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Assumptions and Conventions

A number of assumptions have been adopted for the projections presented in the *Regional Economic Outlook: Middle East and Central Asia*. It has been assumed that established policies of national authorities will be maintained; that the price of oil will average US$52 a barrel in 2009 and US$62.5 in 2010; and that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 1.5 percent in 2009 and 1.4 percent in 2010. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The 2008 data in the figures and tables are estimates. These estimates for 2008 and projections for 2009 and 2010 are based on statistical information available through end-March 2009.

The following conventions are used in this publication:

- In tables, ellipsis points (. . .) indicate "not available," and 0 or 0.0 indicates "zero" or "negligible." Minor discrepancies between sums of constituent figures and totals are due to rounding.
- An en dash (–) between years or months (for example, 2007–08 or January–June) indicates the years or months covered, including the beginning and ending years or months; a slash or virgule (/) between years or months (for example, 2007/08) indicates a fiscal or financial year, as does the abbreviation FY (for example, FY2008).
- "Billion" means a thousand million; "trillion" means a thousand billion.
- "Basis points (bps)" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

As used in this publication, the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

This report on the *Regional Economic Outlook: Middle East and Central Asia* is available in full on the IMF's Internet site, www.imf.org.

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Country and Regional Groupings

The May 2009 *Regional Economic Outlook: Middle East and Central Asia* (REO), covering countries in the Middle East and Central Asia Department (MCD) of the International Monetary Fund (IMF), provides a broad overview of recent economic developments in 2008 and prospects and policy issues for the remainder of 2009 and 2010. To facilitate the analysis, the 30 MCD countries covered in this report are divided into three groups: Middle Eastern oil-exporting countries, Middle Eastern oil-importing countries, and Caucasus and Central Asia countries. The country acronyms used in some figures are included in parentheses.

Middle Eastern Oil Exporters (MEOEs) comprise Algeria (DZA), Bahrain (BHR), Iran (IRN), Iraq (IRQ), Kuwait (KWT), Libya (LBY), Oman (OMN), Qatar (QAT), Saudi Arabia (SAU), Sudan (SDN), the United Arab Emirates (U.A.E.), and Yemen (YMN).

Middle Eastern Oil Importers (MEOIs) comprise Afghanistan (AFG), Djibouti (DJI), Egypt (EGY), Jordan (JOR), Lebanon (LBN), Mauritania (MRT), Morocco (MAR), Pakistan (PAK), Syria (SYR), and Tunisia (TUN).

Caucasus and Central Asia (CCA) countries comprise Armenia (ARM), Azerbaijan (AZE), Georgia (GEO), Kazakhstan (KAZ), the Kyrgyz Republic (KGZ), Tajikistan (TJK), Turkmenistan (TKM), and Uzbekistan (UZB).

In addition, the following geographical groupings are used:

The GCC (Gulf Cooperation Council) is composed of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

The Maghreb comprises Algeria, Libya, Mauritania, Morocco, and Tunisia.

The Mashreq comprises Egypt, Jordan, Lebanon, and Syria.

MENAP (Middle East and North Africa, Afghanistan, and Pakistan) refers to the following countries covered by MCD: Afghanistan, Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Pakistan, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, the United Arab Emirates, and Yemen.

Executive Summary

The Regional Economic Outlook: Middle East and Central Asia (REO) is prepared every six months by the Middle East and Central Asia Department (MCD) of the International Monetary Fund. The last REO was published in October 2008, just as the global economic crisis was breaking, when it was not yet clear how it would manifest itself around the world and affect the countries in the region. The scale and reach of the economic downturn is now much more evident. This REO, therefore, focuses on how the evolving crisis is affecting countries in the Middle East and Central Asia.

The Middle East and Central Asia region comprises a diverse set of countries, ranging from some of the poorest countries in the world to some of the richest, from oil and commodity exporters to oil importers, from countries on the Atlantic coast with strong links to Europe to countries in Central Asia with ties to Russia and lands farther east. The global crisis is meanwhile spreading around the world in many different ways. Ironically, the one channel through which the downturn is not affecting the MCD region in any significant way is through direct exposure to financial stress (and "toxic" assets) in the United States and Europe. The downturn is instead affecting the region through three indirect channels:

- the sharp drop in oil prices, which is shrinking revenues for oil exporters, as well as import costs for oil importers;
- the contraction in global demand, trade, and related activity, which is lowering exports, tourism, and remittances; and
- the tightening of international credit markets and lower investor appetite for risk, which is affecting capital inflows, depressing local asset prices, and reducing investment.

These factors are weighing on MCD countries in different ways, depending on where they are and what they do. The drop in oil prices has most directly affected the oil-exporting countries, whose oil revenues in 2009 will be less than half what they were in 2008. Lower oil prices are, by contrast, helping to reduce import costs for oil-importing countries, offsetting to some extent the decline in their own export receipts. Countries in the Caucasus and Central Asia, many of which are commodity exporters and are suffering from lower commodity prices, have also been affected by the sharp economic downturn in Russia.

In view of these differences, and in order to better analyze the effects of the crisis, this REO has divided the countries of the Middle East and Central Asia region into three subregions: Middle Eastern oil exporters (MEOEs), Middle Eastern oil importers (MEOIs), and the Caucasus and Central Asia (CCA).

Highlights of the REO are shown overleaf. The bottom line is that nearly all countries in the region will be seriously affected by the global crisis in important but different ways. Because of their different starting conditions, for example, outstanding debt levels or inflation rates, some countries may have more room than others to adjust policies to resist the downturn.

In sum, countries that can afford to maintain or enhance spending, such as many of the oil and commodity exporters, can and should do so. Other countries in the Middle East will be more fiscally constrained, but most countries will have some scope to loosen monetary policy. All countries will need to keep a close eye on conditions in their banking systems. And some countries will need to allow greater flexibility in their exchange rates.

Highlights

The countries in the Middle East and Central Asia region grew strongly in 2008, but the global crisis is now affecting these countries, and economic and financial vulnerabilities are rising.

- The downturn in the advanced economies and the drop in international commodity prices since the fall of 2008 have hit export earnings, investment flows, and remittances.
- Economic growth in the MCD countries could slow to 2½ percent in 2009 from 6 percent in 2008.

Despite lower oil revenues, many Middle Eastern oil-exporting countries (MEOEs) are expected to maintain their spending programs, which will contribute an important stimulus to global demand.

- The external current account of the MEOEs as a whole could record a deficit of $10 billion in 2009, compared with a surplus of $400 billion in 2008.
- Inflation is coming down sharply from the peaks recorded in the summer of 2008, in line with lower food and fuel prices.
- A few MEOEs have seen problems emerge in their banking systems, but the authorities have acted swiftly to deal with them through capital injections and liquidity measures.

Oil-importing countries in the Middle East and North Africa (MEOIs) will be particularly affected by the slowdown in Europe.

- Many MEOIs that have high debt levels lack sufficient fiscal space to undertake countercyclical expenditure and thereby cushion the impact of lower external inflows.
- With inflation coming down, there is more room for monetary easing.
- In some MEOI countries, rising unemployment will likely intensify poverty and other social pressures, and increase the need to enhance social safety nets.

Countries in the Caucasus and Central Asia (CCA) are suffering from lower commodity prices and adverse economic developments in Russia.

- Countries in the CCA tend to have relatively low debt levels and therefore have scope to support domestic demand through higher public spending.
- CCA countries' exchange rates need to be more flexible because the Russian ruble has depreciated.
- Continued vigilance over the financial systems of some CCA countries will be necessary.

The global slowdown could be longer and more severe than expected (Box 1); country authorities should prepare for this contingency.

- MCD countries may need to support domestic demand for a longer period, strengthen financial systems further, and develop crisis management frameworks.
- For low-income countries, increased donor financing will be necessary to maintain needed economic development.

Box 1. World Economic Outlook[1]

The global credit crunch has set off by far the deepest worldwide recession since the Great Depression. World economic activity is projected to decline 1.3 percent in 2009. All corners of the globe are being affected: output per capita is projected to decline in countries representing three-quarters of the global economy, and growth in virtually all countries has decelerated sharply from rates observed in 2003–07. Growth is projected to reemerge in 2010, but at 1.9 percent would still be well below potential. These projections build in fiscal stimulus plans in G-20 countries amounting to 1¾ percent of GDP in 2009 and 1¼ percent of GDP in 2010, as well as the operation of automatic stabilizers in most of these countries.

Table 1.1. Overview of the *World Economic Outlook* Projections

(Percent change, unless otherwise noted)

			Projections	
	2007	2008	2009	2010
World output	**5.2**	**3.2**	**-1.3**	**1.9**
Advanced economies	2.7	0.9	-3.8	0.0
Of which: United States	2.0	1.1	-2.8	0.0
European Union	3.1	1.1	-4.0	-0.3
Emerging and developing economies	**8.3**	**6.1**	**1.6**	**4.0**
Of which: Middle East and Central Asia	6.6	5.8	2.5	3.8
Commonwealth of Independent States	8.6	5.5	-5.1	1.2
Of which: Russia	8.1	5.6	-6.0	0.5
World trade volume (goods and services)	**7.2**	**3.3**	**-11.0**	**0.6**
Commodity prices (U.S. dollars)				
Oil	10.7	36.4	-46.4	20.2
Nonfuel (average based on world commodity export weights)	14.1	7.5	-27.9	4.4

The advanced economies are projected to suffer deep recessions. Overall output is projected to contract by 3¾ percent in 2009. Among the major economies, the United States and the United Kingdom will continue to suffer most severely from credit constraints. The euro area will suffer an even deeper decline in activity than the United States as the sharp contraction in export sectors increasingly curtails demand.

Continuing stress and balance sheet adjustment in mature markets will have serious consequences for financing to emerging economies. Overall, emerging markets are expected to experience net capital outflows in 2009 of more than 1 percent of their GDP. Emerging and developing economies as a group are still projected to eke out a modest 1½ percent growth in 2009, rising to 4 percent in 2010. However, real GDP would contract across a wide swathe of countries in 2009. The biggest output declines are projected in the Commonwealth of Independent States countries, most notably Russia, as a reversal of capital flows has punctured credit booms and commodity export revenues have dwindled.

The dominant downside risk to this scenario is that policies will be insufficient to arrest the negative feedback between deteriorating financial conditions and weakening economies. As activity contracts across the globe, the threat of rising corporate and household defaults will imply still-higher risk spreads, further falls in asset prices, and greater losses across financial balance sheets. The risks of systemic events will rise, the task of restoring credibility and trust will be complicated, and the fiscal costs of bank rescues will escalate further.

Against this scenario must be balanced an upside potential to the outlook. Bold policy implementation that is able to convince markets that financial strains are being decisively dealt with could set off a mutually reinforcing "relief rally" in markets, a revival in business and consumer confidence, and a greater willingness to make longer-term spending commitments. The problem is that the longer the downturn continues to deepen, the slimmer the chances that such a strong rebound will occur, as pessimism about the outlook becomes entrenched and balance sheets are damaged further.

[1] See *World Economic Outlook* (IMF) April 2009 for more information.

I. Middle Eastern Oil Exporters: Continued Spending Supports the Global Economy

The global crisis has affected the MEOEs mainly through the sharp fall in oil prices and the tightening of credit conditions. Despite the decline in oil revenues, most countries of the group are maintaining capital spending at a high level. This spending is providing an important stimulus to global demand, but will result in a turnaround in MEOEs' external positions from a massive collective surplus of $400 billion last year to a deficit of $10 billion in 2009. With credit to the private sector declining and financial risks rising, the authorities have acted swiftly and forcefully to ease domestic liquidity conditions and support banking systems. In view of the downside risks to the outlook, especially of a prolonged global recession and/or deteriorating balance sheets in MEOE financial sectors, countries need to enhance oversight of the financial system and support economic activity while preserving fiscal sustainability.

Middle Eastern Oil-Exporting Countries

The oil exporters comprise 12 countries: the six countries of the Gulf Cooperation Council (GCC—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates) and Algeria, Iran, Iraq, Libya, Sudan, and Yemen. Together, they account for 65 percent of global oil reserves and 45 percent of natural gas reserves. The countries are mainly exporters of oil, gas, and refined products, with oil and gas contributing about 50 percent to GDP and 80 percent to revenue. They are diverse and differ substantially in terms of per capita GDP, which in 2008 ranged from $1,200 in Yemen to over $70,000 in Qatar. The GCC subgroup is relatively homogenous, however, with similar economic and political institutions and relatively less diverse per capita incomes.

Note: The country names and borders on this map do not necessarily reflect the IMF's official position.

Note: This chapter was prepared by Abdelhak Senhadji, Khaled Sakr, and Joshua Charap, with research support from Arthur Ribeiro da Silva.

Precrisis boom

With high oil prices and strong global investor interest in the region, the MEOEs grew on average by a robust 5¾ percent a year between 2005 and 2008. These countries launched huge investment projects to pursue economic diversification and human capital development through investments in oil and gas and infrastructure, as well as in petrochemicals, tourism, financial services, and education. As a result, non-oil growth averaged about 6½ percent a year over the same period. In addition, they saved from their record-high export receipts—the external current account surplus averaged over 21 percent of GDP during 2005–08, enabling these countries to accumulate $1.2 trillion in foreign assets and reduce government external debt. Given these favorable conditions, the financial systems appeared sound: banks made large profits, had high capital adequacy ratios, and reported low nonperforming loan ratios.

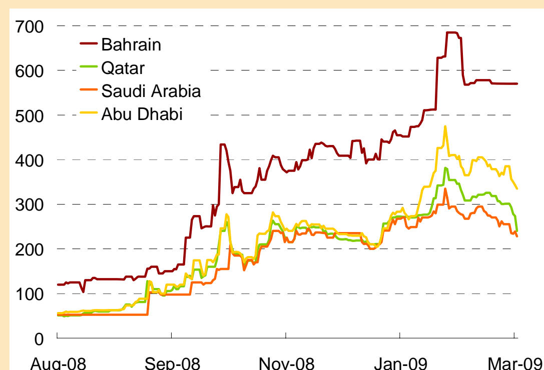
Asset prices are down

With the onset of the global crisis, financial sector risks in the MEOEs are rising. During the boom years, banks had lent substantial amounts for real estate and equity purchases. The value of these assets has since fallen sharply. Reflecting a general increase in financial risks, credit default swap (CDS) spreads on sovereign debt and the rollover risk of foreign debt have increased sharply (Figure 1). In addition, in the last quarter of 2008 corporate profits fell significantly. These trends are likely to weaken banks' balance sheets and feed back to the real economy.

While the direct exposure of MEOEs to U.S. financial distress has been limited, the process of global deleveraging led to a severe tightening of credit conditions, particularly in countries with financial systems that are more integrated with global markets (for example, the GCC). Countries that were highly leveraged and dependent on foreign lines of credit were affected the most—in Dubai, for example, CDS spreads reached almost 1,000 bps as investors' concerns about rollover risks mounted.

Figure 1. Credit Default Swaps

(In basis points; August 1, 2008–March 26, 2009)

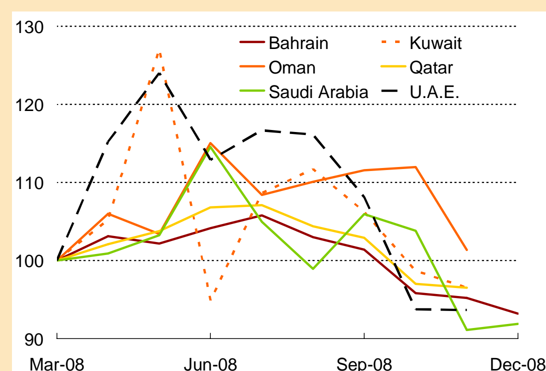


Sources: Markit; and CMA Datavision.

Local real estate and equity prices in the GCC had already begun to correct in the summer of 2008 (Figure 2).[1] The correction accelerated with the intensification of the global financial crisis in September 2008. Dubai, where valuations were not aligned with fundamentals, was particularly affected (Figure 3). By the end of 2008, a large outflow of speculative capital took place: a reversal of inflows

Figure 2. Real Estate Price Index

(Index, March 2008=100)

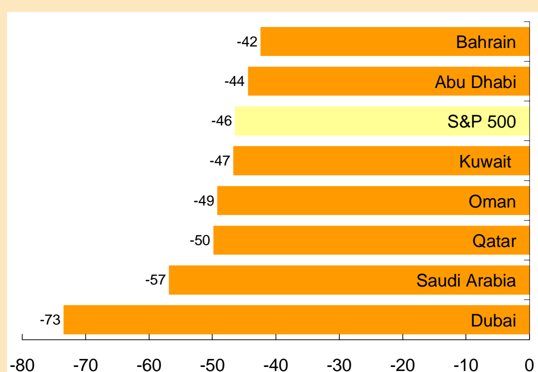


Source: Mazaya.

[1] For a discussion of real estate markets in the MCD region, and the risks associated with the rapid price increases observed through the spring of 2008, see the MCD *Regional Economic Outlook*, May 2008.

Figure 3. MEOEs: Change in Stock Market Indices

(In percent; January 1, 2008–March 30, 2009)



Source: Bloomberg.

that had been accumulating since late 2007 in anticipation of an appreciation of the GCC currencies while oil prices were still high and inflation was rising. As oil prices and inflation began to fall, these expectations receded.

In those MEOEs where financial systems were affected by the global crisis, the authorities responded forcefully to stabilize the interbank market and to restore liquidity (Table 1). Following the tightening of liquidity conditions in the last quarter of 2008, all GCC and some non-GCC central banks provided direct injections of liquidity into the banking system, supplemented by deposits from government institutions and other measures to ease liquidity conditions. To shore up investor confidence, some governments provided guarantees for deposits at commercial banks (Kuwait, Saudi Arabia, and U.A.E.), and sovereign wealth funds (SWFs) were asked to support domestic asset prices and provide capital injections for banks. Despite the policy response, credit markets remain impaired in many countries, largely reflecting global uncertainty, and there is some evidence that even investors with profitable projects are finding it difficult to obtain financing.

Slower growth, but contributing substantially to global demand

GDP growth rates of the MEOEs are expected to decline significantly (Table 2). Oil production has been cut back, as the Organization of Petroleum Exporting Countries is attempting to stabilize prices in response to the lower demand for oil. The slowdown in non-oil growth should be moderated by plans to maintain public expenditure, as well as by the easing of monetary policy.

Table 1. Middle Eastern Oil Exporters: Summary of Crisis Response Measures

(In percent)

	Financial Sector				Macroeconomic	
Country	**Deposit guarantees[1]**	**Liquidity support**	**Capital injections**	**Equity purchases**	**Monetary easing**	**Fiscal stimulus**
GCC						
Bahrain		J			J	
Kuwait	J	J	J	J	J	
Oman		J		J	J	
Qatar		J	J	J		
Saudi Arabia	J	J			J	J
U.A.E.	J	J	J		J	
Other						
Algeria					J	J
Iran		J				
Libya					J	J
Yemen					J	

Source: Data provided by country authorities.

[1] Includes expansion of retail deposit insurance and guarantee of wholesale liabilities.

Table 2. Growth and Inflation, 2007–10

(In percent)

	GCC				Other				Total			
	2007	2008	Proj. 2009	Proj. 2010	2007	2008	Proj. 2009	Proj. 2010	2007	2008	Proj. 2009	Proj. 2010
Real GDP growth	5.1	6.4	1.3	4.2	6.8	4.5	3.1	3.4	6.0	5.4	2.3	3.8
Oil[1]	1.0	4.5	-4.3	3.5	1.4	0.6	-2.9	-1.0	1.2	2.4	-3.5	1.1
Non-oil[1]	6.9	7.2	3.2	3.9	7.6	5.3	4.2	3.8	7.3	6.1	3.7	3.8
Inflation	6.3	10.7	5.3	4.8	13.7	19.9	13.9	11.6	10.3	15.6	10.0	8.5

Sources: Data provided by country authorities; and IMF staff estimates and projections.

[1] Excludes Sudan.

The external current and fiscal account positions of the oil producers are projected to weaken substantially (Figures 4 and 5). With the group as a whole expected to broadly maintain import levels, the combined current account balance is projected to shift from a surplus of $400 billion in 2008 to a deficit of $10 billion in 2009. While some countries (e.g., Bahrain, Oman, Sudan, and Yemen) may need to reduce their imports because their net external asset position is less favorable, their contribution to world demand is relatively small.

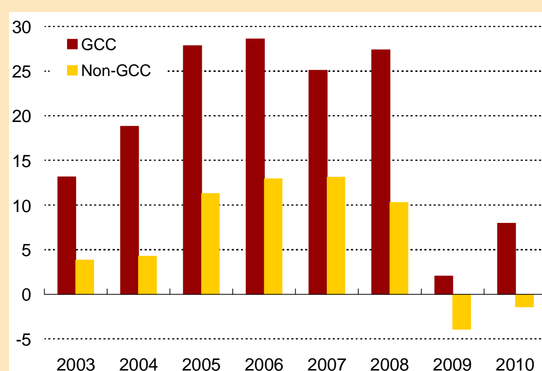
By keeping up their imports, the MEOEs are thus contributing importantly to global demand and acting as stabilizers during the global downturn. Their contribution to global demand is reflected in the doubling of the GCC share in world imports during 2003410, and most notably the sharp increase in this share during 2009410 (Figure 6).

Significant downside risks to the outlook

A major risk to the economic outlook is the possibility of a prolonged global recession. This would keep oil demand and prices low. If MEOE governments come to believe that oil prices will remain depressed for a prolonged period of time, they are likely to reduce their spending to maintain fiscal sustainability. A prolonged economic

Figure 4. MEOEs: Current Account Balance

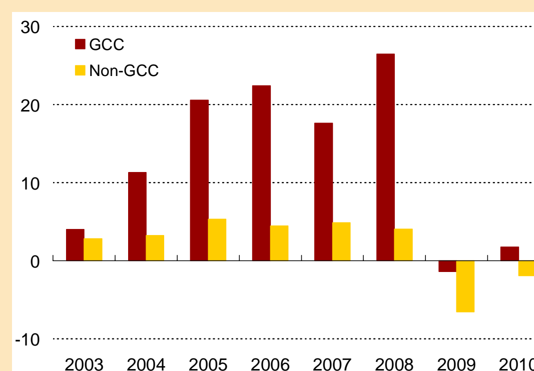
(In percent of GDP)



Sources: Data provided by country authorities; and IMF staff estimates and projections.

Figure 5. MEOEs: Government Fiscal Balance

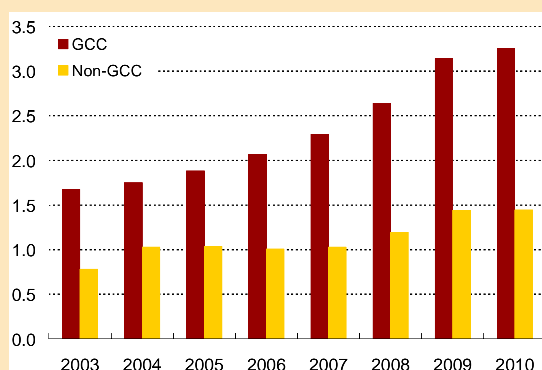
(In percent of GDP)



Sources: Data provided by country authorities; and IMF staff estimates and projections.

Figure 6. Imports of Goods and Services

(In percent of world imports)



Sources: Data provided by country authorities; and IMF staff estimates and projections.

slowdown in the MEOEs would in turn translate into lower growth in neighboring trading partners (notably Egypt, Jordan, Lebanon, Pakistan, and Syria) because of less trade and regional tourism; lower demand for foreign labor and, consequently, lower remittances; and a decline in foreign direct investment (FDI) flows to other countries in the region.

Another key risk that would delay economic recovery is a sharp deterioration in the balance sheets of financial institutions. A key driver would include further asset price deflation, particularly in countries whose banks have large direct or indirect exposures to equity and real estate markets. This could result in a negative feedback loop between the real and financial sectors: limited access to credit and declining aggregate demand affect loan repayments, falling loan repayments weaken banks' balance sheets, banks react by curtailing credit to the private sector, aggregate demand falls further, and the number of nonperforming loans increases.

Indeed, financial risks may be higher than observed so far. Capital adequacy ratios in most countries were high going into the crisis. And there have been improvements in supervisory and regulatory frameworks of many countries, but they could fall short in some countries, including where credit growth was very high. Available financial soundness indicators (FSIs) (Table 3) show healthy banking systems in GCC countries, but these indicators may not fully capture risks posed by high credit growth

Table 3. Banking Sector Performance and Soundness

(In percent)

	Nonperforming Loans	Capital Adequacy	Provisioning Rate	Return on Assets	Return on Equity
GCC					
Bahrain[1]	2.3	18.1	83.0	1.3	16.9
Kuwait[2]	3.1	16.0	84.7	3.2	27.8
Oman[3]	3.2	15.9	107.6	2.1	14.7
Qatar[2]	1.2	15.5	82.8	2.9	21.2
Saudi Arabia[4]	2.1	20.6	142.9	2.8	30.5
U.A.E.[5]	2.5	13.3	101.5	2.3	21.1
Non-GCC					
Algeria[3]	22.1	12.9	88.8	1.1	24.6
Libya[3]	25.0	15.5	66.5	0.4	8.0
Sudan[6]	22.4	10.5	20.0	3.0	23.3
Yemen[5]	18.0	9.4	43.9	0.9	12.2

Sources: *Global Financial Stability Report*; and country authorities.

[1] End-2008 and includes only conventional retail banks.
[2] December 2008.
[3] End-2007.
[4] End-2006 for return on equity; otherwise end-2007.
[5] End-June 2008.
[6] End-2008.

and concentration in real estate. FSIs are available with a lag, tend to be backward looking, and the averages mask the distribution across banks. In the non-GCC MEOEs, the relative weakness in the indicators predates the crisis and reflects structural factors, for example, the use of moral suasion to induce banks to lend to government-sponsored entities (e.g., Iran). As the availability of financing decreases, the likelihood of more directed lending increases, with potentially adverse effects on the health of the banking system.

Where there is fiscal space, use it

By keeping fiscal spending up where there is the fiscal space to do so, despite falling revenue, most MEOEs have been able to mitigate the effect of the crisis on their domestic economic activity. This has helped avert an exacerbation of the negative feedback loop between financial conditions and the real sector and has supported growth elsewhere in the region and globally. Fiscal policies will need to strike a balance between supporting domestic demand and adjusting to lower oil revenue (for an uncertain period of time). Most countries of the group envisage maintaining investment expenditure, although some have indicated they would reduce outlays if faced with further revenue shortfalls. Saudi Arabia has announced the largest fiscal stimulus package among the G-20 for 2009–10 and a $400 billion investment plan over five years. In general, countries with adequate fiscal space should continue to stimulate domestic demand. Expenditures should be limited to reversible measures and focused on high-quality investment. Capacity expansion decisions in the oil sector should continue to be based on the long-term outlook for global demand, in order to minimize large fluctuations in oil prices, serve the strategic interest of exporters, and contribute to global economic stability.

In countries with more limited fiscal space, expenditure prioritization will be necessary to maintain fiscal sustainability, especially if oil prices remain at their current level for a prolonged period. A few countries have taken measures to consolidate their fiscal positions, especially in view of the scarcity of external financing. Some countries—notably Iran, Sudan, and Yemen—were already in deficit in 2008 and are planning to significantly reduce expenditures to preserve fiscal sustainability. For example, the Iranian administration has proposed to parliament a significant increase in energy prices. In Yemen, the authorities issued a decree cutting many expenditure items and have reduced energy subsidies to industry. In Sudan, transfers to the provinces have declined, reflecting lower oil receipts, and the authorities are considering increasing excise taxes on luxury items and rationalizing value-added tax and tariff exemptions. Sudan is also facing binding financing constraints, having official foreign reserves coverage of about one month of imports.

SWFs have played a significant stabilizing role domestically and abroad.[2] They have been called to play a more prominent role in their domestic economies as economic and financial conditions have deteriorated and home bias of foreign investors has increased, underscoring the need for SWFs to maintain an adequate degree of liquidity in their investment portfolios to facilitate short-term stabilization goals and long-term saving objectives. A more active role for SWFs (in their domestic economies) and the increased emphasis placed globally on strengthening regulations and oversight highlight issues of transparency, integration with national budgets, and sustainability of overall macroeconomic policies (Box 2).

Keep a close eye on the banking system

In light of financial sector risks, countries should strengthen financial supervision and risk management. Key steps would include the following:

[2] For a discussion on the role of SWFs, see the MCD *Regional Economic Outlook*, May 2008.

Box 2. Middle Eastern Oil Exporters' Sovereign Wealth Funds: Impact and Implications of the Global Crisis

The role of Sovereign Wealth Funds (SWFs) in supporting domestic macroeconomic and financial stability has increased with the global crisis. As a result, implications for their investment strategies, overall transparency, and consistency with domestic macroeconomic frameworks are receiving attention.

Deteriorating domestic financial conditions have warranted more prominent roles for SWFs in their home countries. For example, the Kuwait Investment Authority (KIA) repatriated part of its foreign assets and deposited them in domestic banks to provide liquidity. SWFs' resources in Kuwait and Oman were used to set up funds investing in local equity markets. In addition, the Qatar Investment Authority and the KIA bought domestic bank shares to help boost bank capitalization and confidence. At the same time, SWFs in the region continue to pursue profitable investment opportunities abroad in real estate, retail, and finance.

The crisis has shown that, notwithstanding their long-term focus, SWFs have a domestic stabilization role with implications for their investment objectives and strategies. In times of financial stress in the domestic economy, SWFs' domestic investments may temporarily deviate from pure profit maximization to support broader macroeconomic and financial stabilization objectives. Going forward, SWFs need to ensure that they hold sufficient liquid assets to take on their stabilization role without realizing losses.

The scope for SWFs' stabilizing role in international capital markets will remain substantial. The sharp downturn in asset prices since early 2008 has likely resulted in losses for MEOE SWFs. This is not surprising given the marked declines in major indices (the S&P 500 and World Equity Index lost, respectively, 39 percent and 42 percent in 2008). Despite their losses and greater domestic focus, SWFs' relative size and influence in the global market will remain large. They are also likely to continue to maintain a longer-term investment strategy than most other investors.

International financial markets are likely to face increased regulation and demand greater transparency and accountability, which may affect SWFs' cross-border operations. Increased regulation may alter the relative attractiveness of some asset classes or industries that SWFs invest in. More directly, SWFs could be affected by requirements that all financial institutions and investment vehicles improve transparency and disclose more financial information.

Furthermore, as SWFs have become more active in their domestic economies, it is important that their domestic operations also support, and be consistent with, the country's macroeconomic framework. Well-designed policies and procedures for adding to or withdrawing from SWFs' resources would ensure consistency with their policy objectives.[1] Spending of SWF resources should be transparent and not undermine budgetary control. Moving SWF assets from abroad should take account of balance of payments and liquidity implications and be closely coordinated with monetary and exchange rate policies to prevent undermining the macroeconomic management of the domestic economy.

Note: This box was prepared by Yinqiu Lu and Iva Petrova.

[1] See International Working Group, 2008, Generally Accepted Principles and Practices: Santiago Principles, GAPP 4.

- conducting comprehensive stress tests to identify potential sources of vulnerability;
- assessing the size of possible recapitalization needs;
- putting in place contingency plans to deal with systemic risk;
- ensuring effective powers of intervention in banks deemed at risk; and
- reviewing resolution mechanisms for financial institutions placed under administration.

In view of the financial links across countries, it is also important to coordinate policies, particularly among GCC members, and develop a clear and effective strategy to articulate publicly policy measures to bolster investor confidence and secure political support.

Global deleveraging and more limited access to foreign financing could provide the necessary impetus for the development of domestic debt markets. Some countries face an ongoing need to raise financing to cover budgetary deficits. Other countries do not require budgetary financing, but would benefit from building their financial markets, with a view to further enhancing financial intermediation, stability, and growth prospects. In this regard, the IMF and the Arab Monetary Fund have launched the Arab Market Development Initiative to improve the efficiency and functioning of debt markets in Arab countries. The project aims to identify supply-side policies for developing and enhancing a liquid bond market and strengthening the framework for effective management of associated debt.

II. Middle Eastern Oil Importers: Delayed Slowdown Under Way

With relatively limited links to global financial markets, the Middle Eastern Oil Importers (MEOIs) have generally escaped the ravages of the global financial crisis. As the global recession deepens, however, MEOIs face weaker prospects for exports, foreign direct investment (FDI), tourism, and remittances. Consequently, MEOI growth is slowing too, but with a lag and more moderately than in advanced economies, and financial sectors in MEOIs are becoming more vulnerable. Most governments are unable to respond with significant fiscal stimulus owing to the limited fiscal space available. As a result, unemployment and poverty could rise substantially—with adverse implications for social stability. Therefore, in low-income countries, an increase in donor financing will be necessary to maintain aggregate demand and enhance social safety nets.

Middle Eastern Oil-Importing Countries

The MEOI group of countries is diverse in terms of geography, level of development, and integration with global and regional markets. Per capita income levels vary widely, as do poverty rates within the group. In terms of nominal GDP, the group is dominated by Egypt and Pakistan (75 percent). Although more diverse in terms of economic structure than the MEOEs and the CCA, the MEOIs do share some common features—including close economic and trade ties with the GCC and Western Europe, lower levels of financial development and integration with world financial markets, and higher levels of public debt.

Note: The country names and borders on this map do not necessarily reflect the IMF's official position.

Note: This chapter was prepared by Domenico Fanizza, Todd Schneider, and Harald Finger, with research support from Hirut Wolde.

Limited impact of global crisis so far . . .

The global financial crisis has played out differently among countries in the group but, as a whole, the financial sectors in the MEOIs have weathered the first round of the crisis reasonably well. Stock markets in the region were hit hard during 2008 in the wake of the first round of the world crisis and diminished investor appetite. With the exception of Egypt and Pakistan, however, the decline in stock markets was generally less pronounced than the global emerging market average (Figure 7).

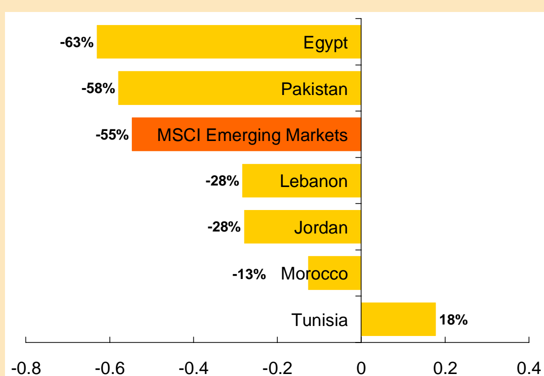
For some emerging markets (Egypt, Lebanon, Pakistan), the pressure from financial turbulence in the more advanced economies has also had an impact through reduced access to international capital markets, lower deposit inflows, and higher rollover risk. However, with the exception of Pakistan, sovereign debt premiums have been no higher than the emerging market average (Figure 8).

There have been no significant runs on banks in the MEOI countries, nor notable bank failures. The resilience of the banking system in the MEOI group reflects, for the most part, the limited foreign exposure of commercial banks, and their relatively high level of liquidity (Table 4). A few restrictions on capital account transactions also remain in some countries. One country (Jordan) instituted a blanket guarantee on bank deposits, while Egypt reiterated an existing blanket guarantee.

While evidence of financial contagion appears to have been limited and centered on the few countries in the group with significant ties to international capital markets, there remains the risk of second-round effects from the global recession. Slower trade and investment, sliding economic performance, and pressure on corporate balance sheets could eventually play through to the financial sector in the form of nonperforming loans.

Figure 7. MEOIs: Change in Stock Market Indices

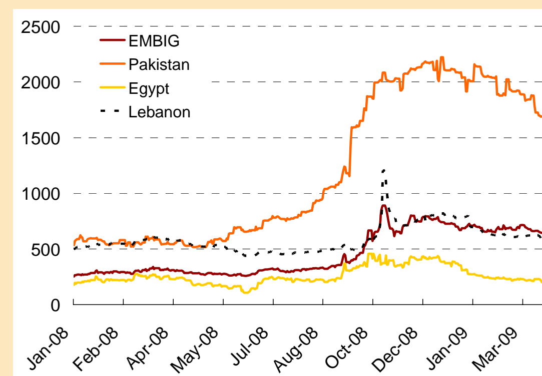
(In percent; Jan. 1, 2008–Mar. 6, 2009)



Source: Bloomberg.

Figure 8. Sovereign Bond Spreads

(In basis points; January 1, 2008–March 31, 2009)



Source: Bloomberg.

Note: EMBIG = *Emerging Market Bond Index Global* (JPMorgan).

Table 4. Financial Soundness Indicators, 2008[1]

(In percent)

	Capital Adequacy Ratio	NonPerforming Loans	Return on Assets	Return on Equity
Afghanistan	14.6	1.8	2.0	…
Djibouti	8.3	16.0	2.4	42.0
Egypt	14.9	16.5	0.8	14.4
Jordan	18.3	4.2	1.4	11.5
Lebanon	11.8	3.1	1.1	14.0
Mauritania	31.9	28.0	2.8	14.1
Morocco	10.7	6.8	1.4	19.0
Pakistan	12.2	9.1	1.2	11.3
Syria	12.9	5.3	0.8	17.2
Tunisia	10.3	16.7	0.9	10.6

Sources: Data provided by country authorities; and IMF staff estimates.

[1] Or latest available.

. . . but impact of the crisis will intensify in 2009

The global financial crisis and recession will weigh on growth in the MEOIs. Because the direct impact of the global financial crisis on these countries has been limited, average growth held up well in 2008, boosted also by strong levels of FDI. The prospects for 2009 are extremely uncertain, and in these circumstances, projections must be considered to be only indicative (Figure 9). Looking ahead, however, it does seem likely that the slowdown in growth in the MEOIs' main trading partners will adversely affect exports, tourism, workers' remittances, and FDI. And the ongoing credit crunch will limit access to international capital markets. Real GDP growth for the group is projected to halve to 3.2 percent in 2009 from 6.2 percent in 2008.

The MEOIs will be affected to different degrees by economic developments in their main trading partners, particularly the GCC and Europe. Strong countercyclical policies in the GCC should help cushion the impact on their own growth, and thereby on growth in their MEOI trading partners (Box 3).

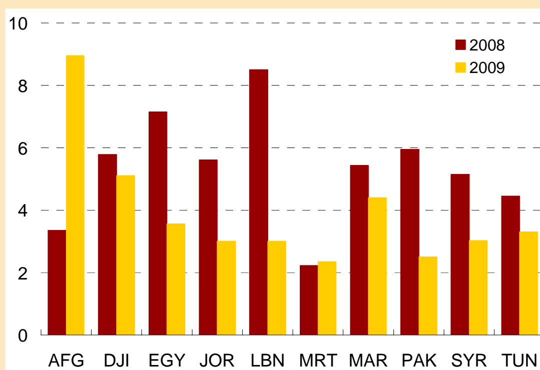
Inflation will decline further

Average inflation for the MEOI group surged in 2008—driven for the most part by the sharp rise in international food and oil prices. Afghanistan, Djibouti, Jordan, Lebanon, and Syria recorded the most marked increases in inflation, reflecting their high dependence on imports of food and fuel.

The reversal in international food and commodity prices had dampened inflation in most countries in the group by year-end, however. Gloomy prospects for global economic growth and demand are likely to put further downward pressure on prices for food, fuel, basic commodities, and industrial inputs in the current year. For the MEOIs as a group, average annual consumer price inflation is projected to fall to 9.7 percent in 2009, from 14.4 percent in 2008, in large part owing to softer food and fuel prices. In some countries, inflation looks set to fall by at least half (for example, in Afghanistan, Djibouti, Jordan, Lebanon, and Syria). Significant reductions are also expected for most other countries in the MEOI group (Figure 10).

Figure 9. MEOIs: Real GDP Growth

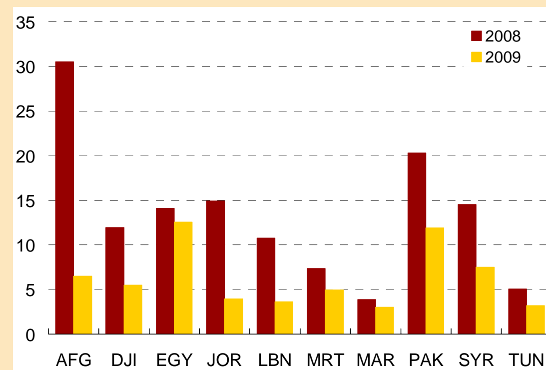
(In percent)



Sources: Data provided by country authorities; and IMF staff estimates and projections.

Figure 10. Consumer Price Inflation

(Average; annual changes in percent)



Sources: Data provided by country authorities; and IMF staff estimates and projections.

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