MENAP Oil-Exporting Countries: Adjusting to Cheaper Oil

New Oil Market Reality

Over the past decade, MENAP oil exporters enjoyed large external and fiscal surpluses and rapid economic expansion on the back of booming oil prices. However, with oil prices plunging in recent years, surpluses have turned into deficits and growth has slowed, raising concerns about unemployment and financial risks. How should the region adjust to the new oil reality?

The oil price drop since mid-2014 has been spectacular: prices have fallen nearly 70 percent to about $40 a barrel. Futures markets anticipate oil prices to recover only modestly to $50 a barrel by the end of this decade, though much uncertainty surrounds this forecast (Figure 1). The weak price prospects reflect the expectation that global oil supply growth will moderate only slowly as Iran boosts its exports and other MENAP oil exporters maintain high output, at a time of sluggish global growth.

MENAP oil exporters declined by $390 billion in 2015 (17½ percent of GDP). Despite a partial offset from reduced imports owing to subdued prices of non-oil commodities, the combined current account of the GCC and Algeria has reversed from a comfortable surplus to a projected deficit of about 8 percent of GDP in 2016. The deficit of other MENAP oil exporters is projected to be 4¾ percent of GDP this year. The current account is expected to improve only gradually over the medium term, as the oil price recovers somewhat and fiscal adjustment unfolds.

Mirroring the large loss in export receipts, fiscal balances have deteriorated considerably (Figure 2). The ample surpluses of the GCC countries and Algeria have turned into significant deficits, projected to average 12¾ percent of GDP in 2016 and remain at 7 percent over the medium term, despite the implementation of sizable deficit-reduction measures. For other MENAP oil exporters—those generally less reliant on oil but with smaller fiscal buffers—the combined deficit is projected to average 7¼ percent of GDP in 2016, and gradually close by the end of the decade as oil output increases and conflicts are assumed to ease.

Large Revenue Losses

The outlook for lower oil prices implies weak oil revenues for years to come, dramatically reducing the capacity of governments to spend. Export receipts in

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Figure 1
Brent Crude Oil
(U.S. dollars a barrel)

Sources: Bloomberg and IMF staff calculations.

1 Derived from prices of futures and options on March 2, 2016. The average price of oil in U.S. dollars a barrel was $50.79 in 2015; the assumed price based on futures markets is $34.75 in 2016 and $40.99 in 2017.

Figure 2
Overall Fiscal Balance
(Percent of GDP)

Sources: National authorities; and IMF staff calculations.
Note: Libya excluded from Other MENAP Oil Exporters.
Policy Adjustment Underway

For most MENAP oil exporters, the fiscal adjustment needed to absorb the oil price shock is unprecedented. Last year, many countries adopted significant deficit-reduction measures, while drawing down financial buffers, where available, or borrowing to smooth the adjustment to lower oil prices. This year’s budgets suggest that policy effort will only intensify (Figure 3).

The bulk of this adjustment has so far comprised spending cuts; however, new sources of revenue are also being considered. Algeria, Iraq, the United Arab Emirates, Saudi Arabia, and, to a lesser extent, Oman have focused on capital spending cuts. Current spending reductions are an important part of the adjustment process in Bahrain, Oman, and Qatar. New revenue measures are being taken in Oman (an increase in the corporate income tax), Bahrain (tobacco and alcohol taxes), and Iran (reduced exemptions and better tax administration). The GCC is planning to introduce a VAT in the coming years.

Significantly, many MENAP oil exporters have initiated substantial energy price reforms in response to lower oil prices. In the GCC, most countries have raised fuel, water, and electricity charges, with some announcing further increases in the coming years. Oman and the United Arab Emirates have introduced automatic pricing mechanisms. Outside the GCC, Algeria recently hiked fuel, electricity, and natural gas prices, and Iran increased fuel prices. Still, local energy prices remain well below global benchmarks in most countries (Figure 4). To minimize the impact of these reforms on vulnerable income groups, targeted support schemes should be strengthened.

In tandem with the fiscal adjustment, Algeria and Iran have allowed their currencies to depreciate. This has boosted local currency budget revenues from oil exports, but the fiscal gains will only last if expenditures, particularly the public wage bill, do not rise in response to depreciation. The GCC countries have maintained their long-standing pegs, underpinned by substantial net foreign assets. Pressures on these pegs in forward currency markets have increased in recent months, although the forward markets are relatively illiquid and most GCC countries have significant buffers.

Further Fiscal Policy Action Needed

Despite the announced policy measures, medium-term fiscal positions remain challenging given the expectation of oil prices remaining low (Figure 2). The cumulative fiscal deficits of the GCC and Algeria are projected at almost $900 billion during 2016-21. Algeria, Bahrain, Oman, and Saudi Arabia will become significant debtors over this period as their...
financing needs are expected to exceed their current liquid financial buffers. The budgets of almost all non-GCC countries are also projected to remain in deficit by the end of the decade.

Further saving measures are needed over the medium term to restore fiscal sustainability, rebuild buffers, and save sufficiently for future generations. In the GCC, ambitious fiscal consolidation is also required to support the fixed exchange rate regimes. The timing and composition of these policy measures should be designed to minimize the short-term impact on growth, while enhancing equity and medium-term growth prospects. Structural policies (see below) can complement fiscal adjustment efforts.

Large fiscal adjustment will inevitably entail difficult choices, including rethinking the role and size of the public sector and modifying the social contract. There is room to cut public spending, which ballooned during the oil price boom, and to raise new revenues. On average, the GCC countries spend twice as much on their public wage bills as other emerging market and developing countries, and almost 50 percent more on public investment as a share of GDP. Further energy price reforms could save some 2 percent of GDP. Revenue efforts should focus on designing broad-based tax systems. For example, introducing a 5 percent VAT could raise about 1½ percent of GDP.1

Deficits are being financed with asset drawdowns and debt issuance. After the significant withdrawals of financial savings last year, some countries may issue more debt this year. Policymakers need to strike a balance between drawing down buffers, issuing domestic debt—thus helping to develop domestic capital markets, but potentially crowding out private investment—and borrowing abroad. Yet with lower oil prices and rising U.S. interest rates, funding costs have risen. A number of sovereign credit ratings have been downgraded. CDS spreads have widened, but remain well below the peaks of the global financial crisis.


Nonetheless, increased oil production and non-oil economic activity in postsanctions Iran,2 and the projected bottoming out of activity in Libya and Yemen with the assumption of conflicts gradually easing, are projected to raise the aggregate growth rate of MENAP oil exporters to 2.9 percent in 2016 and 3.1 percent in 2017 from 1.9 percent last year.

With oil prices projected to remain low and fiscal tightening expected to weigh on economic activity, medium-term growth forecasts have been revised down in most countries. Non-oil growth in the GCC is

2 For more details on the economic effects of easing sanctions on Iran, see the October 2015 REO, available at www.imf.org.
now projected at 3¼ percent over the next five years—well below the 7¼ percent in 2006–15.

**Risks Are Tilted to the Downside**

Risks to this outlook are mainly to the downside. Planned fiscal deficit-reduction measures could exert a larger-than-expected drag on growth, especially given tightening financial conditions. In some countries, the fiscal consolidation implemented so far has not yet been sufficient to restore fiscal sustainability, potentially reducing confidence and increasing uncertainty. The recent increase in oil prices could result in some improvement. However, in view of the persistent excess in global oil supply over demand, a further drop in prices cannot be ruled out, especially in the case of a further slowdown in China’s growth. Another risk relates to regional conflicts, which could become more protracted, disrupting economic activity. A faster-than-anticipated increase in U.S. interest rates would further raise external borrowing costs and feed into higher domestic interest rates.

Domestic financial risks are also on the rise. Amid worsening fiscal balances and slowing economic activity, public and private sector bank deposit growth has stalled, reducing liquidity in the financial system (Figure 6). Meanwhile, policymakers in Bahrain, Kuwait, Saudi Arabia, and the United Arab Emirates have hiked policy rates after the Fed’s interest rate increase in December 2015. These developments will moderate private sector credit growth. Authorities have eased liquidity pressures by increasing loan-to-deposit ratios (Saudi Arabia), cancelling T-bill auctions (Qatar), and preparing to reactivate central bank lending facilities (Algeria). Bank asset quality may deteriorate as the non-oil economy slows, eroding bank profitability, although capital buffers generally remain strong.

Greater risks call for enhancing financial surveillance and policies. Priorities include the design and implementation of policies for effective monitoring and management of liquidity, operationalizing central bank lending facilities, developing appropriate collateral regimes, and enhancing public debt management strategies. Given the increased cross-border activities of banks, enhanced cooperation between home and host supervisors is needed.

**Urgent Need to Reduce Oil Dependence**

With medium-term growth prospects weakening significantly as a result of the slump in oil prices, the need to reduce oil dependence has become even more critical. The current growth model based on the redistribution of resources by the government is no longer sustainable, given the fiscal retrenchment and a rapidly growing labor force. In light of budget pressures, the public sector will not be able to absorb all the new labor market entrants.

Hence, a deepening of structural reforms is essential to promote diversification and non-oil sector growth in order to create jobs for the growing workforce. Job creation and growth in the oil-exporting countries in the region will also have important positive spillovers for trading partners, who will benefit from higher trade and remittances. Reform priorities include further improvements in the business environment, a reduction in the public-private sector wage gap, and education and skills becoming more aligned to market needs. Privatization of state-owned enterprises would increase productivity and efficiency—Oman and Saudi Arabia, for example, have indicated plans to privatize selected state assets.

Iran’s post-sanctions growth dividend, meanwhile, depends crucially on the implementation of much-needed domestic reforms. In conflict countries (Iraq, Libya, Yemen), improving security is a prerequisite for further development and diversification (Box 1).

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3 For more details on diversification in the GCC, see Cherif, R., F. Hasanov, and M. Zhu (2016) “Breaking the Oil Spell: the Gulf Falcons’ Path to Diversification.”