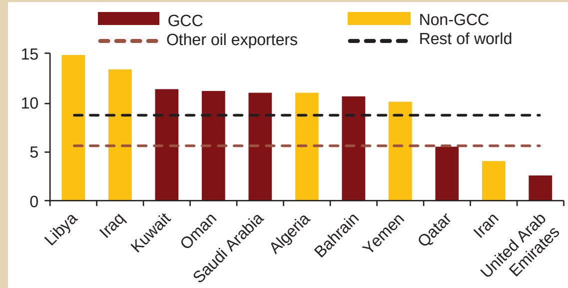
- ***Gradually reducing energy subsidies*** would help prevent diversion of investment to sectors that are energy-intensive but not job-intensive.

- ***Reorienting incentives toward tradable sectors.*** Rising government spending on infrastructure and wages skews incentives for domestic production toward low-skill and low-value-added nontradable goods and services. To encourage tradable production, policies need to focus on reducing barriers to competition and stepping up trade facilitation and export promotion.

Figure 1.13

Public Sector Wage Bills Are High

*(Percent of GDP, 2014)*




Sources: National authorities; and IMF staff calculations.

Non-GCC countries face a number of longstanding prerequisites for sustained growth, which to varying degrees have been difficult to enact because of adverse economic, political, and security circumstances:

- ***An improved business and political environment.*** Addressing the poor security situation of some countries, although extremely difficult, will be crucial to increase and stabilize oil production. Because political instability deters foreign direct investment flows to nonresource tradable sectors more than to the resource-intensive and nontradable sectors (World Bank 2013), an improved political environment would encourage growth and diversification.

- ***Lower bureaucratic costs associated with starting and running a business, and enhanced access to finance*** will promote private sector entrepreneurship (Annex III).

- ***Higher public infrastructure spending when resources allow***, while containing current expenditures. Public capital spending has been falling as a share of GDP (Figure 1.5), understandably, given the immediate spending needs of some countries; however, the fiscal multiplier for capital spending is more than twice as high as that for current spending (Abdallah and others forthcoming) and can have long-lasting effects on the level of output (Chapter 3, October 2014 *World Economic Outlook*).

## MENAP Oil Exporters: Selected Economic Indicators

| | Average 2000–10 | 2011 | 2012 | 2013 | Projections 2014 | Projections 2015 |
|---|---|---|---|---|---|---|
| **Real GDP Growth** | **5.5** | **5.3** | **5.7** | **2.2** | **2.5** | **3.9** |
| *(Annual change; percent)* | | | | | | |
| Algeria | 3.9 | 2.8 | 3.3 | 2.8 | 3.8 | 4.0 |
| Bahrain | 5.5 | 2.1 | 3.4 | 5.3 | 3.9 | 2.9 |
| Iran, Islamic Republic of | 5.0 | 3.9 | –6.6 | –1.9 | 1.5 | 2.2 |
| Iraq | … | 10.2 | 10.3 | 4.2 | –2.7 | 1.5 |
| Kuwait | 4.8 | 10.2 | 8.3 | –0.4 | 1.4 | 1.8 |
| Libya | 4.6 | –62.1 | 104.5 | –13.6 | –19.8 | 15.0 |
| Oman | 3.6 | 4.1 | 5.8 | 4.8 | 3.4 | 3.4 |
| Qatar | 12.7 | 13.0 | 6.1 | 6.5 | 6.5 | 7.7 |
| Saudi Arabia | 5.0 | 8.6 | 5.8 | 4.0 | 4.6 | 4.5 |
| United Arab Emirates | 4.8 | 4.9 | 4.7 | 5.2 | 4.3 | 4.5 |
| Yemen | 4.5 | –12.7 | 2.4 | 4.8 | 1.9 | 4.6 |
| **Consumer Price Inflation** | **7.2** | **8.8** | **10.3** | **10.2** | **7.0** | **7.5** |
| *(Year average; percent)* | | | | | | |
| Algeria | 3.3 | 4.5 | 8.9 | 3.3 | 3.2 | 4.0 |
| Bahrain | 1.6 | –0.4 | 2.8 | 3.3 | 2.5 | 2.4 |
| Iran, Islamic Republic of | 14.5 | 21.5 | 30.5 | 34.7 | 19.8 | 20.0 |
| Iraq | 20.7 | 5.6 | 6.1 | 1.9 | 4.7 | 6.2 |
| Kuwait | 3.1 | 4.9 | 3.2 | 2.7 | 3.0 | 3.5 |
| Libya | 3.8 | 15.9 | 6.1 | 2.6 | 4.8 | 6.3 |
| Oman | 2.6 | 4.0 | 2.9 | 1.2 | 2.8 | 2.8 |
| Qatar | 5.0 | 1.9 | 1.9 | 3.1 | 3.4 | 3.5 |
| Saudi Arabia | 1.8 | 3.7 | 2.9 | 3.5 | 2.9 | 3.2 |
| United Arab Emirates | 5.1 | 0.9 | 0.7 | 1.1 | 2.2 | 2.5 |
| Yemen | 11.0 | 19.5 | 9.9 | 11.0 | 9.0 | 11.4 |
| **General Government Overall Fiscal Balance** | **7.2** | **5.7** | **7.6** | **4.4** | **2.0** | **1.2** |
| *(Percent of GDP)* | | | | | | |
| Algeria | 5.2 | –1.2 | –4.1 | –1.9 | –5.1 | –5.1 |
| Bahrain[1] | 0.4 | –1.5 | –3.2 | –4.3 | –4.8 | –5.7 |
| Iran, Islamic Republic of[2] | 2.7 | –1.4 | –2.0 | –2.3 | –2.1 | –2.2 |
| Iraq | … | 4.7 | 4.1 | –5.9 | –3.0 | –0.6 |
| Kuwait[1] | 28.0 | 34.7 | 34.8 | 32.1 | 28.6 | 26.5 |
| Libya | 14.0 | –15.9 | 27.8 | –4.0 | –52.1 | –30.2 |
| Oman[1] | 9.6 | 9.4 | 4.6 | 8.1 | 3.0 | 0.2 |
| Qatar | 8.3 | 6.5 | 9.6 | 15.4 | 11.4 | 9.0 |
| Saudi Arabia | 10.7 | 12.0 | 14.7 | 8.7 | 5.2 | 1.6 |
| United Arab Emirates[3] | 6.5 | 4.2 | 8.9 | 6.5 | 6.3 | 6.2 |
| Yemen | –2.2 | –4.5 | –6.3 | –6.9 | –5.4 | –5.0 |
| **Current Account Balance** | **12.7** | **18.4** | **18.4** | **14.8** | **11.6** | **9.8** |
| *(Percent of GDP)* | | | | | | |
| Algeria | 14.5 | 9.9 | 5.9 | 0.4 | –3.0 | –2.9 |
| Bahrain | 5.9 | 11.2 | 7.2 | 7.8 | 7.0 | 6.4 |
| Iran, Islamic Republic of | 5.9 | 11.0 | 6.6 | 7.5 | 4.2 | 1.7 |
| Iraq | … | 12.0 | 6.7 | –0.8 | 3.0 | 2.4 |
| Kuwait | 30.7 | 43.6 | 45.5 | 40.5 | 40.8 | 38.6 |
| Libya | 25.4 | 9.1 | 29.1 | 13.6 | –27.1 | –20.9 |
| Oman | 8.8 | 15.8 | 13.3 | 11.9 | 9.9 | 5.6 |
| Qatar | 19.1 | 30.6 | 32.7 | 30.9 | 27.1 | 23.2 |
| Saudi Arabia | 15.5 | 23.7 | 22.4 | 17.7 | 15.1 | 12.4 |
| United Arab Emirates | 8.0 | 14.7 | 18.5 | 16.1 | 11.1 | 11.8 |
| Yemen | 0.7 | –3.0 | –1.7 | –3.1 | –1.3 | –1.1 |

Sources: National authorities; and IMF staff estimates and projections.
Note: Variables reported on a fiscal year basis for Iran (March 21/March 20) and Qatar (April/March).
[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.