

2. MENAP Oil-Importing Countries: Addressing Fiscal Challenges amid Social Pressures

Growth in oil-importing countries in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region is expected to be muted in coming years, and lower than comparators. High public debt levels and associated financing costs are not only holding back growth in the region, but also pose a source of acute fiscal stress. Yet a mix of sustained social tensions, unemployment, and global headwinds leave policymakers facing a difficult trade-off between rebuilding fiscal buffers and addressing growth challenges. For now, supportive global financial conditions and lower oil prices are helping to ease this trade-off. But managing high levels of public indebtedness will require fiscal consolidation and policies to deliver higher, more inclusive growth.

A Tepid Recovery Expected to Continue

Real GDP growth in MENAP oil importers is expected to fall slightly in 2019 to 3.6 percent, down from 4.3 percent in 2018, driven mostly by Pakistan and Sudan. Excluding these two countries, the rest of the region's real GDP growth in 2019 is projected to be 4.4 percent. In Egypt, growth is expected to remain strong, supported by gas production and a return of tourism. Overall, though, growth in most countries is projected to be below its 2000–15 average in 2019.

In 2020, real GDP growth in the region is expected to remain about 3.7 percent but recover to 5 percent over the medium term. This is largely driven by Pakistan, where ongoing reforms are expected to boost growth. However, this outlook implies that the region is set to fall behind other countries with similar income levels (Table 2.1).

Inflationary pressures have been largely kept at bay by weak domestic and external demand.

Prepared by Philip Barrett with research assistance by Gohar Abajyan.

Table 2.1. Real GDP Growth
(Median by group)

	2018	2019	2020
Emerging market economies			
MENAP oil importers	2.7	2.4	2.4
Rest of world	3.0	2.8	3.1
Low-income countries			
MENAP oil importers	2.8	3.0	3.5
Rest of world	4.6	5.0	5.0

Sources: National authorities; and IMF staff calculations.

Note: MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

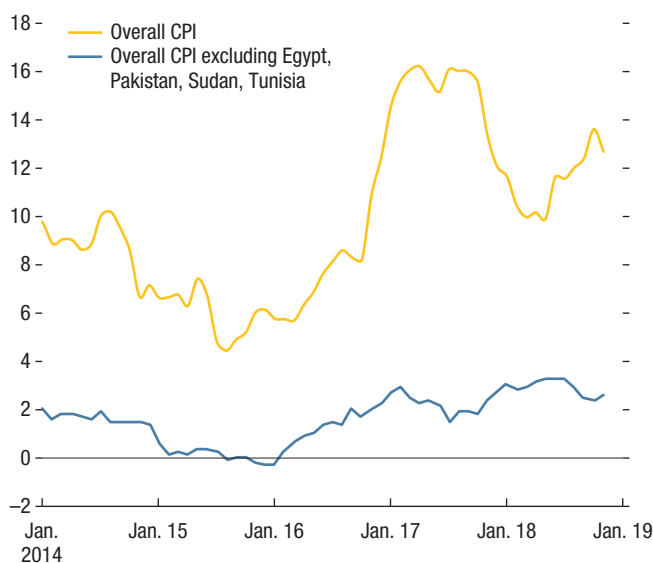
Egypt, Pakistan, Sudan, and Tunisia are notable exceptions where, at different times in the last three years, exchange rate depreciations, while helping reduce external imbalances, have contributed to increased inflation (Figure 2.1).

Despite lower global oil prices (relative to the April 2019 *Regional Economic Update: Middle East and Central Asia*), external imbalances remain large for nearly all oil importers, held back by the slowdown in world trade (particularly in China and other key trading partners in the European Union and the Gulf Cooperation Council), and in some cases overvalued exchange rates. Although partly mitigated by a rebound in remittances—often from oil-exporting Middle Eastern countries and thus tending to track oil prices—such deficits leave countries vulnerable to changing sentiments in international capital markets. Overall, immediate short-term external financing needs (amortization of external debt plus current account deficits) are expected to total some \$238 billion in 2019, or more than 160 percent of reserve assets.

Current account deficits in oil importers are financed principally by bank flows (see Chapter 4) and reserve losses. For example, Lebanon's current account deficit has exceeded one-fifth of GDP every year since 2015. In previous years, short-term deposits from nonresidents represented a substantial share of financing. But as nonresident deposit growth declined in 2018, reserves fell by 7 percent. In Jordan, a large current account deficit of 7 percent of GDP, together with private

Figure 2.1. Inflation

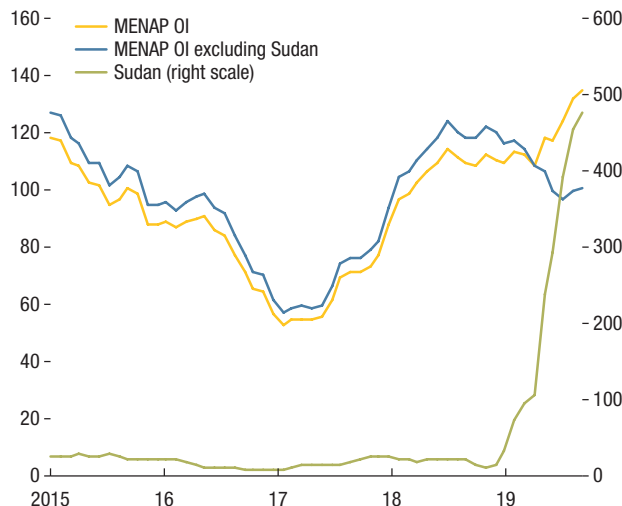
(Consumer prices; period average, annual percentage change)



Sources: Haver Analytics; national authorities; and IMF staff calculations.
 Note: CPI = consumer price index. Overall CPI excludes Djibouti and Syria due to lack of recent data.

Figure 2.2. Reported Social Unrest

(Index, average 2014–present = 100, 12-month rolling average)



Sources: Factiva; and IMF staff calculations.
 Note: Index measures monthly mentions of unrest and related topics in major English-language newspapers and broadcast networks. See April 2019 *Regional Economic Outlook: Middle East and Central Asia* for further details.
 MENAP OI = Middle East and North Africa, Afghanistan, and Pakistan oil importers.

sector capital outflows and falling foreign direct investment (FDI) inflows, resulted in reserve losses. And in Tunisia, donor support continues to play an important role in financing the current account deficit.

Although there has been some progress on the structural reforms necessary to address twin social and economic challenges (Egypt—see Box 2.1—Mauritania), the business climate across the region lags behind comparators such as East Asia. This is reflected in weak FDI, which underperformed relative to other emerging market economies since the global financial crisis (see Chapter 4).

Looking forward, current account deficits in individual countries are likely to stay broadly constant. Inflation is forecast to stabilize over the medium term as level effects (particularly those from exchange rate depreciation) fade.

Tense Social Conditions

Social and political tensions remain prominent throughout the region (Figure 2.2): uncertainties

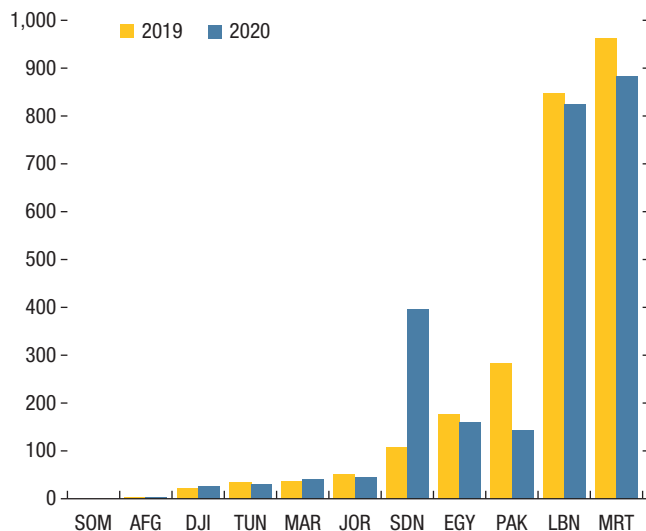
over political control have left Sudan’s spiraling economic problems unaddressed; internal and international political disputes are bringing the West Bank and Gaza economy to a halt; the runup to elections in Tunisia is hampering implementation of policies and reforms; and violent conflict is interfering with everyday life in Afghanistan, Somalia, and Syria.

At the same time, unemployment has remained high in many countries, furthering social tensions. Unemployment averages 11 percent throughout the region versus 7 percent across other emerging market and developing economies. Women and young people are particularly likely to be out of work, with more than 18 percent of women and nearly 23 percent of young people without jobs in 2018.

Fiscal Constraints Become More Pressing

Recent positive developments, including lower global oil prices and interest rates (see Global

Figure 2.3. Gross Financing Needs in Percent of Government Revenues
(Percent of revenues)



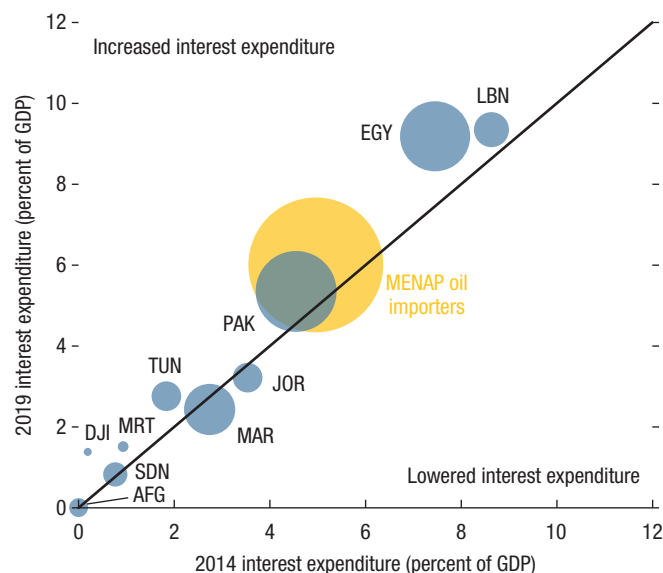
Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

Developments), have had little benefit for the central concern in the region: mounting public debt, which has been a main drag on inclusive growth. Public debt levels are very high in many countries—exceeding 85 percent of GDP on average, and more than 150 percent in Lebanon and Sudan.

Having built over many years, the cost of public debt burdens has become sizeable, preventing investments critical to the region's long-term economic future. For several governments in the region, the immediate budgetary pressure is acute; gross financing needs—which account for the impact of debt maturity—are particularly high in Egypt, Lebanon, Mauritania, and Pakistan at several multiples of public revenues (Figure 2.3). As a result, many governments are vulnerable to sudden changes in market sentiment. High debt levels are also coincident with low FDI, consistent with public debt crowding out productive private investment (see Chapter 4).

In many countries (Egypt, Lebanon, Pakistan) the largest component of short-term budgetary

Figure 2.4. Government Interest Expenditure, 2014 and 2019
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: Size of bubbles denotes weight in regional GDP. MENAP = Middle East, North Africa, Afghanistan, and Pakistan. Country abbreviations are International Organization for Standardization (ISO) country codes.

pressure is mounting interest payments. Despite temporary relief from looser global financial conditions since June, this has grown to absorb large shares of total GDP (Figure 2.4) in many countries, crowding out growth-enhancing investment and social spending. For instance, interest expenditures in MENAP oil importers average 50 percent of capital investment, or more than triple social spending.

Current fiscal positions are stressed further by weak domestic demand (Jordan, Lebanon, Sudan, Tunisia), which would usually provide a motive for countercyclical fiscal expansion. Yet with large outstanding debts, governments are forced to confront a difficult trade-off between debt stabilization and fiscal sustainability (Fournier 2019). At the same time, limited revenue capacity (Jordan, Pakistan), a narrow tax base and relatively inefficient tax administrations (Sudan), and large current expenditures (Jordan, Lebanon) constrain the ability of governments to raise surpluses quickly. Despite medium-term consolidation plans, primary fiscal balances

will likely remain negative in all but one of 11 oil-importing countries during 2019.

High Debts Driven by Lack of Fiscal Adjustment and Lower Growth

The acute cost of such large debt burdens raises two questions. What has caused debt to be so high? And what can be done to reduce debt?

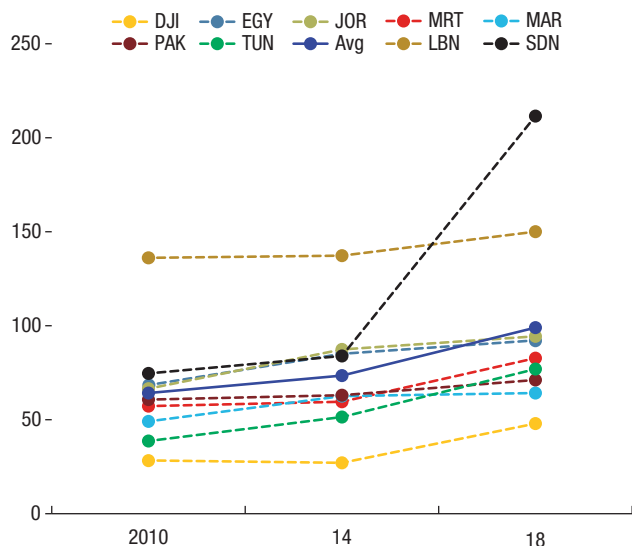
Figure 2.5 speaks to the first of these questions. It shows that MENAP oil importers' high public debt levels are not the result of a sudden runup in debt (except perhaps Sudan). Instead, most countries have experienced increases over many years, primarily driven by a combination of sustained declines in growth and a rise in primary deficits, particularly in the wake of the Arab uprisings in 2011 (Egypt, Jordan, Morocco, Tunisia).

Figure 2.6 shows the important role of growth (in red; notably in Jordan and Lebanon).¹ Indeed, during periods of relatively strong growth, including prior to and in the early stages of the global financial crisis, debt ratios declined throughout most of the region, even in countries where primary deficits increased (in yellow; Djibouti and Jordan). However, in more recent years debt has amassed amid persistent growth-weakness and increased spending on public wages and subsidies in many countries.

This vicious cycle of low growth and rising debt has limited space for growth-enhancing capital investments. As a result, many countries have found it difficult to reduce debt levels, even those tightening their fiscal stance (Egypt, Morocco, Pakistan, Tunisia). The current level of primary deficits would have been sustainable if growth were at precrisis levels. However, the growth being persistently weaker, debt under current fiscal policy is no longer sustainable. In combination

¹In Figure 2.6, country-specific factors are a residual, which can include factors such as debt forgiveness and interest spreads over US rates.

Figure 2.5. Government Debt Has Been Increasing Steadily (Percent of GDP)



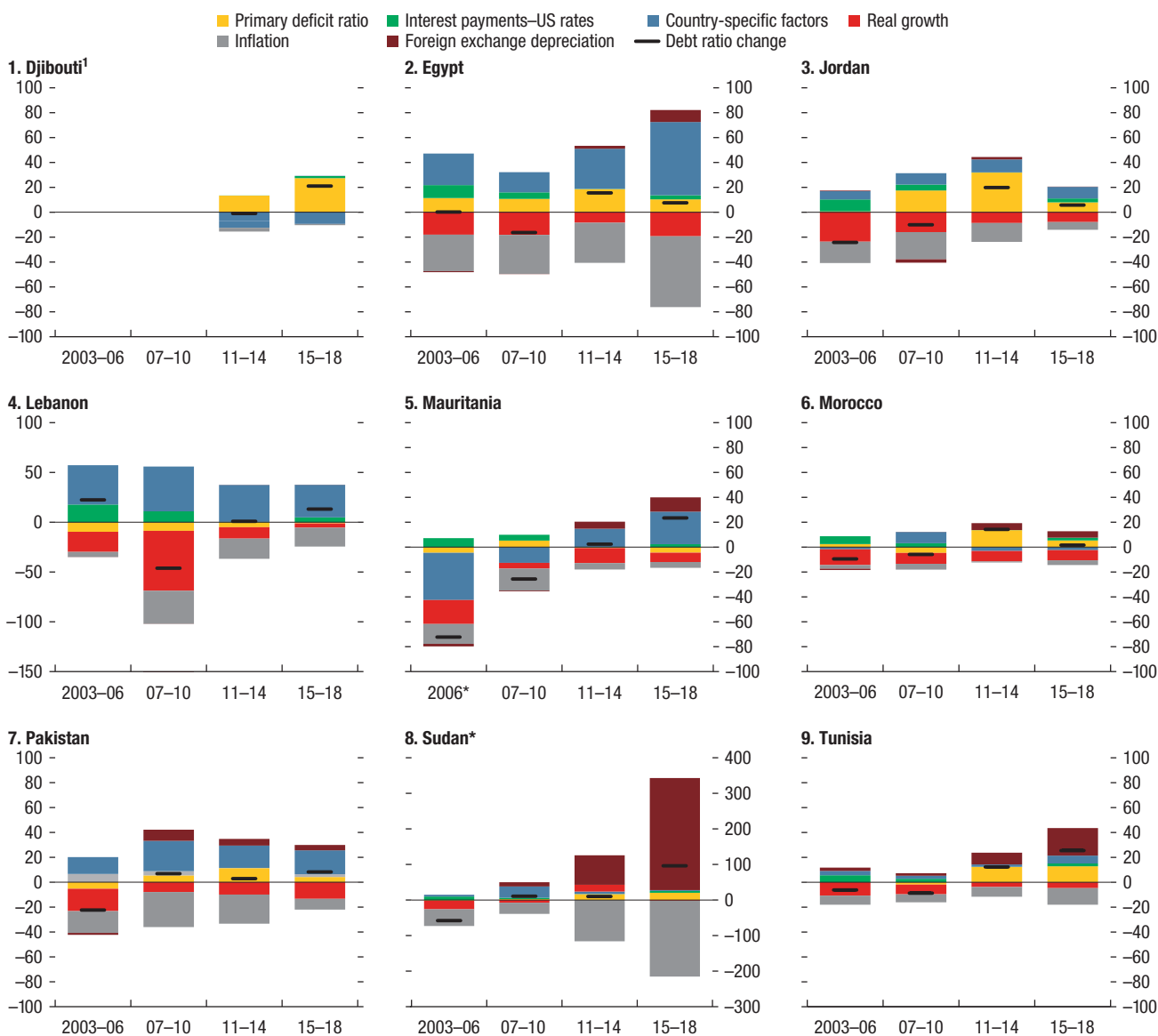
Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

with already-elevated debt, this has resulted in higher country-specific interest rate spreads (blue bars), further accelerating the rate of debt increase.

Figure 2.6 shows that changes in global interest rates (green bars) have contributed relatively little to debt dynamics, pointing to only modest benefits from the recent easing of global financial conditions. This is because risk-free interest rates have been relatively low since early 2009, and because debt levels need to be very high for this impact to be large.² However, pressures in the external and monetary sectors can have a significant impact on debt dynamics. For example, in Tunisia, threats to external sustainability were mitigated by a sizable exchange rate depreciation during 2015–18, which contributed to a higher debt ratio. Similarly, the debt ratio in Egypt increased in 2017 following the exchange rate depreciation, which was needed to reduce external imbalances. In Pakistan, tighter

²Even at a debt ratio of 100 percent of GDP, a 50 basis point interest rate rise will increase annual debt service costs by only 0.5 percent of GDP. And with long-maturity debt, this impact will be much delayed.

Figure 2.6. Changes in Government Debt Ratios
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.

Note: *Sudan appears on a different scale.

¹Includes central government and debt related to the railway and the water pipeline.

monetary policy was required to stem ongoing reserve losses, at the expense of higher interest payments.

In Sudan, the relationship between the monetary and fiscal sectors is particularly apparent. While the inflation generated by monetizing deficits has eroded the debt ratio, this has been offset by the corresponding devaluation of the Sudanese pound,

increasing the domestic value of foreign currency debts (see purple and gray bars in Figure 2.6). Nor is higher inflation a viable long-term strategy for debt sustainability in countries with large domestic currency debts. In these countries, nominal interest rates would rise in expectation of higher inflation, offsetting the reduction in nominal debt from higher inflation (reflected in opposing gray and blue bars for many countries in Figure 2.6).

Table 2.2. Annualized Contributions to Changes in Debt Ratios for MENAPOs, Cross-Country Average
(Percentage of GDP, per year)

	2003–10	2011–18
Change in debt ratio	-2.8	4.0
Primary deficit	0.5	2.5
Growth	-3.8	-1.6
Other factors (inc. spreads)	0.5	3.1

Source: IMF staff calculations.

Note: Afghanistan omitted 2003–06.

In summary, increases in primary deficits after the Arab uprisings have not been the only driver of high debt levels. A persistent decline in growth has also played a critical role. Once debt started to rise, spreads increased, generating adverse debt dynamics and accelerating the growth of debt ratios (see Table 2.2, which summarizes Figure 2.6).

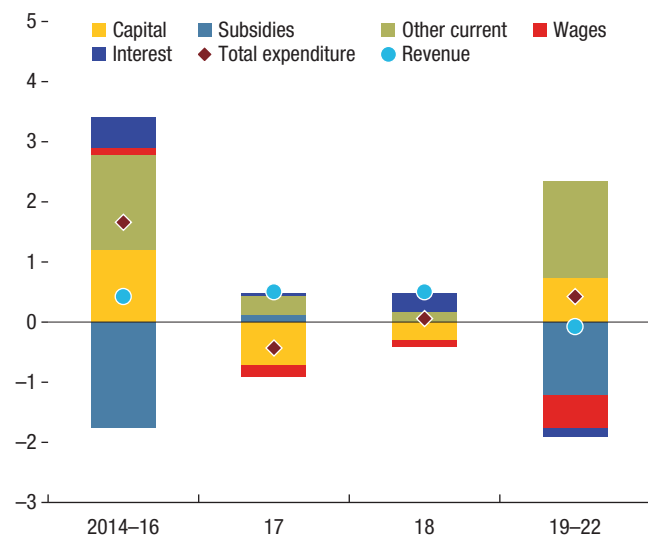
Ensuring Debt Sustainability

There are two key policy approaches that can be used to reduce debt ratios: lowering primary deficits and raising growth.

Policies that boost growth directly are discussed in the next section. Yet growth cannot be ignored when pursuing fiscal consolidation. While deficit reduction may dampen growth, via higher taxes or reduced government spending, there is considerable scope for governments in oil-importing countries to minimize the cost of consolidation by focusing on the composition of fiscal adjustments.

On the expenditure side, this means rebalancing the composition of spending away from inefficient current spending and toward investments that will enhance growth in the long term. Performance on this front has varied (Figure 2.7). Cuts in capital spending have helped contribute to debt stabilization but come at the price of lower future growth. Large public sector wage bills continue to be a significant component of non-capital expenditure (Morocco, Tunisia). Indeed, over the last decade public wage bills in MENAP oil importers have averaged about 8 percent of GDP, a level comparable to oil exporters worldwide (see Tamirisa and others 2018). Efforts to reduce

Figure 2.7. Changes in Government Spending and Revenues¹
(Percent of GDP, change vs. start of period, simple averages)



Sources: National authorities; and IMF staff calculations.

¹Excludes Jordan, Pakistan, Sudan, and Tunisia due to limited data availability.

or even eliminate regressive energy subsidies have resulted in considerable gains (Egypt, Jordan, Morocco, Tunisia). Although progress slowed somewhat in 2018—as the deteriorating economy and higher oil prices increased both political pressures for subsidies and their cost—ongoing reforms are expected to reverse this trend.

On the revenue side, the picture is similarly mixed. In Tunisia, an ambitious package of new measures and improved administration led to a revenue increase of more than 2 percent of GDP. In other countries, considerable scope remains for increased revenues through broadening the tax base and removing exemptions (Jordan, Pakistan).

The ways in which fiscal consolidation balances expenditure and revenue measures also have growth implications. Although Tunisia's tax package helped reduce the deficit, forgoing civil service wage hikes and cutting subsidies could have achieved the same consolidation with smaller growth costs.

Alongside changes in the fiscal stance, reforms to the systematic conduct of policy are essential. More robust fiscal institutions, particularly those

that can establish transparency and credible medium-term frameworks, are crucial in rebuilding fiscal buffers (see Chapter 5). Moreover, enhancing debt management frameworks, including by developing a medium-term debt management strategy, would help governments navigate market risks and take advantage of opportunities, such as lower global interest rates.

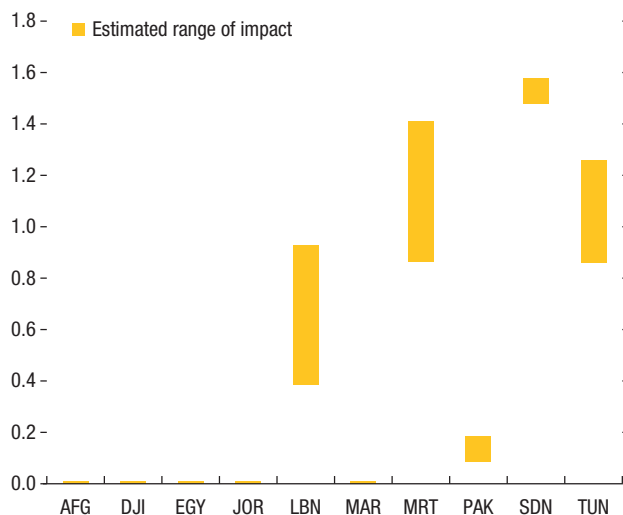
Fiscal sustainability can also be jeopardized by external shocks. Governments could thus take care to minimize their exposure to such risks. For example, those countries with ongoing energy subsidies or fixed domestic prices may be particularly vulnerable to fluctuations in global oil prices (Figure 2.8; Lebanon, Mauritania, Sudan, Tunisia). And in the case of Sudan, monetization of deficits due to inability to access international debt markets puts downward pressure on the exchange rate, further raising the cost of energy subsidies. In contrast, fiscal positions in countries with near-complete cost recovery are much less vulnerable to global oil price increases (Egypt, Jordan, Morocco).

Delivering Higher and More Inclusive Growth

Across the region, continued scope for structural reforms to boost growth in the long term remains (see October 2018 *Regional Economic Outlook: Middle East and Central Asia*). For example, privatizing state-owned enterprises (SOEs)—which have outsized influence in the market and crowd out private sector investment, including FDI—would reduce the stock of public debt, while improving their governance would create space for private sector activity and is a priority in Egypt (Box 2.1) and Tunisia.

Governance in the public sector more broadly also lags comparator countries. One way in which this is evident is via a lack of adequate recording and monitoring of off-balance-sheet contingent liabilities, particularly in the case of SOE debt in the region. Likewise, collateralization of debt may constrain policy options in the future (for

Figure 2.8. Estimated Impact of \$10 Increase in Oil Prices on Subsidy Expenditures
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: Range shows estimated impact of a \$10 oil price increase on total subsidy expenditures given current policies. Country abbreviations are International Organization for Standardization (ISO) country codes.

example, Egypt). A second important aspect of governance is corruption, which can limit growth and undermine social cohesion, and often has roots in poor governance. Reforms that make governments more transparent and accountable, as well as those that strengthen fiscal institutions, can help tackle this problem. (Chapter 5, Jarvis and others forthcoming, provides more details)

Limited access to finance (Jordan, Mauritania; see Blancher and others 2019) and poor infrastructure (Lebanon, Tunisia) continue to hinder growth. Low female labor force participation represents a huge untapped resource; remedying this will require continued public investments in high-quality education and health services (especially in Egypt, Mauritania, Morocco, and Tunisia).

In some cases, tackling domestic issues will require external support, particularly in countries where large refugee programs increase public burdens (Jordan, Lebanon, Tunisia). The international community can support these countries by providing concessional financing (for example,

Jordan and Mauritania), direct budgetary support (for example, IMF programs in Egypt, Jordan, and Tunisia), and technical assistance to improve economic management.³

To be sustainable, growth must also be inclusive (see Purfield and others 2018). Social unrest has risen in recent years, most notably in Sudan. This too represents a risk for countries in the region; social unrest may directly disrupt economic development or lead to short-term policy fixes that do not tackle underlying problems. Yet it is also an opportunity for governments to show that they

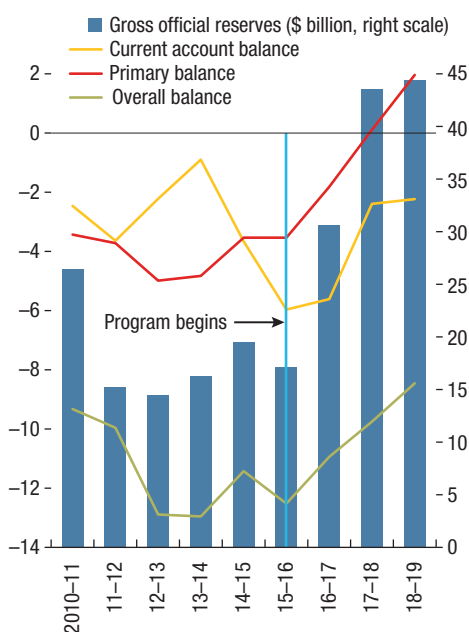
can respond to the society's demands for improved governance and better opportunities. To this end, governments could further examine efforts to raise social spending—which remains low—to protect the most vulnerable in society.

In conclusion, oil-importing MENAP countries are facing twin threats of slow growth and fiscal unsustainability. Governments across the region cannot afford to delay implementing the mix of growth-friendly consolidation and structural reforms necessary to meet these challenges.

³In 2020, planned IMF technical assistance to the region will include advice on managing the fiscal risks of SOEs and public-private partnerships, expenditure rationalization, tax administration, deepening and strengthening bank supervision, and laws and institutions to combat money laundering and terrorist financing.

Box 2.1. Egypt: From Stabilization to Inclusive Growth

Figure 2.1.1. External and Internal Imbalances
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.

By mid-2016, an unsustainable macroeconomic policy mix had left Egypt facing low growth, elevated and rising public debt, and a mounting balance of payments problem with severe shortages of foreign exchange and an overvalued exchange rate. Egypt's reform program, supported by an IMF arrangement under its Extended Fund Facility, implemented a significant policy adjustment anchored by the liberalization of the foreign exchange market and fiscal consolidation to ensure public debt sustainability. This included the phasing out of costly and poorly targeted fuel subsidies, which were a significant drain on budget resources and crowded out spending on health and education. Fiscal savings were used in part to ease the burden of adjustment on the most vulnerable through the expansion of cash transfer programs from 200,000 to 2.3 million households, covering about 10 million people. The authorities' strong ownership and decisive up-front policy actions were critical in stabilizing the economy: growth has accelerated to among the highest in the region; current account and fiscal deficits have narrowed; international reserves have risen; and public debt, inflation, and unemployment have declined.

Achieving macroeconomic stabilization is an essential precondition to long-term growth and job creation. Egypt needs to generate at least 700,000 jobs a year to absorb new entrants to the labor market expected from its fast-growing population. The recent acceleration in growth has been driven, in part, by the rebound in tourism and

natural gas production. To sustain the growth momentum, Egypt is focusing increasingly on long-standing structural impediments to growth in other sectors. Reforms to industrial land allocation, competition, and public procurement, and improved governance are important first steps, but the transition to a transparent, market-driven economy will require broadening and deepening reforms to create an enabling environment for private sector development. Continued efforts will be needed to improve the business climate, tackle corruption, and reduce the role of the state.

Prepared by Matthew Gaertner.

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2. MENAP OIL-IMPORTING COUNTRIES: ADDRESSING FISCAL CHALLENGES AMID SOCIAL PRESSURES

MENAP Region: Selected Economic Indicators, 2000–20

(Percent of GDP, unless otherwise indicated)

	Average 2000–15	2016	2017	2018	Projections	
					2019	2020
MENAP¹						
Real GDP (annual growth)	4.6	5.3	2.1	1.6	0.5	2.7
<i>of which non-oil growth</i>	5.7	2.7	2.9	1.8	2.0	3.0
Current Account Balance	8.2	-3.9	-0.5	2.9	-0.3	-1.4
Overall Fiscal Balance	2.9	-9.5	-5.6	-3.2	-4.7	-5.1
Inflation (year average; percent)	6.5	5.4	7.0	9.3	7.9	9.1
MENAP oil exporters						
Real GDP (annual growth)	4.7	6.1	1.2	0.2	-1.3	2.1
<i>of which non-oil growth</i>	6.2	2.1	2.3	0.4	1.1	2.6
Current Account Balance	11.6	-3.2	1.8	6.2	1.7	0.1
Overall Fiscal Balance	5.7	-10.4	-5.2	-1.9	-3.9	-4.5
Inflation (year average; percent)	6.9	4.4	3.6	8.7	7.0	8.2
MENAP oil exporters excl. conflict countries and Iran						
Real GDP (annual growth)	5.3	4.3	-0.4	1.6	1.3	2.8
<i>of which non-oil growth</i>	7.1	1.8	1.6	1.9	2.7	3.0
Current Account Balance	13.7	-4.7	1.3	6.8	2.8	1.0
Overall Fiscal Balance	7.0	-11.3	-5.4	-1.2	-3.3	-3.9
Inflation (year average; percent)	3.5	2.4	0.9	2.2	-0.3	2.1
Of which: Gulf Cooperation Council (GCC)						
Real GDP (annual growth)	4.8	2.3	-0.3	2.0	0.7	2.5
<i>of which non-oil growth</i>	6.7	1.9	1.9	1.9	2.4	2.8
Current Account Balance	15.3	-2.8	2.8	8.5	5.3	3.1
Overall Fiscal Balance	8.6	-10.7	-5.6	-1.8	-2.4	-3.3
Inflation (year average; percent)	2.7	2.1	0.2	2.1	-0.7	2.0
MENAP oil importers						
Real GDP (annual growth)	4.3	3.7	4.0	4.3	3.6	3.7
Current Account Balance	-2.2	-5.6	-6.7	-6.5	-5.9	-5.2
Overall Fiscal Balance	-5.7	-7.3	-6.8	-6.9	-7.0	-6.5
Inflation (year average; percent)	6.0	7.5	14.4	10.4	9.7	10.7
MENA¹						
Real GDP (annual growth)	4.6	5.4	1.8	1.1	0.1	2.7
<i>of which non-oil growth</i>	5.8	2.4	2.6	1.3	1.9	3.1
Current Account Balance	8.8	-4.2	-0.2	3.8	0.1	-1.3
Overall Fiscal Balance	3.5	-10.1	-5.6	-2.9	-4.4	-4.9
Inflation (year average; percent)	6.3	5.7	7.4	10.1	8.1	8.6
Arab World						
Real GDP (annual growth)	4.9	3.8	1.3	2.4	1.9	3.3
<i>of which non-oil growth</i>	6.2	2.2	2.2	2.5	3.1	3.4
Current Account Balance	9.8	-5.6	-0.9	3.7	0.6	-0.9
Overall Fiscal Balance	4.0	-11.4	-6.4	-2.9	-4.4	-4.9
Inflation (year average; percent)	3.9	4.9	6.9	6.0	3.3	4.8

Sources: National authorities; and IMF staff calculations and projections.

¹2011–20 data exclude Syrian Arab Republic.

Notes: Data refer to the fiscal year for the following countries: Afghanistan (March 21/March 20) until 2011, and December 21/December 20 thereafter, Iran (March 21/March 20), and Egypt and Pakistan (July/June).

MENAP oil exporters: Algeria, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, the United Arab Emirates, and Yemen.

GCC countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.

MENAP oil importers: Afghanistan, Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Pakistan, Somalia, Sudan, Syria, and Tunisia.

Arab World: Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, United Arab Emirates, and Yemen.