

# 1. MENAP Oil-Exporting Countries: Grappling with Lower Oil Prices and Conflicts

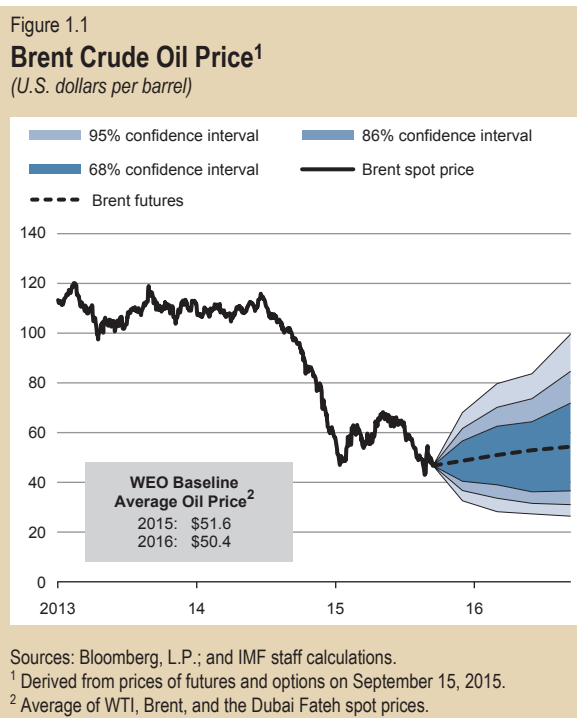
*Intensifying conflicts and depressed oil prices are weakening growth prospects and raising risks across the region, a situation compounded by the recent bout of global financial market volatility. Growth is expected to decelerate over the near term, but only moderately, as countries use fiscal buffers and financing options where possible. Faced with lower oil revenues, many countries have initiated fiscal consolidation, but the measures are unlikely to be adequate for ensuring medium-term fiscal sustainability and intergenerational equity, and for rebuilding the necessary buffers against future oil price shocks. Early formulation of comprehensive fiscal adjustment plans and good communication are necessary to maintain confidence. Fiscal pressures also highlight the need for private sector-led growth, job creation, and diversification. The prospective easing of sanctions on Iran is likely to have a mixed effect on other oil exporters in the region: some countries will face possible further declines in oil prices while benefiting from higher investment and non-oil trade.*

## The New Environment: Lower Oil Prices

Oil prices fell dramatically in the second half of 2014, and again this summer.<sup>1</sup> Between July 2014 and January 2015, oil prices dropped from about \$110 a barrel to less than \$50 a barrel. They have remained volatile since then, initially rebounding to about \$65 a barrel in the spring, but then falling back below \$50 a barrel amid resilient supply and still weak demand (Figure 1.1).

Supply-side forces have contributed significantly to this new environment of lower oil prices. The shale revolution, the decision by the Organization of the Petroleum Exporting Countries (OPEC) to protect its market share, and the anticipated lifting of sanctions on Iran are all putting downward pressure on prices. Persistently weak global growth has also contributed to lower oil prices from the demand side, most recently amid concerns over slowing growth in China and emerging market vulnerabilities more generally (Husain and others 2015).

Markets expect oil prices to increase modestly over the medium term, but without recovering to the



2014 peaks. The 2015 oil price is expected to be \$52 a barrel, increasing gradually to about \$63 by 2020.<sup>2</sup> However, considerable uncertainty surrounds these figures. Risks to global growth remain tilted to the downside, not least because of the recent bout of financial market and exchange rate volatility. It is unclear how quickly Iran can ramp up production

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<sup>1</sup> Chapter 4 provides more details on the policy response of MENAP and CCA policymakers to lower oil prices.

<sup>2</sup> This reference is to the Average Petroleum Spot Price, a simple average of U.K. Brent, Dubai Fateh, and West Texas Intermediate.

(Chapter 5), while oil output in conflict-affected countries is likely to remain volatile.

Lower oil export revenue—by \$360 billion for MENAP oil exporters as a whole in 2015—will sharply reduce the region's external surplus, turning it into a deficit. GCC countries will see their current account balance dwindle from a surplus of 15 percent of GDP in 2014 to a deficit of  $\frac{1}{4}$  percent in 2015, while the current account deficit of non-GCC oil exporters will widen to  $8\frac{3}{4}$  percent of GDP in 2015, compared with  $1\frac{1}{2}$  percent of GDP in 2014. Over the medium term, as oil prices recover somewhat and fiscal adjustment proceeds, the GCC current account position is expected to return to a surplus of 2 percent of GDP, while the non-GCC current account balance is projected to reach a surplus of about  $\frac{1}{4}$  percent of GDP.

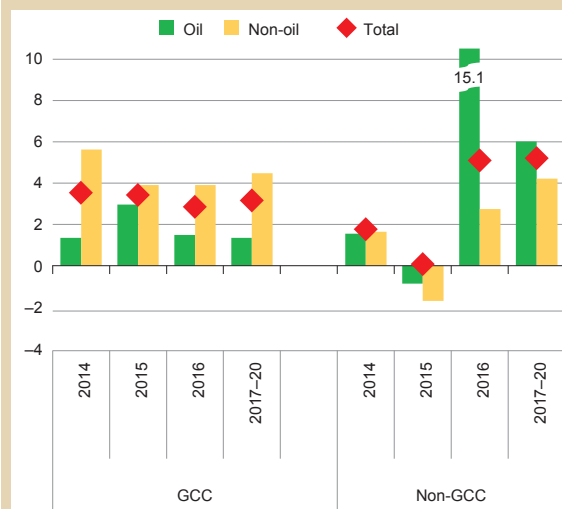
## Fiscal Consolidation and Conflict Weighing on the Economy

Growth in the GCC is expected to slow in the short term as countries initiate fiscal consolidation. Non-oil growth is projected at just below 4 percent for both 2015 and 2016, a reduction of  $1\frac{3}{4}$  percent compared with 2014, as fiscal adjustment, or the anticipation thereof, begins to have effects, notably in Saudi Arabia and the United Arab Emirates (Figure 1.2). On average, non-oil primary balances are expected to improve by  $1\frac{1}{4}$  percentage points (see below) in 2015. Slowing non-oil growth is partly offset by higher oil production, notably in Saudi Arabia. Over the medium term, continued fiscal consolidation could imply slightly slower overall growth (relative to 2014), despite a modest recovery in oil prices and anticipated payoffs from structural reforms.

In non-GCC MENAP oil exporters, 2015 GDP is expected to remain flat after growing by  $1\frac{3}{4}$  percent in 2014. This is largely owing to the economic impact of the conflict in Yemen and the slowdown in Iran, which has exhausted the positive effect of the 2014 interim agreement and is yet to benefit fully from the recent breakthrough in P5+1 negotiations. In Iraq and Libya, growth has been driven by an increase in

Figure 1.2

### Oil, Non-Oil, and Total GDP Growth (Percent)



Sources: National authorities; and IMF staff calculations.

oil production, but the non-oil economy continues to suffer from ongoing conflict. In 2016 and beyond, an assumed normalization of the security situation in conflict-ridden countries, coupled with the easing of sanctions in Iran, is expected to help non-GCC growth accelerate to about 5 percent (Chapter 5).

## Diverging Inflation Trends

Inflation in most countries of the region is moderating, with decelerating food price growth and the appreciating U.S. dollar, to which many countries effectively tie their currencies.<sup>3</sup> In the GCC region, inflation is expected to ease slightly from 2.6 percent in 2014 to 2.4 percent in 2015. In Iran, tighter monetary and fiscal policy helped to keep inflation steady at about 15 percent, after it reached an alarming 35 percent in 2013. Inflation accelerated in Algeria and especially in Yemen, driven by the large

<sup>3</sup> On average, the real effective exchange rates appreciated by 4 percent in GCC countries, and remained broadly stable in non-GCC oil exporters during the first half of 2015.

depreciation of the Algerian dinar vis-à-vis the dollar and by the conflict in Yemen.

## Risks to the Outlook Remain Elevated

Large uncertainties surround these growth projections, stemming primarily from the future

path of oil prices, which has important ties to the growth outlook in emerging markets including China (Husain and others 2015). Because oil prices are already low and most MENA governments are projected to post a budget deficit, a further drop in oil prices would accelerate fiscal adjustment, with adverse implications for growth (Box 1.1).

### Box 1.1

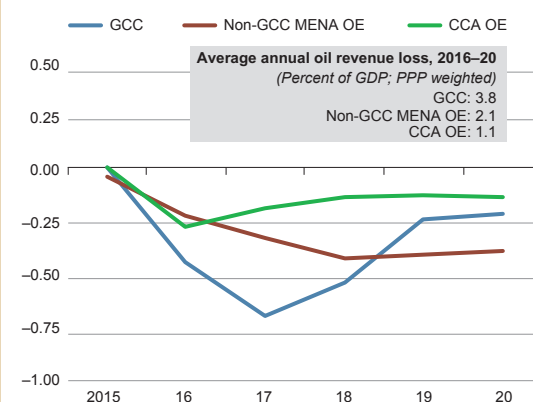
#### Growth Impact of Lower Oil Prices in MENA and CCA Countries

Lower oil prices reduce growth in countries that are highly dependent on hydrocarbon exports mainly through government spending (Husain, Tazhibayeva, and Ter-Martirosyan 2008). In the MENA and CCA regions, oil profits largely accrue to governments that, faced with lower revenues, may decide to cut back expenditures. Anticipating these cuts—or in response to them—consumers and companies are likely to hold back consumption and investment. In countries with flexible exchange rate regimes, currency depreciation could help ease the adverse impact of lower oil prices on government revenues expressed in domestic currency, thereby reducing needed public spending cuts, at least in nominal terms (see Chapter 4).

This box assesses the possible growth implications of oil prices falling \$10 a barrel below the IMF baseline on a sustained basis during 2016–20. Almost all MENA and CCA oil exporters are expected to post budget deficits under the current baseline, which already envisages low oil prices; consequently, the revenue loss stemming from the \$10 oil price drop is assumed to be gradually offset by new revenue and spending measures. As discussed in this chapter, many oil exporters have been able to use their financial buffers to postpone or avoid full fiscal adjustment. However, this box adopts more conservative fiscal policy assumptions to explore possible downside risks from very low oil prices. The growth impact was calculated by IMF country teams on the basis of so-called fiscal multipliers estimated in Cerisola and others (2015), Espinosa and Senhadji (2011), and other literature.

- In MENA oil exporters, growth would slow by  $\frac{1}{4}$ – $\frac{1}{2}$  percentage point in 2016, and the slowdown would deepen further to  $\frac{1}{2}$ – $\frac{3}{4}$  percentage point of GDP during 2017–18 as the contractionary fiscal response builds in. Over the medium term, growth would be lower by about  $\frac{1}{4}$ – $\frac{1}{2}$  percentage point than in the baseline as tighter fiscal policies continue to constrain growth (Figure 1.1.1).

Figure 1.1.1  
Impact of Fiscal Consolidation on Real GDP Growth  
(Percentage point deviation from the IMF baseline; GDP PPP weighted)



Source: IMF staff calculations.

Note: The scenario assumes a \$10 per barrel reduction in oil prices below the IMF baseline during 2016–20. Fiscal policy is assumed to offset one-half of the revenue loss in 2016, with the offset gradually rising to 100 percent in 2020. OE = oil exporters; PPP = purchasing power parity.

**Box 1.1 (continued)**

- In the CCA oil exporters, growth reductions are smaller than in MENA, peaking at about  $\frac{1}{4}$  percentage point of GDP annually. This result reflects generally lower reliance of budgets on oil revenues, greater flexibility of exchange rates, and—to a lesser degree—the expectation that some CCA countries would be more likely to consider raising non-oil revenues than MENA oil exporters where the fiscal adjustment would involve significant public investment cuts.

The actual impact on growth may differ substantially from these average estimates. Some governments, especially those with larger initial buffers and/or lower initial debt, could decide to continue offsetting the lost oil revenues only partially, and draw down assets or allow additional debt accumulation. In some countries, the negative growth impact could be exacerbated through financial channels—for instance, governments and oil companies may decrease their deposits in the banking system, reducing funding for loans, and sharp exchange rate depreciation would raise debt service on foreign currency obligations (see Chapter 6). In CCA countries, spillovers from Russia—an oil exporter and the region’s key trading partner—could amplify the growth drag from domestic fiscal consolidation (see Chapter 7).

Finally, reducing public investment can be damaging for growth in countries with underdeveloped infrastructure. To minimize these adverse effects, the investment cuts need to be driven by prioritizing high-return projects and costs savings through a more transparent and competitive investment management process (Albino-War and others 2014). Energy pricing reform would be another option to make fiscal adjustment more growth friendly (see Box 4.3).

Within the region, the pace of fiscal consolidation poses a risk to GCC growth prospects, if the chosen mix of adjustment policies (see Chapter 4) leads to a larger-than-expected decline in domestic demand. Further risks relate to potential structural reform fatigue as the effects of the fiscal consolidation filter through to the wider economy.

Risks to growth projections for conflict-ridden countries are tilted downwards. Conflicts in Iraq, Libya, and Yemen could prove more persistent than assumed in these projections, reducing growth in these countries, and imparting negative spillovers to neighboring countries. Sustained conflicts could also have an important impact on region-wide confidence, further dimming growth prospects (Box 1.2). On the upside, post-sanctions Iran could well see a higher growth dividend than the baseline if the country initiates complementary domestic reforms, with spillovers to the region (see Chapter 5).

The prospective normalization of monetary conditions in advanced economies, particularly the United States, could be less gradual or

orderly than markets currently expect. Funding costs could increase and access to markets could tighten for countries in the region, at a time when lower oil prices imply an increased need to tap the markets (Box 1.3). Improving U.S. economic prospects, relative to the rest of the world, could lead to persistent dollar strength, implying a procyclical tightening of monetary conditions in countries with exchange rates linked to the dollar.

Recent weak data from China have amplified global financial market volatility. Even though non-oil trade between China and MENAP oil exporters is relatively small (Figure 1.3), a larger-than-expected growth slowdown in China is likely to put further pressure on oil prices, reflecting China’s important role in global oil demand; a slackening of demand in China could cause a further deterioration in fiscal and external balances for oil-exporting countries, with a negative impact on growth (Figure 1.4). Financial linkages with China are small and further declines in equity prices, or the value of the Chinese renminbi, are

## Box 1.2

## Estimating the Economic Costs of Conflicts

Conflicts are spreading and becoming more intense in the MENAP region. After receding during the 1990s, the scope and intensity of conflicts in the MENAP region increased in the early 2000s, bucking the downward trend in the rest of the world (Figures 1.2.1 and 1.2.2). Conflicts in the MENAP region have also, increasingly, been domestic, rather than inter-state, in nature. With the expanding role of non-state violent actors such as the Islamic State of Iraq and the Levant (ISIL), violence increasingly affects civilians, and has a particularly adverse effect on confidence and expectations, and consequently on economic activity.

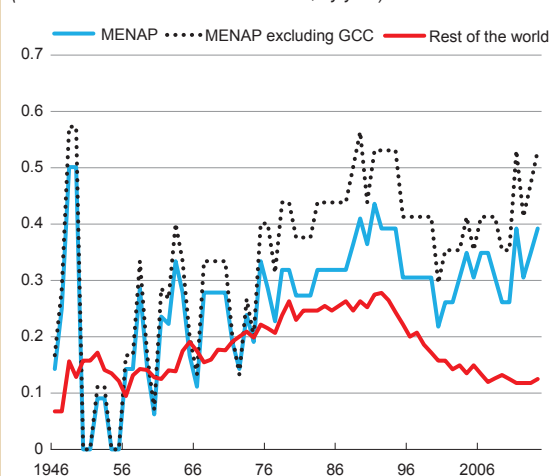
Conflicts can affect economic activity through multiple channels. They reduce the stock of human and physical capital through casualties, the massive displacement of people, and destruction of infrastructure, buildings, and plants. They can disrupt established production methods and trade routes. They create uncertainty, thus undermining confidence. Lower stocks of human and physical capital also reduce potential growth. The brunt of the burden of conflicts tends to fall on the poor and the most vulnerable, as new pressures on public budgets (for example, from increased security and military spending or—for neighboring countries—from tending to refugees) tend to crowd out social expenditure or lower the quality of public service.

To estimate these effects, we have used data on major episodes of political violence from the Center for Systemic Peace. These data cover episodes of internal and international conflict/violence for an unbalanced panel of countries (from 66 in 1946 to 167 in 2014), and provide an assessment of their intensity, on a scale ranging from 0 (no conflict) to 10 (total warfare).<sup>1</sup> For our purposes, we have used as a measure of the intensity of conflict the sum of the intensities of domestic and international major episodes of political violence. Thus, in theory this measure could range

Figure 1.2.1

## Frequency of Conflict, by Region

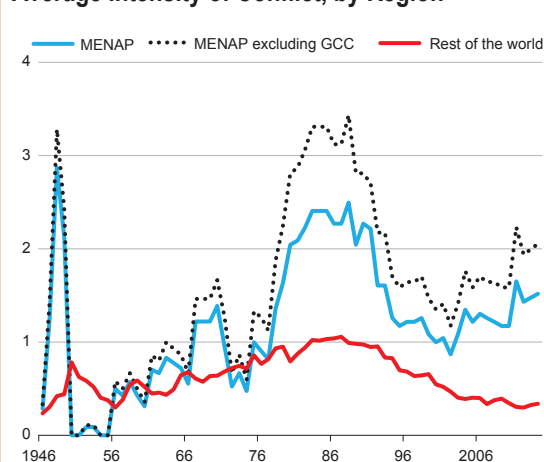
(Share of countries in conflict over total, by year)



Sources: Center for Systemic Peace; and IMF staff calculations.

Figure 1.2.2

## Average Intensity of Conflict, by Region



Sources: Center for Systemic Peace; and IMF staff calculations.

Note: Intensity of conflicts is the sum of intensities of domestic and international major episodes of political violence, as calculated by the Center for Systemic Peace.

Prepared by Davide Lombardo.

<sup>1</sup> Other studies have followed different approaches to quantifying the economic impact of conflicts. Some have focused on individual conflict cases, comparing post-conflict outturns against precrisis projections and/or counterfactuals (Meyersson 2015), or against comparator regions (Abadie and Gardeazabal 2003). Other studies use a more narrative approach (Sab 2014).

**Box 1.2 (continued)**

between 0 (no conflicts) and 20. In practice, however, its maximum value in the sample is 13 (observed in Iran during 1980–85 and in Iraq during 1990–91).

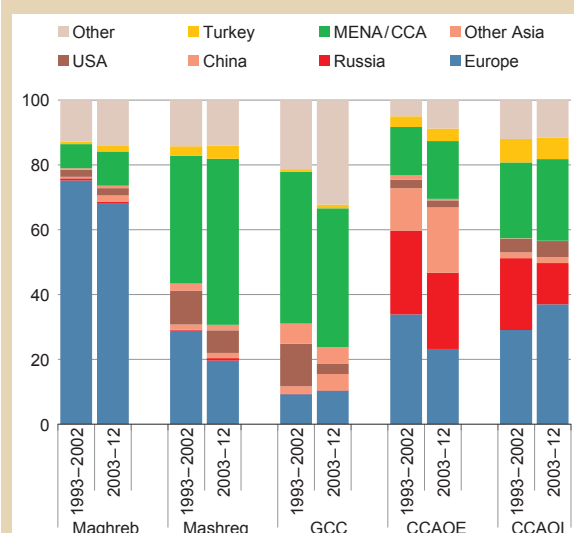
Our empirical analysis confirms that violent conflicts have significantly negative effects on macroeconomic performance. Thus, for example, countries that were in conflict during the past five years are estimated to have suffered an average output decline of 2¼ percentage points each year as a result. In addition:

- Even countries that have no conflicts of their own tend to have lower GDP growth if any of their neighboring countries experience violent conflicts.
- Conflicts also adversely affect inflation (typically after a one-year lag) and net foreign direct investment inflows, again both in directly affected countries and in their immediate neighbors.
- Finally, these effects tend to accumulate as conflicts persist.

These results mean that conflicts are a force to be reckoned with for policymakers in the affected countries and for the international community. Besides exacting a tragic human toll, the rise of conflicts in the MENAP region is an increasingly pressing threat to the region's macroeconomic stability, with the potential for negative spillovers that reach well beyond the immediately affected areas.

**Figure 1.3****Share of Non-Oil Exports by Destination**

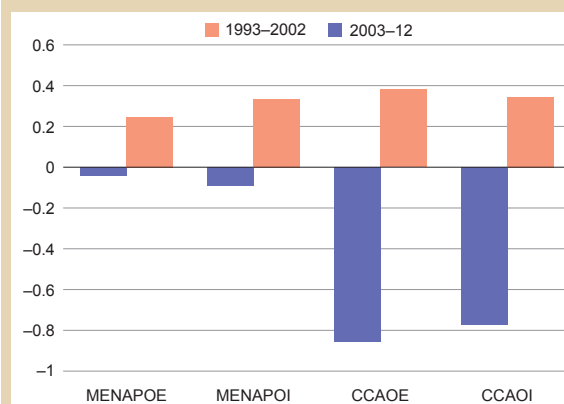
(Percent, period averages)



Sources: UN Comtrade; and IMF staff calculations.

Note: OE = oil exporters; OI = oil importers.

unlikely to have a major impact on MENAP oil exporters, though regional equity markets dropped in response to the emerging market turmoil, especially in Oman, Saudi Arabia, and the United Arab Emirates.

**Figure 1.4****Average Growth Correlations with China**

Sources: National authorities; and IMF staff calculations.

Note: OE = oil exporters; OI = oil importers.

## Lower Oil Prices Call for Further Fiscal Consolidation

The decline in oil prices has led to a substantial deterioration in fiscal balances. Fiscal deficits are expected to be 13 percent of GDP in the GCC and 12 percent of GDP in non-GCC countries, before improving somewhat over the medium term (Figure 1.5). The recent drop in fiscal balances

## Box 1.3

**How U.S. Monetary Policy Normalization Would Affect the Middle East and Central Asia**

In August 2015, expectations of an imminent rise in U.S. interest rates receded in response to increased concerns about emerging market growth, but normalization remains in the cards. When it takes place, it will create far-reaching spillovers. Normalization is expected to occur in response to an improving U.S. growth outlook and rising inflation pressures. Higher U.S. growth should support stronger global economic activity through trade, creating a tailwind for commodity prices.

However, as the increase in U.S. interest rates is transmitted across the world, it might cause capital outflows from emerging markets, depreciation of their currencies, and a tightening of domestic and external financing conditions. As the May–June 2013 “taper tantrum” showed, speculation over the timing and pace of U.S. interest rate increases can trigger financial market volatility. Overall, emerging markets are likely to gain from higher global growth, but these gains may be partly offset by tighter financing conditions and changes in commodity prices. The net impact on individual countries will depend on whether they export or import commodities and the pattern of their international linkages.

The impact of U.S. interest rate increases is likely to vary across MENAP and the CCA, reflecting these regions’ different structural characteristics, policy regimes, cyclical positions, and economic linkages:

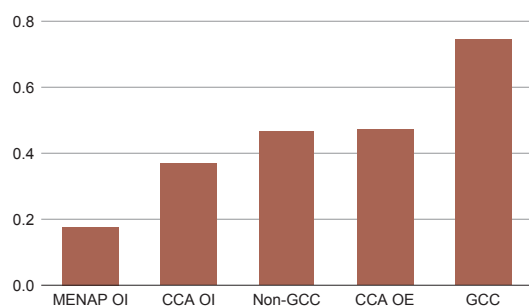
- GCC economies are likely to experience a neutral impact. Greater U.S. demand and its positive spillovers to global growth will raise oil export revenues. But in the case of higher U.S. growth, U.S. monetary policy would normalize, resulting in higher interest rates. This could offset some of the increased demand for oil if it results in higher global financial market volatility that hurts emerging market growth, or if it reduces demand for oil as an investment vehicle. Higher U.S. interest rates would also raise external borrowing costs, especially for GCC banks and corporations pursuing large-scale investment projects. Pass-through of higher U.S. interest rates will be strong, given the GCC pegs to the U.S. dollar, and could slow private investment in non-oil sectors (Figure 1.3.1). However, the decline in private sector credit is unlikely to have a major effect on economic activity, which is driven mainly by government spending.
- Other MENAP oil exporters are expected to experience similarly positive spillovers from stronger U.S. growth. Because these countries have more limited global financial ties and weak monetary policy transmission, the adverse consequences of U.S. monetary policy normalization are likely to be smaller (Figure 1.3.2).
- MENAP oil importers stand to gain should stronger U.S. growth spill over into higher growth in their main export destinations and remittance sources (the euro area, the GCC, and emerging markets)—notwithstanding the downside risks of U.S. monetary policy normalization that could lead to further global financial market volatility (Figure 1.3.3). At the same time, many of these countries peg their currencies to the U.S. dollar. The resulting nominal exchange rate appreciation against the euro would hurt their competitiveness, and direct pass-through of higher U.S. interest rates would be limited by weak monetary policy transmission. Though the historical correlations of long-term bond yields have been low, global financial market turmoil could raise external borrowing costs for governments, corporations, and banks, in turn raising domestic private sector lending rates and running counter to monetary easing policies amid still-large negative output gaps.
- CCA economies are less likely to benefit from higher U.S. growth. Their economies are heavily dependent on Russia for trade and remittances, and the positive spillovers from the United States to Russia are now more

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Prepared by Pritha Mitra with research assistance by Mark Fischer.

## Box 1.3 (continued)

Figure 1.3.1  
**Correlation of Prime Lending Rates between MENAP and CCA Countries and the United States**



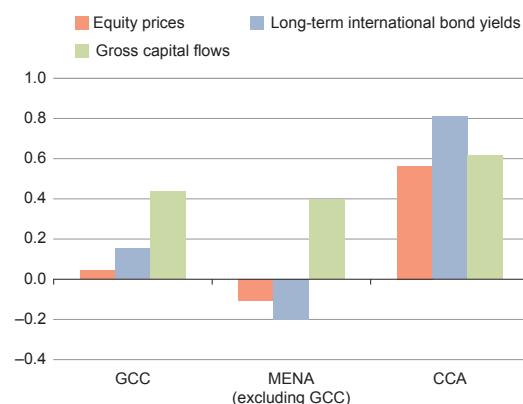
Sources: Haver Analytics; and IMF staff calculations.

Note: Simple correlations of contemporaneous series. MENAPOI excludes Somalia, Sudan, and Syria. CCAOE excludes Turkmenistan and Uzbekistan. GCC excludes Bahrain and Saudi Arabia. OE = oil exporters; OI = oil importers.

limited than in the past. Strong ties to Russian financial markets could transmit emerging market turmoil to equities, raise bond yields, and spur capital outflows. Depreciation pressures in the context of higher dollarization could also create strains for private sector balance sheets. A rise in interest rates would counter monetary policy easing in countries with still-large output gaps. However, CCA exporters of oil and other commodities will gain export revenues from higher global demand for commodities.

Macroeconomic policies can help augment positive spillovers while mitigating the negative ones. Solid macroeconomic fundamentals—including broad-based economic growth, robust current account positions, low inflation, sustainable public debt, and liquid financial markets—should amplify positive spillovers to growth and support investor confidence, mitigating any adverse financial market reactions. Financial system resilience to asset price volatility and a sudden decline in market liquidity can be strengthened through macroprudential policy and risk monitoring. Oil importers that do not have a hard peg to the U.S. dollar—and that still have large negative output gaps—may consider countering upward interest rate pressures by easing monetary policy.

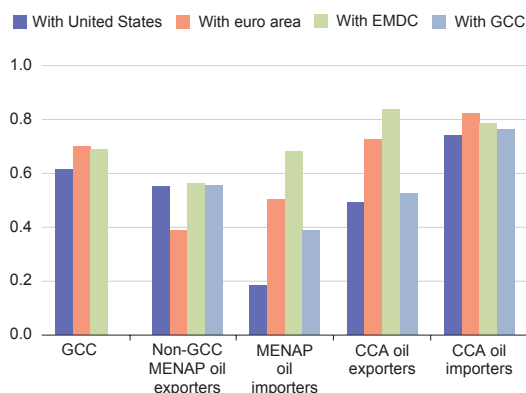
Figure 1.3.2  
**Financial Market Correlation with Emerging Markets, 2013–15**



Sources: Bloomberg L.P.; EPFR; JP Morgan; and MSCI.

Note: Correlations are between contemporaneous series. Country coverage for emerging market equity and bond yields is as provided by MSCI and JP Morgan, respectively. Country coverage for capital flows corresponds with available data for countries included in the *World Economic Outlook's* emerging market and developing country aggregate.

Figure 1.3.3  
**Growth Correlations, 2003–14**



Sources: National authorities; and IMF staff calculations.

Note: Correlations are between contemporaneous series. Bars represent the correlation of real GDP growth between each pair of aggregate country groupings. Aggregates represent World Economic Outlook database definitions. EMDC = emerging market and developing countries.

has been more pronounced in GCC countries because they are more reliant on oil revenues (see Figure 1.9).

Chapter 4 provides an in-depth analysis of fiscal challenges faced by MENAP oil exporters. The key takeaways are as follows:

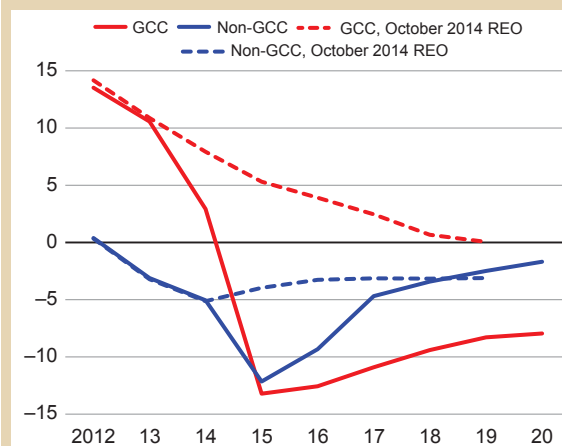
- The oil price decline is expected to have a large, permanent component. Therefore, oil exporters will need to adjust their spending and revenue policies to ensure fiscal sustainability, attain intergenerational equity, and rebuild space for policy maneuvering. Countries with larger buffers can adjust more gradually so as to contain the negative impact on growth. Countries without available buffers have no choice but to adjust quickly, irrespective of their cyclical position (Husain and others 2015).
- For most countries, the fiscal measures currently being considered are likely to be inadequate to achieve the needed medium-term fiscal consolidation. Apart from Kuwait, Qatar, and the United Arab Emirates, under current policies, countries would run out of buffers in less than five years because of large fiscal deficits (Figure 1.6).<sup>4</sup> In addition, none of the MENAP oil exporters are saving enough of their hydrocarbon wealth for intergenerational purposes, as measured against the Permanent Income Hypothesis benchmark (see Figure 4.3 in Chapter 4). Finally, the large and persistent oil price volatility calls for precautionary buffers to be replenished over the medium term, so that any new shocks can again be dealt with in an orderly way (October 2015 *Fiscal Monitor*). This is especially relevant given the most recent

<sup>4</sup> Buffers are defined here as the number of years until gross government assets turn negative, assuming no fiscal adjustment (for instance, non-oil primary balance to non-oil GDP remains at the 2014 level) and no government borrowing. In practice, many MENAP oil exporters can finance deficits through borrowing and other means—see Box 4.1 for a more general discussion of “fiscal space” available to MENAP policymakers.

Figure 1.5

### Fiscal Balance, 2012–20

(Percent of GDP)

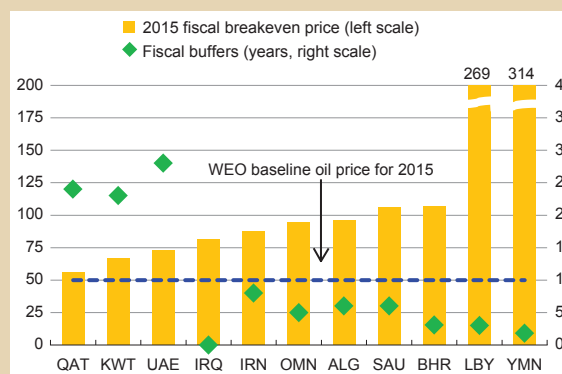


Sources: National authorities; and IMF staff calculations.

Figure 1.6

### Fiscal Buffers and Breakeven Oil Prices, 2015

(Years and U.S. dollars per barrel)



Sources: National authorities; and IMF staff calculations.

Note: Years of buffers are calculated with the assumption of no extra debt buildup (that is only running down assets). Country abbreviations are International Organization for Standardization (ISO) country codes.

developments when oil prices fell sharply again after a year of large declines.

- Nevertheless, some progress on fiscal consolidation is envisaged (Figure 1.7). In the GCC, adjustment over the medium term is expected to come mainly from a reduction in investment and an unwinding of one-off

spending items. The projected fiscal adjustment in non-GCC countries that are less dependent on oil revenue (for example, Iran) is smaller, while conflict-affected countries such as Libya and Yemen are being forced to adjust because available buffers are low.<sup>5</sup>

- The composition of fiscal adjustment should be tilted toward curbing current spending, while preserving high-return public capital spending and essential social expenditures.
- Several countries (Iran, Kuwait, the United Arab Emirates) have introduced welcome energy pricing reforms, which have reduced the gap between local prices and international benchmark prices. Direct fiscal savings are relatively modest, however, because in most countries the cost of low energy prices is implicit.<sup>6</sup> More progress needs to be made in this area across the region.
- Developing medium-term fiscal frameworks early on, in tandem with good communication, is essential to maintain policy credibility, not least because a number of countries have started issuing debt to finance deficits. The debt issuance will support local bond market development (Box 4.2 in Chapter 4).
- In some circumstances, the burden of fiscal adjustment can be eased through other policies, such as exchange rate and structural policies. Countries with long-standing exchange rate pegs and undiversified economies (in particular, the GCC countries) should maintain their currency pegs, but aid adjustment through adequate medium-term fiscal consolidation plans.

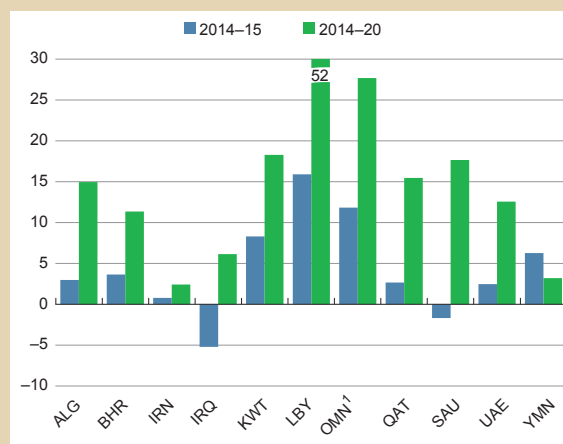
<sup>5</sup> Iraq's non-oil primary balance is expected to improve in 2015 in level terms, but because of the large fall in nominal non-oil GDP, the change in the non-oil primary balance as a percentage of non-oil GDP is negative.

<sup>6</sup> Most MENAP oil exporters do not provide explicit subsidies, but keep local prices below international prices, which entails considerable fiscal opportunity costs (Coady and others 2015).

Figure 1.7

### Change in Non-Oil Primary Balances

(Percent of non-oil GDP)



Sources: National authorities; and IMF staff calculations.

Note: Bars denote changes in non-oil primary balance from 2014–15 and 2014–20, respectively. Country abbreviations are International Organization for Standardization (ISO) country codes.

<sup>1</sup>The reduction in Oman's non-oil primary balance partly reflects an unwinding of exceptional spending measures and an automatic decline in energy subsidies due to lower international oil prices.

## Financial Sectors Sound, with Pockets of Vulnerabilities Mainly in Non-GCC Countries

Banking systems in MENAP oil exporters are generally well positioned to withstand the effects of the oil shock, though profits could come under pressure (see Chapter 6). Macprudential policies have reduced vulnerabilities related to real estate exposure and household indebtedness. The slowdown in deposit growth is affecting credit growth in some countries (for example, Oman and Saudi Arabia).

There are, however, some pockets of weakness. In Algeria and Iraq, macrofinancial risks have increased because of bank dependence on oil-related deposits and exposure to state-owned enterprises, whose performance is driven by oil. In Algeria, the cap on trade finance could affect private banks' profitability. The banking sector in Yemen is exposed to sovereign risks from high government credit exposures, with fiscal indicators deteriorating.

Iranian banks suffer from weak asset quality and thin capitalization, in part because of

government-mandated credit policies and limited enforcement power of banking supervisors. The removal of sanctions is expected to boost growth and reintegrate the Iranian banks into the international banking system. These developments, coupled with comprehensive domestic reforms in the banking sector, could help improve the financial health of Iranian banks and their ability to support the projected recovery. Vulnerabilities in GCC countries are mainly related to high loan concentrations to single borrowers and/or sectors (such as real estate).

## Wanted: A Diversified Private Sector

Lower oil prices will eventually force governments of oil exporters to hire fewer public servants. In the GCC (excluding the United Arab Emirates), more than 2 million nationals are expected to join the workforce by 2020. If private sector job growth were to follow past trends, and public sector employment growth is consistent with the current fiscal projections, more than half a million job market entrants will end up being unemployed (Figure 1.8, yellow bar), in addition to the 1 million who are already out of work. The aggregate GCC unemployment rate would increase from 12¾ percent to 16 percent. Clearly, if more fiscal adjustment were to take place, with some of it in the form of reined-in public sector hiring, unemployment rates would be even higher. In the non-GCC region, about 8 million people will enter the labor force over the next five years. Under current growth projections, and using historical growth–employment elasticities, the average unemployment rate would increase from 14 percent to 15½ percent.<sup>7</sup> In practice, the increase could be much higher, because cash-strapped governments will not be able to maintain the pace of public sector hiring.

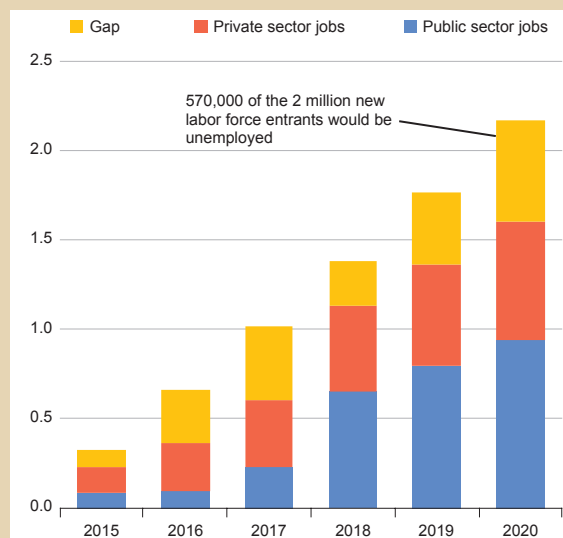
Clearly, the private sector will have to take over from the public sector as the main source of job creation. However, the expansion of the private sector and the diversification away from oil that are needed to absorb the growing workforce have

<sup>7</sup> Data on public and private sector employment is not readily available for non-GCC countries.

Figure 1.8

### Employment Outlook in the GCC

(Millions of new labor market entrants, cumulative)



Sources: National authorities; and IMF staff calculations.

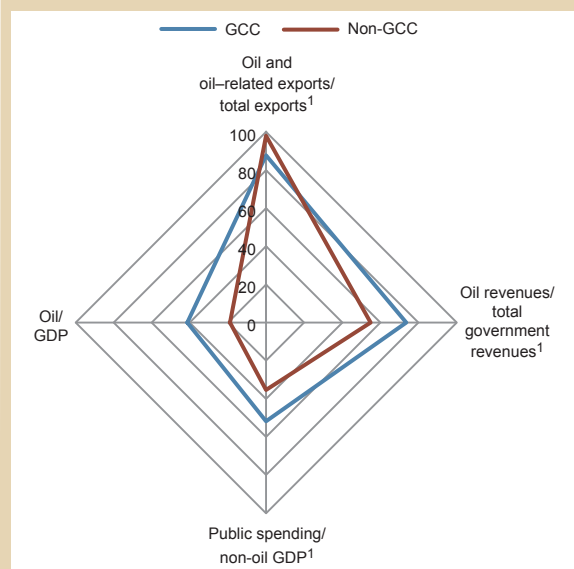
Note: Data for the United Arab Emirates not included. Public sector jobs are projected by using projected World Economic Outlook (WEO) wage bill growth rates, while private sector jobs are projected by using historical employment non-oil growth elasticities and non-oil growth current WEO projections (as in Behar 2015).

so far proven elusive. Though some progress has been made, most economies in the region are still deeply dependent on the capital-intensive hydrocarbon sector, which generates limited direct employment (Figure 1.9). The private sector itself is highly reliant on government spending and needs to become self-sustaining through increased competitiveness in other markets (including exports). Creating incentives for nationals to move to the private nonhydrocarbon sector, improving skills, and making those skills more relevant to the private sector by improving the quality of education<sup>8</sup> are crucial in this respect.<sup>9</sup>

<sup>8</sup> Recent research by the Organization for Economic Co-operation and Development shows that oil exporters could increase their long-run growth significantly if they achieved universal secondary education and all students acquired basic skills. Oman would gain 1.7 percentage points of GDP, Qatar 1.3 percentage points, Saudi Arabia 1.25 percentage points, and Iran and Bahrain about 1 percentage point (Manushek and Woesmann 2015, Table 5.5).

<sup>9</sup> See Callen and others (2014) for a deeper analysis of diversification prospects in the GCC region.

Figure 1.9

**Diversification***(Higher is less diverse)*

Sources: National authorities; UN Comtrade; World Trade Organization; and IMF staff calculations.

<sup>1</sup> Calculated using three-year averages ending in the specified year, or the latest three-year period for which data are available.

In non-GCC countries, there is an urgent need to improve the business environment, even though this is difficult for those conflict-affected countries with low institutional capacity. The specific needs and challenges of those countries are discussed in Box 1.4.

**Box 1.4****Trying Times for Fragile States in MENAP**

*Economic conditions worsened much more in MENAP's fragile states than in the rest of the region in 2014–15. In the oil-exporting countries (Iraq, Libya, Yemen), already weak socioeconomic conditions were exacerbated by regional conflicts and the drop in oil revenue. For net oil importers (Afghanistan, Somalia, Sudan, Syria, West Bank and Gaza), long-standing conflicts and other country-specific shocks had significant impacts. Because of low buffers and weak institutional capacity, external support to fragile states will need to be both sustained and flexible to achieve stabilization and reconstruction, and ultimately, to foster resilience and inclusive growth.*

Today, eight MENAP countries and territories are considered “fragile” due to weak institutional capacity and/or conflicts. Five have been fragile for more than a decade (Afghanistan, Iraq, Somalia, Sudan, West Bank and Gaza) and three have joined the ranks during the past few years because of new conflicts (Libya, Syria, Yemen). Fragility has multiple causes, but common factors have been weak governance and noninclusive political and economic institutions. Institutional capacity has seen little improvement over the past decade in the three countries for which the World Bank's Country Policy and Institutional Assessment is available (Afghanistan, Sudan, Yemen) (Table 1.4.1).

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## Box 1.4 (continued)

**Table 1.4.1. Country Policy and Institutional Assessment**

	2006	2010	2014
Afghanistan	2.6	2.6	2.7
Sudan	2.5	2.4	2.4
Yemen	3.3	3.2	3.0

Source: World Bank.

Note: Ratings range from 1 (lowest) to 6 (highest) against a set of 16 criteria grouped in four clusters: economic management, structural policies, policies for social inclusion and equity, and public sector management and institutions.

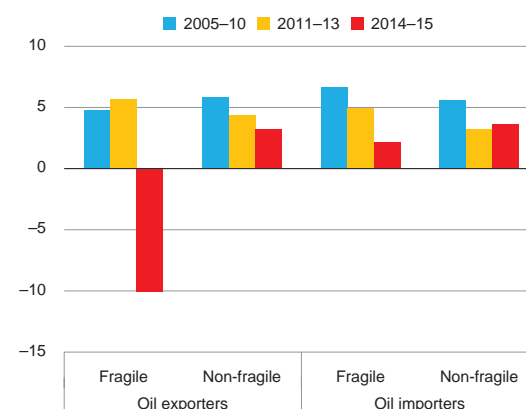
Conflicts and shocks have had a dramatic impact on economic performance in fragile states. In the fragile oil importers, growth slowed significantly over the past five years as a result of conflicts and country-specific shocks (such as the withdrawal of foreign troops from Afghanistan, the secession of South Sudan, and the deterioration of security in the West Bank and Gaza) (Figure 1.4.1). In Syria, GDP is estimated to have shrunk by half since 2010. In the fragile oil exporters (Iraq, Libya, Yemen), intensified conflicts led to a sharp drop in GDP in 2014–15. Fragile states have also experienced much higher inflation, on average, than non-fragile states. Substantial destruction of human capital and physical infrastructure has made economic recovery much more difficult.

Policy buffers have dwindled in fragile states, further weakening their capacity to respond to shocks. International reserves have been drawn down in many fragile states and fiscal deficits have widened (Figure 1.4.2). Reduced buffers have increased vulnerabilities as well as the need for external financial support.

Overcoming fragility is a daunting long-term challenge. Past experience in Sub-Saharan Africa suggests that focusing on inclusive politics, effective governance, and increasing fiscal space offers a viable route to overcoming fragility and achieving inclusive economic growth (Gelbard and others 2015). The journey to recovery and resilience is long; it is subject to both political and security risks, and is highly vulnerable to a reversal in progress. Therefore, policies and reforms should be carefully sequenced and take into account country-specific circumstances. They should focus on: (1) building political consensus and restoring peace and security, including via demobilization/reintegration of combatants; (2) supporting economic stabilization; and (3) reinforcing capacity and institutional building (including strengthening fiscal institutions, transparency, and accountability).

With their weak domestic capacity and low policy buffers, the region's fragile states will need urgent and sustained support from the international community to achieve resilience. Support will have to be multidimensional—to tackle the multiple facets of fragility—adaptive, and well coordinated among all stakeholders. The IMF helps

Figure 1.4.1

**Real GDP Growth Rates for MENAP Oil Exporters and Importers**

Sources: National authorities; and IMF staff calculations.

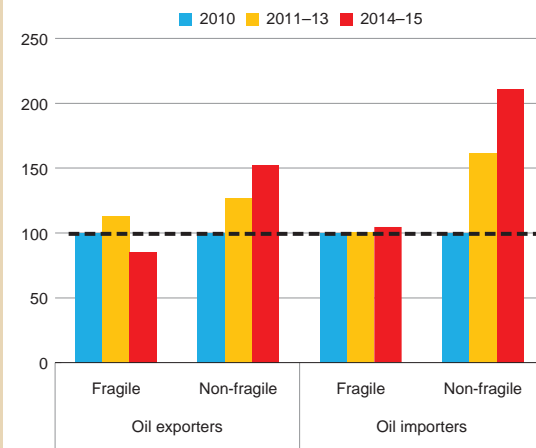
**Box 1.4 (continued)**

fragile states promote macroeconomic stability (which is critical for economic recovery and employment); rebuild institutional capacity for macroeconomic management through technical assistance in public financial management, revenue mobilization, and macroeconomic statistics; and catalyze donor support. The IMF recently re-engaged with Somalia through an Article IV consultation, provided financial assistance to Iraq and Yemen, and engaged with Afghanistan and Sudan through IMF staff-monitored programs. Close coordination with donors and country authorities has also been critical.

Figure 1.4.2

**Gross International Reserves**

(Index, 2010 = 100)



Sources: National authorities; and IMF staff calculations.

## MENAP Oil Exporters: Selected Economic Indicators

	Average 2000–11	2012	2013	2014	Projections	
					2015	2016
<b>Real GDP Growth</b>	<b>5.5</b>	<b>5.9</b>	<b>1.9</b>	<b>2.6</b>	<b>1.8</b>	<b>3.8</b>
<i>(Annual change; percent)</i>						
Algeria	3.8	2.6	2.8	3.8	3.0	3.9
Bahrain	5.2	3.6	5.3	4.5	3.4	3.2
Iran, Islamic Republic of	5.2	-6.6	-1.9	4.3	0.8	4.4
Iraq	...	13.9	6.6	-2.1	0.0	7.1
Kuwait	5.3	7.7	0.8	0.1	1.2	2.5
Libya	-1.0	104.5	-13.6	-24.0	-6.1	2.0
Oman	3.7	5.8	4.7	2.9	4.4	2.8
Qatar	13.0	4.9	4.6	4.0	4.7	4.9
Saudi Arabia	5.5	5.4	2.7	3.5	3.4	2.2
United Arab Emirates	4.8	7.2	4.3	4.6	3.0	3.1
Yemen	3.0	2.4	4.8	-0.2	-28.1	11.6
<b>Consumer Price Inflation</b>	<b>7.4</b>	<b>10.4</b>	<b>10.4</b>	<b>5.8</b>	<b>6.0</b>	<b>5.1</b>
<i>(Year average; percent)</i>						
Algeria	3.4	8.9	3.3	2.9	4.2	4.1
Bahrain	1.4	2.8	3.3	2.7	2.0	2.1
Iran, Islamic Republic of	15.1	30.5	34.7	15.5	15.1	11.5
Iraq	18.5	6.1	1.9	2.2	1.9	3.0
Kuwait	3.3	3.2	2.7	2.9	3.3	3.3
Libya	5.3	6.1	2.6	2.8	8.0	9.2
Oman	2.7	2.9	1.2	1.0	0.4	2.0
Qatar	4.7	1.9	3.1	3.0	1.6	2.3
Saudi Arabia	2.0	2.9	3.5	2.7	2.1	2.3
United Arab Emirates	4.8	0.7	1.1	2.3	3.7	3.0
Yemen	11.7	9.9	11.0	8.2	30.0	15.0
<b>General Government Overall Fiscal Balance</b>	<b>6.7</b>	<b>7.3</b>	<b>4.2</b>	<b>-0.8</b>	<b>-12.7</b>	<b>-11.1</b>
<i>(Percent of GDP)</i>						
Algeria	4.6	-4.0	-1.5	-7.9	-13.9	-11.4
Bahrain <sup>1</sup>	0.2	-3.2	-4.3	-5.7	-14.2	-13.9
Iran, Islamic Republic of <sup>2</sup>	2.1	-1.9	-2.2	-1.1	-2.9	-1.6
Iraq	...	4.1	-5.8	-5.3	-23.1	-17.7
Kuwait <sup>1</sup>	27.9	34.6	34.0	26.3	1.2	0.0
Libya	11.5	27.8	-4.0	-43.5	-79.1	-63.4
Oman <sup>1</sup>	9.5	4.7	3.2	-1.5	-17.7	-20.0
Qatar	9.3	14.2	20.7	14.7	4.5	-1.5
Saudi Arabia	7.8	12.0	5.8	-3.4	-21.6	-19.4
United Arab Emirates <sup>3</sup>	11.1	10.9	10.4	5.0	-5.5	-4.0
Yemen	-2.4	-6.3	-6.9	-4.1	-8.5	-9.2
<b>Current Account Balance</b>	<b>12.9</b>	<b>17.3</b>	<b>15.2</b>	<b>8.9</b>	<b>-3.4</b>	<b>-4.3</b>
<i>(Percent of GDP)</i>						
Algeria	14.1	5.9	0.4	-4.5	-17.7	-16.2
Bahrain	6.4	7.2	7.8	3.3	-4.8	-5.9
Iran, Islamic Republic of	4.8	4.0	7.0	3.8	0.4	1.3
Iraq	...	6.7	1.3	-2.8	-12.7	-11.0
Kuwait	31.7	45.2	41.2	31.0	9.3	7.0
Libya	24.0	29.1	13.6	-30.1	-62.2	-49.1
Oman	9.0	10.3	6.6	2.0	-16.9	-24.3
Qatar	18.9	32.6	30.9	26.1	5.0	-4.5
Saudi Arabia	16.2	22.4	18.2	10.3	-3.5	-4.7
United Arab Emirates	11.9	21.3	18.4	13.7	2.9	3.1
Yemen	0.4	-1.7	-3.1	-1.7	-5.3	-5.4

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).

<sup>1</sup>Central government.<sup>2</sup>Central government and National Development Fund excluding Targeted Subsidy Organization.<sup>3</sup>Consolidated accounts of the federal government and the emirates Abu Dhabi, Dubai, and Sharjah.

