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The analysis in this report was coordinated under the general supervision of Jihad Azour (MCD Director). The project was directed by Taline Koranchelian (MCD Deputy Director), Allison Holland (Chief of the MCD Regional Studies Division), and Ali Al-Eyd (Deputy Chief of the MCD Regional Studies Division). The primary contributors to this report were Philip Barrett, Anastasia Guscina, Boaz Nandwa, Frantisek Ricka, Aminata Touré, Juan Treviño, and Fang Yang.

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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$69.38 a barrel in 2018 and US$68.76 a barrel in 2019, and that the six-month London interbank offered rate (LIBOR) on US dollar deposits will average 2.5 percent in 2018 and 3.4 percent in 2019. 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 2018 and 2019 data in the figures and tables are projections. These projections are based on statistical information available through early September 2018.

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, 2011–12 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, 2011/12) indicates a fiscal or financial year, as does the abbreviation FY (for example, FY 2012).

- “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.

The boundaries, colors, denominations, and any other information shown on the maps do not imply, on the part of the International Monetary Fund, any judgment on the legal status of any territory or any endorsement or acceptance of such boundaries.

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1Simple average of prices of UK Brent, Dubai Fateh, and West Texas Intermediate crude oil.
Country Groupings

The October 2018 *Regional Economic Outlook: Middle East and Central Asia* covers countries in the Middle East and Central Asia Department (MCD) of the International Monetary Fund (IMF). It provides a broad overview of recent economic developments and of prospects and policy issues for the medium term. To facilitate the analysis, the 31 MCD countries covered in this report are divided into two groups: (1) countries of the Middle East, North Africa, Afghanistan, and Pakistan (MENAP)—which are further divided into oil exporters and oil importers; and (2) countries of the Caucasus and Central Asia (CCA). The country acronyms and abbreviations used in some tables and figures are included in parentheses.

**MENAP oil exporters** include Algeria (ALG), Bahrain (BHR), Iran (IRN), Iraq (IRQ), Kuwait (KWT), Libya (LBY), Oman (OMN), Qatar (QAT), Saudi Arabia (SAU), the United Arab Emirates (UAE), and Yemen (YMN).

**MENAP oil importers** include Afghanistan (AFG), Djibouti (DJI), Egypt (EGY), Jordan (JOR), Lebanon (LBN), Mauritania (MRT), Morocco (MAR), Pakistan (PAK), Somalia (SOM), Sudan (SDN), Syria (SYR), and Tunisia (TUN).

**MENA** includes Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, the United Arab Emirates, and Yemen.

**MENA oil importers** include Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Somalia, Sudan, Syria, and Tunisia.

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

The **non-GCC** oil-exporting countries are Algeria, Iran, Iraq, Libya, and Yemen.

**CCA countries** are Armenia (ARM), Azerbaijan (AZE), Georgia (GEO), Kazakhstan (KAZ), the Kyrgyz Republic (KGZ), Tajikistan (TJK), Turkmenistan (TKM), and Uzbekistan (UBZ).

**CCA oil exporters** are Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.

**CCA oil importers** are Armenia, Georgia, the Kyrgyz Republic, and Tajikistan.
Global Developments and Outlook: Implications for the Middle East and Central Asia Regions

Global growth for 2018–19 is projected to remain steady at its 2017 level of 3.7 percent (see table). However, this projection is 0.2 percentage point lower than the April 2018 World Economic Outlook, with the growth outlook marked down for a number of major economies. In the United States, while the outlook for 2018 is unchanged at 2.9 percent, the forecast for 2019 has been revised down due to recently announced trade measures. Growth projections have also been marked down for the euro area and the United Kingdom, following surprises that suppressed activity in early 2018. The outlook for emerging and developing economies is also weaker, reflecting downward revisions for some large emerging market economies due to country-specific factors, tighter financial conditions, geopolitical tensions, and higher oil import bills. For instance, China is projected to experience somewhat weaker growth in 2019 in the aftermath of recently announced trade measures.

The weaker outlook for the euro area could pose challenges for some countries in the Middle East, Afghanistan, North Africa, and Pakistan (MENAP) and the Caucasus and Central Asia (CCA) regions, particularly for oil importers with strong trade ties. The regions may also face headwinds from the projected moderation in activity in China.

Oil prices rose above $75 a barrel in June 2018—the highest level since November 2014—reflecting the collapse in Venezuela’s production and unexpected outages in Canada and Libya. Prices dropped back to about $70 a barrel following the June 2018 decision by the Organization of the

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See the October 2018 World Economic Outlook, Global Financial Stability Report, and Fiscal Monitor for a more comprehensive discussion of the global outlook.
Petroleum Exporting Countries (OPEC) and other major oil-exporting countries (together OPEC+) to increase production, but prices have increased recently due to geopolitical tensions. While the impact of US sanctions on Iranian exports could further lift prices in the near term, oil prices are expected to decline over the medium term due to increased production by US shale producers and OPEC+ members (see figure). Nevertheless, medium-term futures prices have firmed significantly relative to the baseline in the May 2018 *Regional Economic Outlook: Middle East and Central Asia Update*.

Although still supportive of growth, global financial conditions have started to tighten. Between March and September, the US Federal Reserve has raised the federal funds target rate by 75 basis points and has signaled additional tightening of 100 basis points by the end of 2019. With higher US interest rates, a stronger US dollar, and some episodes of financial market volatility, pressure points have emerged in some emerging market and developing economies. Following a sharp rebound early in 2018, capital flows to these economies have weakened considerably since mid-April, although they stabilized somewhat in July. Policy reactions so far have been varied, including a mix of exchange rate flexibility and interest rate hikes, and intervention in the foreign exchange market.

Market sentiment remains vulnerable to uncertainties stemming from global trade tensions and geopolitical developments, including related to Iran and Turkey. A systemic escalation of trade tensions would further dampen the global recovery and depress medium-term growth (see the “Scenario Box—Global Trade Tensions” in the October 2018 *World Economic Outlook*). Sanctions against Iran will undercut its near-term trade and growth prospects, increasing the risk of spillovers, while developments in Turkey could impact the region through trade and financial linkages, as well as through market confidence effects (see Box 1). A worsening of these developments, or faster-than-anticipated monetary policy tightening in advanced economies, increases the risk of a sudden reversal in global risk appetite. The MENAP and CCA regions would be vulnerable in this environment, especially those countries that rely heavily on international capital to meet external financing needs.

In this context, policy uncertainty has increased and near-term risks to global growth have shifted to the downside. Tightening global financial conditions and softening growth in large economies limit prospects for upside surprises, while risks highlighted in the April 2018 *World Economic Outlook* have become more pronounced or have partially materialized. Medium-term risks remain skewed to the downside, reflecting the continued buildup of financial vulnerabilities and the possibility of shifts to unsustainable policies in the face of weaker growth prospects. The materialization of these risks would have significant implications for countries in the MENAP and CCA regions through their impact on external demand, remittances, capital flows, commodity prices, and financing conditions.
As in other regions in the world, countries in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) and Caucasus and Central Asia (CCA) regions are exposed to tightening in global financing conditions and ongoing global trade tensions. The former has already begun to impact several emerging market economies in MENAP and could have more severe implications should financial market sentiment suddenly deteriorate. Escalating global trade tensions will have a limited direct and immediate impact on these regions but could impart significant strains over time through negative effects on trading partners and through market confidence effects.

**Exposure to Emerging Market Contagion**

Countries in the MENAP and CCA regions are exposed to potential contagion from current financial market pressures in emerging markets. Following recent developments in Argentina, Turkey, and other emerging markets, sovereign spreads of MENAP oil-importing countries have moved broadly in line with other emerging markets, rising by about 100 basis points between April and August. This illustrates the region's exposure to financial market volatility and raises new challenges, particularly for countries in need of international borrowing.

Moreover, there could be additional spillovers from Turkey to the MENAP and CCA regions through banking sector linkages and trade channels. MENAP-owned banks represent 7 percent of Turkish banking assets (as of March 2018), with shareholder equity of US$5.3 billion—of which the largest share represents Qatari interests, followed by those of Lebanon, Kuwait, and Libya. This has contributed to declines in these countries' equity indices in recent months. Nevertheless, as direct banking exposures represent less than 1 percent of these countries' GDP on average, the risk of broad-based financial stress is relatively small.

On the trade side, while Azerbaijan would be most affected by reduced demand for exports from Turkey, the impact of the depreciation of the Turkish lira on the region is more uncertain. Given the proportion of imports from Turkey, a sustained 20 percent depreciation of the Turkish lira (as occurred between July and September) would suggest that the current account deficits of Djibouti, Iraq, the Kyrgyz Republic, and Libya could narrow by about 1 percent of GDP (assuming no change in import volumes). However, Turkish products will become more competitive, which could trigger a combination of an increase in Turkish imports to the region and a reduction in the region's exports to markets where they compete with Turkish exports. This makes the overall impact more indeterminate.

**Escalating Trade Tensions**

The October 2018 *World Economic Outlook* analyzes the potential impact on global growth of five scenarios related to an escalation of trade tensions. The combined impact of these scenarios indicates that the level of global GDP could fall by more than 0.75 percent in the short term and remain about 0.4 percent lower in the long term, with the impact on China, the United States, and emerging markets relatively more pronounced.

Overall, the direct impact of the trade measures recently imposed and those trade measures that have been announced or considered, but not yet imposed, on countries in the MENAP and CCA regions is likely to be small. For example, Bahrain's exports of aluminum to the United States constitute less than 5 percent of its total exports, and there remains the prospect of an exemption from the tariffs. Similarly, while exports of cars and car parts are significant for Georgia (9 percent of total exports) and Morocco (14 percent of total exports), most are destined for other CCA or euro area countries (about 50 and 45 percent, respectively). However, there could be an indirect impact of potential product tariffs on MENAP and CCA countries through their impact on demand from more directly affected trading partners—for instance, through countries' participations in global value chains (see the October 2017 *Regional Economic Outlook: Middle East and Central Asia*).
More importantly, there could be a significant impact on growth in key trading partners and on global growth more generally. If this is translated into lower demand for exports from MENAP and CCA countries, it would slow economic activity and add to external pressures. Specifically, a slowdown in demand from China and the euro area would be of concern for Mauritania (minerals, fish) and Tunisia (cars, electronics, food, textiles), where the current account deficits are already wide (Table 1). Oil exporters would be exposed to a slowdown in economic activity in China, the euro area, and the United States, given the concentration of their oil exports to these countries, as well as the impact of lower oil prices triggered by a slowdown in global growth. And all countries would be hit, especially those with large financing needs, if investor confidence was affected or financing conditions tightened sharply (see the October 2018 Global Financial Stability Report).

Table 1. MENAP and CCA Export Intensity by Recipient 2016
(Exports of goods, percent of GDP)

<table>
<thead>
<tr>
<th>MENAP Oil Exporters</th>
<th>Algeria</th>
<th>Bahrain</th>
<th>Iran</th>
<th>Iraq</th>
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</tbody>
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Source: UN COMTRADE.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan.
*Using mirror data.
Supported by higher oil prices, oil exporters in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region will experience visible improvements in external and fiscal balances in 2018–19. Non-oil activity is expected to continue its recovery, supported by a slower pace of fiscal consolidation, while oil production picks up where spare capacity is readily available. Risks remain skewed to the downside over the medium term. These include a faster-than-anticipated tightening of global financial conditions, escalating trade tensions that could affect global growth and put downward pressure on oil prices, geopolitical strains, and spillovers from regional conflicts. While a slower pace of fiscal consolidation may be justified in the short term, consolidation efforts should continue over the medium term. This will enable countries to mitigate the potential impact of shocks and ensure a sustainable use of hydrocarbon revenue. Continued structural reforms will facilitate private sector development and strengthen long-term resilience. Any delays on the structural reform agenda could curtail economic diversification and inclusion.

Recovery Underway

Oil prices continued to increase through the first half of 2018 and are now trading at about $75 a barrel, largely reflecting the collapse in Venezuela’s production, unexpected outages in Canada and Libya, and the prospect of lower exports from Iran following US sanctions (see Global Developments). At the same time, production restrictions have been removed following the 4th OPEC and non-OPEC Ministerial Meeting (OPEC+) in June. Against this backdrop, economic activity in MENAP oil-exporting countries is expected to strengthen this year and next. Real GDP growth is projected at 1.4 percent in 2018 and 2 percent in 2019, up from 1.2 percent in 2017. This reflects a pickup in non-oil activity (except in Bahrain and Iran), underpinned by a slower pace of fiscal consolidation, as well as spillovers from higher oil output (especially in Saudi Arabia). Nonetheless, non-oil growth for MENAP oil exporters is projected to remain virtually unchanged this year and next compared with the 2.4 percent growth in 2017, mainly due to a drop in non-oil activity in Iran (Figure 1.1).

Projections in each subgroup are as follows:

- Growth in the Gulf Cooperation Council countries (GCC) is expected to recover to 2.4 percent in 2018 and 3 percent in 2019, following a 0.4 percent contraction in 2017. This is mainly due to the implementation of public investment projects, including those consistent with the five-year development plan in Kuwait, infrastructure investment projects ahead of the FIFA 2022 World

Prepared by Juan Treviño (lead author) and Sebastian Herrador Guzman.
Cup in Qatar (where the effect of the rift with Saudi Arabia has been contained), and ongoing preparations for Expo 2020 in the United Arab Emirates (UAE). In Bahrain, the expected fiscal consolidation is projected to dampen non-oil activity, despite rising aluminum production capacity.

- Growth in non-GCC oil exporters is projected to slow to 0.3 percent in 2018, from 3 percent the previous year, and pick up modestly to 0.9 percent in 2019. This largely reflects the expected impact of the re-imposition of US sanctions on Iran, which is likely to reduce Iranian oil production and exports significantly over the next two years at least. In Algeria, higher public spending is expected to boost growth in 2018, but the planned fiscal contraction in the following years will likely result in a sharp slowdown in non-oil growth over the medium term. Iraq’s growth is also projected to rebound in 2018–19, largely from continuing reconstruction efforts.

- In oil-exporting countries affected by conflict, growth performance has been mixed. While growth in Libya was strong in 2017, primarily driven by increased oil production, activity in Yemen contracted further. The outlook for these countries is expected to improve, but that is predicated on the assumption that the conflicts recede. Therefore, these projections remain highly uncertain and subject to security developments (see Box 1.1).

Notwithstanding recent oil price developments and some increase in futures prices relative to the May 2018 Regional Economic Outlook Update: Middle East and Central Asia, markets continue to expect oil prices to peak in 2018 and then decline gradually to about $60 a barrel by 2023 (see Global Developments).

As the effect of higher oil prices fades, growth in MENAP oil exporters is projected to decelerate to an average of 2.3 percent in 2020–23, well below historical trends. Furthermore, while the impact of the shock to non-oil growth triggered by the 2014 drop in oil prices was of a magnitude broadly similar to the slowdown triggered by the global financial crisis, the projected recovery is anticipated to be weaker this time (Figure 1.2). As described in detail in the October 2009 Regional Economic Outlook: Middle East and Central Asia, MENAP oil exporters were affected by the 2009 global financial crisis by way of a 36 percent drop in oil prices, a contraction in the global economy, and a sudden drying up of capital flows. The pickup in oil prices of 28 percent in 2010 and 32 percent in 2011 is comparable to the 23 percent increase observed in 2017 and the 30 percent increase projected for 2018–19. However, global growth is anticipated to be weaker this time relative to the years following the 2009 crisis, as the global expansion has become more uneven and appears to have peaked in major economies, where slack is diminishing while capacity utilization is beginning to constrain supply (see Chapter 1 of the October 2018 World Economic Outlook).

The growth outlook for MENAP oil exporters remains subject to significant uncertainty about the future path of oil prices. Potential spillovers
associated with the re-imposition of sanctions on Iran and the persistence of geopolitical risks could create near-term upward pressures on oil prices. However, these factors, along with a further escalation of trade tensions, could reduce global demand, potentially depressing oil prices more than currently envisaged. Such developments could also have a negative impact on investor and consumer confidence throughout the region—in some countries exacerbated by possible contagion from recent developments in Turkey and other emerging markets—and act as a further impediment to growth.

**External Balances Improving**

With oil prices having increased significantly since 2016, most MENAP oil exporters have seen tangible improvements in their external positions, although those positions remain weak in some countries (Algeria, Bahrain, Oman, Yemen). Oil exports have increased by about $260 billion during 2016–18—mostly due to price effects given the OPEC+ restrictions on production—and the current account balance is expected to shift from a deficit of $68 billion in 2016 to a surplus of $120 billion in 2018, an improvement of almost 8 points of GDP (Figure 1.3).

The financial account is also projected to improve further in 2018 (Figure 1.4). Many countries have tapped global financial markets this year—as of June 2018, MENAP oil exporters had issued sovereign debt worth $32 billion (of which $22 billion corresponds to Qatar and Saudi Arabia). Capital inflows following Saudi Arabia’s inclusion in the MSCI Emerging Markets Index (March 2018) and the FTSE Russell Equity Indices (June 2018) are also supporting the improvement of its financial account. Against this backdrop, foreign exchange reserve accumulation has resumed in several countries, although coverage is low in some.

The recent tightening of financing conditions in emerging markets, however, has exposed vulnerabilities in MENAP oil exporters with weaker fundamentals, where sovereign spreads have widened (Figure 1.5). Rising regional...
uncertainties from the re-imposition of sanctions on Iran have also dampened investor sentiment in some countries. With a large volume of non-sovereign international debt falling due by end-2019 ($135 billion), some countries are highly exposed to further tightening of financial conditions or higher risk aversion, which could lead to higher financing costs and capital flow reversals. This could hinder any further reserve accumulation and, in some countries, aggravate risks to external sustainability. Nevertheless, the inclusion of GCC countries in key emerging market bond indices will likely strengthen demand for GCC sovereign debt and mitigate some of these pressures (see Box 1.2).

**Stronger Oil Revenues Providing Fiscal Space**

With the recovery in oil prices and non-oil activity, combined in some countries with revenue mobilization measures (for example, the introduction of a value-added tax in Saudi Arabia and the UAE), fiscal balances are expected to improve notably across MENAP oil exporters. In several countries, including Saudi Arabia and the UAE, higher oil revenue has more than offset increases in public spending. The overall fiscal deficit for MENAP oil exporters is therefore projected to decline from 5.1 percent of GDP in 2017 to 1.6 percent in 2018 and 0.1 percent in 2019, and average 1.1 percent during 2020–23.

However, these trends mask differences in the fiscal stance across countries, as reflected by the change in the non-oil primary fiscal balance relative to non-oil GDP over time (Figure 1.6).

- In Saudi Arabia and the UAE, the available fiscal space provides the opportunity to temporarily adopt a modestly expansionary fiscal stance, consistent with the expected boost to non-oil activity. In Kuwait and Qatar, the fiscal stance is appropriately balanced, with the underlying fiscal position continuing to improve. In the coming years, however, each of these countries needs a further tightening of the fiscal position to ensure intergenerational equity (see Chapter 4).
In Bahrain and Oman, spending restraint has contributed to notable improvements in the underlying fiscal positions. However, significant additional fiscal adjustment is still needed to maintain fiscal and external sustainability in these countries.

Non-GCC oil exporters have adopted varying fiscal strategies. In Iraq, the fiscal stance is loose. In contrast, Algeria recently increased spending to boost economic activity, largely relying on monetary financing given limited fiscal savings, with a return to a steep fiscal consolidation planned from 2019 onward.

Fiscal Reforms Should Continue

Despite their varying fiscal stances, all MENAP oil exporters confront similar medium-term fiscal challenges. Given the high dependence on oil revenue—average fiscal break-even prices in 2020–23 are projected to be above the current oil price levels (except in Iraq, Kuwait, Qatar, Saudi Arabia, and the UAE)—fiscal balances remain vulnerable to oil price movements. Also, despite recent adjustment efforts, the gap between the actual non-oil fiscal balance and the balance consistent with the long-term income expected to be generated by oil revenue remains significant in many countries (see Figure 4.2 in Chapter 4). Thus, further consolidation over the medium term will help secure intergenerational equity and maintain fiscal sustainability while supporting economic activity. In addition, further consolidation would ensure that fiscal policy remains consistent with maintaining external sustainability, especially in countries with fixed exchange rates.

The current environment of temporarily high oil prices also provides an opportunity for countries to rebuild buffers. The potential threats to the global outlook, including rising trade tensions, could put additional downward pressures on oil prices (see below). Therefore, countries should further strengthen their fiscal frameworks to create space in the event policy support is needed.

Given that fiscal multipliers associated with capital expenditure in the region are estimated to be larger than current expenditure (Fouejieu, Rodriguez, and Shahid 2018), reducing less-productive current spending could provide space to preserve critical public investment and make the desired fiscal consolidation more growth-friendly (see Chapter 4). In this context, countries should tackle current expenditure rigidities, including public wage bills and subsidies, while safeguarding social safety nets. In parallel, efforts are needed to improve the efficiency of public spending, focusing on high-return public investments.\(^1\)

Mobilizing non-oil revenues would also reduce reliance on commodity-related revenues and strengthen fiscal resilience. To this end, tax policy frameworks should continue to be broadened. The implementation of the value-added tax in Saudi Arabia and the UAE is welcome and should proceed in the remaining GCC countries. Other taxes, some of which are already operational in some countries, should also be considered. These include the income tax (especially corporate and eventually also personal), property tax, and excise duties where not already implemented (see Chapter 4).

Private Sector Credit Remains Tepid

Higher oil prices have also improved liquidity conditions for banks. Nevertheless, private sector credit growth remains generally subdued (Figure 1.7), largely reflecting weak demand given the nascent economic recovery, and a weak real estate market in several GCC countries. In Bahrain, growth in corporates’ demand for credit is weak given that major investment projects are financed by GCC funds. In Oman, demand for credit in the construction sector has weakened, partly reflecting the effects of fiscal consolidation. In Qatar, where real estate lending represents a large share of loans, credit growth remains weak.

\(^1\)The literature on the magnitude of fiscal multipliers is generally mixed (Ilzetzki, Mendoza, and Vegh 2011), and several factors may affect the composition of public spending.
in part because of the downward trend in real estate prices. In Saudi Arabia, lower credit to the construction sector has more than offset stronger mortgage lending. In addition, policy rates in the GCC have risen in line with increases in the United States’ federal funds rate, resulting in higher interest rates that could have also affected the demand for credit.

Among non-GCC economies, monetization of the fiscal deficit in Algeria implied substantial liquidity injections that provided a boost in 2017 to both private and public sector credit. In Iran, continued central bank liquidity injections to address liquidity and interest rate pressures have supported private sector credit. In Iraq, the weak banking sector and the prevalence of a parallel exchange rate market have hampered healthy financing to the private sector.

Credit growth is anticipated to pick up gradually over the next two years in most countries as the economic recovery continues. Accordingly, policies that support growth are likely to strengthen credit demand. In parallel, structural challenges that hamper financial sector development and inclusion should also be addressed. Lending to small and medium enterprises should be encouraged, supported by the development of further regulations (including bankruptcy laws and corporate governance practices) and effective supervision, to strengthen lender and borrower rights and lending practices.

The improvement of secured transactions and the development of credit information systems (credit bureaus) would also help improve lending and borrowing. Fintech and financial education, as well as programs that target women and the young—whose participation gaps are large—would promote greater access to finance and inclusion. Deepening domestic financial markets, including corporate bond markets, would also support the economic diversification strategy by creating new sources and channels for private sector access to capital.

**Short-Term Risks Are Balanced, but Skewed to the Downside Beyond**

Relative to the May 2018 *Regional Economic Outlook Update: Middle East and Central Asia*, risks to the outlook have improved in the short term, largely reflecting the recovery in global oil prices, but remain skewed to the downside over the medium term. In some countries, including Kuwait, Saudi Arabia, and the UAE, the positive effect on investor confidence from higher oil prices could improve the outlook in the short term. Also, the projected payoff of reforms implemented to date in some countries (especially Qatar, Saudi Arabia, and the UAE) could be higher than anticipated.

However, there is a tangible risk that the commitment to implement key fiscal measures and structural reforms will weaken amid higher oil prices. Also, any delays to reforms that would facilitate a greater role for the private sector in the economy—for example, through privatization in Qatar, Saudi Arabia, and the UAE—could curtail economic diversification efforts.
In addition, the overall uncertainty surrounding the future path of oil prices and the risk of downward pressures from escalating trade tensions remain significant sources of vulnerability for MENAP oil exporters. Similarly, an abrupt change in global risk appetite, including from trade tensions, faster than expected monetary policy tightening in the United States, or spillovers from volatility and policy uncertainty in some emerging market economies, represents another downside risk.

At the regional level, ongoing conflicts and geopolitical risks persist, including potential spillovers from the re-imposition of sanctions on Iran. These factors could exert upward pressure on oil prices in the near term but could be offset by losses in investor and consumer confidence.

### Addressing Labor Market Distortions and Improving the Business Environment

The medium-term growth outlook appears less positive when placed in historical perspective, as illustrated above. In addition, the temporary nature of the oil price surge and the rising risks to the global economy make it more urgent to continue efforts to diversify the economy and create private sector jobs for the growing population (Purfield and others 2018)—IMF staff calculations suggest that the GCC will need to create about 1 million new jobs a year for at least the next five years to absorb new entrants into the labor market. While fiscal measures continue, including the tax policy reforms discussed earlier (Saudi Arabia and the UAE), energy subsidy reforms (Algeria, the GCC, Iran), and efforts to contain the public wage bill (Kuwait, Oman), more impetus is needed on the structural reform agenda, which has focused on job creation and inclusive growth (Purfield and others 2018).

Considering the need to reduce commodity dependence and promote economic diversification, two areas deserve special attention: labor market reforms and improving the business environment.

A number of countries have undertaken reforms that aim to address labor market distortions—for example, by leveling incentives between expatriates and nationals—and to reduce employment in the public sector (where more than 25 percent of the labor force in the GCC and Algeria work, well above the 9 percent in emerging market and developing economies).

In addition, countries have acted to support job creation for nationals, for instance by developing programs that encourage greater female and youth employment (Bahrain, Saudi Arabia). Reforms to soften hiring conditions for expatriates have also been implemented, including immigration regulations (self-sponsorship in Bahrain), and changes to visa requirements (Qatar granting residence to foreign workers and Saudi Arabia through visa amnesty). Nevertheless, a few countries have tightened restrictions on foreign workers (Oman, Kuwait). This could generate costly adjustments to employers, with differentiated effects on productivity across sectors. In the short term, such measures could negatively affect economic activity by restricting access to labor. In the long term, this could create distortions in labor costs that reduce competitiveness.

Therefore, strengthening the skills of nationals by investing in education and training should be prioritized, while efforts to increase the mobility of expatriates and promote female and youth participation should continue, accompanied by changes to public sector wages and benefits (Tamirisa and Duenwald 2018). This would create the appropriate incentives for nationals to compete for private sector jobs, while also ensuring they have the skills to be competitive.

Progress is also being made, especially in the GCC, in improving the business environment and encouraging private sector development. Bahrain, Kuwait, Qatar, Saudi Arabia, and the UAE are in the process of implementing policies to ease the time and cost of starting a business by introducing one-stop registration, and, in some cases, using e-government technologies. Other reforms include streamlining customs procedures.
(Saudi Arabia), enacting new laws to support small and medium-size enterprises (Algeria), developing and strengthening public-private partnership frameworks (Algeria, Kuwait, Qatar), and improving the bankruptcy framework (UAE).

To further improve the business environment (Figure 1.8), GCC countries need to ease access to finance. In this context, developing domestic capital markets as an alternative and complementary source of funding could prove beneficial. Non-GCC oil exporters need to make progress in several areas, including improving government effectiveness, transparency, and accountability, streamlining regulations, and reducing corruption and barriers to entry. These actions would ensure stronger and more inclusive long-term growth.

Figure 1.8. Challenges to Doing Business in MENAP Oil Exporters excl. Conflict Countries
(Percent of countries identifying the constraint among the top five)

Access to finance
Restrictive labor regulations
Inefficient govt bureaucracy
Inadequately educated workforce
Policy instability
Inflation
Poor work practices
Corruption
Inadequate supply of infrastructure
Tax rates
Insufficient capacity to innovate

Box 1.1. Conflict in the Middle East and Central Asia: Costs and Economic Policy Priorities

Violent conflict in the Middle East and Central Asia imposes vast humanitarian and economic costs (Rother and others 2016). While the direct effects are concentrated in just a few countries—Afghanistan, Iraq, Syria, and Yemen accounted for more than 90 percent of conflict deaths in the region in 2017—the indirect effects spill across the region.

One aspect of this has been the very large flows of refugees across the region (Figure 1.1.1) and further afield, especially Europe. Host countries often face a significant strain in accommodating large numbers of displaced people. For instance, data from United Nations High Commissioner for Refugees imply that refugees in Jordan and Lebanon accounted for about 7 and 16 percent of their respective populations in 2017. Violence itself can also spill over into nearby countries. For example, instability in eastern Lebanon is largely a result of conflict in neighboring Syria. The impact of these spillovers on trade and investor confidence also takes a toll.

The unpredictability of conflict presents a further challenge, as former safe havens can quickly become violent. For instance, Syria once offered a sanctuary to Iraqis fleeing sectarian violence following the invasion of 2003 and by 2007 more than 1.5 million Iraqi refugees were living in Syria. Since 2015, the roles have reversed; there are almost no Iraqi refugees in Syria, but nearly a quarter million Syrians have sought refuge in Iraq.

Figure 1.1.1. Net Refugees and Internally Displaced Persons, 2017 (IDPs and originated refugees minus hosted refugees, per 1,000 residents)

Prepared by Philip Barrett.

1 The region accounts for 10 of 36 countries on the World Bank’s Harmonized List of Fragile Situations, and 12 of 25 entries on the Council on Foreign Relations’ list of global conflicts.

2 Based on fatalities reported in the commonly used Uppsala Conflict Data Program (UCDP). Data from another standard data set, the Armed Conflict Location & Event Data Project, coincide with the UCDP. Data from the UCDP also suggest that the region accounted for more than three-quarters of conflict deaths worldwide in 2017.
In addition to its human cost, conflict also has substantial economic effects. To illustrate the potential scale of economic cost, Figure 1.1.2 shows the gap between the actual evolution of GDP and what it would have been if the country grew in line with regional peers for three recent conflicts.\(^3\)\(^4\)

All three countries saw large relative declines in output following the start of conflict.\(^5\) This is consistent with cross-country studies of the cost of conflict, such as Rother and others (2016), World Bank (2017), and Box 1.1 of the April 2017 World Economic Outlook.\(^6\)

However, the speed and extent of the impact varies substantially, potentially reflecting a variety of country-specific factors, including the severity and duration of the conflict. It also suggests that the structure of the economy explains much of the variation in the responses. The deeper declines in Libya and Yemen compared to Syria are largely due to reduced oil production, which is highly sensitive to conflict (for example, production or export may be impossible in an insecure environment), and which represented a large share of pre-conflict economic activity.\(^7\)

Given the inherent uncertainty in measuring the cost of conflict, other measures of economic loss are also relevant. Government revenues are one such measure. For instance, in Libya, declines in oil production have deprived the government of an essential revenue stream (estimated at close to $50 billion during 2012–16 or about 90 percent of 2012 revenues). And the length and severity of the Afghanistan conflict are estimated to have reduced cumulative government revenues by about $3 billion (about 17 percent of GDP) since 2005.\(^8\) Looking ahead, reconstruction efforts in conflict-affected countries are likely to be a source of further costs.

The extent and duration of conflict are beyond the control of economic policymakers. Nevertheless, steps can be taken to mitigate economic harm during conflict and promote recovery once peace arrives. Three general priorities stand out: (1) protecting institutions from becoming inoperative or corrupt; (2) prioritizing public

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\(^3\)For example, the value of –60 for Yemen in year 2 means that the country would have produced 60 percent more output in the second year of the conflict if it had grown at the same rate as other MENAP oil exporters.

\(^4\)The comparison set for a given country is the relevant sub-regional grouping—MENAP oil exporters for Libya and Yemen, and oil importers for Syria—minus the country itself. Comparing to regional peers is a simple way to control for other external shocks that may occur simultaneously, such as fluctuations in global oil price or world demand.

\(^5\)Two major conflicts in the region cannot be analyzed in this way: Afghanistan, because of absent pre-conflict data; and Iraq, where the removal of sanctions on oil sales following the 2003 invasion caused a rapid re-orientation of the economy towards oil exports, undermining the validity of comparison with other countries.

\(^6\)For example, World Bank (2017) use a sophisticated economic model to estimate cumulative GDP losses in Syria of $226 billion. The equivalent statistic of about $200 billion implied by Figure 1.1.2 is very close.

\(^7\)Post-2011 events in Libya are sometimes considered as two separate (albeit related) conflicts: a revolution in 2011, and civil war from 2014. This is reflected in the partial rebound in Libyan GDP in 2012 (year 2 of Figure 1.1.2). But at this recovery still entails an output loss of nearly 30 percent both episodes are treated here as one conflict.

\(^8\)See Barrett (2018) for further details.
Box 1.1 (continued)

spending to protect human life, limiting fiscal deficits to preserve macroeconomic stability, and preserving economic potential; and (3) stabilizing macroeconomic and financial developments through effective monetary and exchange rate policy (see the October 2016 *Regional Economic Outlook: Middle East and Central Asia*). In Libya, for example, this means: keeping the National Oil Corporation as one entity; unifying the central bank and the finance ministries; devaluing the exchange rate; and replacing huge fuel subsidies with cash transfers. And in the case of Yemen, there is an urgent need for donors to support food imports and facilitate payments of public salaries and cash transfers.

The IMF supports these economic objectives by providing policy advice and technical assistance to help stabilize and preserve institutions (see the April 2017 *Regional Economic Outlook Update: Middle East and Central Asia*). In addition, it provides financing support (Afghanistan, Iraq) and helps mobilize additional resources from donors and other international financial institutions (Iraq, Somalia, West Bank and Gaza). The IMF can also facilitate the transition to recovery by coordinating with donors and other international organizations. Recognizing the economic costs for neighboring countries, the IMF similarly plays a role in mobilizing international donor support (Jordan) and has tailored IMF arrangements to take into account the impact of refugees and the internally displaced (Iraq, Jordan).
Box 1.2. The Impact of Including Gulf Cooperation Council Countries in the Global Diversified Emerging Market Bond Index

JP Morgan’s expected inclusion of Bahrain, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates in its Global Diversified Emerging Market Bond Index (EMBI-GD) in September 2018 represents an important opportunity for these Gulf Cooperation Council (GCC) economies to mitigate risks relating to changes in global financial conditions.\(^1\)

Although some GCC countries are already included in other bond indices, their contributions are small, and the scope for inclusion is limited by countries’ relatively high credit ratings. For instance, GCC issuers represent less than 5 percent of the Bloomberg Barclay’s Global Aggregate Index. In contrast, the move to include them in the EMBI-GD adds roughly $150 billion to the index, according to market estimates. This reflects the $127 billion issued by GCC sovereigns in 2014–17 plus the $32 billion issued in 2018.

Overall, with GCC sovereign bonds accounting for some 15 percent of total emerging market bonds outstanding, inclusion in the EMBI-GD index could lead to a significant increase in demand for GCC sovereign bond issues. Market estimates indicate passive investment by index-tracking funds could amount to $30 billion to $45 billion of new demand, or about 30 percent of the value of outstanding GCC sovereign issuance. This would lead to a decline in sovereign spreads relative to international benchmarks, reducing the premium they pay relative to similar or lower rated issuers (Figure 1.2.1). For instance, this could amount to up to 30 basis points for Qatar.

This passive demand would further ease access to global financial markets and likely lower funding costs, including for corporates. With international bond issuance by corporates also significant—about $40 billion from 2014 to the first half of 2018 (Dealogo)—securing a reduction in financing costs could result in higher private investment and stronger and more broad-based economic growth. Easing access to global financial markets would help ease the impact of tightening global financial conditions and provide an important channel to mitigate the risk of further bouts of financial market volatility.

Prepared by Juan Treviño.

\(^1\)EMBI-GD is a widely tracked US dollar-denominated sovereign bond index. Oman is already a member of this index.
References


## MENAP Oil Exporters: Selected Economic Indicators

### Real GDP Growth

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<td>3.7</td>
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<td>3.8</td>
<td>3.2</td>
<td>2.6</td>
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### Consumer Price Inflation

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### General Gov. Overall Fiscal Balance

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<td><strong>Yemen</strong></td>
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### Current Account Balance

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<tr>
<td><strong>Yemen</strong></td>
<td>9.1</td>
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Sources: National authorities; and IMF staff estimates and projections.

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

1 2018 projection is based on assumption that conflict ends in 2019.

2 Central government.

3 Central government and National Development Fund including Targeted Subsidy Organization.

4 Consolidated accounts of the federal government and the emirates Abu Dhabi, Dubai, and Sharjah.
Growth among oil-importing countries in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region is expected to continue at a modest pace in 2018 and to strengthen slightly over the medium term. However, growth is uneven and likely to remain low relative to previous trends, while unemployment remains elevated. Furthermore, higher oil prices are weighing on already weak external and fiscal balances. The outlook is increasingly clouded by tightening global financial conditions, bouts of financial market volatility, and mounting global trade tensions. Continued strengthening of policy frameworks is needed to alleviate vulnerabilities and enhance economic resilience against rising risks. Moreover, to achieve higher, sustainable, and broad-based growth countries need to sustain their implementation of structural and institutional reforms aimed at improving competitiveness, boosting investment and productivity, and fostering a dynamic job-creating private sector.

A Need to Enhance Resilience

Growth in MENAP oil importers continues at a moderate pace, reflecting ongoing reforms and continued external demand. However, lingering structural weaknesses, elevated public debt, limited policy space, and spillovers from regional conflicts and uncertainty present notable headwinds to growth and further reform efforts. Moreover, the external environment is turning less supportive as global financial conditions tighten and growth in key economic partners moderates.

The outlook is also increasingly clouded by bouts of financial market volatility, including those driven by developments in Turkey, which can raise risk aversion and generate capital flow pressures and uncertainties stemming from mounting global trade tensions (see Box 1).

Prepared by Boaz Nandwa. Research assistance provided by Gohar Abajyan and Sebastian Herrador Guzman.

These factors underscore the importance of sustained reforms that promote economic resilience. In this environment, the region faces two key challenges going forward: enhancing the resilience of the recovery, especially given higher oil prices, and achieving higher, more inclusive growth, in particular to address persistent unemployment and inequality.

Slow and Uneven Recovery Underway

Growth in the region is projected to reach 4.5 percent in 2018, up from 4.1 percent in 2017, before moderating to 4 percent in 2019 (Figure 2.1). Continued strong growth in Egypt and Pakistan in FY2018 is driving the regional aggregate growth higher, masking weaker and more fragile growth in other countries, particularly those affected by conflict or its spillovers (Afghanistan, Jordan, Lebanon, Somalia; see Box 1.1 in Chapter 1).

A recent pickup in public consumption in some countries (Afghanistan, Pakistan) and relatively stable private consumption across the region have provided a moderate boost to growth. Credit expansion (Pakistan, Tunisia) and improved security (Pakistan) have also lifted growth by spurring private investment. Together, these developments have helped offset the negative effects of low agricultural output (Mauritania, Morocco), policy uncertainty (Lebanon, Pakistan, Tunisia), security risks (Afghanistan, Somalia, Tunisia), and spillovers from regional conflicts (Jordan, Lebanon).

Looking ahead, apart from Egypt and Tunisia, domestic demand will increasingly become the main driver of growth as contributions from the external sector fade (Figure 2.2). Several factors will sustain private consumption—including growth in remittances (Egypt, Lebanon,
Tunisia), increases in grants, and social transfers (Tunisia)—against a backdrop of higher energy and food prices.

Private investment is expected to increase in some countries (Egypt, Tunisia) benefiting from improved confidence. However, lingering policy uncertainty and persistent macroeconomic imbalances in some countries (Lebanon, Pakistan, Sudan, Tunisia), along with tightening global financing conditions, underscore risks to private investment, and thus prospects for achieving a more balanced and broad-based mix of growth (see Chapter 5).

Growth projections for 2018–19 have been revised downward in nearly half of the countries from the May 2018 Regional Economic Outlook Update: Middle East and Central Asia due to low agricultural output resulting from drought (Mauritania), policy slippages and external imbalances (Lebanon, Morocco, Pakistan, Sudan), and weak extractive sector output (Mauritania).

Authorities in the region must sustain ongoing structural reform efforts and accelerate other reforms to strengthen the resilience of the recovery and sow the seeds for higher medium-term growth. In particular, completing subsidy reforms, improving governance and competitiveness, and further enhancing the business environment, together with addressing macroeconomic imbalances in some countries, would lessen policy uncertainty and boost confidence.

**External Balances Improving, but Vulnerabilities Elevated**

Steady export growth has helped mitigate the impact of higher oil prices on the region’s external balance. The current account deficit is expected to edge down to 6.5 percent of GDP in 2018, from 6.6 percent last year, and decline further to 6.1 percent in 2019 (Figure 2.3). Annual export growth in 2018 is projected to more than double from last year to 15.4 percent, outpacing import
growth of 10.1 percent, up from 8 percent. This surge is largely driven by Egypt, reflecting base effects from receding macroeconomic imbalances during 2016–17 and an improved business environment. Moreover, tourist arrivals have risen steadily following improvements in security, a weaker exchange rate, and a resumption of direct flights from Russia. More broadly, growth in Europe has supported an increase in exports across the region.

Positive spillovers through exports, tourism, foreign direct investment, and remittances from rebounding Gulf Cooperation Council economies are also expected to support external sectors in the region. The exception is Pakistan where imprudent economic policies have contributed to a surge in imports and a wider current account deficit.

Nevertheless, significant dependence on oil imports (as a share of both imports and GDP) leaves many countries in the region vulnerable to further rises in global fuel prices. For example, if oil prices were to rise by $10 through 2019 (instead of remaining stable), current account deficits across the region could worsen by between 0.1 to 1.6 percent of GDP (Figure 2.4).

Bilateral and multilateral official financing has supported reserve buffers in several countries (Egypt, Jordan, Pakistan, Somalia, Tunisia). Despite improvements in current account balances, however, reserves have continued to decline in some countries since the start of 2018. Further appreciation of the US dollar and higher interest rates in the United States could reinforce capital outflow pressures, which, coupled with higher oil import bills, would put additional strains on reserve buffers in some countries, particularly those with significant external financing needs (Pakistan, Sudan).

**Financial Conditions Reflect Increased Global and Regional Risks**

For the most part, banks in the region are stable, liquid, and adequately capitalized. Credit growth
to the private sector remains modest, reflecting fragile growth and the prevalence of government financing by the region’s banks. With tighter and more volatile global financing conditions, the credit environment will become more challenging, potentially limiting the scope of the financial sector to support higher growth.

MENAP oil-importing countries issued about $12 billion in sovereign bonds in the first half of 2018, covering approximately two-thirds of the planned borrowing for the year, and almost $3 billion more than in 2017. This reflected borrowing by Egypt and Lebanon of $6.5 billion and $5.5 billion, respectively, amid favorable external financing conditions earlier this year. The market anticipates issuances from other countries in the region later this year. However, this could prove challenging as emerging market financial conditions have tightened (see the October 2018 World Economic Outlook). Indeed, sovereign spreads for MENAP oil importers have generally widened by 50 to 300 basis points since April, owing to a combination of increased global policy uncertainty and reduced risk appetite, including from geopolitical and economic developments in Turkey (Figure 2.5). Tighter global financial conditions could worsen external and fiscal burdens (Lebanon, Pakistan, Tunisia), while putting strains on the balance sheets of banks and private firms.

**With Elevated Public Debt, Further Growth-Friendly Consolidation Needed**

Recent fiscal trends are encouraging. The average fiscal deficit has fallen from a peak of over 9 percent of GDP in 2013 to a projected 6.6 percent of GDP in 2018. The deficit is envisaged to drop further to 6.3 percent of GDP in 2019 on the back of improved revenue collection, continued cuts in primary expenditure, and rationalization of capital spending (Figure 2.6).
Fiscal consolidation efforts during 2017 targeted expenditure, including cuts in capital spending, reducing or freezing of public wage bills (Tamirisa and Duenwald 2018), and spending on goods and services. However, a reversal in the reduction of subsidies amid higher oil prices, coupled with increases in debt service, is expected to strain fiscal balances in 2018.

Efforts have also been made to increase revenue, by raising or rationalizing value added tax rates (Jordan, Lebanon, Morocco, Tunisia), eliminating tax exemptions (Jordan, Morocco), improving tax administration (Afghanistan, Mauritania, Morocco, Tunisia), and rationalizing customs duties (Djibouti, Mauritania, Tunisia). And while increased spending on social safety nets has helped to mitigate the impact of fiscal adjustment on the poor, social tensions remain in a few places (Jordan, Tunisia).

Despite these measures, large vulnerabilities persist. Public debt levels remain elevated, leaving countries with little fiscal space to absorb increased financing costs or the impact of higher oil prices. Public debt will exceed 90 percent of GDP in nearly half of the countries in the region in 2018. A large part of this debt (52 percent) is denominated in foreign currency, with a substantial amount maturing soon (Figure 2.7). Moreover, interest payments are significant and rising, absorbing more than 20 percent of revenues in 2017, compared to 17 percent in 2016. These large interest obligations limit the scope to use any savings or additional revenue to increase growth-enhancing spending (see Chapter 4).

Going forward, maintaining the pace of fiscal consolidation in an environment of tighter financial conditions will be more challenging. Widening the tax base, reducing tax exemptions, making greater use of technology in tax collection (digitalization), and revising income tax thresholds could help increase equity and foster higher revenue mobilization (see Chapter 4). Pushing energy subsidy reforms to completion will be critical, including by enacting automatic fuel pricing adjustment (Egypt, Tunisia) to avoid the risk of reversal and create space for more growth-friendly capital spending. This should be coupled with increased spending efficiency through strong evaluation, prioritization, and implementation of infrastructure projects. With global financing conditions becoming more uncertain, deepening domestic bond markets could help reduce future financing risks.

**Inflationary Pressures Modest Amid Rising Energy Prices**

The regional inflation trajectory is expected to edge down to 10.3 percent in 2018 from 14.4 percent last year and is envisaged to trend lower in the medium term. But performance varies considerably across countries. Most countries have low, single-digit inflation rates, with six recording inflation of less than 6 percent. For now, the combination of administered prices in some countries, the absence of automatic pricing adjustments for fuel, and relatively stable food prices has helped keep inflationary pressures contained despite higher oil prices.
Monetary authorities in the region have largely maintained a neutral or tightening monetary policy stance (Egypt, Jordan, Tunisia; Figure 2.8) that remains broadly appropriate. However, they will need to remain vigilant against a rise in inflation and stand ready to anchor inflation expectations should second-round effects from higher energy and food prices materialize. In some countries (Lebanon, Pakistan, Sudan) further fiscal consolidation will also be required to rein in central bank financing and limit any inflationary pass-through. Monetary policy space is also limited by the need to remain alert to potential shifts in emerging market sentiment that would trigger capital outflows or exchange rate volatility.

Medium-Term Growth Too Low to Address Employment Challenges

The region’s economic recovery is expected to remain gradual and be much slower than previous episodes (Figure 2.9). Medium-term growth will likely average about 4.3 percent during 2020–23, notably below the 2000–10 average of 5 percent. Only a quarter of the countries in the region are expected to grow at an average rate above 5 percent in the medium term, which is insufficient to improve living standards and address labor market needs.

Real per capita growth in the region has been substantially lower than in other middle- and low-income countries over the past decade, and the gap has recently widened (Figure 2.10). At the same time, high unemployment, averaging above 10 percent in 2017 in most countries, increases social and economic costs and remains a major policy concern in a region where more than half the population is below 30 years of age.

In order to raise current per capita incomes to those of peers in emerging market and developing economies, and to absorb the currently unemployed and projected new entrants into the labor market over the medium term, annual growth would need to reach 7 percent (Figure 2.11). Many of the factors that constrain greater employment opportunities—such as...
2. MENAP OIL-IMPORTING COUNTRIES: SAFEGUARDING THE GROWTH RECOVERY AMID RISING RISKS

Limited Policy Space: Continued Structural Reforms Needed for Durable and Inclusive Growth

In addition to continued fiscal consolidation, a number of complementary structural reforms are needed to raise the region’s economic potential, create jobs, and enhance inclusion (see Chapters 4 and 5):

- **Improve the business environment:** Several countries have passed legislation that makes it easier to open, operate, and close businesses. With new laws on bankruptcy and insolvency, Egypt and Tunisia have sought to facilitate the restructuring of failing firms. Egypt is also taking steps to make it easier to improve access to industrial land for business and will sell minority shares in five state firms this year to reduce the role of the state in the economy.

- **Strengthen governance and institutions:** Recognizing that corruption can adversely affect the pace of reforms, the cost of doing business, and private investment (IMF 2017; see also Chapter 5), some countries are putting in place frameworks to combat corruption, including through legislation (Afghanistan, Mauritania, Tunisia), and are enhancing transparency and accountability of state-owned enterprises, while increasing competition by enacting regulations to standardize the public procurement process and strengthening the competition authority (Egypt).

- **Enact labor market reforms:** Skill shortages and mismatches, coupled with inefficient labor markets, impede productivity and limit the ability of firms to compete effectively or generate more jobs. Educational attainment...
and learning outcomes in MENAP oil importers remain low relative to other emerging market economies. More efficient and outcome-based spending on education is needed to boost productivity as well as generate more inclusive and equitable growth. Some countries (Morocco) are revamping their education system, linking vocational training to private sector skill gaps. In addition, reforming labor regulations could help increase labor market dynamism (Morocco) and reduce labor informality, thereby supporting the private sector. Pension reforms could also encourage greater job-seeking in the private sector (Morocco, Tunisia).

- **Reduce informality:** A large section of the economy in the region is dominated by a low productivity informal sector, with the formal sector accounting for only a third of employment in the region. Businesses with five or fewer employees dominate the private sector in Egypt (60 percent), Jordan (40 percent), and Tunisia (37 percent). However, the informal sector has difficulty accessing credit, market opportunities, and government services, and this limits the vibrancy of the private sector. Tight labor market regulations impede firms from expanding and gaining economies of scale, constraining most small businesses to informality. Moreover, the government loses out on revenues since this sector remains largely untaxed (see Chapter 4).

- **Enact productivity-enhancing reforms:** Macroeconomic and structural reforms to improve competitiveness through exchange rate adjustments (Tunisia), easing access to credit (Egypt, Morocco, Pakistan) and industrial land (Egypt), and diversifying the economy (Mauritania), among other measures, would help the private sector compete more effectively, better enabling it to take advantage of external demand. A recent study highlights that business climate reforms that generate a 1 point increase on the World Economic Forum’s Global Competitiveness Index for Middle East North Africa countries would raise productivity growth by 1.4 percentage points (Purfield and others 2018).

### Risks Remain to the Downside

The outlook remains vulnerable to changes in oil prices, financing conditions, the global growth and trade outlook, and geopolitical developments. The combination of high public debt and rising interest burdens leaves fiscal positions exposed to higher oil prices through energy subsidies. Higher oil prices would also erode gains in external balances, threatening those countries with declining international reserve buffers. A sudden tightening of global financial conditions and a reversal of risk appetite would reinforce external and fiscal pressures, especially for countries with significant maturing external obligations. Similarly, a rise in trade tensions that leads to a widespread loss in confidence would undermine global growth, impact financial markets and risk appetite, and expose fragilities among MENAP oil importers. Countries with greater exchange rate flexibility will be better equipped to absorb external shocks than those with pegged or tightly managed exchange rate regimes.

In addition, a number of specific regional and domestic risks persist. Notably, a worsening of security conditions or social tensions (Afghanistan, Lebanon, Somalia, Tunisia) and increased spillovers from regional conflicts (Jordan, Lebanon, Tunisia) could weaken economic activity. Political and social tensions could result in slower implementation of reforms, hampering economic resilience and inclusive growth. Finally, countries where the agricultural sector makes a sizable contribution to growth (Afghanistan, Mauritania, Morocco, Pakistan, Somalia) remain vulnerable to weather developments.
References


### MENAP Oil Importers: Selected Economic Indicators

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<td>-8.8</td>
<td>-10.5</td>
<td>-9.6</td>
<td>-8.5</td>
</tr>
<tr>
<td>West Bank and Gaza²</td>
<td>-17.3</td>
<td>-16.3</td>
<td>-10.1</td>
<td>-10.9</td>
<td>-12.7</td>
<td>-13.4</td>
</tr>
</tbody>
</table>

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

**Note:** Variables reported on a fiscal year basis for Afghanistan (March 21/March 20) until 2011, and December 21/December 20 thereafter, and Egypt and Pakistan (July/June), except inflation.

¹Data for 2011 exclude South Sudan after July 9. Data for 2012 and onward pertain to the current Sudan.

²2011–19 data exclude Syria.

³West Bank and Gaza is not a member of the IMF and is not included in any of the aggregates.

⁴Central government. For Lebanon, includes transfers to electricity company.

⁵Overall fiscal balance includes the transfers to the electricity company NEPCO until the end of 2014. From 2015 transfers were stopped.

⁶Includes oil revenue transferred to the oil fund.

⁷Including grants.

⁸Includes bank recapitalization costs and arrears payments.
After a recovery in 2017, GDP growth in the Caucasus and Central Asia (CCA) region is expected to stabilize in 2018 and in the medium term. However, at forecast growth rates, it will take nearly two decades to raise CCA living standards to the current levels of emerging Europe. To ensure that citizens benefit from the catching-up process, countries in the region need to move to a private-sector-led growth model by reducing the large state footprint in the economy, while creating an enabling business climate for the private sector and promoting competition. Meanwhile, buffers that were heavily depleted during the 2014 external shock need to be rebuilt to address the risks stemming from continued weaknesses in the financial sector and high public debt. Stronger buffers will also help if risks to global growth, including from escalating trade tensions, materialize.

Growth Recovery Stabilizing and Inflation Remains Subdued

The CCA region grew by 4.1 percent in 2017, supported by higher commodity prices, robust external demand, and fiscal stimulus in some countries. Growth is expected to remain steady at 4 percent in 2018 and 2019, and to stabilize at about 4.2 percent over the medium term, much lower than the average 9 percent experienced in the first decade of the century.

For oil exporters, growth is projected to remain broadly stable at 3.8 percent in 2018 and 3.9 percent in 2019 (Figure 3.1). In Azerbaijan, a surge in public investment is projected to boost the nonhydrocarbon sector and lead to a significant increase in growth in 2018. Stronger nonhydrocarbon sector growth in 2018–19 is also expected in Kazakhstan, driven by structural reforms aimed at enhancing competitiveness and productivity, as well as improvements in the business climate, opportunities opened by the Belt and Road Initiative, and reforms in Uzbekistan. In contrast, hydrocarbon growth is expected to slow as the gains from the new Kashagan field moderate.

For oil-importing countries, growth is expected to slow from 6 percent in 2017 to 5 percent in 2018 and 4.8 percent in 2019. Economic activity in the region will continue to be underpinned by robust external demand and remittances, as Russia continues to recover from the 2015–16 recession. Domestic consumption will remain robust in Georgia and Armenia, though the overall pace of

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Prepared by Philip Barrett and Fang Yang. Research assistance provided by Jorge de Leon Miranda.

1Emerging Europe consists of Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Macedonia, Montenegro, Poland, Romania, Serbia, and Turkey.
growth will likely moderate in Armenia, where an exceptionally strong performance in 2017 was driven by a rebound in domestic demand. Growth in the Kyrgyz Republic will also be slower in 2018 due to weaker gold production but is expected to recover in 2019. Growth will remain strong in Tajikistan, supported by the construction of large public investment projects and domestic demand.

Over the medium term, the region’s growth momentum is expected to fade, due to softer growth in key economic partners, an expected moderation of oil prices, and an anticipated scaling back of public investment in some countries. Eventually, growth will stabilize, but at lower levels, held back by weak private investment and productivity.

Bilateral exchange rates against the US dollar have been broadly stable for most countries in the region, but the depreciation of the Russian ruble has led to an appreciation of effective exchange rates. This has helped contain inflationary pressures across the region, despite the increase in oil prices. The recent appreciation against the Turkish lira will generate further appreciation of real exchange rates in those countries with significant Turkish imports (Georgia, the Kyrgyz Republic; see Box 3.1). Inflation is expected to remain generally subdued in 2018, and the adoption of inflation-targeting regimes in some countries is helping anchor inflation expectations. In most countries, this has allowed central banks to maintain an appropriately accommodative monetary stance, with Azerbaijan, Georgia, Kazakhstan, and Tajikistan reducing policy rates in 2018.

In Uzbekistan, price reforms and the lagged effects of exchange rate depreciation have triggered higher inflation in 2018, but this is expected to subside in 2019. Inflationary pressures have also edged up in Turkmenistan as reforms of utility and energy prices continue.

### Fiscal Consolidation Underway

While oil-exporting countries continued to undertake expansionary fiscal policy in 2017 to offset the impact of the 2014–16 external shocks, fiscal consolidation is now under way in most oil exporters. Therefore, the non-oil fiscal balance is anticipated to narrow from –17.4 percent of GDP in 2017 to –12.1 percent in 2018, and further to –11.9 percent in 2019 (Figure 3.2). Expenditure reforms are envisaged in Kazakhstan, where the $9 billion Nurly Zhol Plan to develop and modernize infrastructure that started in 2015 has concluded; in Turkmenistan, where capital spending will be reduced; and in Uzbekistan, where a cut in onlending operations will be partially offset by increased social expenditures. In Azerbaijan, however, the planned increase in capital expenditure, linked mostly to oil sector investments, will cause the non-oil primary balance to deteriorate. These measures, coupled with further increases in oil revenue, will shift the overall fiscal balance in oil-exporting countries into a surplus from 2018 onward.

In contrast, fiscal restraint in oil importers helped to improve fiscal balances in 2017, from –5.4 percent of GDP in 2016 to –4.4 percent in 2017. Further improvements are expected in 2018 (to –3.9 percent) and over the medium term. This is mainly because fiscal policy in Armenia and Georgia remains slightly contractionary, though a more neutral stance is expected in Georgia over the medium term. However, the deficit in the Kyrgyz Republic is expected to widen due to discretionary spending.

### Higher Oil Prices Driving External Positions

External positions strengthened in 2017, with current account deficits improving in almost all CCA countries. Improvements in oil exporters reflected higher oil prices, while oil importers benefited from robust external demand and higher remittances.
Positive terms of trade shocks and the gradual recovery of foreign direct investment have also helped CCA countries rebuild international reserves. Nonetheless, some countries could benefit from further strengthening their buffers against external shocks (Figure 3.3).

In 2018, higher oil prices will further improve the external positions of CCA oil exporters, with stronger growth of oil exports outstripping import growth (Figure 3.4). The exception is Uzbekistan, where the current account balance is expected to decline in 2018 and over the medium term, as trade liberalization generates strong import growth.

In contrast, the current account deficit of oil importers is projected to widen from 4.9 percent of GDP in 2017 to 8 percent in 2018, as strong import growth driven by higher oil prices is expected to exceed the growth of remittances. Lower gold exports in the Kyrgyz Republic and the imports associated with the large construction projects in Tajikistan are also contributing to the widening of current account deficits in these countries.

Over the medium term, as commodity prices and global demand moderate, the current account balances will likely stabilize, although at more negative levels than their average before the 2014 external shock.

External Risks Rising

The baseline projection for the region is subject to rising global risks. In the short run, the emerging pressures in Turkey may impact the region (Box 1), particularly through direct trade...
channels and because of countries’ strengthened currencies vis-à-vis the lira. For example, Turkey is Azerbaijan’s second and Georgia’s third largest export destination. The likelihood of sustained and escalating trade actions could depress the growth prospects of key trading partners (including China and Russia) and reduce demand for CCA exports and remittances, thus disrupting the economic recovery.

Lower commodity prices associated with a weaker global outlook would also worsen the external and fiscal positions of countries in the region.

And while financial linkages with advanced economies are relatively limited, an unexpected tightening of global financial conditions could also lead to capital flow reversals and sharp movements of exchange rates. Countries with relatively large external debt and high dollarization in the banking sector (Azerbaijan, Georgia, and Tajikistan) are particularly vulnerable.

**Figure 3.4. Current Account Balance and Exports for CCA (Percent of GDP)**

<table>
<thead>
<tr>
<th>Year</th>
<th>AZE</th>
<th>KAZ</th>
<th>TKM</th>
<th>UZB</th>
<th>ARM</th>
<th>GEO</th>
<th>KGZ</th>
<th>TJK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil exporters</td>
<td>Current account balance</td>
<td>Exports (right scale)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: National authorities; and IMF staff calculations. Note: CCA = Caucasus and Central Asia. Country abbreviations are International Organization for Standardization (ISO) country codes.

**Growth Too Low to Raise Living Standards Over the Medium Term**

Given the outlook and rising risks, the medium-term growth prospects for the CCA remain much lower than historical experience, and too low to raise living standards to levels of comparable economies over the medium term. At these projected growth rates, and given demographic trends, it will take on average 18 years for countries in the region to either graduate from their low-income status or reach the current per capita income levels of European emerging markets (Table 3.1).

This average masks, however, a wide variety in convergence time across countries, ranging from less than a decade to more than a generation. Further, the current convergence gap is similar to the gap that prevailed prior to the global financial crisis (20 years in 2007), suggesting a lack of meaningful progress with reforms over the past decade.

Achieving a moderate improvement in growth could shorten these times dramatically. For instance, half a percentage point of additional growth per year would reduce the convergence time by two years. A sustained larger increase in growth rates to those of 2010–14 would reduce the average convergence time to 12 years (and to a decade for oil exporters).

**Reducing the State Footprint to Provide Room for the Private Sector**

A large state sector is an important factor limiting medium-term growth prospects. State-owned enterprises (SOEs) make up a sizable share of economic activity in the CCA, frequently with dominant positions in key industries. For example, in Kazakhstan, SOEs are heavily involved in extractives, telecommunications, finance, and transportation. Weak SOE governance contributes to inefficient production, and subsidized prices cause distortions in inputs to consumption and
production. In Georgia, SOEs are sufficiently large (and fragile) as to constitute a principal fiscal risk, although the authorities have proactively taken steps to disclose this risk.

Heavy state involvement in market activities can distort incentives and lead to a misallocation of economic resources. In the Kyrgyz Republic, energy prices do not reflect the true cost of providing services to consumers, creating a bias in favor of energy-intensive activities. In Azerbaijan, industrial policy continues to play an important role in the government’s diversification strategy. Caution will be needed to avoid “picking winners,” which risks suppressing competition by biasing outcomes in favor of government-preferred firms. In addition, direct state intervention often comes at a fiscal cost, either implicit or explicit, in contrast to market-based alternatives.

By competing for resources and talent, economies with large state sectors can struggle to produce a dynamic private sector. For example, although total credit from the region’s banking sector is well below that of other peers, public companies receive a larger share of that credit, especially in Azerbaijan, Tajikistan, and Uzbekistan (Figure 3.5). This has the potential to sustain loss-making public enterprises, and further aggravate the challenges of private sector access to credit, which is a key input of production.

Reducing the role of the state can free up resources for the private sector, allowing it to flourish. In Kazakhstan, for example, successful completion of plans to conduct initial public offerings for major SOEs would send a strong signal that the role of the state is being meaningfully reduced, and provide an opportunity for the private sector to increase its role in the economy. In parallel, the governance of SOEs should be improved to reduce fiscal risks. In this context, efforts in the Kyrgyz Republic to streamline the organization of SOEs—reducing their number by about a half—are welcome.

Boosting competition throughout the economy will also be critical to improving the allocation of resources and rewarding efficiency. This would ensure that state control is not replaced with private monopolies. To this end, Armenia’s amended law on economic competition and protection is a welcome step forward. In Georgia, care should be taken to prevent high concentration in some sectors (including banking and health services) from translating into noncompetitive practices.

<table>
<thead>
<tr>
<th>Oil Exporters</th>
<th>GDP per Capita in 2017 (USD)</th>
<th>Comparator</th>
<th>Average per Capita GDP Growth 2020–23</th>
<th>Years to Converge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Azerbaijan</td>
<td>4,141</td>
<td>EMEU</td>
<td>2.2</td>
<td>45</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>8,762</td>
<td>EMEU</td>
<td>3.1</td>
<td>7</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>6,643</td>
<td>EMEU</td>
<td>5.0</td>
<td>10</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>1,520</td>
<td>LIC</td>
<td>5.3</td>
<td>9</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Oil Importers</th>
<th>GDP per Capita in 2017 (USD)</th>
<th>Comparator</th>
<th>Average per Capita GDP Growth 2020–23</th>
<th>Years to Converge</th>
</tr>
</thead>
<tbody>
<tr>
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<td>3,857</td>
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<td>23</td>
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<tr>
<td>Georgia</td>
<td>4,086</td>
<td>EMEU</td>
<td>5.8</td>
<td>18</td>
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<tr>
<td>Kyrgyz Republic</td>
<td>1,208</td>
<td>LIC</td>
<td>2.9</td>
<td>23</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>801</td>
<td>LIC</td>
<td>2.9</td>
<td>38</td>
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<table>
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<th>GDP per Capita in 2017 (USD)</th>
<th>Comparator</th>
<th>Average per Capita GDP Growth 2020–23</th>
<th>Years to Converge</th>
</tr>
</thead>
<tbody>
<tr>
<td>CCA Oil Exporters</td>
<td>6,071</td>
<td>EMEU</td>
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<td>17</td>
</tr>
<tr>
<td>CCA Oil Importers</td>
<td>2,696</td>
<td>EMEU</td>
<td>4.3</td>
<td>34</td>
</tr>
<tr>
<td>Emerging and developing Europe</td>
<td>10,965</td>
<td>LIC</td>
<td>2.9</td>
<td>23</td>
</tr>
</tbody>
</table>

| Sources: National authorities, United Nations; and IMF staff calculations. |
| Note: CCA = Caucasus and Central Asia; EMEU = emerging and developing Europe; and LIC = low-income countries. |
Creating an Enabling Business Environment for Private Investment

Private investment was robust in the first decade of the century before it declined following the global financial crisis. Today, the private investment-to-GDP ratio has not yet recovered to the level of 2000–10 (Figure 3.6), even for oil exporters, where it rebounded in 2015–17 largely reflecting foreign oil companies’ investments in the oil sector, particularly in Kazakhstan.

Firms face a number of challenges that will influence investment decisions. As discussed, difficulty accessing finance is consistent with a state sector that competes with the private sector for resources. The prominence of responses from businesspersons citing taxes, corruption, regulation, and bureaucracy as a barrier to business (Figure 3.7) is also symptomatic of an oversized state footprint in the economy. Measures to alleviate these challenges would encourage more private investment and help boost growth (see Chapter 5). In this context, the Armenian government’s commitment to reducing corruption and improving competition is welcome.

New firms particularly struggle in the region. Business entry rates in the CCA are much lower than in other regions, including sub-Saharan Africa (Figure 3.8). A notable exception is Georgia, where the success of structural reforms—including those implemented in the early 2000s and in recent years—has resulted in continuously higher rates of new business entries, as well as private investment higher than the regional average.

Private sector growth can also be stimulated via reforms that pursue greater regional and global economic integration. Opening the region to more trade and investment would increase access to goods and services at lower prices, spur competition, promote diversification, and ultimately increase productivity and growth.
Recent price and product market reforms in Uzbekistan, for example, have the potential to catalyze change and prosperity in the wider region. The progress of the Belt and Road Initiative also presents an opportunity for the region to integrate further into global trade networks, if challenges are adequately addressed (see the May 2018 Middle East and Central Asia Regional Economic Outlook Update).

Enhancing the Financial Sector Contribution to Growth

Financial systems continue to play a limited role in supporting growth. The external shocks starting in 2014 exposed the underlying vulnerabilities in the banking sector of several CCA countries. Despite recent efforts to address unviable banks, weak bank balance sheets continue to constrain credit provision and undermine banks’ ability to support economic growth (Figure 3.9).

Accordingly, while credit growth has been robust in Georgia and Armenia, where banking sectors are in good health, it remains weak in countries where banking sectors are yet to fully recover from financial stress, such as Azerbaijan, Kazakhstan, and Tajikistan. Resolving the stock of bad assets and nonviable banks remains a priority for these countries to ease the credit constraint on the private sector.

Financial sector stresses in the region have deep-rooted structural causes, including lack of competition, weak governance, segmentation of the credit market, and weak regulation and supervision. Dollarization of the banking sector generally remains elevated in the CCA, which can exacerbate balance sheet losses in the case of sharp exchange rates movements. Thus, fundamental reforms to address these structural issues are critical for financial stability and resilience.³ While the strategy and timeline

²For a detailed discussion of policies to support regional and global integration, see Kunzel and others (2018).

³For a comprehensive discussion of strategies to improve financial resilience, see Vera-Martín and others (2018).
depend on country circumstances, for most CCA countries strengthening risk-based regulations and supervision, removing legal and structural barriers to competition, and improving bank governance structure remain priorities for financial stability. Countries should also continue to pursue efforts to reduce dollarization.

Countries are making progress. For instance, a new bank resolution framework was established in Azerbaijan. In Kazakhstan, initiatives have been adopted to strengthen the central bank’s supervisory power. Tajikistan initiated the asset quality review of systemic banks and approved legislation on the regulation of payment services. In the Kyrgyz Republic, the central bank has implemented prudential norms that meet international standards, and is taking steps toward risk-based supervision. And Georgia and Armenia are enhancing bank regulation and supervision, improving the banking resolution framework, and strengthening bank governance.

Measures to strengthen the banking system should be complemented by efforts to further develop capital markets, including developing securities market infrastructure and strengthening regulation and supervision. This would help provide an alternative channel for firms to access long-term capital for investment and facilitate broader access to finance. In this context, Kazakhstan’s initiative to deepen the local securities market is welcome.

In addition, efforts to promote financial inclusion should be sustained as part of the broader objective to promote inclusive growth, including by promoting Fintech, particularly mobile payment systems (see the October 2017 Regional Economic Outlook: Middle East and Central Asia).

### Enhancing Resilience through Growth-Friendly Fiscal Consolidation

The significant increase in public debt experienced by some CCA countries raises vulnerabilities and could impede efforts to promote higher and inclusive growth. Public debt in Azerbaijan, Armenia, the Kyrgyz Republic, and Tajikistan has increased to above 50 percent of GDP.
3. CAUCASUS AND CENTRAL ASIA: UNLOCKING THE REGION’S GROWTH POTENTIAL

(Figure 3.10). The large share of government debt in foreign currency or linked to the exchange rate raises countries’ vulnerabilities to large exchange rate movements. The materialization of contingent liabilities associated with the financial sector and SOEs could also aggravate the debt burden.

Countries’ medium-term fiscal plans suggest they are aiming to stabilize debt at current levels. However, the increase in debt vulnerabilities, coupled with the need to build fiscal space to close infrastructure gaps in some countries, points to the need for more ambitious fiscal targets while keeping fiscal consolidation growth-friendly and inclusive.

Medium-term adjustment should come from a balanced mix of revenue mobilization and expenditure rationalization, such as reducing transfers to SOEs, while improving spending efficiency and promoting growth. In this context, the fiscal reform in Kazakhstan to provide funding to health and education service providers on a per capita basis, expand public-private partnerships and outsourcing, and review public wages is on the right track, provided that reforms are well designed and executed. In Azerbaijan, the management of SOEs has been tightened and efforts are being made to raise tariff rates and make subsidies more transparent. At the same time, social spending should increase. Levels of cash transfers—a key means of supporting low-income households—are low by international standards (Figure 3.11). Progress on both of these fronts, as well as better targeting of benefits, would help mitigate the impact of adjustment on the most vulnerable groups, ensuring that fiscal policy is not just growth-friendly but also inclusive (see Chapter 4).

In addition, strengthening medium-term fiscal frameworks would support consolidation efforts. In this context, initiatives to amend the budget code and implement the fiscal rule in the Kyrgyz Republic are commendable. The

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4 For discussion of strategies to improve fiscal buffers, see Gemayel and others (2018).
A new fiscal rule in Armenia will help reduce the bias toward procyclical fiscal policy and avoid large and abrupt fiscal adjustments. Finally, increasing fiscal transparency and accountability would help underpin the credibility of the public sector and improve market confidence.

Measures in Kazakhstan and Turkmenistan to align fiscal reporting to international standards, and the commitment to bring all fiscal operations on-budget in Uzbekistan, will help to strengthen the effectiveness of fiscal management.
Forecast growth rates suggest that it will take close to two decades to raise living standards in the Caucasus and Central Asia (CCA) region to the current levels of emerging Europe. Securing higher and more inclusive growth will require that the region find new growth drivers to boost its economic potential and move away from the current state-led growth model.

A recent IMF staff paper (Kunzel and others 2018) suggests that greater economic integration could help. Opening the region to more trade and investment would expand access to goods and services at lower prices, spur competition, promote diversification, and ultimately improve productivity and growth. Estimates suggest that growth rates in the CCA could be 1 percentage point higher on average if the region were to increase trade openness (October 2017 Regional Economic Outlook: Middle East and Central Asia). Opportunities for greater integration include reducing tariff and nontariff barriers, enhancing the productive capacity to integrate into global value chains, strengthening participation in multilateral trade initiatives led by the World Trade Organization, and capitalizing on regional integration initiatives, such as the Belt and Road Initiative.

To support these integration efforts, reforms are needed in the following areas:

- **Fiscal.** Stronger fiscal frameworks are needed to manage the fiscal risks associated with regional integration initiatives, such as the Belt and Road Initiative (Kunzel and others, 2018). More ambitious fiscal adjustment would also enhance macroeconomic resilience and send a clear signal of fiscal responsibility to investors, encouraging more foreign direct investment. It would also help mitigate any negative fiscal impact of trade liberalization—for instance, through lower tariff revenues that currently yield about 1.7 percent of GDP (Figure 3.1.1).  

- **Monetary.** The move toward greater exchange rate flexibility and inflation targeting in the region will encourage higher investment by promoting price stability and improving economic resilience.

- **Financial sector.** Healthier banking systems and deeper capital markets would promote more efficient financial intermediation, and help absorb larger capital inflows, again facilitating more investment and economic diversification.

- **Structural.** Reforms to strengthen infrastructure, the business environment, governance, and labor skills would make countries more competitive and attractive to outside investors (see Chapter 5).

Prepared by Peter Kunzel.

Note that the overall fiscal impact will depend on offsetting gains from higher-income tax revenues, given stronger economic growth.

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**Box 3.1. Opening Up in the Caucasus and Central Asia**

Figure 3.1.1. Estimated Contributions of Trade Measures to Growth

(Percent)

<table>
<thead>
<tr>
<th>Measure</th>
<th>2019–23 projected average growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade openness</td>
<td>—</td>
</tr>
<tr>
<td>Participation in GVC</td>
<td>—</td>
</tr>
<tr>
<td>Diversification</td>
<td>—</td>
</tr>
<tr>
<td>Quality</td>
<td>—</td>
</tr>
</tbody>
</table>

Source: IMF staff calculations.

Note: The growth increase is conditional on an increase in the given trade measure equal to the best historical period-over-period improvement observed in region in the last 20 years: 7.7 percentage points (pp) for trade openness; 4 pp for global value chains; 2.4 pp for diversification; 1.5 pp for quality. GVC = global value chain.
References


### CCA: Selected Economic Indicators

<table>
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<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
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<td><strong>Real GDP Growth</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Annual change; percent)</td>
<td>8.1</td>
<td>3.1</td>
<td>2.5</td>
<td>4.1</td>
<td>4.0</td>
<td>4.0</td>
</tr>
<tr>
<td>Armenia</td>
<td>7.3</td>
<td>3.3</td>
<td>0.3</td>
<td>7.5</td>
<td>6.0</td>
<td>4.8</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>10.9</td>
<td>0.6</td>
<td>−3.1</td>
<td>0.1</td>
<td>1.3</td>
<td>3.6</td>
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<td>2.8</td>
<td>5.0</td>
<td>5.5</td>
<td>4.8</td>
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<td>1.1</td>
<td>4.0</td>
<td>3.7</td>
<td>3.1</td>
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<td>3.9</td>
<td>4.3</td>
<td>4.6</td>
<td>2.8</td>
<td>4.5</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>7.8</td>
<td>6.0</td>
<td>6.9</td>
<td>7.1</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>11.1</td>
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<td>6.2</td>
<td>6.5</td>
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<td>7.0</td>
<td>7.9</td>
<td>7.8</td>
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<td>13.0</td>
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<tr>
<td>(Percent of GDP)</td>
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<tr>
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<td>(Percent of GDP)</td>
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<td>0.7</td>
<td>0.6</td>
<td>3.5</td>
<td>−0.5</td>
<td>−1.5</td>
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Sources: National authorities; and IMF staff estimates and projections.

¹Central government.

²State government.

²2011–15 data exclude Syria due to the uncertain political situation.
Middle East and Central Asia policymakers face the challenge of boosting inclusive growth amid limited fiscal policy space. Further fiscal consolidation is needed across the region to secure debt and fiscal sustainability. While some adverse impact on growth may be unavoidable, the composition of adjustment can mitigate this impact. Currently, countries are adopting a mix of spending cuts and revenue-boosting measures that may not necessarily foster durable and inclusive growth. To ensure that future fiscal adjustment is as growth-friendly and equitable as possible, countries need to (1) rebalance the composition of expenditure toward growth-enhancing and high-quality capital investment, while fostering well-targeted social spending; and (2) move to a more progressive tax structure, diversify the revenue base, and eliminate distortions. Embedding the adjustment in a well-defined medium-term fiscal framework, coupled with greater fiscal transparency, would make fiscal consolidation more durable.

Why Is Fiscal Adjustment Necessary in the Middle East and Central Asia Countries?

The rapid accumulation of debt in recent years—exceeding 50 percent of GDP in nearly half the countries in the Middle East and Central Asia (Figure 4.1)—calls for further fiscal adjustment to put fiscal positions on a sounder footing (see Chapters 1–3). At the same time, some asset-rich oil-exporting countries in the region need further adjustment to ensure that the benefits of oil revenues are spread equitably across generations and to preserve long-term sustainability (see Chapter 1).1

The expected further tightening of global financial conditions makes the need for this adjustment even more urgent. This will mitigate the risk that rising financing costs crowd out other social and pro-growth spending, such as investment in physical and human capital. Creating space for pro-growth spending is also essential to address the demographic pressures from a rapidly expanding labor force and already high unemployment rates, especially for youth.

While the speed and optimal composition of the fiscal adjustment required varies among countries, the question is how such an adjustment can be designed to minimize the adverse impact on inclusive growth.

Against this backdrop, this chapter takes stock of the nature of fiscal adjustment in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) and the Caucasus and Central Asia.
(CCA) regions in recent years. It also discusses how future adjustment can be designed to support inclusive growth. The chapter concludes with policy recommendations.

**Growth-Friendly Fiscal Adjustment: Size and Composition Matter**

Empirical studies on the assessment of fiscal multipliers confirm that public investment has a larger impact on growth and promotes more equal distribution of income than current spending or revenue (Bova and others 2013; Woo and others 2013).

Research also indicates that the success of fiscal adjustment, especially the growth response, depends on the quality and durability of the specific measures underpinning it. For instance, emerging market and developing economies with lower subsidies and transfers or higher revenues are more likely to sustain consolidations. Similarly, developing countries that cut selected current spending, while protecting capital spending, tend to experience longer-lasting benefits. For countries with low revenue-to-GDP ratios due to structural problems in their tax system (many emerging market and developing economies), revenue increases can also reinforce the duration of fiscal consolidation (Gupta, Clements, and Inchauste 2004; IMF 2010).

These findings suggest that fiscal adjustment programs that protect and enhance the quality of capital spending while reducing current expenditures (especially public wage bills or subsidies) or raising revenues would minimize the impact on growth and help make the gains more durable. Accompanying fiscal consolidation with measures to strengthen and simplify the tax system—by broadening the tax base and reducing exemptions—would not only improve revenue collection but also make revenue adjustment more equitable and efficient (see Table 4.1 in the Online Background Papers).

**What Has Been the Composition of Adjustment to Date?**

On average, except for CCA oil importers, countries have improved their fiscal balances over 2015–18. However, the ways in which this has been achieved have differed through the years and across countries (Figure 4.2).

By end-2018, MENAP oil exporters are expected to see their primary and overall fiscal balances improve by, on average, nearly 9 percent and slightly more than 8 percent of GDP, respectively, relative to end-2015. This is equivalent to an improvement in their non-oil primary and non-oil overall fiscal balance of just under 8 percent and nearly 7 percent of non-oil GDP, respectively. While the recent recovery in oil revenue accounts for about 1 percent of this, most of the improvement (over 5 percent of GDP) is driven by a significant reduction in current spending. In particular, MENAP oil exporters are seeing the benefits of subsidy reform, with spending on subsidies reduced while capital expenditure protected, which has only been cut by 1 percent of GDP. In contrast, to date, tax revenues have only delivered 0.3 percent of GDP of the improvement. The impact of the rising debt burden and tighter financial conditions has led to a notable increase in interest expenditure (0.6 percent of GDP), absorbing about half of the improvements in revenues.

The pattern of adjustment in CCA oil exporters has been similar to that of MENAP oil exporters. Cuts in current expenditure have delivered the bulk of the adjustment—2 percent of the 4 percent of GDP adjustment (or an improvement of about 3.5 percent in the non-oil fiscal balance relative to non-oil GDP), with the underlying primary balance improving by an additional 0.2 percent of GDP (or 0.3 percent of non-oil GDP). Cuts in subsidies and transfers account for more than 1 percentage point of the adjustment, while cuts in the public wage bill represent a relatively smaller contribution of under 0.3 percent of GDP that is completely absorbed by higher interest payments. Similar to MENAP
oil exporters, the savings secured on current expenditure have facilitated a relatively smaller adjustment in capital expenditure—of 0.7 percent of GDP. Again, to date, tax revenues have played a relatively small role in the adjustment, increasing by 0.3 percent of GDP during this period.

MENAP oil importers improved their overall fiscal balances by slightly more than 2 percent of GDP on average. However, the composition of adjustment has been very different from that of oil exporters. Tax reforms have made an important contribution to this adjustment—accounting for more than 1 percentage point of GDP—although these efforts were offset by a decline in other revenues. In addition, spending on subsidies and transfers dropped significantly in 2016, only to increase again with the recent increase in oil prices. This episode illustrates how gains can be short-lived in the absence of complete reform. Finally, while progress has been made on cutting public wage bills, these improvements were again offset by higher debt-servicing costs and higher subsidies. Consequently, current expenditure has actually increased by 0.3 percent of GDP relative to 2015, and the burden of adjustment has fallen on capital expenditure, which dropped by 2.5 percent of GDP.

In contrast to other countries, the fiscal balance of CCA oil importers has widened over 2015–18. Important savings have been generated through cuts in the public wage bill (0.3 percent of GDP) and other current spending (0.8 percent of GDP),

Sources: National authorities; and IMF staff calculations.
Note: Other revenue includes non-tax revenues and grants. MENAP oil exporters excludes Libya, Syria, and Yemen. CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan.
as well as through extra tax revenues mobilized (0.7 percent of GDP). However, higher interest payments (0.5 percent of GDP) and increased subsidies and transfers (0.4 percent of GDP) mean that current expenditure has only narrowed by 0.3 percent of GDP. At the same time, capital expenditure has increased by 0.7 percent of GDP. Combined with a decline in other revenues (1.3 percent of GDP), this has resulted in an accumulation of new debt over the period. Overall, oil exporters appear to have undertaken a relatively more growth-friendly fiscal adjustment. This shows the importance of completing energy subsidy reforms and further reducing public wage bills to strengthen the durability of fiscal adjustment and to facilitate greater spending on public investment (Sdralevich and others 2014; Tamirisa and Duenwald 2018).

What More Is Needed?

Fiscal Policy Design for Inclusive Growth

Even if consolidation efforts go as planned in 2018, debt will remain very high in a number of countries. In particular, debt in Bahrain, Egypt, Jordan, Lebanon, Mauritania, Morocco, Pakistan, Sudan, and Tunisia will remain above the 60 percent vulnerability threshold for emerging market economies. The importance of addressing the debt burden is also illustrated by the significant gains from fiscal adjustment being lost through rising interest payments. Accordingly, going forward, a significant fiscal adjustment is still needed.

To avoid myopic thinking and to prevent slippages, this adjustment should be grounded in a medium-term fiscal framework. For instance, in oil exporters, a fiscal anchor independent of oil price fluctuations (for example, the non-oil primary balance) would be particularly important for guiding policy decisions and managing the inherent fiscal procyclicality in such economies. Multi-year budgeting, the use of explicit fiscal rules, and enhanced expenditure controls over line ministries would help ensure that fiscal policy is consistent with longer-term policy objectives, such as debt sustainability and intergenerational equity (see the April 2015 Fiscal Monitor). At the same time, the composition of adjustment should be carefully designed to minimize the potential negative impact on growth.

Increasing the Role of Revenue Reforms

Although there is still likely to be scope for further adjustment on the expenditure side, shifting some of the burden to enhancing revenues is warranted going forward. Indeed, total tax revenue collection in the MENAP region is significantly less than in other emerging market economies (Figure 4.3). The largest discrepancy is for oil exporters, where non-oil tax revenues represent less than 10 percent

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2To support higher growth, fiscal policy should be well coordinated with other macroeconomic policies (including monetary and exchange rate policies).
of GDP, against more than 20 percent of GDP in emerging market economies.

Overall, and in line with other emerging market economies, consumption-based taxes (including the value-added tax—VAT) provide the broadest source of tax revenues in most of the region—61 percent of taxes in the CCA and 49 percent in MENAP oil-importing countries (46 percent in emerging market economies). The exception is the MENAP oil-exporting countries where, as of 2017, consumption-based taxes contributed only 17 percent of total tax revenues. In this context, the recent introduction of the VAT and excise taxes in some Gulf Cooperation Council (GCC) countries is welcome and should be completed in the remaining countries as soon as feasible.

The relative roles of personal and corporate income taxes differ more widely across the region. In emerging market economies, the contribution across personal and corporate income taxes is broadly balanced, with both contributing 17 percent to total tax revenues. In contrast, there is a heavier burden on personal income taxes in the CCA (22 percent) relative to corporate taxes (15 percent), while the reverse is true in MENAP oil-importing countries (14 percent through personal income taxes and 21 percent through corporate income taxes).

This difference is even more pronounced in MENAP oil exporters, especially in the GCC, where there is no personal income tax. In these countries, although the level of income tax collection is relatively small, corporate taxes bear most of the burden (35 percent for MENAP oil-exporters overall, and 62 percent in the GCC). The GCC is also notable for its reliance on other taxes, including items such as fees and stamp duties, which account for 17 percent of total tax revenues in the GCC countries, compared to 10 percent in emerging market economies. Against this backdrop, gradually introducing personal income taxes in GCC countries would provide an opportunity to reduce or remove these more regressive and administratively costly fees and stamp duties (for example, user-based fees on government services) (IMF 2015a, 2016) and bring the balance of the tax burden more in line with other countries.

The other notable area where MENAP countries differ from other emerging market economies is social contributions, which account for approximately 4 percent of total tax revenues across the region, compared to 16 percent for emerging market economies. This likely reflects a large informal sector, but could also indicate weak administrative capacity. In contrast, the collection of social contributions in the CCA is similar to emerging market economies. Mirroring this, spending on social benefits is also notably lower in MENAP countries than emerging market economies (Figure 4.4), but is much more comparable with countries in the CCA.

This suggests that finding ways to increase social
contributions in MENAP countries, such as by encouraging an increase in the formality of the economy, strengthening tax administration, or decoupling social contributions from wage earnings, would help broaden the financing and increase the scope to spend on social benefits.

Tax reforms vary by their very nature, involve trade-offs between growth, government revenue, and equity, and can be painful in the short term because they require changes in the social contract between governments and citizens. Analyzing the welfare and macroeconomic effects of fundamental tax reforms indicates that a broad-based package of reforms, coupled with improved social safety nets, could provide a better outcome than more partial measures (Box 4.1).

**Room to Simplify the Tax System and Remove Distortions**

There seems to be significant scope to further reduce exemptions, improve the progressivity of the tax structure, and broaden the tax base. This would not just make a significant contribution to the needed fiscal adjustment effort but also help make it more equitable, efficient, and growth-friendly.

Reducing exemptions would make the tax regime simpler and less complex, by reducing administrative costs and minimizing the scope for tax avoidance (Mansour 2015). For instance, widespread corporate tax exemptions (especially in the GCC, where corporate tax for the most part applies to foreign-owned firms but not to domestic firms) lead to fiscal losses, make the system more complex, and create a bias in favor of large corporations over small and medium enterprises that are pivotal for growth and job creation (Box 4.1; see also Jewell and others 2015). The equity implications of VAT exemptions on consumer goods should be carefully considered to ensure that well-off consumers do not benefit more than the poor.

The tax systems of most countries in MENAP rely overwhelmingly on regressive indirect taxes (Alvaredo, Assouad, and Piketty, 2017). Introducing or increasing taxes on the wealthier segment of the population (property, inheritance, capital gains, dividends, interest), would help make tax systems more progressive and fair (see Table 4.1 in the Online Background Papers). In particular, in countries where introducing personal income tax may not be feasible in the short run, taxes that target the wealthy could provide a partial substitute (Jewell and others 2015).

Reducing the complexity of the tax system (exemptions, income brackets) in countries with limited tax administration capacity and large informal sectors would also make implementation simpler, enhance compliance, and reduce a key impediment to greater revenue mobilization. Personal income tax regimes with multiple income brackets, while more progressive, are not practical in the absence of well-functioning tax administration, as this can generate incentives for informality, underreporting, and tax avoidance.

While because of these exemptions and distortions, tax expenditures in the region can be large (Jewell and others 2015), very few countries undertake a comprehensive inventory of special tax arrangements and explicitly assess the related fiscal costs. This process, when properly implemented, enhances transparency and accountability but also fosters the rationalization of tax codes and fiscal provisions. In this area, Morocco has led the way, by including an annex on tax expenditures with the annual budget law since 2006. According to the Moroccan tax expenditure report annexed to the country’s 2018 budget law, partial and total fiscal exemptions stood above 3 percent of GDP in 2017. Djibouti is also making progress and is expected to publish a report on exemptions and special tax regimes with the 2019 budget law. A 2014 study for Jordan indicates that tax expenditures were estimated at 11.4 percent
of GDP (Heredia-Ortiz and Timofeev 2016), confirming that such expenditures are large.

Expenditure Reforms

A comparison of spending across the region provides some insight into the potential priorities for more sustained expenditure reforms. In 2017, expenditure as a share of GDP in the region stood at almost 38 percent, compared with 31 percent in other emerging market economies (Figure 4.4). While spending levels are broadly comparable on aggregate with other emerging market economies, spending in the GCC tends to be substantially higher (IMF 2017a).

On average, for MENAP oil exporters, while capital spending and spending on goods and services are broadly comparable with other emerging market economies, public wage bills and other expenses, including subsidies and transfers, are larger. This suggests that, despite recent efforts, streamlining public-sector wage bills should continue to be a priority (Tamirisa and Duenwald 2018). Reforming public compensation in the GCC could also improve the incentives for nationals to take employment in the private sector, which would foster private-sector growth and economic diversification (see Chapter 5; see also Behar and Mok 2013).

In MENAP oil importers spending on the public wage bill is similar to other emerging market economies. However, on average, capital spending—which has the highest multiplier—is lower, at a time many countries need infrastructure upgrading. As discussed earlier, capital expenditure has also borne most of the burden of adjustment so far, suggesting that finding ways to increase capital spending within the current fiscal envelope should be a priority. Again, the importance of reducing the debt burden is highlighted by the relatively high debt service costs compared to emerging market economies.

For countries in the CCA, while the compensation of employees is relatively low compared to other emerging market economies, and while capital expenditure marginally higher, the scale of spending on other categories, such as transfers to state-owned enterprises (SOEs) is more of a concern, particularly since many SOEs are incurring losses, rather than contributing to growth. This suggests that reforms focused on enhancing the governance and profitability of SOEs and on limiting budget transfers may be most beneficial. More broadly, scaling back the role of SOEs in the economy by transferring these activities to the private sector may be more economically efficient and boost private sector growth (see Chapter 5).

For low-income countries in the region, as is the case of low-income countries worldwide, expenditure is dominated by capital spending, particularly to address large infrastructure gaps (especially in Djibouti and Mauritania). However, spending on goods and services and public wage bills are relatively high. This suggests that there is scope for expenditure rationalization.

Other expenditures are relatively large in the MENAP region compared to emerging market economies. For instance, these expenditures account for 35 percent of total spending in the GCC (or 10 percent of GDP), about twice as much as in emerging market economies. Given the burden of conflict in the region, this partly reflects relatively large defense spending. This is a further indication of the economic costs of conflict (see Box 1.1 in Chapter 1) and highlights the potential benefits of securing greater stability in the region.

Ensuring the Quality of Spending

Regardless of the scale of spending, the quality of spending is also important, especially where resources are constrained. Where countries still face a large infrastructure gap, higher spending is justified (Albino-War and others 2014).

4 Transfers to SOEs is also an issue in some MENAP countries.
5 For instance, countries in the MENAP region spend about 5 percent of GDP on average on military expenditure, compared to about 3 percent in the CCA and about 1.6 percent in other emerging market and developing economies. See the Stockholm International Peace Research Institute’s Military Expenditure Database at https://www.sipri.org/databases/milex.
However, where the quality of infrastructure remains relatively low despite relatively high public investment, close attention needs to be paid to the public investment management framework, including project appraisal, selection, and evaluation, to ensure additional capital expenditure is truly productive (Figure 4.5). Overall, stronger public investment management frameworks will ensure not only better use of resources and value to the taxpayer, but also promote growth.

Similarly, spending on education and health care, which has been shown to promote long-term growth and lower inequality by benefitting the poor (Dollar and Kraay 2002), is not delivering quality outcomes. For instance, even in countries where this spending is in line with international peers, it has not translated into high educational attainment and health outcomes, with most countries falling below the estimated health and education efficiency frontiers (Figure 4.6; see also Tamirisa and Duenwald 2018).

**Transfers and Subsidy Reforms for Fairness and Efficiency**

Completing subsidy reform would help build and preserve fiscal buffers, increase the durability of adjustment, remove market distortions, free up budget resources for social spending, and reduce overconsumption and overproduction (energy, water, agriculture). Most subsidies are also highly regressive—for instance, distorted tariff structures for water and electricity benefit the rich, while the poor suffer from lack of access (Sdrallevich and others 2014; IMF 2015b). In oil-exporting countries, fuel subsidies promote capital- and energy-intensive industries at the expense of labor-intensive industries that could provide jobs for the rapidly growing workforce. Some studies suggest that the elimination of fuel subsidies across the MENAP region would save about 2 percent of GDP and allow for a 40 percent increase in social protection spending (IMF 2015b; 2017b).

As noted above, some countries have made important progress in reducing subsidies, especially fuel subsidies, and, consequently, in improving their fiscal resilience. In parallel, to enhance the equity of reform and support growth, some countries (Egypt, Jordan, Pakistan, Oman, Saudi Arabia) have coupled subsidy reforms with strengthening targeted social safety nets. It is notable that the level of social spending is relatively low across the MENAP region. In contrast, social spending in the CCA is comparable with other emerging market economies, reflecting higher social contributions. This supports the observed improvements in inequality in the CCA region (see Chapter 3).
Increased transparency facilitates greater public accountability not only by supporting spending controls and fiscal discipline (Benito and Bastida, 2009) but also by reducing the scope for corruption, misappropriation of public resources, and boosting tax revenues (Figure 4.7; see also the October 2013 Fiscal Monitor; Cimpoeru and Cimpoeru 2015; and Brusca, Manes Rossi, and Aversano 2017).

Countries in the region are making important progress in reducing corruption and strengthening government transparency and accountability. Tunisia has recently moved forward in modernizing and strengthening anti-corruption institutions to help curb fraud and improve the compliance culture of taxpayers. Afghanistan and Iran have made significant progress in improving government transparency by publishing and disseminating detailed budget data in 2018 for the first time. The adoption of new procurement laws in Egypt and Saudi Arabia will increase the transparency of public procurement and enhance public oversight. This will help increase the efficiency of public expenditure and improve fairness in the selection process, both of which will support growth.

Better perceptions of government accountability can also help reduce the cost of borrowing for both the sovereign and the private sector, further boosting investment and growth (see Chapter 5). By ensuring better management of public funds, this reduces the probability of default, thereby lowering the risk premium. Kemoe and Zhan (2018) find that the openness of the budget process, fiscal data transparency, and accountability of fiscal actors reduce sovereign interest rate spreads and increases foreign holdings of sovereign debt.

Digitalization can play a major role in fostering openness and transparency (Figure 4.8; see also Bertot, Jaeger, and Grimes 2010, lowering...
administrative costs, improving indirect tax collection (see the October 2018 Fiscal Monitor), and ensuring better targeting of expenditure. Bahrain, Kazakhstan, and the United Arab Emirates rank as top performers on the United Nations e-government development index. Together with Morocco, Oman, Tunisia, and Uzbekistan, these countries also perform particularly well on the United Nations e-participation index, which measures access to information and public services and participation in policymaking.

Finally, a comprehensive approach to governance and corruption that encompasses areas outside the direct scope of fiscal governance can generate substantial dividends. For instance, simplifying regulations can both improve the business environment and preserve revenues by limiting or reducing tax exemptions.

**Policy Recommendations**

Most countries in the Middle East and Central Asia need to undertake further fiscal adjustment. While the size and speed of fiscal adjustment depends on each country’s unique circumstances, there appears to be scope to make such adjustments more growth-friendly and equitable. Some of the key priorities going forward include the following:

- There is room to increase the contribution of revenue reforms to the adjustment effort. MENAP oil importers should focus on rebalancing direct and indirect taxation, including gradually increasing the contribution of personal income taxes to revenues. Introducing or increasing taxes on the wealthier segments of the population in MENAP oil exporters would also improve the progressivity of the tax system. For CCA countries, there is scope to raise the
contribution of corporate taxes to revenues, in line with personal income taxes.

- All countries should undertake a regular and detailed evaluation of the revenue and efficiency losses associated with tax exemptions.

- Reducing the complexity of tax systems in countries with limited tax administration capacity and large informal sectors (MENAP oil importers) would simplify collections and promote greater revenue mobilization.

- Reducing informality in the economy may increase social contributions and allow for greater social spending in the MENAP region.

- On the expenditure side, all countries should focus on strengthening public investment management frameworks to ensure the quality of public investment.

- There is further scope to streamline spending on the public wage bill in MENAP countries, in particular the GCC countries, coupled with structural reforms to ensure a durable adjustment.

- MENAP oil-importing countries should focus on completing energy subsidy reforms to augment benefits of other fiscal reforms.

- Strengthening the governance of SOEs would also help contain spending on subsidies and transfers, especially in the CCA.

- Low-income countries in the region should explore the scope to scale back current expenditure in order to secure fiscal space to maintain needed public investment.

Overall, fiscal adjustments need to be guided by strong medium-term fiscal frameworks and operationalized by multi-year budgeting and credible fiscal targets. Strengthening fiscal institutions and modernizing public financial management frameworks could help enhance the credibility of fiscal adjustment programs.

Transparency and accountability should go hand in hand with fiscal adjustment measures. Strengthening audit institutions and anti-corruption agencies could help bolster growth and preserve fiscal resources. To build public support and increase the durability of reform, country authorities should consult with key stakeholders on the design of adjustment programs and communicate transparently with the public.
A tax reform package implies a complex trade-off between growth, government revenue, and equity. A comprehensive approach associated with better targeted social programs, broadens the tax base, removes tax distortions, better distributes the tax burden, and mitigates adverse distributional effects (that is, improves welfare) by making the tax system more progressive and reducing inequalities.

The welfare and macroeconomic effects of fundamental tax reforms can be assessed using a dynamic stochastic general equilibrium model. The general model presented here has been designed to match the characteristics of emerging markets and developing economies and represents a closed economy with households composed of four types of workers: informal sector workers, formal manufacturing and service workers, rural workers, and entrepreneurs. The economy produces three goods: food, manufacturing, and informal services. The large number of households and products allows the model to capture elements of a complex tax system—in particular, allowing for differential tax rates for value-added taxes (VAT), personal income taxes, and corporate income taxes. Tax reforms change the marginal costs/benefits of economic agents (for instance, marginal utility, relative prices), which triggers a reallocation of consumption and production factors, and ultimately affects growth, tax revenue, and welfare. The model has been calibrated to oil-importing countries in the Middle East and Central Asia region.

The impact of a range of tax reforms has been simulated. For instance, model simulations indicate that a marginal increase of 1 percent in the VAT rate would raise government revenue by an average of 0.7 percent. However, given the relatively high share of food in the consumer basket in the region, the incidence of this increased VAT rate has different effects on household’s welfare and on GDP. Specifically, if the VAT is increased on manufactured goods, consumers switch consumption towards more food and services, and firms respond to this extra demand (generating extra employment for workers) thereby increasing profits for entrepreneurs. Overall, this results in an increase in GDP of 0.13 percent. In contrast, if the VAT is increased on food, there is less scope for consumers to switch consumption and overall demand falls resulting in a decline in profits and a 0.03 percent decline in GDP. With food consumption relatively inelastic and no increase in production by firms, workers are relatively worse off under the second scenario. Note that a well-targeted social safety net could mitigate the adverse effects of a VAT increase on workers, but at the expense of reduced revenue yield.

In contrast, a scenario in which corporate income taxes are reduced (to support growth) and all tax exemptions are also minimized (to broaden the tax base and make it more inclusive), would boost both government revenue and output. In this case, a 1 percent decrease in both corporate income taxes rates and exemptions would increase output by an average of 0.6 percent and government revenue by 0.4 percent in the long-run. While some households would be negatively affected by the loss of VAT exemptions, overall, this mix of fewer tax exemptions and lower corporate income taxes would increase profits for entrepreneurs. Again, depending on the design of the policy, a well targeted social safety net could mitigate some of the negative effects on workers from the loss of VAT exemptions.

More broadly, Figure 4.1.1 shows that a comprehensive reform package yields better outcomes (represented by the blue area in the figure) than a partial reform. Such a comprehensive package combines: (1) increasing VAT rates, (2) reducing tax exemptions, (3) raising property taxes, (4) lowering corporate tax rates, and (5) strengthening safety nets, (more specifically, better targeting transfers to rural households).

Applying this simulation to a specific country context shows that, for instance, the impact of the comprehensive reform package planned in Morocco could raise government revenue by 1.5 percent of GDP, and boost GDP by about 1 percent over the long term. In this case, the reform package is aimed at making

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the tax system more equitable and supportive of competitiveness. It includes plans to align the VAT on manufactured goods and services with the standard VAT rate, reduce tax exemptions while reducing and simplifying corporate tax rates, raise property taxes, and better target social programs (IMF 2018).
References


5. Private Investment for Inclusive Growth in the Middle East and Central Asia

Between 2000 and 2017, annual private investment in Middle East and Central Asia countries averaged 15.6 percent of GDP, the second lowest worldwide after sub-Saharan Africa. Since the global financial crisis, investment ratios have declined markedly relative to peers. A more dynamic private sector, underpinned by robust private investment, is needed to foster greater job creation and boost inclusive growth. Increasing access to finance, investing in education and infrastructure, reducing the role of the state in the economy, and improving government effectiveness and governance would unlock private investment, laying the foundation for higher and more inclusive growth. These efforts would enable a transition from the current state-led economic growth model, which has inhibited private sector development, to more dynamic private-sector-led growth.

Boosting Private Investment Is Key to Achieving Higher and Inclusive Growth

The Middle East and Central Asia region needs higher and more inclusive growth to create jobs for a growing population and to enhance economic resilience, as discussed in Chapters 1–3 of this report.

Increasing investment—both public and private—would add to aggregate demand in the short run and lay the foundation for higher potential growth going forward, including by improving productivity. Public investment has an important role to play by providing the necessary infrastructure (for example, energy, transportation, communication) to unlock private investment, and by helping to build human capital (for example, investment in education and health).

However, as shown in Chapter 4, limited fiscal resources means that increasing private sector investment will be key. In addition, private investment is critical to expand an economy’s productive capacity and to boost productivity through the introduction of new techniques and processes.

Although many countries in the Middle East and Central Asia are taking steps to promote private sector development—including improving the business environment, strengthening governance, and pursuing productivity-enhancing reforms (see Chapters 1–3)—private investment is low relative to peers, and its contribution to growth has been declining (Figure 5.1). This chapter seeks to understand the main drivers of private investment in order to help guide policy and reform efforts to mitigate current impediments to private investment and unlock the region’s growth potential.

Private Investment in Middle East and Central Asia Countries is Low

Between 2000 and 2017, annual private investment in Middle East and Central Asia countries averaged 15.6 percent of GDP, the second lowest worldwide after sub-Saharan Africa’s 14.5 percent (Figure 5.2) (see Chapter 3 in the April 2018 Regional Economic Outlook: Sub-Saharan Africa). During the same period, private investment ratios in Latin America and the Caribbean and in emerging Europe were higher by about 1.2 and 2.3 percentage points, respectively. Emerging Asia has outperformed Middle East and Central Asia countries by almost 3 percentage points. Investment ratios are markedly low relative to peers for low-income countries and for high-income Gulf Cooperation Council (GCC) countries (Figure 5.3).
Private investment has also declined in the region since the global financial crisis, in line with emerging Europe. This is due to a combination of factors, including weak economic activity, firms’ expectations of lower profitability, and tighter financial conditions, coupled with the sharp decline in oil prices over 2014–15.

However, regional averages mask some notable differences across these countries (Figure 5.4):

- The ratio of private investment to GDP increased on aggregate in oil exporters in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region. However, this result is driven by Algeria, where the average investment ratio increased from 14 percent of GDP to 22 percent. This likely reflects large investments by state-owned enterprises (SOEs), which are difficult to disentangle from private investment in the data. Excluding...

See Chapter 4 of the April 2015 *World Economic Outlook* for a discussion of factors affecting investment in the wake of the global financial crisis. See IMF (2016a) for a discussion of investment trends in Middle East and North Africa oil exporters and importers.
Algeria, investment ratios stayed broadly stable, with modest gains in Iraq, Kuwait, and Oman offset by modest declines in Iran, Saudi Arabia, and the United Arab Emirates.

- Most MENAP oil importers have exhibited a decline in their private-investment-to-GDP ratio since 2008, particularly in Egypt. This trend can also be seen in Afghanistan and Pakistan since 2004. This indicates that political instability has not been conducive to attracting private investment.

- Within the Caucasus and Central Asia (CCA) region, investment ratios have declined since the global financial crisis, especially among oil importers. This was largely driven by a steady decline in Armenia, which more than offset a recent pickup in Georgia. Among oil exporters, while the private-investment-to-GDP ratio has increased, this has been partially offset by a slow decline in Kazakhstan.

Investment Flows in the Region Driven by Commodity Cycles

The continued dominance of commodities in the region’s economic model is also reflected in the relationship between investment—both public and private—and commodity prices, especially oil prices (Figure 5.5).

Higher oil prices tend to be associated with an expansion in public investment in oil-exporting countries, reflecting the strong procyclicality of capital expenditure. In parallel, oil prices indirectly affect the availability of resources for investment in oil-importing countries given spillovers through remittances, grants, and direct investments from oil exporters. These channels are more pronounced in the CCA, where transnational oil projects are prominent.\(^2\)

\(^2\)Oil exporters such as Azerbaijan and Kazakhstan are among the top investors in Georgia and the Kyrgyz Republic, respectively. Large oil and gas projects, such as the construction of Turkmenistan-China gas pipeline, are spurring new FDI in oil importers, including the Kyrgyz Republic and Tajikistan.
Foreign direct investment (FDI) has been a key driver in the decline in private investment. In line with the overall trend in private investment, inflows of FDI have nearly halved since the global financial crisis (Figure 5.6). As FDI is heavily concentrated in the commodity sector, this likely reflects the decline in oil prices, with oil exporters in MENAP (especially Bahrain, Oman, Qatar, and Saudi Arabia) and CCA seeing the largest decline in the rate of FDI inflows.

Although overall FDI flows have declined, they have also become more concentrated in the oil and mining sectors, with less of an impact on job creation given the capital-intensive nature of those sectors. The share of FDI flowing to these sectors in the Middle East and Central Asia increased from an average of 29 percent of inflows between 2004–08 to 40 percent of inflows between 2012–16. CCA countries accounted for most of this increase. In CCA oil importers, the share of FDI inflows to oil and mining sectors increased from an average of 5 to 22 percent of total inflows during the same period (Figure 5.7). In CCA oil exporters, the oil and mining sectors constituted more than 75 percent of total inflows during 2012–16. During the same period, the average share of inflows to the sector in MENAP oil exporters declined from already-elevated levels, while it remained flat in MENAP oil importers.

Large Public Sectors Impeding Private Sector Development

Although public investment can be an important complement to private investment, there are indications that it may be crowding out private investment in the MENAP and CCA regions (Figure 5.8). This crowding out is one indication that the large state sector is competing with—rather than complementing—the private sector for limited resources, including access to credit and talent.
The larger share of credit being allocated to SOEs in the MENAP and CCA regions relative to other regions is also indicative that the state is heavily involved in the productive sector of the economy (Figure 5.9). This is most pronounced in MENAP oil exporters, where the ratio of SOE credit to total credit is several times the average of emerging market and developing economies.

In addition, public sectors in the region are larger employers than in peers, exposing the private sector to competition for talent. The ratio of public employment to overall employment in CCA oil exporters is 2.7 times the average for emerging market and developing economies (Figure 5.10). Also, in several MENAP oil-exporting countries, large gaps exist between public and private sector compensation, effectively raising labor costs for the private sector (IMF 2016b). Particularly in the GCC, public wages are about two to three times higher than average private sector wages (Tamirisa and Duenwald 2018).

The Middle East and Central Asia region’s natural resource endowments, with strong interlinkages across economies, coupled with the heavy role of the state in the productive sector, has deterred private investment in non-oil sectors. This has dampened the region’s gains in productivity and job creation, limiting investment opportunities and leaving the government as an employer of last resort, in some cases.

Constraints in the Business Climate Holding Back the Private Sector

Ongoing weaknesses in the business environment also impede the private sector. In particular, access to finance and talent emerge as important impediments to doing business, as do issues related
to government bureaucracy and regulations, also potentially linked to the heavy state presence in the economy (Figure 5.11).

New business entry remains a major challenge across the region, with the creation of new businesses lagging other emerging economies (Figure 5.12). Average business entry levels in MENAP trail other regions significantly, while the CCA is on par with sub-Saharan Africa and Latin America and the Caribbean, lagging only emerging market economies. Thanks to its structural reforms in the early 2000s, Georgia stands out among the regional countries, with twice as many new business entries as its closest follower, the United Arab Emirates. Iraq and Pakistan suffer from particularly low levels of business creation, with one business per 5,000 and 1,000 residents, respectively.\(^3\)

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\(^3\)However, low levels of business creation could be the result of the high levels of informality in some countries.
Empirical Determinants of Private Investment

The empirical analysis of the determinants of private investment for emerging market and developing economies confirms that financial development, domestic growth prospects and trading partner growth, oil price volatility, and public investment are key determinants of private investment (Box 5.1; Figures 5.13 and 5.14). Overall, securing a one standard deviation change in any of the factors highlighted in Figure 5.13 would lead to a significant increase in private investment (all other factors being equal), and consequently boost overall growth.

As expected, better economic growth prospects lead to higher levels of private investment, as businesses invest more when they expect prosperity. Similarly, private investment is higher when countries’ trading partners are experiencing stronger growth and thus providing more demand for companies’ products.

Oil producers attract higher levels of private investment when oil markets are stable (as measured by the volatility of oil prices). This again highlights their exposure to commodity cycles. Greater economic diversification would likely reduce this effect and lead to more stable investment levels.

The results seem to confirm that public investment can crowd out private investment. However, given the role that public investment can play in supporting business—by providing a skilled workforce, critical infrastructure, etc.—some level of public investment is necessary to enable private investment in the first place.

Institutional Factors Also Matter

To assess the relevance of more institutional factors, this chapter takes the analysis a step further. Further results provide more insight into the supportive role of the public sector by confirming the importance of access to education.
(to boost human capital) and infrastructure in encouraging private investment (Figure 5.14).

These results also confirm the importance of a stable political environment, strong governance, government effectiveness and integrity, and the rule of law.

**The Importance of Closing Key Gaps in the Quality of the Business Environment**

Overall, the analysis underscores the importance of narrowing the gaps in some key areas between the Middle East and Central Asia and peers.

In particular, financial development in MENAP oil importers and CCA countries lags behind averages for emerging market and developing economies (Figure 5.15). Similarly, these countries have large gaps relative to emerging market and developing economies across a number of governance indicators, such as the rule of law (Figure 5.16). Closing these gaps would make an important contribution to securing more private investment and higher growth in these countries.

Better access to education is also needed across the entire region. Enrollment and educational attainment levels are weaker in MENAP at all levels of education relative to peers (see Chapter 4; see also Purfield and others 2018). Enhancing the focus of public investment on increasing access to quality education could play a significant role in boosting private investment and growth.

Finally, the quality of infrastructure varies significantly across the region (see Chapter 4). Thus, for some countries, important gains could be made by undertaking some well-designed infrastructure development.

**Policy Recommendations**

Promoting greater private investment is a high priority for the countries of the Middle East and Central Asia to raise and sustain higher growth to create jobs. Developing a dynamic private sector and attracting greater private investment will, in
turn, require supportive macroeconomic policies and structural and institutional reforms.

In particular, measures to increase access to finance across the region would play a key role in increasing private investment. These measures could include efforts to introduce and expand the coverage of credit bureaus, strengthen creditor rights in enforcement of collateral and the related operational quality of court (and out-of-court) systems, improve bankruptcy laws and proceedings, and strengthen banking systems (especially in the CCA) to enhance access to bank credit. Greater competition among banks could also be promoted by easing entry requirements and removing preferential treatment for publicly owned banks. In parallel, efforts to deepen domestic capital markets would expand the channels for the private sector to access capital, including equity capital as well as other private capital, such as venture capital. Strengthening insolvency and bankruptcy frameworks, as well as furthering the development of Fintech, would also help (Lukonga, forthcoming). Regulatory and supervisory frameworks would need to be strengthened to support sound financial development.

Well-targeted public spending on education (including orienting education and vocational training toward the skills needed in the private sector) and physical infrastructure are paramount for building human capital and enhancing competitiveness and productivity. This type of public investment would act as a strong complement to private investment. For most countries in the region facing fiscal constraints, this will entail reallocating spending from unproductive uses (for example, untargeted subsidies and high wage bills) toward investment. Embedding this into strong public investment management frameworks would ensure the quality of spending and efficient and sustainable use of resources (see Chapter 4).

Complementing these measures with efforts to improve government effectiveness—including by reducing bureaucracy, enhancing transparency and accountability to reduce perceptions of corruption, and strengthening the legal framework for businesses—would also support private investment. Promoting a competitive business environment by lowering barriers to entry and reducing the public footprint (for example, through state-owned enterprises) would reduce the dominance of the public sector and provide greater space for the private sector to flourish. These efforts would enable a shift from the current state-led economic growth model to more dynamic private-sector-led growth. This would support greater economic diversification in oil-exporting countries and ensure broad-based and inclusive growth across the region, enhancing countries’ economic resilience.
Box 5.1. Determinants of Private Investment: An Empirical Examination

Two-stage regressions are estimated to empirically identify the determinants of private investment in the Middle East and Central Asia. In the first stage, a country fixed-effects panel regression is used to estimate the historical relationship between the private-investment-to-GDP ratio and a selection of macroeconomic variables for a sample of 140 emerging market and developing economies covering the period 1991–2015. Specifically, the following relationship is estimated:

\[
\left( \frac{I}{Y} \right)_{i,t} = \beta_0 + \beta_1 \left( \frac{I}{Y} \right)_{i,t-1} + B X_{i,t} + \gamma_t + \delta_i + \epsilon_{i,t}.
\]

The set of explanatory macroeconomic variables \(X_{i,t}\) includes public investment to GDP; GDP per capita; the cumulative three-year GDP forecast from the World Economic Outlook (made in the same year as the private investment in question); growth in the country’s trading partners; an oil producer dummy; the inverse of the standard deviation of the daily oil price; interaction of the former two variables; and measures of financial development (see the Financial Development Index detailed in Svirydzenka 2016), capital account openness (the Chinn-Ito, 2006, indicator), and trade openness. The panel regression includes year and country fixed effects. Table 5.1.1 presents the regression results and Figure 5.13 in the main text summarizes the economic significance of variables with statistically significant coefficients.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Private Investment, % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private investment, % of GDP, lagged</td>
<td>0.796*** (0.0360)</td>
</tr>
<tr>
<td>Public investment, % of GDP</td>
<td>-0.0822** (0.0369)</td>
</tr>
<tr>
<td>GDP per capita, PPP, log, lagged</td>
<td>-2.255*** (0.612)</td>
</tr>
<tr>
<td>Vintage 3-year cumulative WEO growth forecast</td>
<td>0.0437* (0.0233)</td>
</tr>
<tr>
<td>Trading partner growth</td>
<td>0.136** (0.0689)</td>
</tr>
<tr>
<td>Oil producer dummy x inverse of daily oil price standard deviation</td>
<td>2.990** (1.456)</td>
</tr>
<tr>
<td>Financial Development Index</td>
<td>5.772*** (1.925)</td>
</tr>
<tr>
<td>Capital account openness</td>
<td>1.103 (0.790)</td>
</tr>
<tr>
<td>Trade openness</td>
<td>0.484 (0.792)</td>
</tr>
<tr>
<td>Constant</td>
<td>Yes</td>
</tr>
<tr>
<td>Country fixed effects</td>
<td>Yes</td>
</tr>
<tr>
<td>Year fixed effects</td>
<td>Yes</td>
</tr>
<tr>
<td>Observations</td>
<td>3,210</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.676</td>
</tr>
<tr>
<td>Number of countries</td>
<td>140</td>
</tr>
</tbody>
</table>

Sources: Chinn and Ito (2006); IMF, World Economic Outlook; Svirydzenka (2016); and IMF staff calculations.

Note: WEO = IMF, World Economic Outlook; PPP = purchasing power parity. Standard errors in parentheses *** \( p < 0.01 \), ** \( p < 0.05 \), * \( p < 0.1 \).

1 The panel regression includes year and country fixed effects and uses a clustered sandwich estimator to allow for correlation of standard errors over time for each country. It avoids the need to use instruments (as in Chapter 5 of the April 2018 Regional Economic Outlook: Sub-Saharan Africa) by selecting explanatory variables that are not directly driven by the dependent variable. In particular, the regression uses a lagged value of GDP per capita, and instead of contemporaneous same-country GDP growth, it includes contemporaneous trading partner growth and vintage World Economic Outlook growth projections to proxy for expectations of same-country economic growth when the private investment in question was made.
The first-stage regression does not include any institutional variables, which tend to change very little over time in each individual country. The cross-country variation between them is captured in the first-stage regression by the country fixed effects. The importance of these factors is then assessed in a set of second-stage regressions, each of which relates the country dummies and various institutional and infrastructure variables (using averages of available values for 1991–2015). These include the overall scores and their components from the World Bank’s Doing Business Indicators, the World Governance Indicators, the Economic Freedom Indices and their components from the Heritage Foundation and Fraser Institute, the World Economic Forum’s Ease of Access to Loans Index, Transparency International’s Corruption Perceptions Index, the International Country Risk Guide’s Political Risk Index and its components, and the World Bank’s series on access to electricity and secondary and tertiary school enrollment.

Each regression only relates the country dummies to one institutional variable at a time, since the latter are often strongly correlated. To compare the economic significance of the various institutional factors in explaining the cross-country differences in private investment, Figure 5.14 in the main text displays the highest of the $R^2$-squared coefficients of the individual regressions.
References


