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The analysis in this report was coordinated under the general supervision of Jihad Azour (Director of MCD). The project was directed by Taline Koranchelian (Deputy Director in MCD), Bikas Joshi (Chief of MCD's Regional Studies Division), and Ali Al-Eyd (Deputy Chief of MCD's Regional Studies Division). The primary contributors to this report were Olumuyiwa Adedeji, Philip Barrett, Dalmacio F. Benicio, Qiaoe Chen, Lawrence Dwight, Matthew Gaertner, Divya Kirti, Sergejs Saksonovs, Moussé Sow, Iulia R. Teodoru, and Ling Zhu.

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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[1] will average US$61.80 a barrel in 2019 and US$57.90 a barrel in 2020, and that the six-month London interbank offered rate (LIBOR) on US-dollar deposits will average 2.3 percent in 2019 and 2.0 percent in 2020. 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 2019 and 2020 data in the figures and tables are projections. These projections are based on statistical information available through late September 2019.

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.

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

Country Groupings

The October 2019 *Regional Economic Outlook* (REO): *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 comprise 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[1] comprise 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 comprises 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 comprise Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Somalia, Sudan, Syria, and Tunisia.

The **GCC** (Gulf Cooperation Council) comprises 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 comprise Armenia (ARM), Azerbaijan (AZE), Georgia (GEO), Kazakhstan (KAZ), the Kyrgyz Republic (KGZ), Tajikistan (TJK), Turkmenistan (TKM), and Uzbekistan (UZB).

CCA oil exporters comprise Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.

CCA oil importers comprise Armenia, Georgia, the Kyrgyz Republic, and Tajikistan.

[1]Somalia is included in all regional aggregates starting with the October 2017 publication of the *Regional Economic Outlook*. For Sudan, data for 2012 onward exclude South Sudan. Because of the uncertain economic situation, Syria is excluded from the projection years of REO aggregates.

Global Developments: Implications for the Middle East and Central Asia Region

Global developments continue to impact the Middle East and Central Asia (MCD) region. Average growth worldwide has once more been revised down and is anticipated to reach 3 percent in 2019, and 3.4 percent in 2020 versus projections one year ago of 3.7 percent for both of these years (see October 2019 *World Economic Outlook*). Although the reduction in global demand may be partly offset by the recent loosening of global monetary policy, concentration of the slowdown among key trading partners (especially Europe and China) has amplified the impact on the MCD region. Despite rising geopolitical tensions, including those related to Iran, recent disruptions to Saudi Arabia's oil production, and ongoing conflicts in the region (Libya, Yemen), global oil prices have remained low and financial conditions relatively loose.

Real GDP Growth, 2018–24

	2018	2019	2020	2021–24
World	3.6	3.0	3.4	3.6
Euro area	1.9	1.2	1.4	1.4
United States	2.9	2.4	2.1	1.6
China	6.6	6.1	5.8	5.7
Russia	2.3	1.1	1.9	2.0
MENAP	1.6	0.5	2.7	3.1
MENAP oil exporters	0.2	–1.3	2.1	2.1
of which: non-oil GDP growth	0.4	1.1	2.6	2.5
MENAP oil importers	4.3	3.6	3.7	4.8
CCA	4.2	4.4	4.4	4.5
CCA oil and gas exporters	4.1	4.3	4.4	4.5
of which: non-oil GDP growth	3.0	5.1	4.6	4.2
CCA oil and gas importers	5.2	4.9	4.5	4.5

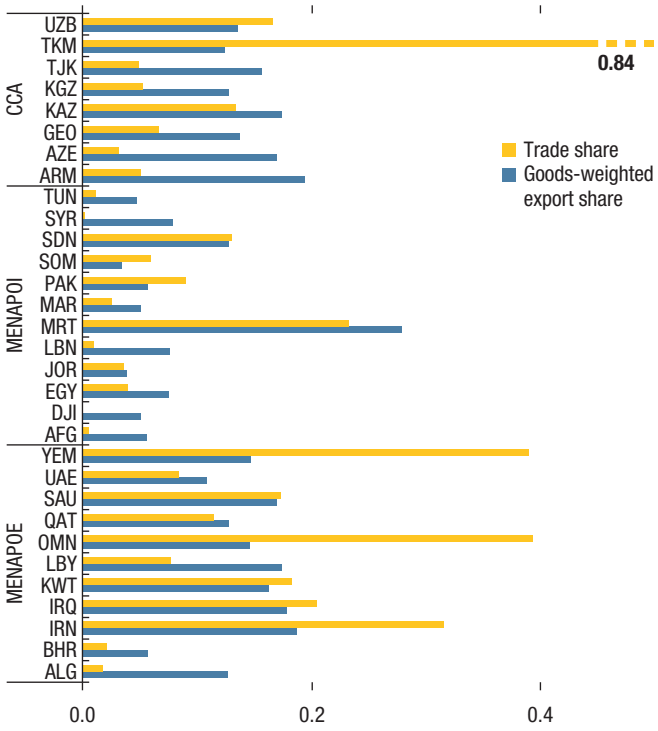
Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, Pakistan.

The outlook for the MCD region is driven by a large contraction in Iran in the short term (see Chapter 1) followed by a rebound in 2020. The risks around the forecast are skewed to the downside and are highly dependent on global factors.

- Ongoing *trade tensions* represent a substantial risk to the region. In September, the United States introduced additional tariffs on Chinese goods, with more scheduled for December. Regional trade links to China are concentrated in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) oil exporters and Central Asia. Yet the spillovers from a China-focused slowdown may not be solely concentrated in these countries. Export shares capture only the direct effects of an external slowdown, so can underestimate exposure to a given country through indirect channels. For example, even countries with few direct sales to China may be impacted considerably by increased competition from redirected trade, as countries with large exports to China seek new markets. Figure 1 addresses this, comparing two measures of export elasticity to a reduction in Chinese demand: one assuming the effect of displaced competition is zero, and one that it is spread equally across all exporters to China. When these competitive spillovers are considered, the likely impact of a China-focused slowdown is more uniform across MCD countries.[1]
- *Oil price volatility* has risen, while remaining below the highs of 2018. The overall level, however, remains similar to that expected in the spring (Figure 2). This is likely a function of both increasingly elastic global oil supply—due to expanded US shale production—and shocks to geopolitical tensions

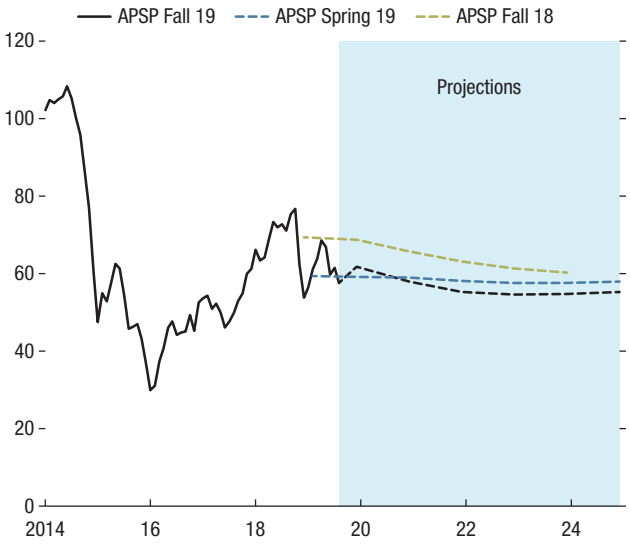
[1]The goods-weighted export share to China for country i is $\sum_m w_m^i \omega_m$, in which w_m^i is the share of good m in country i's exports, and ω_m is China's share of all imports of good m. This measure captures at least some of the spillovers as other exporters adjust. For example, one of Georgia's main exports is metal ore, particularly copper. China is a very large purchaser in this market, constituting nearly half of global demand. A reduction in Chinese demand will likely increase competition for Georgian copper exports as other producers seek to find new markets. Although direct exports to China are very small (about 6 percent of total in 2018), the impact through competitive spillovers may be larger, and is captured at least in part by the goods-weighted exposure.

Figure 1. MCD Exposure of Exports to China, 2017
(Share of exports)



Sources: BACI International Trade database; Centre d'Etudes Prospectives et d'Informations Internationales; and IMF staff calculations.
Note: The goods-weighted export share for each country is the sum of the product of exports in 4-digit harmonized system goods categories with Chinese import shares of each good. It thus measures the elasticity of exports to a goods-neutral reduction in Chinese demand assuming that exporters' shares of global goods markets remain fixed. CCA = Caucasus and Central Asia; MENAPOE = Middle East, North Africa, Afghanistan, and Pakistan oil-exporting countries; and MENAPOI = Middle East, North Africa, Afghanistan, and Pakistan oil-importing countries. Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 2. Evolution of Oil Prices
(APSP, US dollars a barrel)



Sources: National authorities; and IMF staff calculations.
Note: APSP = average petroleum spot price. APSP is the average of UK Brent, Dubai Fateh, and West Texas Intermediate crude oil prices.

and global demand (Box 1). Yet recent events in the Gulf have highlighted the sensitivity of the global oil market to disruptions in oil shipments and facilities.

- A *disorderly Brexit* could also significantly impact the region. A general slowdown across Europe from Brexit will reduce external demand in countries with tight trade links to the continent, such as Morocco and Tunisia. Yet the direct spillovers from a sharp contraction in the UK economy are likely to be much more acute and more unpredictable. Financial channels could be particularly important, as the UK is the largest banking counterparty for the MCD region, and several countries have considerable exposure to the pound sterling (Kuwait, Oman, Pakistan).
- Finally, *social tensions* across the region remain elevated. Protests earlier this year in Algeria and Sudan have been accompanied by those in Georgia and Kazakhstan (Box 2). The evolution of these events highlights the urgent need for reforms to deliver higher and more inclusive growth, and will shape policymakers' options for addressing the economic challenges faced by the region.

In the longer term, even larger risks loom. Foremost among these are *demographic changes*, which are already straining labor markets and demand for public services, and *climate change*, which will most likely impact the region through more adverse weather events, oil price uncertainty, and tension over scarce resources, particularly water.

Given this environment, regional governments' ***policy objectives*** should, in the near term, stabilize macroeconomic conditions and build resilience by addressing unsustainable fiscal policies while protecting the most vulnerable, and in the medium term, promote inclusion and raise growth by tackling impediments to jobs and investment. More accommodative policies should be considered if there is further slowdown in countries where growth is already too low and when there is policy space.

To achieve these objectives, country authorities will face ***three key policy challenges***, highlighted in this report. First, fundamental reforms to the *conduct and institutions of fiscal policy* are essential to tackle high public debt and inefficient government services. This will include the adoption of policies to promote fiscal transparency *and* predictability, such as credible medium-term fiscal frameworks. Second, the composition of *capital flows* to the region has changed, becoming less conducive to growth. Foreign direct investment (FDI) has been replaced by portfolio flows, especially in MENAP countries; policies to promote deeper markets, reduce restrictions on investment, and improve macroeconomic stability can help attract FDI. Third, *structural reforms* are essential for boosting growth and employment throughout the region. A failure to deliver higher and more inclusive growth may fuel already-elevated social tensions, threatening regional stability.

Box 1. Decoupling of Regional Geopolitical Tensions and Oil Prices

Although global oil prices used to rise sharply and remain elevated for long periods in response to major geopolitical tensions in the MENAP region, more recent episodes of heightened geopolitical tensions have had a much less severe impact. For example, oil prices rose by nearly 60 percent, from $22 a barrel in November 2002 to $35 a barrel in March, in the lead-up to the 2003 Iraq war. However, they only rose by 8 percent from $71 in August to $77 in October following the reimpositions of US sanctions on Iran, which was much milder than expected given the fact that Iran is a large oil producer.

This subdued response of oil prices to geopolitical tensions can be explained by a combination of key factors. First, increased risks of an adverse demand shock, most recently owing to the rising uncertainties in global trade, have been a major dampening force on oil prices. Second, supply-side considerations matter. The oil market structure has changed with US shale oil producers playing an increasingly important role. US shale oil production increased from slightly less than 7 percent of the total US crude oil production in the early 2000s to more than 60 percent in 2018.

A regression analysis using monthly data confirms these relations (Table 1). There is a positive and significant relationship between political risks in the MENAP region and real oil prices. However, this effect is dampened by the rise of shale oil since 2010, when US shale oil production started to accelerate (Box Figure 1.1).[1] The increased shale oil production has also contributed to crude oil inventory in the United States, which has remained at historically high levels since 2015, exerting further downward pressure on oil prices. Trade uncertainty, captured by recent spikes in the Chicago Board Options Exchange Volatility Index (VIX), is associated with a further negative impact on oil prices.

Table 1. Selected Determinants of Oil Price

Variables	Δ Real oil price
Δ Political risk in MENAP	0.96**
	(0.59)
Δ Political risk in MENAP * Shale dummy	–0.87*
	(0.63)
Δ VIX	–0.12***
	(0.03)
Δ US crude inventory	–0.31***
	(0.16)

Sources: Haver, International Energy Agency (IEA); PRS Group; IMF Research Department; and IMF staff calculations.

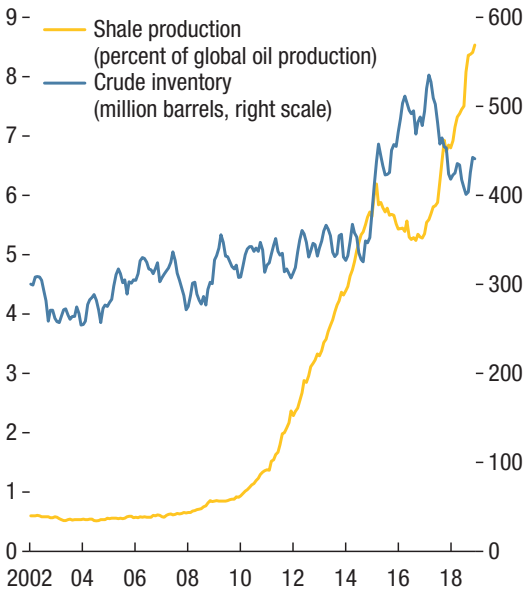
Note: Sample period is from January 1999 to June 2019. Real oil price is calculated by deflating the monthly average petroleum spot prices using the US consumer price index. Political risk in MENAP is proxied using median political risk ratings of all MENAP countries by Political Risk Service Group—transformed so a higher number indicates increased risks. Shale dummy is set to 0 before year 2010, and 1 from year 2010 onward. All time-series variables are in percentage changes from previous month to ensure stationarity. 11-(month) lagged dependent variables are included as additional controls to alleviate omitted variable bias and reduce serial correlations (Durbin-Watson test confirms no serial correlation). Constant term and coefficients of shale dummy and lagged dependent variables are omitted in the table to save space. Robust standard errors in parentheses. ***$p < 0.05$, **$p < 0.1$, *$p < 0.2$. VIX = Chicago Board Options Exchange Volatility Index.

Prepared by Ling Zhu.

[1]Political risks in the MENAP region are proxied using MENAP countries' median political risk ratings, as calculated by the Political Risk Service Group. This measure accounts for political stability of a country on a comparable basis with other countries by assessing risk points for each of the component factors of government stability, socioeconomic conditions, investment profile, internal conflict, external conflict, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability, and bureaucracy quality. Original ratings range from a high of 100 (least risk) to a low of 0 (highest risk); data for this analysis were transformed—subtracting the index from 100—to imply a higher number indicating increased risks.

Box 1 *(continued)*

Box Figure 1.1. US Shale Oil Production
(Percent of global oil production; million barrels)



Sources: US Energy Information Administration; Haver Analytics; and IMF staff calculations.

The muted response of oil prices to changes in perceptions of political risk seems driven by two factors: First, the increasing importance of the US shale oil, especially its role as a major swing producer, has weakened the link between oil prices and geopolitical tensions in the MENAP region. Given the secular nature of the rise in US shale oil, the link between geopolitical tensions and oil prices is likely to remain subdued. Second, trade uncertainty appears to play a large role in keeping oil prices from rising. A protracted trade dispute, increasing the risk of a further global slowdown on top of an already slowing world economy, is expected to keep oil prices low despite geopolitical tensions in the region.

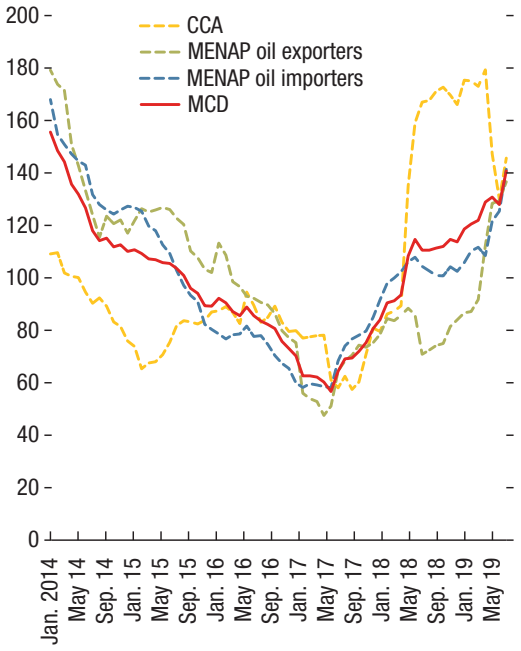
Box 2. Monitoring Social Unrest in the Middle East and Central Asia

Social unrest is growing throughout the Middle East and Central Asia. The Reported Social Unrest Index (RSUI), which counts media reports of social unrest in member countries, shows that reported social unrest has risen to highs not seen since 2014 (Box Figure 2.1).[1]

This recent trend is widespread. Unrest earlier this year had been concentrated in Algeria and Sudan. More recently, though, protests have flared in Georgia and Kazakhstan—albeit in a very different social and political context to that in North Africa (Box Figure 2.2). Still, this contrasts with previous bouts of unrest; prior to 2017 social unrest was relatively more prevalent in countries in the Middle East, North Africa, Afghanistan, and Pakistan region (Box Figure 2.1).

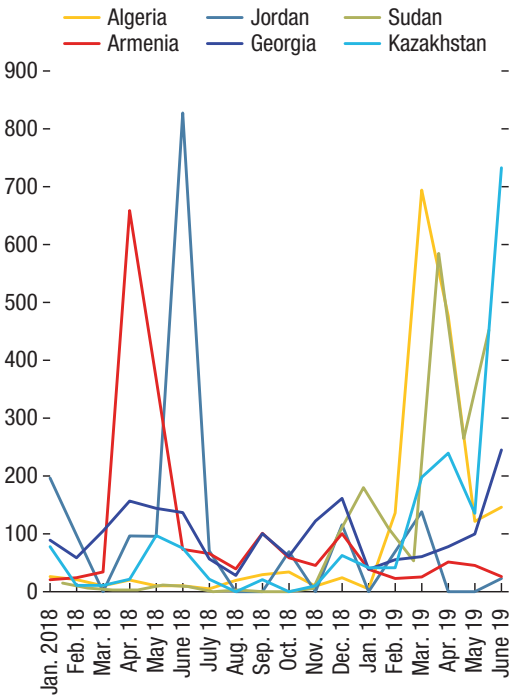
Social unrest constrains policymakers' choices. For example, urgent reforms to Tunisia's public sector wage bill were postponed earlier this year due to fear of widespread protests. And major demonstrations last year led to policy changes in both Armenia and Jordan (Box Figure 2.2). Yet policymakers cannot shy away from reform. Authorities are faced with persistent structural shortcomings, which are limiting jobs and opportunities for their citizens, likely risking further instability.

Box Figure 2.1. Reported Social Unrest Index
(12-month rolling average, 2014–present = 100)



Sources: Factiva; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MCD = Middle East and Central Asia Department; MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

Box Figure 2.2. Reported Social Unrest Index
(Average, 2018–present = 100)



Sources: Factiva; and IMF staff calculations.

Prepared by Philip Barrett.

[1]See Box 1 in the April 2019 *Regional Economic Outlook: Middle East and Central Asia* and associated online annex for further discussion about the construction of this index. Previously computed only for 7 MENA countries, this index is now calculated for the 27 MCD countries for which there are sufficient data.

1. MENAP Oil-Exporting Countries: Transitioning to a Sustainable Fiscal Position and Higher Growth

Growth in the near term remains subdued for oil exporters in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region, amid volatile oil prices, precarious global growth, elevated fiscal vulnerabilities, and heightened geopolitical tensions. In addition, declining productivity is dampening medium-term growth prospects. To reduce dependence on oil prices and pave the way for more sustainable growth, fiscal consolidation needs to resume, underpinned by improved medium-term fiscal frameworks. In parallel, structural reforms and further financial sector development would boost foreign direct investment (FDI) and domestic private investment and foster diversification, thus contributing to improved productivity and potential growth.

Managing External and Domestic Policy Challenges

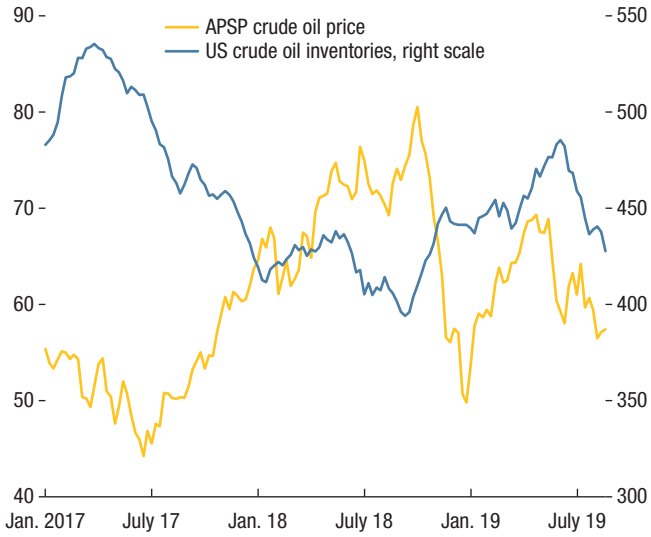
Against a backdrop of slowing global growth, ongoing trade tensions, and renewed geopolitical risks, including developments in Iran and recent attacks on Saudi Arabia's oil facilities, oil prices remain volatile, swinging from $55 to $75 a barrel since the start of the year (see Global Developments). Uncertainties related to future Organization of the Petroleum Exporting Countries and other major oil producers (OPEC+) production decisions and the pace of US oil output expansion add to bouts of oil price volatility (Figure 1.1). At the same time, ongoing conflicts in Libya and Yemen limit scope for effective macroeconomic policies in these countries and further intensify ongoing regional uncertainties.

In this context, growth in MENAP oil exporters (excluding countries affected by conflict and Iran) is expected to be 1.3 percent in 2019 (a downward revision of 0.9 percentage point since April 2019) compared to 1.6 percent in 2018. Increased activity in the oil and gas sectors is expected to support a moderate pickup in growth in these countries to 2.8 percent in 2020. However, this too reflects a downward revision relative to April of 0.7 percentage point, while considerable downside risks underscore prospects for much lower growth outcomes.

Downside risks are significant. Lower global demand and oil production could potentially weaken oil prices, business confidence, and investment decisions, with adverse implications for growth and fiscal and external positions.

Meanwhile, increased fiscal vulnerabilities in some countries—in the context of higher public spending to support growth—reinforce risks from lower projected medium-term oil prices. Finally, while increased bond and equity inflows can finance investment, and potentially stimulate

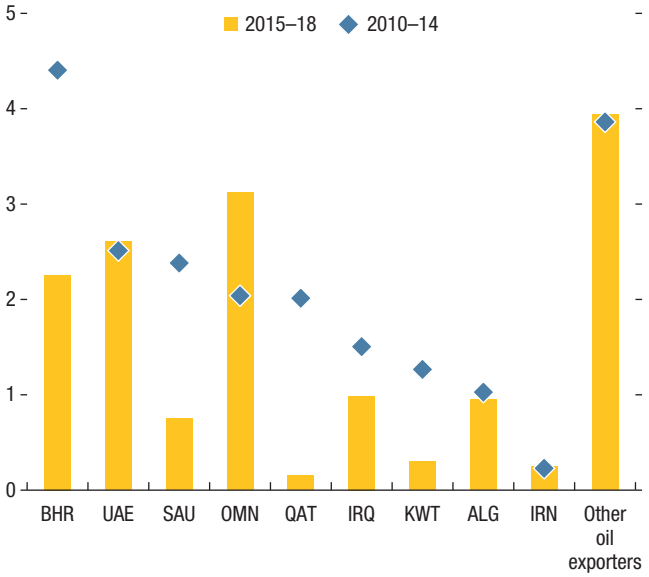
Figure 1.1. APSP Crude Oil Prices and US Crude Oil Inventories
(US$ a barrel and thousands of barrels, right scale)



Sources: Bloomberg Finance L.P.; US Energy Information Administration; and IMF staff calculations.
Note: APSP = average petroleum spot price.

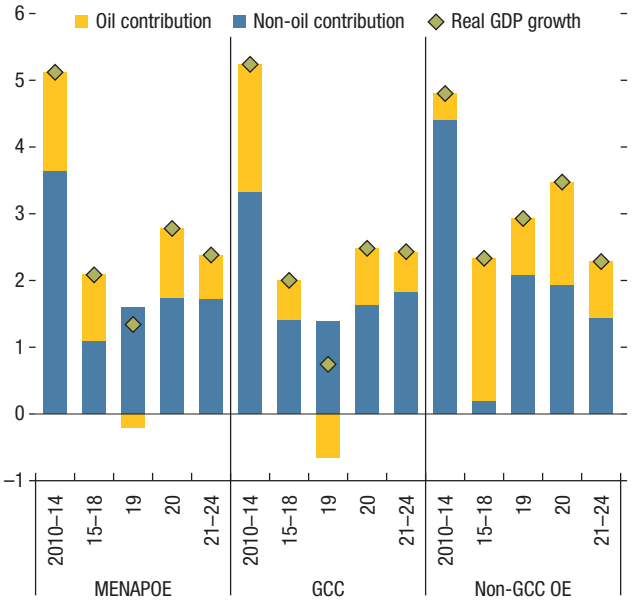
Prepared by Olumuyiwa Adedeji (lead author), Divya Kirti, Jorge de Léon Miranda, and Moussé Sow.

Figure 1.2. FDI Inflows, 2010–18
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: FDI = foreign direct investment. Other oil exporters comprise: Albania, Angola, Bolivia, Brunei Darassalam, Cameroon, Chad, Republic of Congo, Côte d'Ivoire, Democratic Republic of the Congo, Ecuador, Equatorial Guinea, Gabon, Indonesia, Mexico, Nigeria, Norway, Papua New Guinea, Russia, Timor-Leste, Trinidad and Tobago, Venezuela, and Vietnam. Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 1.3. Real GDP Growth: Non-Oil and Oil Contributions
(Percent)



Sources: National authorities; and IMF staff calculations.
Note: Iran and Libya are excluded from MENAPOE and non-GCC OE. GCC = Gulf Cooperation Council; MENAPOE = Middle East, North Africa, Afghanistan, and Pakistan oil-exporting countries; OE = oil exporters. Country-specific weights correspond to purchasing-power-parity-adjusted GDP.

growth, they can also make the region more susceptible to developments in international financial markets (see Chapter 4).

Looking ahead, growth is constrained by a slowdown in productivity, amid reduced FDI flows (Figure 1.2) and scope to improve the allocation of fiscal resources. In this environment, further boosting demand through expansionary fiscal policy would heighten fiscal vulnerabilities and have only a modest impact on growth.

Against this outlook, a mix of macroeconomic and financial policies that would strengthen resilience and promote private-sector-led, job-rich growth is required. Reducing fiscal vulnerabilities is a priority, combined with enhanced emphasis on structural reforms to spur growth. The pace of fiscal consolidation in individual countries should take into consideration the growth impact. Fiscal adjustment needs to be embedded in a medium-term fiscal framework and focused on improving the collection of non-oil revenue, containing wage bills, raising energy prices, and improving the quality of public expenditure (see Chapter 5). Structural and financial sector reforms would boost FDI and investment, and foster private sector activity, thus helping to lift productivity and potential growth.

Improving but Subdued Growth

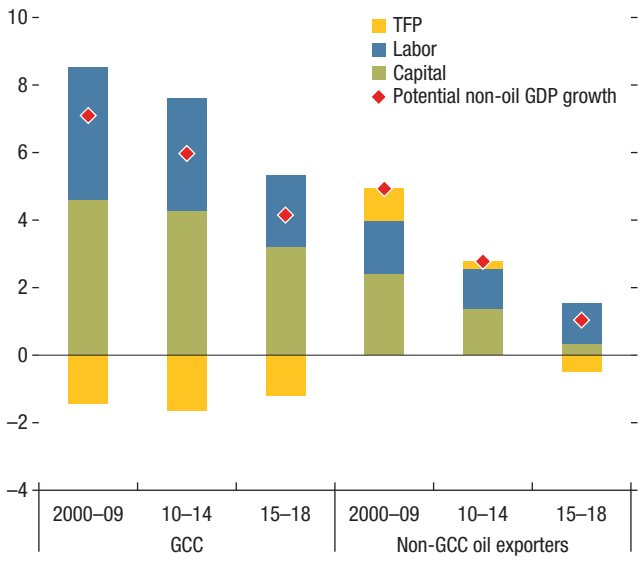
The implementation of ongoing infrastructure projects and improved credit conditions will reinforce the projected near-term recovery in growth of MENAP oil exporters (Figure 1.3). But the growth outlook is fragile given the projected downward trend in oil prices, elevated oil price volatility, and emerging fiscal vulnerabilities.

- Growth in Gulf Cooperation Council (GCC) countries is projected to be 0.7 percent in 2019, down notably from 2 percent in 2018. This decline mainly reflects oil production cuts in line with OPEC+ agreements. Growth

in 2020 is expected to rebound to 2.5 percent, driven by a recovery in real oil GDP growth of 1.9 percent (compared to –1.4 percent in 2019 and 2.5 percent in 2018). This reflects a mix of rising oil production in Kuwait and Saudi Arabia, the Jizan refinery becoming fully operational (Saudi Arabia), and a pickup in gas output in Oman and Qatar. However, it is uncertain whether the OPEC+ agreement in place will expire by March 2020. Non-oil GDP growth (increasing to 2.8 percent in 2020 from 2.4 percent in 2019) will be supported by infrastructure spending (Kuwait and UAE seeing a boost to tourism from Expo 2020, and Qatar, given its preparations toward hosting the 2022 World Cup).

- Iran's economy has entered a steep recession. Output in 2019 is expected to shrink by 9.5 percent as US sanctions have continued to tighten. Iran's main export, oil, is severely restricted, and imports have collapsed. Some stability in the level of output is expected in 2020, culminating in near-zero growth.[1]
- Other non-GCC oil exporters show a mixed growth outlook. Growth in Iraq is projected to be 3.4 percent in 2019, improving from –0.6 percent in 2018 on rising public spending and a modest increase in oil production. Similar trends, alongside better rainfall and sustained improvement in electricity production, will see growth increase to 4.7 percent in 2020. In Algeria, growth is expected to reach 2.6 percent in 2019, up from 1.4 percent in 2018, on rising oil production, before moderating to 2.4 percent in 2020 reflecting ongoing uncertainty. Security and political conditions have deteriorated since April 2019 in Libya, adversely impacting economic performance. Growth is expected to decline slightly in Yemen. The projected growth in non-GCC oil exporters assumes some easing of regional tensions. Growth could be lower if this critical expectation fails to materialize.

Figure 1.4. Potential Real Non-Oil GDP Growth: Contributions of Capital, Labor, and Productivity
(Percent)



Sources: National authorities; and IMF staff calculations.
Note: Libya is excluded from non-GCC oil exporters. GCC = Gulf Cooperation Council; TFP = total factor productivity. Simple averages are used to compute regional aggregates.

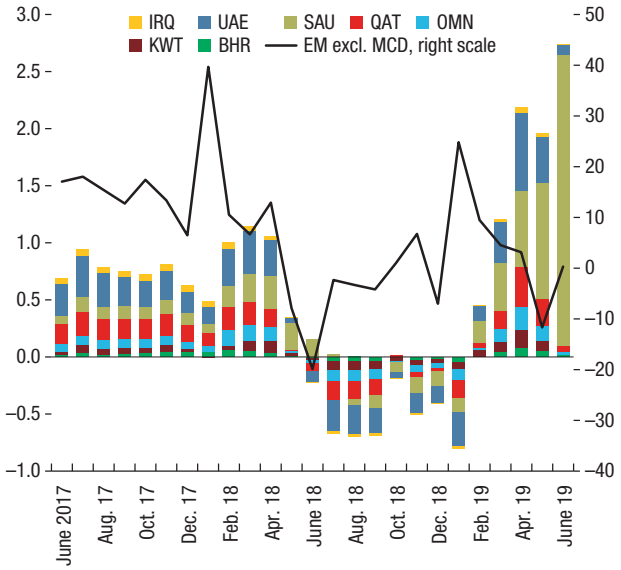
Potential non-oil GDP growth has slowed, reflecting diminishing productivity growth in non-GCC oil exporters, persistently negative productivity growth in GCC oil exporters, and declining capital accumulation across MENAP oil exporters (Figure 1.4).[2] Dominant public sectors in GCC countries continue to skew incentives for investment toward nontradables, weighing on diversification and productivity growth (Callen and others 2014; Cherif and Hasanov 2016).

Against this background, activity is expected to remain subdued over the medium term. Real GDP growth is expected to average about 2.4 percent for GCC countries and 2.3 percent for non-GCC oil exporters (excluding Iran and Libya) during 2021–24. These growth levels are too low to create the approximately 1 million new jobs a year needed to absorb new entrants into labor markets.

[1]See Box 1.1 on the regional spillovers of the re-imposition of economic sanctions on Iran.

[2]Oil prices may also significantly impact confidence and the pace of government investments, with impacts on potential output.

Figure 1.5. EPFR Bonds and Equity Net Flows
(US$ billions, rolling 3-month cumulative flow)



Sources: Haver Analytics; and IMF staff calculations.
Note: EM = emerging market economies; EPFR = Emerging Portfolio Fund Research; MCD = Middle East and Central Asia Department. Country abbreviations are International Organization for Standardization (ISO) country codes.

Improving Financial Conditions Supporting Growth

MENAP oil-exporting countries are benefiting from supportive global financial conditions. Interest rate cuts by major central banks (matched in most GCC countries), and the inclusion of GCC countries in global equity and bond indices, boosted debt and equity flows to many countries in the region in 2019, outperforming other emerging market economies (Figure 1.5).

There has been a modest recovery in private credit growth in GCC countries, partly supported by lower domestic interest rates in response to recent easing by the US Federal Reserve. Nonetheless, pressures in real estate markets persist, impacting financial and monetary conditions (see the April 2019 *Regional Economic Outlook Update: Middle East and Central Asia* for the computation of financial conditions indices).

The banking sector in GCC countries is adjusting to the decline in real estate prices by reducing credit allocation to construction and real estate sectors (Qatar), while mortgage lending is increasing in Saudi Arabia from a low base. Although the banking sector remains healthy, safeguarding the stability of the financial system will require continued effective monitoring of emerging trends in the real estate sector and exploring the scope for continued use of macroprudential measures to contain risks as needed.

In other countries (Algeria, Iran, Yemen), monetary financing of fiscal deficits and inflation driven by exchange rate pressures have lowered real credit growth to the private sector. In conjunction with containing fiscal deficits, these countries need to redouble efforts to mop up liquidity already injected through monetary financing operations to contain inflationary and exchange rate pressures and the associated adverse impacts on economic activity. In Iraq, bank balance sheets remain weak. The public banking system requires restructuring to safeguard financial stability.

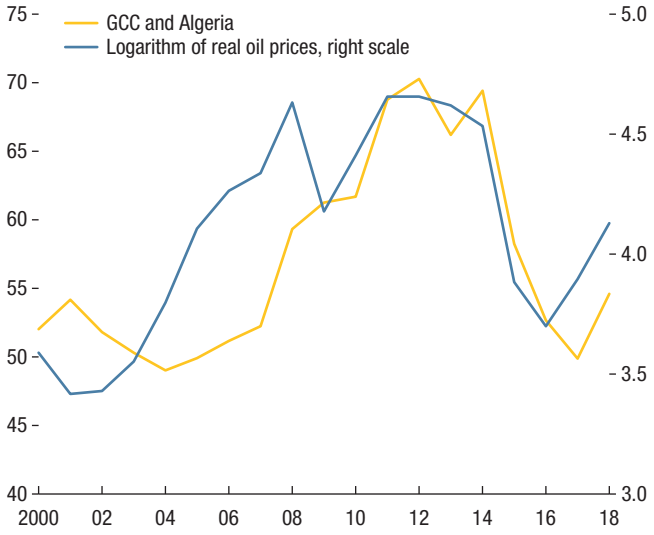
Comovements between Oil Prices and Expenditures, and Fiscal Risks

With concerns about weak growth, the challenge of the strong association between oil prices and government expenditures remains (Figure 1.6). Fiscal consolidation is slowing in some countries and reversing in others (Figure 1.7) due largely to increased spending (Figure 1.8). Nonetheless, the spending effect on growth has been modest so far, partly because of the composition of spending (Figure 1.9).[3] As a result, fiscal vulnerabilities have increased, especially compared to the pre-2014 period. Gross financing needs and public debt have moved up, while governments' net financial positions have deteriorated (Figure 1.10).[4] Thus, countries are now more vulnerable to a decline in oil prices, particularly those with limited fiscal buffers (Bahrain, Iran, Iraq, Oman, Yemen). The estimated gap between the non-hydrocarbon primary balance needed to ensure

[3]See Fouejieu, Rodriquez, and Shahid 2018.
[4]This measure excludes sovereign wealth funds due to lack of information on the size of their liquid components.

Figure 1.6. Real Oil Prices and General Government Expenditure

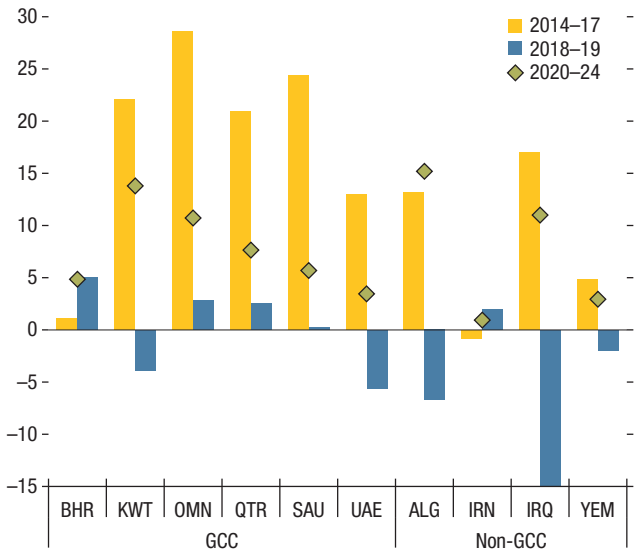
(Logarithm of oil prices and percent of non-oil GDP, weighted averages)



Sources: National authorities; and IMF staff calculations.
Note: The real oil prices are calculated using the US GDP deflator. Country-specific weights correspond to nominal GDP in US dollars. GCC = Gulf Cooperation Council.

Figure 1.7. MENAPOE: Changes in Non-Oil Primary Fiscal Balances

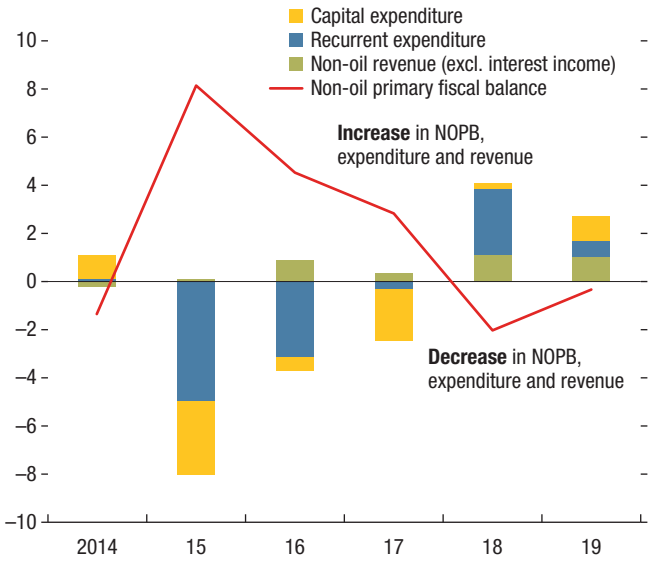
(Percent of non-oil GDP)



Sources: National authorities; and IMF staff calculations.
Note: Country-specific weights correspond to GDP in US dollars. GCC = Gulf Cooperation Council; MENAPOE = Middle East, North Africa, Afghanistan, and Pakistan oil-exporting countries. Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 1.8. MENAPOE: Changes in the Non-Oil Primary Balance, Expenditure, and Non-Oil Revenue

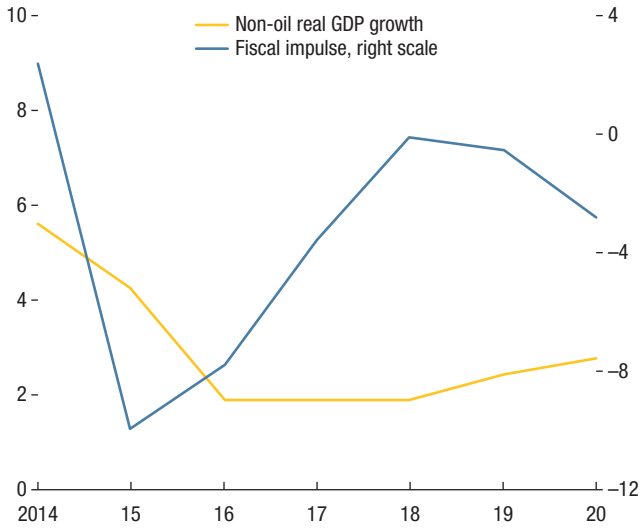
(Percent of non-oil GDP, weighted averages)



Sources: National authorities; and IMF staff calculations.
Note: MENAPOE = Middle East and North Africa, Afghanistan, and Pakistan oil-exporting countries; NOPB = non-oil primary fiscal balance. Country-specific weights correspond to GDP in US dollars.

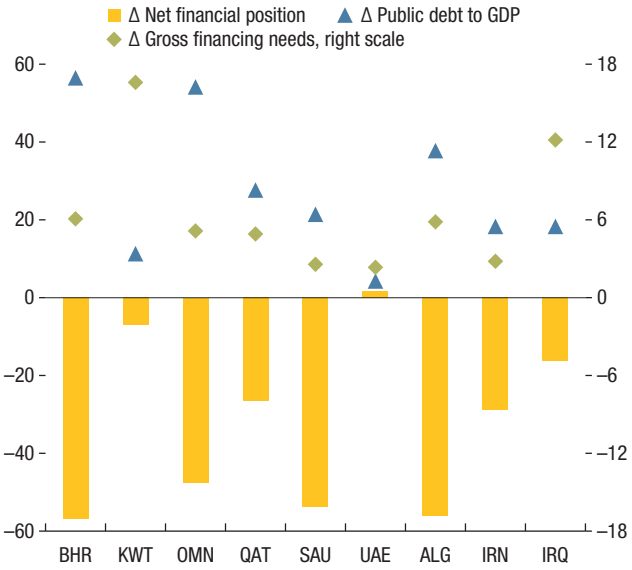
Figure 1.9. GCC: Non-Oil Real GDP Growth and Fiscal Impulses

(Percent and percent of non-oil GDP, weighted averages)



Sources: National authorities; and IMF staff calculations.
Note: Fiscal impulse is calculated using the change in non-oil primary deficit to non-oil GDP ratio. Country-specific weights correspond to purchasing-power-parity-adjusted GDP. GCC = Gulf Cooperation Council.

Figure 1.10. MENAPOE: Changes in the Gross Public Debt, Gross Financing Needs, and the Net Financial Positions, 2014–19
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: The net financial position is the difference between domestic and external debt, and government deposits. Gross financing needs for Kuwait include mandatory transfers to the sovereign wealth fund. Sovereign wealth funds are not included in the definition of the net financial position due to lack of information. Country abbreviations are International Organization for Standardization (ISO) country codes.

intergenerational equity and the projected primary balance in 2019 ranges between 5 and 23 percentage points of nonhydrocarbon GDP.

Addressing Fiscal Vulnerabilities and Intergenerational Equity

Resumption of fiscal consolidation would help rebuild policy buffers and complement efforts to achieve private-sector-led growth. Individual countries' fiscal space, economic conditions, and financing needs should determine the magnitude and pace of the adjustment. However, in the event of adverse shocks or if cyclical conditions warrant, countries with significant fiscal space (Kuwait, Qatar, United Arab Emirates) could undertake slower fiscal consolidation. Overall, an effective fiscal consolidation would depend on several important elements:

Enhancing non-oil revenue collection. MENAP oil exporters have taken significant steps to improve non-oil revenue mobilization.[5] However, there is scope to further augment tax revenues by undertaking comprehensive tax reforms. The strategy could be to prioritize measures to broaden the base by gradually reducing exemptions, eliminating loopholes in tax legislations, and strengthening tax administration. Some countries (Kuwait, Oman, Qatar) would benefit from introducing a value-added tax to enhance domestic revenue mobilization. Consumption taxes could be expanded and enhanced in Iraq. In addition, consideration could be given to introducing other measures, including income and property taxes.

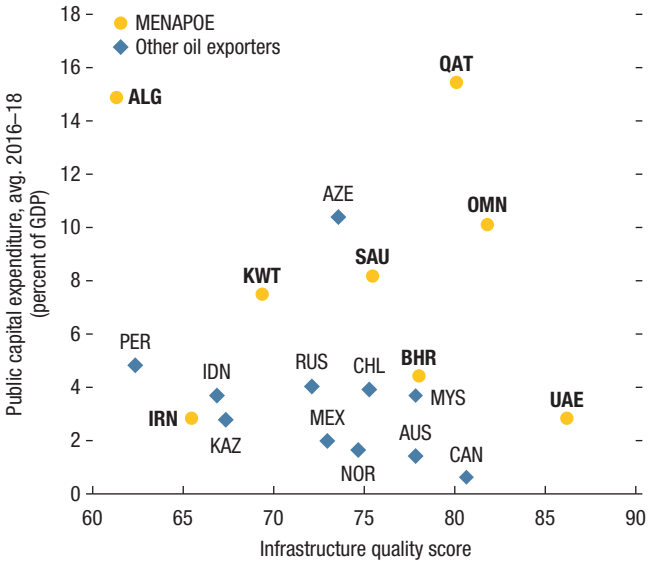
Contain wage bills and energy subsidies and improve the quality and efficiency of spending. Efforts to contain and streamline wage bills (see Tamirisa and others 2018) and energy subsidies[6] (with emphasis on cost-recovery and incentives to reduce energy intensity and inefficiencies) together with strengthening social protection would contribute to a more effective and efficient allocation of resources, crucial for improved productivity. While infrastructure quality in MENAP oil exporters varies, such quality has been achieved at high levels of capital expenditures as ratios of GDP (Figure 1.11), indicating room for improving the efficiency of public investment. Key areas for improvement are procurement, transparency, and appraisal and selection processes.

Strengthening fiscal frameworks. The uncertainty about oil price prospects underscores the need to decouple the evolution of public expenditures from volatile oil receipts. Medium-term fiscal frameworks could prove useful. Strengthening fiscal institutions, including improving transparency and adopting credible medium-term fiscal frameworks, could help improve the

[5]Saudi Arabia introduced a set of measures, including a 5 percent value-added tax rate in January 2018, excises, and an expatriate levy to improve non-oil revenue collection. The United Arab Emirates introduced excises in late 2017, and a value-added tax in January 2018. Bahrain introduced a value-added tax at a 5 percent rate in January 2019. Qatar introduced excise taxes in 2019 (100 percent on tobacco, 50 percent on all carbonated drinks, and 100 percent on all energy drinks).

[6]In some countries lower subsidies going forward will raise revenues rather than lower expenditures (Saudi Arabia).

Figure 1.11. MENAPOE and Comparators: Infrastructure Quality Score and Public Capital Expenditure
(Score and percent of GDP)



Sources: WEF *Global Competitiveness Report 2018–2019*; and IMF staff calculations.
Note: The World Economic Forum's Global Competitiveness indicators combine both official data and survey responses from business executives.These indicators should be interpreted with caution due to a limited number of respondents, limited geographic coverage, standardized assumptions on business constraints, and information availability. They may also not reflect more recent important structural transformations. MENAPOE = Middle East and North Africa, Afghanistan, and Pakistan oil-exporting countries. Country abbreviations are International Organization for Standardization (ISO) country codes.

macroeconomic performance of MENAP oil exporters (see Chapter 5, Adedeji and Zhang 2019).

Structural Reforms to Achieve Higher and Inclusive Growth

Even as continued fiscal consolidation remains a priority, there is a pressing need to generate jobs across the region. To this end, further financial development and structural reforms would help raise economies' supply potential (see Chapter 4 and the October 2019 *World Economic Outlook*). This is important as growth must come from the private sector to ease the burden of much-needed fiscal adjustment.

A recent analysis of GCC countries indicated that increased financial development could raise annual per capita income growth by 0.4–0.7 percentage point and increased financial inclusion in this region could be associated with higher growth of some 0.3–0.7 percentage point (Ben Ltaifa and others 2018).

Strategies to improve financial development and inclusion should focus on the following:

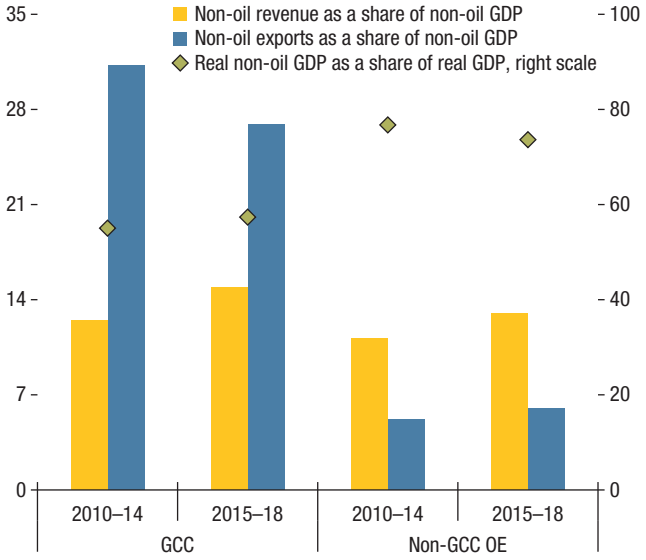
- *Reforms to strengthen access to finance for young and growing companies*. Promoting financial sector competition would help enhance access to finance. Financial literacy and insolvency frameworks could also be improved.
- *Debt and securities markets*. Developing debt markets, making stock markets more accessible to a larger pool of companies and investors, and further improving corporate governance and investor protection would support improved productivity and higher growth.

Although non-oil revenues have been strengthened, considerable scope exists for increasing the non-oil share of economic activity and exports (Figure 1.12).

Structural reforms to support private-sector-led non-oil growth and raise productivity are therefore important. Emphasis could be placed on four key objectives:

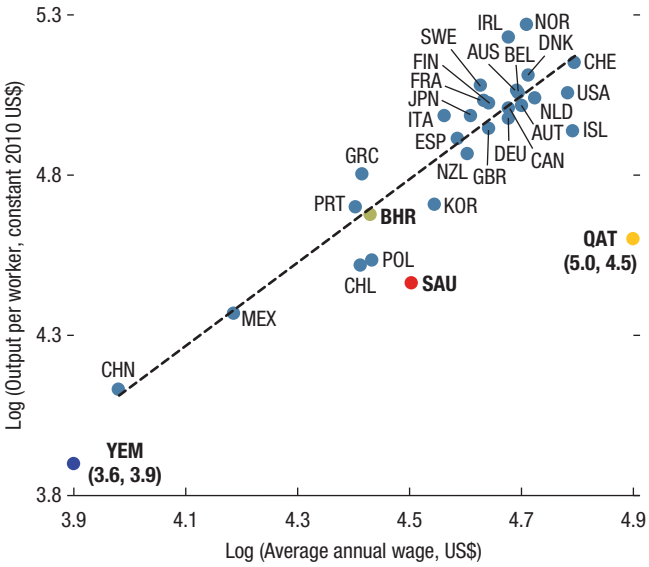
- *Further improving an environment in which the private sector can flourish.* Continued initiatives in GCC countries and concerted efforts in non-GCC oil exporters to improve business environments will help catalyze domestic and foreign direct investment. FDI can lift productivity and growth through technology spillovers and knowledge creation (OECD 2002, WEF 2013). Closing FDI gaps in GCC countries could raise real non-oil GDP per capita growth by as much as 1 percentage point (Stepanyan and others 2018). Relaxing restrictions on foreign ownership would help attract FDI (Algeria).
- *Improving competition and discipline.* A more focused role for the public sector through

Figure 1.12. Diversification from Oil: Real Non-Oil GDP, Non-Oil Revenues, and Non-Oil Exports
(Percent of real GDP and non-oil GDP)



Sources: National authorities; and IMF staff calculations.
Note: Libya was excluded due to data availability. GCC = Gulf Cooperation Council; OE = oil-exporting country. Country-specific weights correspond to purchasing-power-parity-adjusted GDP.

Figure 1.13. Average Annual Wage and Productivity
(Logarithm of output per worker and logarithm of average annual wage)



Sources: Haver Analytics; International Labour Organization; national authorities; World Bank; and IMF staff calculations.
Note: Productivity for Gulf Cooperation Council (GCC) countries is estimated using the relationship between the quality of human capital—based on the World Bank's Human Capital Index—and productivity in the sample of countries shown, as direct data on productivity of nationals in GCC countries are not available. Values for Qatar and Yemen are not within the range of the scale and are shown in parentheses. The remaining MENAP oil-exporting countries are excluded due to data availability. Country abbreviations are International Organization for Standardization (ISO) country codes.

privatization and effective public–private partnerships (in GCC countries), broader and better enforced competition laws (Algeria and GCC countries), and a level playing field between the private sector and state enterprises and foundations (Algeria, Iran) would support competition. All six GCC countries have adopted national visions with significant industrial policy components. Although such policies could encourage the development of new sectors, it is important for these policies to be approached with caution and that any support targets sectors rather than individual companies and is time-bound with specific performance criteria.

- *Incentivizing private sector employment and improving competitiveness.* Wages seem higher than would be suggested by productivity levels in some countries (Figure 1.13; see Kirti 2019). As high public wages and employment contribute to wage-productivity gaps, public-private wage gaps need to be contained (Kuwait, Oman, Saudi Arabia, United Arab Emirates) by more closely linking compensation to performance and improving control over bonuses and allowances (see Tamirisa and others 2018), and expectations of limited growth in public sector jobs communicated (Kuwait, Oman, Saudi Arabia). Improved education and training are essential to improving human capital and raising productivity for all MENAP oil exporters.
- *Improving governance.* Legal frameworks require strengthening to protect contractual, ownership, and creditor rights. Reinforcing the rule of law would require increasing the transparency of corporate beneficial ownership. Many countries would benefit from enhancing asset declaration systems for senior public officials, criminalizing bribery and embezzlement, and reducing the scope for corruption and rent seeking.

Box 1.1. Iran: Regional Spillovers

A lack of integration in global trade means that the sharp recession in Iran will probably have limited spillovers to the rest of the region. The largest impact will likely be in the international oil market, although geopolitical tensions, as well as responses of other oil producers and weakening global oil demand, make the resultant price impact highly uncertain. Other specific markets—including tourism, agriculture, and electricity—in particular countries may also be moderately impacted.

Iran's trade links are limited. In 2017, Iran's gross trade (imports plus exports) was 47 percent of GDP, about half that of other MENA oil exporters (84 percent). Few countries were dependent on Iranian demand for their exports prior to the latest round of sanctions (Table 1.1.1) and even those partners for which Iran's share of exports is large are insulated either through their role as reexporters (United Arab Emirates) or their small export sector (Afghanistan, Tajikistan).

Despite limited overall exposure, trade in specific markets may be severely impacted. For example, Iraq relies on Iran for about one-third of its electricity, both as direct supplies and gas for power stations. Excess demand for US dollars in Iran has spilled over to Afghan currency markets, amplifying depreciation of the Afghani. Agricultural producers in the Caucasus may also be exposed to lower Iranian demand.

Loss of Iranian oil supply contributed to global oil price volatility. Iran's share of global oil production dropped from 5.5 percent in 2017 to only 4 percent at the end of 2018. While increased OPEC and US shale production has cushioned the loss of Iranian supply, uncertainty over the timing of these adjustments and the extent of sanction exemptions granted to importers of Iran's oil contributed to higher oil price volatility since the first half of 2018.

Financial linkages are limited. Foreign residents have relatively few claims on Iranian assets. The Bank for International Settlements reports Iranian financial liabilities to foreign residents of only $1.9 billion in the third quarter of 2018. However, Iranian assets held overseas rose above $25 billion—more than double 2017 levels—with much of the increase in Germany and Korea (Figure 3). US sanctions triggered a decline in correspondent banking relationships, from about 350 relationships in 2017 to fewer than 60 in 2018.

Table 1.1.1. Countries with Significant Exports to Iran

	Goods exports to Iran, 2017			Iranian import share	
	US$ (millions)	*Export share (percent)*	*GDP share (percent)*	*(percent)*	**Major products**
Tajikistan	67.42	0.06	0.01	0.00	
UAE	7,716.94	0.04	0.02	0.28	Motor vehicles
Armenia	84.12	0.04	0.01	0.00	Live animals
Georgia	76.35	0.03	0.01	0.00	Live animals
Uzbekistan	258.30	0.02	0.01	0.00	
Afghanistan	32.36	0.02	0.00	0.00	
Turkey	3,259.27	0.02	0.00	0.05	Metals
Oman	597.40	0.02	0.01	0.00	Tobacco
Sri Lanka	177.00	0.02	0.00	0.00	Tea, Coffee
Brazil	2,559.77	0.01	0.00	0.01	Corn seed

Sources: National authorities; and IMF staff calculations.
Note: This table lists the 10 countries for which exports to Iran account for the largest fraction of total exports.

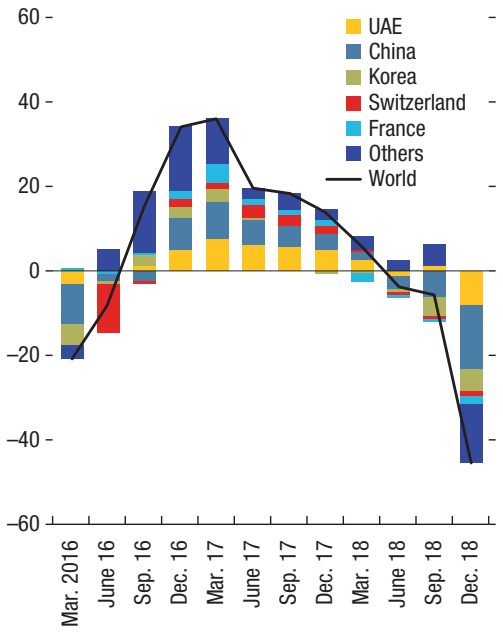
Prepared by Philip Barrett.

Box 1.1 *(continued)*

Tourism and migration flows may compound trade and financial spillovers from Iran. Lower incomes and a weaker rial are likely to reduce tourism from Iran. According to the UN World Tourism Organization, Iranian residents made more than 10.5 million international trips in 2017, a rise of 60 percent since 2015. Turkey was the most popular destination, with more than 2.5 million visits. Iran hosts nearly 1 million refugees, who may be more likely to return home. The UN International Office of Migration reports that more than 500,000 undocumented Afghans returned from Iran in the first nine months of 2018, more than double the same period in 2017.

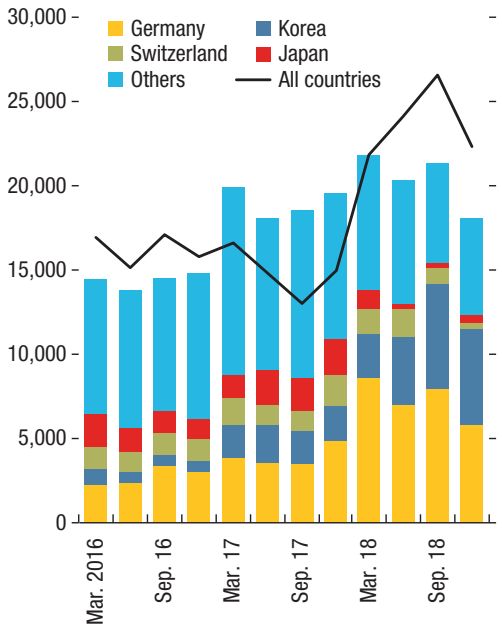
Geopolitical tensions may directly impact international trade. The Persian Gulf is a critical global shipping lane for oil; according to the US Energy Information Administration, oil shipments through the Strait of Hormuz were equivalent to more than 20 percent of global consumption in 2018. Recent tensions, including explosions aboard two oil tankers in June and the detention of a UK-registered ship in July, highlight the risk that increased geopolitical tensions could impact global trade, especially in oil.

Figure 1.1.1. Imports Growth
(Percent, year-over-year growth rate)



Sources: Bloomberg Finance L.P.; Haver Analytics; Iranian authorities; and IMF staff calculations.

Figure 1.1.2. Iranian Overseas Claims
(US$, millions)



Sources: Bloomberg Finance L.P.; Haver Analytics; Iranian authorities; and IMF staff calculations.

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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

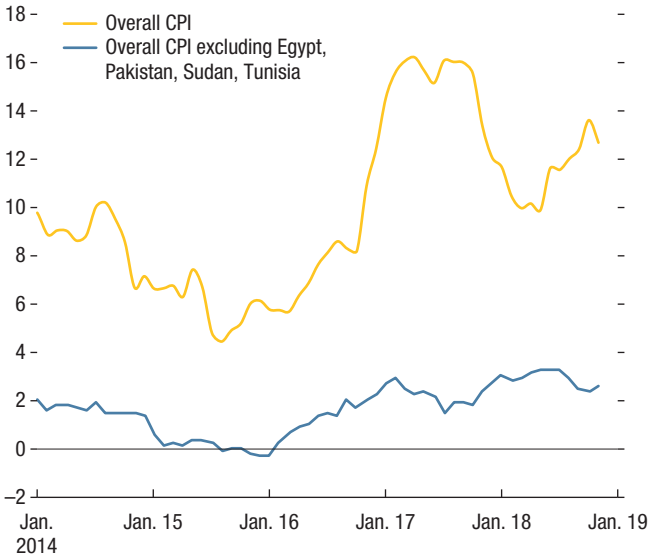
Sources: National authorities; and IMF staff calculations.
Note: MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

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.

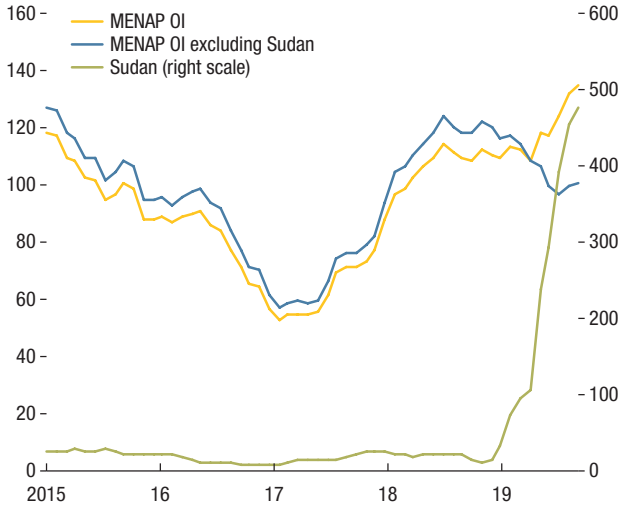
Current account deficits in oil importers are financed principally by bank flows (see Chapter 4) and reserve losses. For example, Lebanon's current account deficit has exceeded one-fifth of GDP every year since 2015. In previous years, short-term deposits from nonresidents represented a substantial share 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

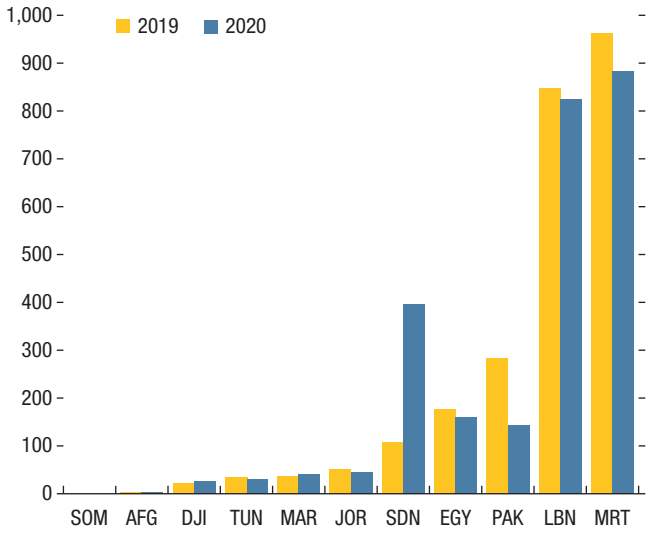
Social and political tensions remain prominent throughout the region (Figure 2.2): uncertainties over political control have left Sudan's spiraling economic problems unaddressed; internal and international political disputes are bringing the West Bank and Gaza economy to a halt; the runup to elections 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

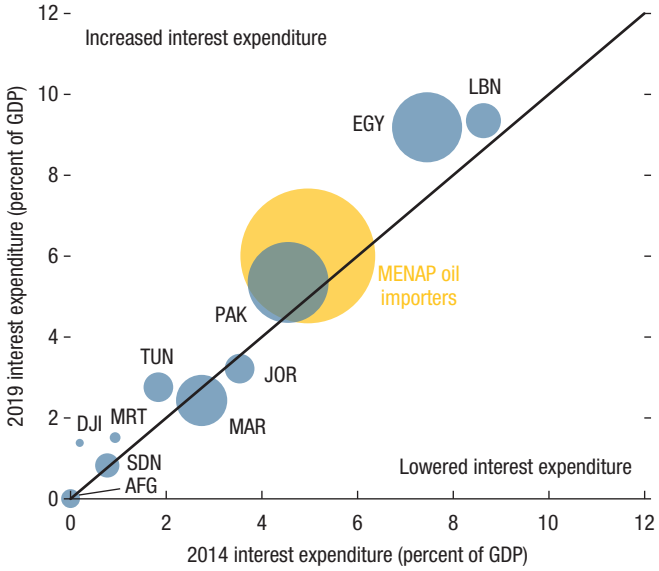
Recent positive developments, including lower global oil prices and interest rates (see Global

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.

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.

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 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 adminstrations (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

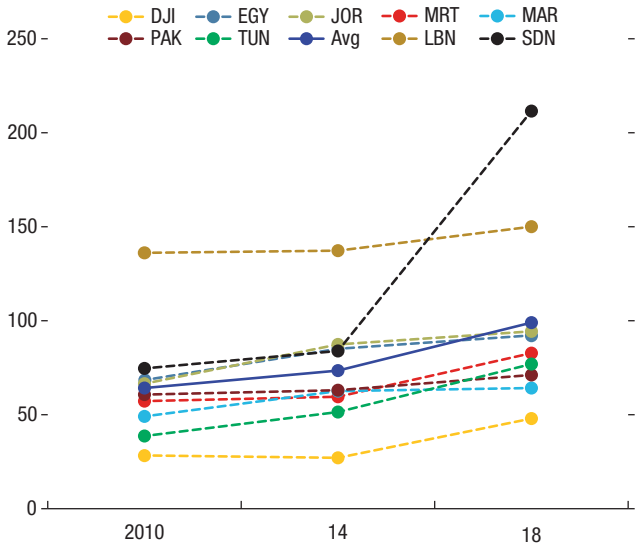
The acute cost of such large debt burdens raises two questions. What has caused debt to be so high? And what can be done to reduce debt?

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

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



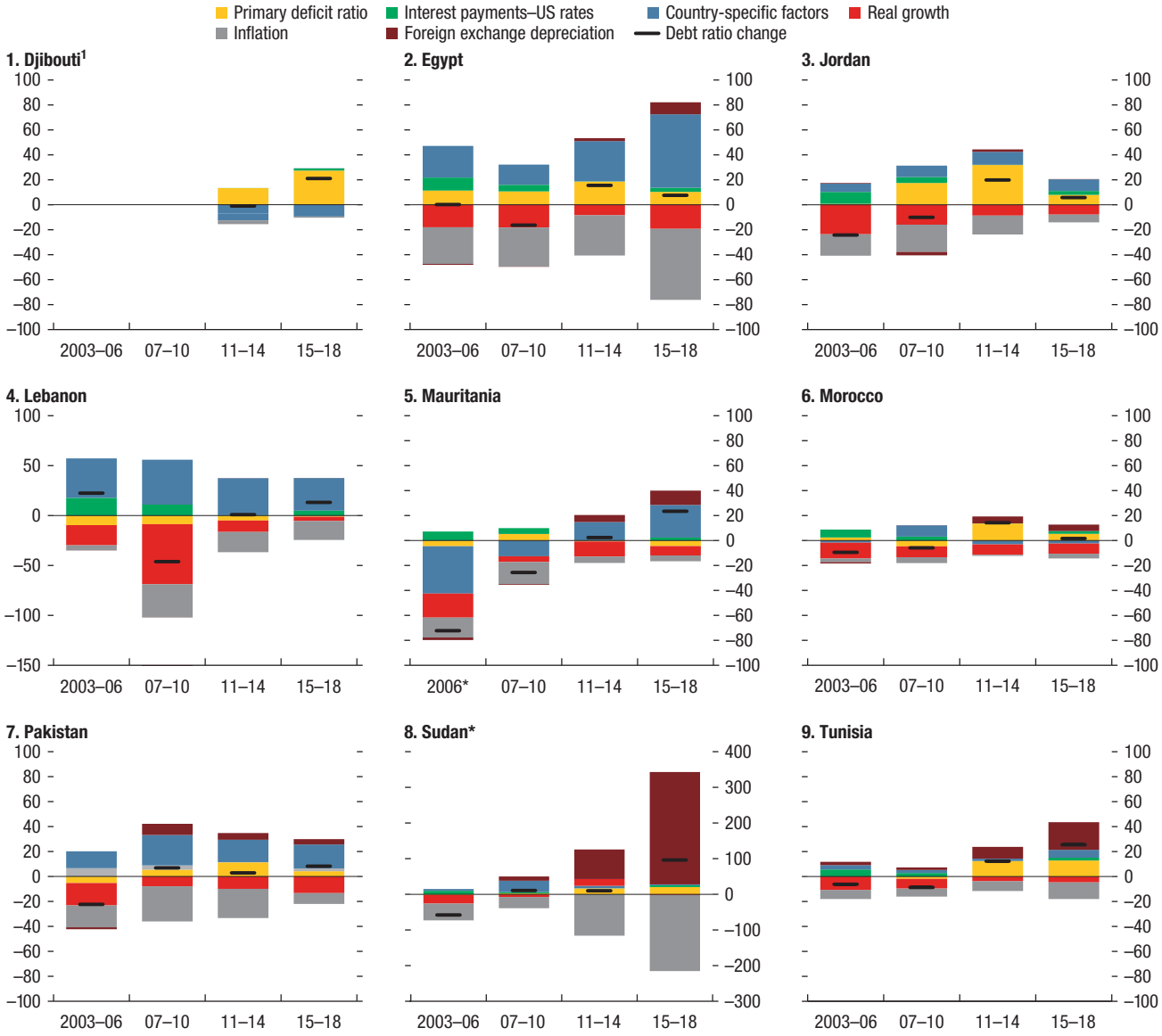
Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

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

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

[2]Even 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.
[1]Includes 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).

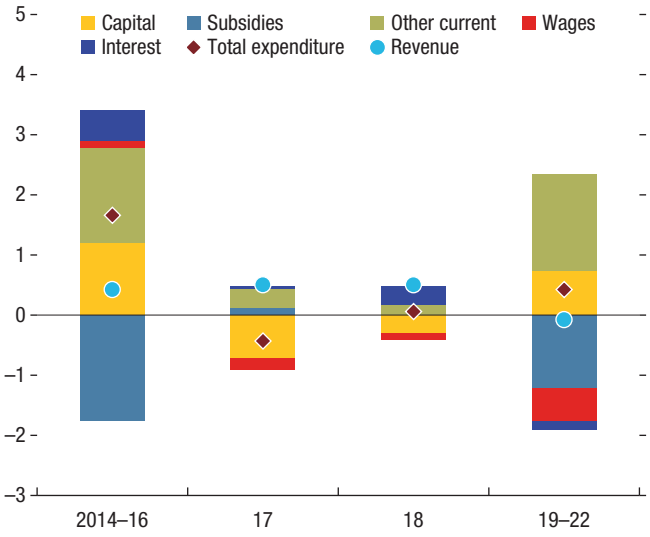
Table 2.2. Annualized Contributions to Changes in Debt Ratios for MENAPOIs, Cross-Country Average
(Percentage of GDP, per year)

	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).

Figure 2.7. Changes in Government Spending and Revenues[1]
(Percent of GDP, change vs. start of period, simple averages)



Sources: National authorities; and IMF staff calculations.
[1]Excludes Jordan, Pakistan, Sudan, and Tunisia due to limited data availability.

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 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).

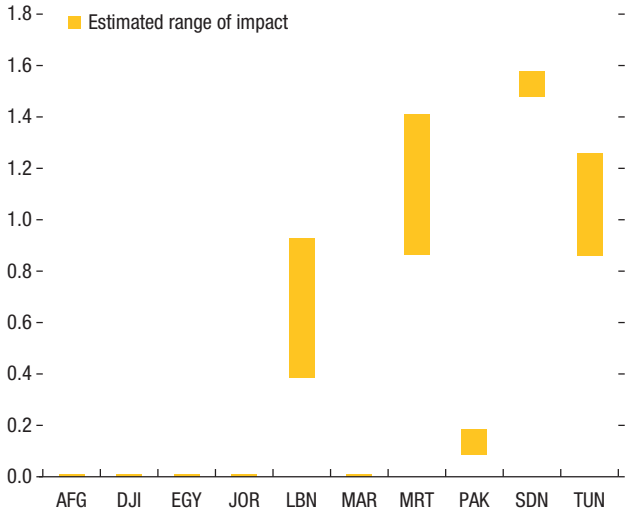
The ways in which fiscal consolidation balances expenditure and revenue measures also have growth implications. Although Tunisia's tax package helped reduce the deficit, forgoing civil service wage hikes and cutting subsidies could have achieved the same consolidation with smaller growth costs.

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).

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.

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 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]

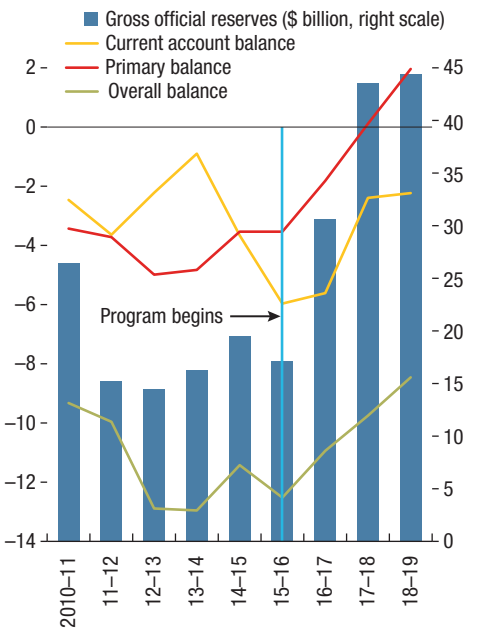
To be sustainable, growth must also be inclusive (see Purfield and others 2018). Social unrest has risen in recent years, most notably in Sudan. This too represents a risk for countries in the region; social unrest may directly disrupt economic development or lead to short-term policy fixes that do not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

[3]In 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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MENAP Region: Selected Economic Indicators, 2000–20
(Percent of GDP, unless otherwise indicated)

	Average 2000–15	2016	2017	2018	Projections 2019	2020
MENAP[1]						
Real GDP (annual growth)	4.6	5.3	2.1	1.6	0.5	2.7
of which non-oil growth	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
of which non-oil growth	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
of which non-oil growth	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
of which non-oil growth	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
MENA[1]						
Real GDP (annual growth)	4.6	5.4	1.8	1.1	0.1	2.7
of which non-oil growth	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
of which non-oil growth	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.
[1]2011–20 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.

3. Caucasus and Central Asia: Boosting Competitiveness for Higher and More Inclusive Growth

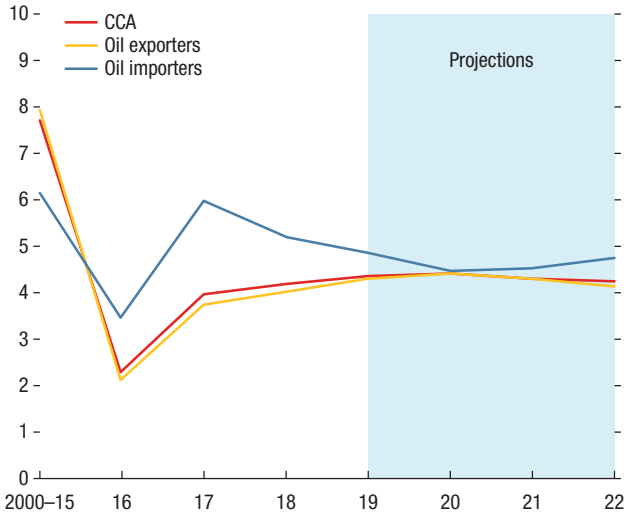
Global trade tensions and slowing growth in key trading partners are affecting the Caucasus and Central Asia (CCA) region. However, despite a decline in export growth, growth will remain broadly stable in 2019–20, supported by a looser fiscal stance and private sector credit growth. Nevertheless, a slowdown in total factor productivity—especially in the region's oil and gas exporters—points to lower potential growth and underscores the challenge of creating enough jobs for new workers. To foster higher and more inclusive growth and raise living standards, CCA policymakers should strengthen competitiveness, leverage comparative advantages, and foster diverse sources of growth to reap the gains from trade and integration into global value chains. This will include promoting private-sector-led growth, improving the efficiency of state-owned enterprises, and ensuring a well-functioning labor market. Macroeconomic policies should focus on addressing weak banking sectors, strengthening fiscal institutions, investing in infrastructure and human capital, and upgrading monetary policy frameworks to sustain stable and low inflation and support greater exchange rate flexibility.

Global Trade Tensions Weigh on the Outlook

The CCA region faces a less-favorable global environment, including from trade tensions and slowing growth in key trading partners. Despite weaker trade, overall growth for the CCA region is expected to remain about 4½ percent in 2019–20 (Figure 3.1), largely owing to a looser fiscal stance.

Growth in the region's major trading partners, including China, Russia, and major euro area economies, is projected to fall from 3.2 percent in 2018 to 2.3 percent in 2019, while import growth is projected to decline from 11.4 percent in 2018 to –1.4 percent in 2019 (see Global Developments).

Figure 3.1. CCA Real GDP Growth
(Percent)

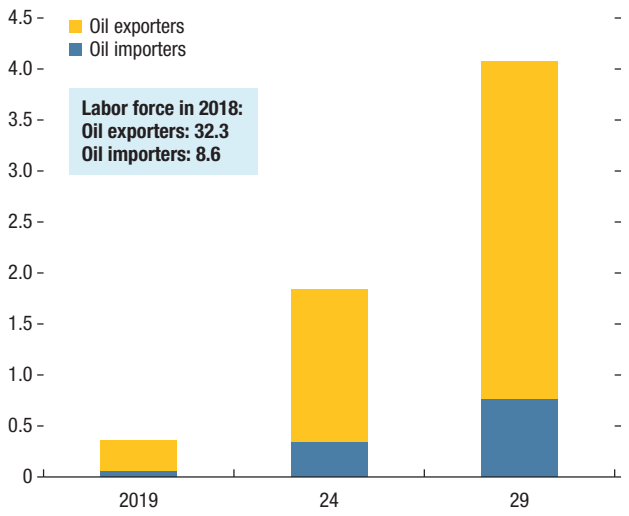


Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia.

These developments are contributing to a sharper projected slowdown in trade in the CCA region in 2019. Growth in exports of goods and services of oil and gas exporters is projected to drop from 23 percent in 2017–18 to about –1.7 percent in 2019–20. The drop in the growth of exports of oil and gas importers is projected to be noticeable yet less dramatic. Import growth in oil and gas exporters is projected to decelerate from 10 percent in 2017–18 to 5.6 percent in 2019–20, owing to restrained domestic demand in some countries. Consequently, current account balances for oil and gas exporters are projected to deteriorate, while the sizable current account deficits of oil importers are projected to improve slightly. Overall, the CCA region's current account balance is projected to decline from a surplus of 0.3 percent of GDP in 2018 to a deficit of 1.5 percent of GDP in 2019–20.

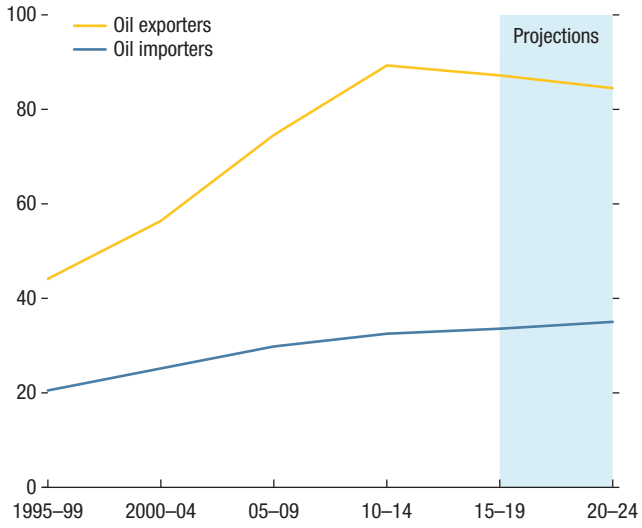
Prepared by Dalmacio F. Benicio and Lawrence Dwight, with research assistance of Oluremi Akin-Olugbade and Jorge de Leon Miranda.

Figure 3.2. Projected Cumulative Labor Force Increase Relative to 2018
(Millions)



Sources: International Labour Organization estimates; and IMF staff calculations.

Figure 3.3. Per Capita GDP Convergence
(Percent of EMEU per capita GDP, in PPP dollars)



Sources: National authorities; and IMF staff calculations.
Note: EMEU = emerging Europe; PPP = purchasing power parity.

Fiscal Expansion Will Offset External Shocks

Nonetheless, growth will be supported by a looser fiscal stance, with the CCA region's general government fiscal balance declining by 1.5 percent of GDP from 2018 to 2019 to 0.6 percent. In oil and gas importers, GDP growth is projected to decelerate modestly from 5.2 percent in 2018 to 4.7 percent in 2019–20. Besides fiscal support, oil and gas exporters will benefit from a pickup in consumer lending coupled with firmer construction, manufacturing, and services demand in Kazakhstan, Turkmenistan, and Uzbekistan. This will boost non-oil GDP growth from 3 percent in 2018 to 4.9 percent in 2019–20.

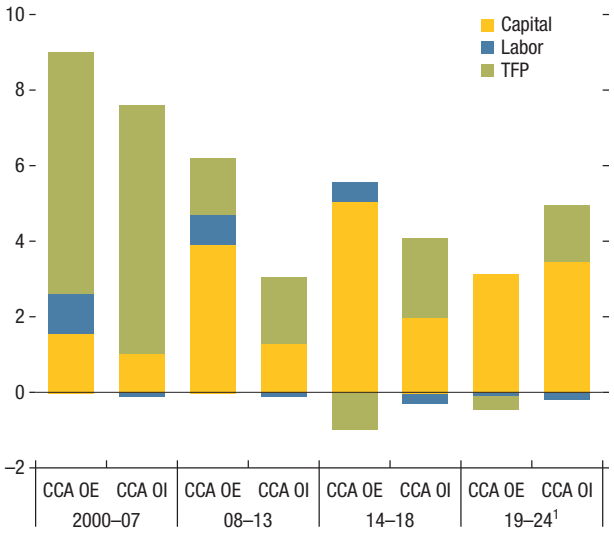
Given the stable growth outlook and lower global energy prices (see Global Developments), inflation expectations are generally well-anchored, though inflation remains in the double digits in Turkmenistan and Uzbekistan (13.4 and 14.7 percent, respectively) mainly owing to high credit growth and increases in utility tariffs.

The region's medium-term growth is projected to remain about 4½ percent, assuming a resumption in trading partner growth and a recovery in oil and gas production. Government debt levels are projected to remain stable at about 23 percent of GDP for oil and gas exporters and 49.8 percent of GDP for oil and gas importers this year. However, growth will not be sufficient to lift per capita incomes to emerging Europe levels (see April 2019 *Regional Economic Outlook Update: Middle East and Central Asia*) or reduce unemployment given 4 million new entrants (12 percent of the labor force) over the next 10 years (Figures 3.2 and 3.3). Currently, Armenia and Georgia have the highest unemployment rates, while Kazakhstan and Uzbekistan—with the largest populations in the CCA region—will have to absorb the greatest number of new workers.

Moreover, the growth in total factor productivity (TFP) in the CCA region has slowed considerably, driven by lower global growth following the global financial crisis, and for oil and gas exporting countries, by lower energy prices since 2014.[1] A slower catch-up effect following the economic

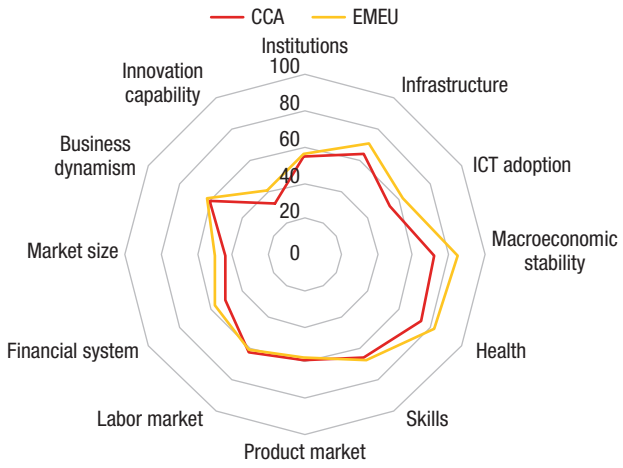
[1]For example, TFP for oil exporters was positive in 2008–13 when average global oil prices rose 6 percent a year but became negative in 2014–18 when average prices fell 8 percent a year.

Figure 3.4. Growth Accounting, CCA Oil Exporters vs. Oil Importers, 2000–24
(Percent)



Sources: International Labour Organization; national authorities; World Economic Outlook database; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; CCA OE = CCA oil exporters; CCA OI = CCA oil importers; TFP = total factor productivity.
[1]CCA OE does not include Turkmenistan for the period 2019–24.

Figure 3.5. Global Competitiveness Index
(0–100, where 100 is best)



Source: *World Economic Forum Global Competitiveness Report*, 2018.
Note: CCA = Caucasus and Central Asia; EMEU = emerging Europe; ICT = information and communication technology.

transition in the 1990s may also have played a role (Fayad and others 2019; OECD 2018a; Figure 3.4).

Downside risks cloud the region's outlook. External risks include intensified trade tensions, slower global growth, lower commodity prices, and rising geopolitical risks. Domestic risks include slowing reform momentum. A possible upside is higher growth from accelerated reforms in Kazakhstan and Uzbekistan.

How Competitive Are CCA Countries?

Global trade uncertainties and weak export performance in the CCA region underscore the need to strengthen competitiveness, leverage comparative advantages, and foster diverse sources of growth. While global trade has slowed, it will likely outpace medium-term global growth. As CCA countries are relatively closed, increased openness and trade could boost growth and efficiency.

Competitiveness is a multidimensional concept. Thus, several indicators are used to compare competitiveness with emerging Europe and Asia.

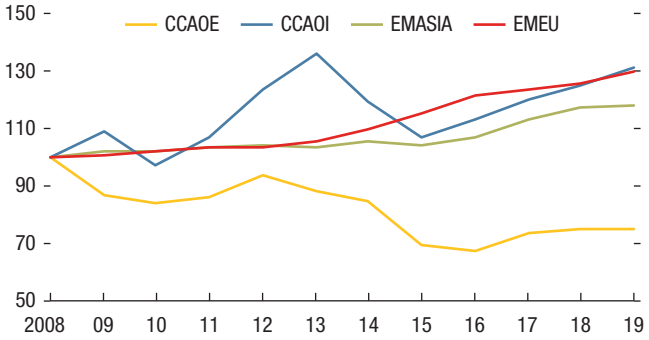
The CCA region scores favorably on several measures. The IMF assesses *exchange rates* to be in line with fundamentals for most countries following devaluations across the region after the large external shocks in 2014–16. Moreover, CCA countries compare well with peers on perceptions of *non–price competitiveness* (Figure 3.5). And CCA countries rate higher than emerging Asia on measures of *human* capital, though lower than emerging Europe.

Nonetheless, several impediments prevent the region from leveraging these advantages to more fully integrate into global markets and raise productivity and potential growth. First, CCA countries rate lower than their peers on access to finance, the tax burden on the formal economy, and the cost of regulation.

Second, trade costs and transport times are high. The average cost to ship a container to Shanghai or Rotterdam is more than five times higher for most

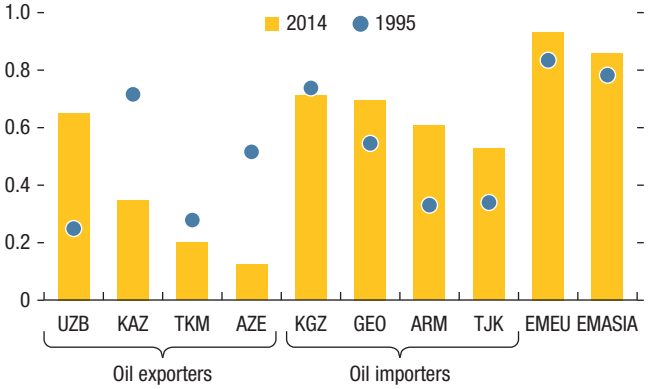
Figure 3.6. Characteristics of Exports

1. Share of Noncommodity Exports in Global Exports
(Index 2008 = 100, share of volume of world exports)



Sources: National authorities; and IMF staff calculations.
Note: CCAOE = CCA oil exporters; CCAOI = CCA oil importers; EMASIA = emerging Asia; EMEU = emerging Europe. EMASIA comprises Bangladesh, Cambodia, Indonesia, Lao P.D.R., Malaysia, Philippines, Thailand, and Vietnam. EMEU comprises Bulgaria, Czech Republic, Hungary, North Macedonia, Poland, Romania, Slovak Republic, and Slovenia.

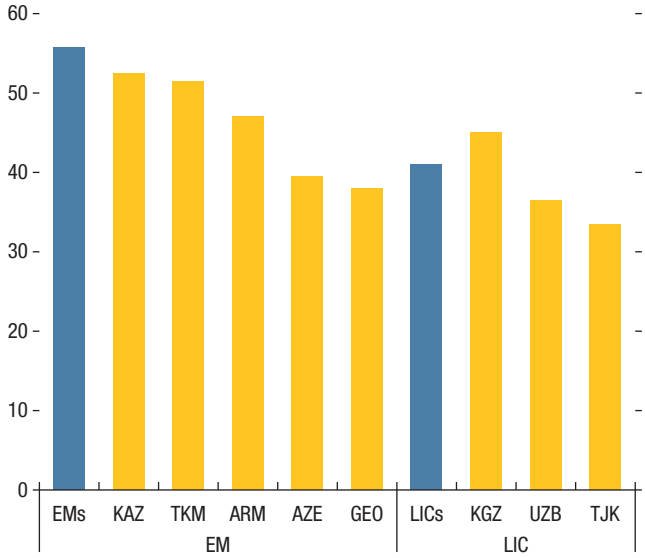
2. Export Quality[1]
(Index, 0–1, higher is more diverse)



Sources: IMF Diversification database; and IMF staff calculations.
Note: EMASIA = emerging Asia; EMEU = emerging Europe. Country abbreviations are International Organization for Standardization (ISO) country codes. Export Quality index rebased to be from 0 to 1, and is equal to a Theil index of export concentration.
[1]2014 is latest available year for the quality index.

Figure 3.7. Global Value Chain Participation Rate

(Percent)



Source: United Nations Conference on Trade and Development (UNCTAD)–Eora Global Value Chain (GVC) database.
Note: EM = emerging market economies; and LIC = low-income countries. Country abbreviations are International Organization for Standardization (ISO) country codes. Global value chain participation rate is calculated as the sum of foreign and domestic value added as a share of a country's gross exports. The larger the rate the higher the intensity of a country's involvement in global value chains.

CCA countries compared with those in emerging Europe (World Bank 2019b). Although high costs reflect geographic disadvantages (for example, landlocked economies, harsh climates, and low population density), they also reflect restrictions on trade and foreign direct investment (FDI), weak border management, and underdeveloped transportation and logistics infrastructure.

Third, the region's oil and gas exporters' share of the world's noncommodity export volumes has not kept pace with emerging market peers. The quality of exports has also fallen since 1995, implying the need to diversify and upgrade product quality (Figure 3.6). Moreover, FDI inflows are relatively small (see Chapter 4), and participation in global value chains (GVCs) is lower than in similar economies (Figure 3.7).[2]

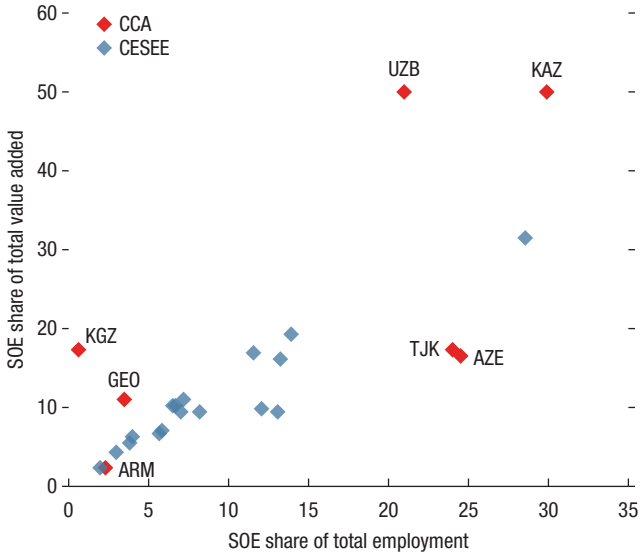
Fourth, government's large role in the economy, reflected in the dominance of state-owned enterprises (SOEs) in local markets, impedes efficiency and entrepreneurship. For example, in Kazakhstan SOEs account for about half of total value added, one-third of employment, and hold assets equal to nearly one-half of GDP (World Bank 2018; OECD 2018b; Figure 3.8). Yet some

[2]The GVC participation rate is measured as the sum of value added of intermediate imports and exports as a share of gross exports.

SOEs have weak operations, lose money, require subsidies, or lack transparency and effective oversight. Moreover, implicit guarantees on SOE liabilities are a growing concern and if they require fiscal support could have a significant impact on governments' fiscal positions (IMF 2019d).

Aside from competitiveness, oil and gas exporters are highly vulnerable to shocks in global commodity markets. CCA oil and gas importers are more diversified, but still have significant exposure to commodity cycles, including directly through exports of minerals and metals and indirectly through remittances from oil exporters, especially Russia. This underscores the region's vulnerability to the subdued outlook for commodity prices and global trade.

Figure 3.8. Value Added vs. Employment
(Percent)



Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; CESEE = Central, Eastern, and Southeastern Europe; SOE = state-owned enterprises. Country abbreviations are International Organization for Standardization (ISO) country codes. Turkmenistan is excluded due to data availability.

Promoting Competitiveness and Inclusive Growth

Although CCA countries have recently taken steps to sustain or enhance competitiveness, such as greater exchange rate flexibility, further efforts are needed to foster higher and more inclusive growth, generate jobs, raise living standards, build resilience, and reduce exposure to external shocks.

Policymakers should also continue to address legacy challenges from external shocks in 2014–16. This means addressing weaknesses in banking systems (Azerbaijan, Kazakhstan, Tajikistan) while modernizing monetary policy frameworks to support greater exchange rate flexibility (Azerbaijan, Kyrgyz Republic, Tajikistan, Turkmenistan, Uzbekistan). It also means strengthening fiscal institutions to support fiscal consolidation, rebuild buffers where needed (Armenia, Azerbaijan, Kazakhstan, Tajikistan), and create space for more productive investment in infrastructure and human capital (see April 2019 *Regional Economic Outlook Update: Middle East and Central Asia*). Improvements to fiscal institutions could include strengthening fiscal rules, fiscal transparency, and the efficiency of tax regimes and revenue administration.

In addition, CCA countries need to boost external competitiveness, FDI, and infrastructure investment, while guarding against risks such as global trade tensions (IMF 2018). Thus, governments should create an enabling environment for the private sector, including by fostering competition and implementing sound industrial policy.

Policymakers should also focus on reforms to achieve greater integration, higher growth, and more jobs. These reforms should reduce trade costs and help companies participate in GVCs, exploit comparative advantages, reform SOEs, nurture entrepreneurship, and ensure well-functioning labor markets. Taken together, these policies would help raise potential output, reinvigorate convergence in living standards, and help address unemployment.

Policies to Promote Participation in GVCs

Policies to promote inclusive growth and participation in GVCs include overcoming geographic remoteness by improving connectivity and lowering trade costs, liberalizing trade, promoting foreign investment, and improving the rule of law and contract enforcement (World Bank 2019a).

First, transport infrastructure could improve connectivity, lower trade costs, and boost FDI. Estimates suggest reduced trade costs could help CCA countries unlock trade and investment opportunities. For example, Belt and Road Initiative (BRI) transport projects could increase trade by 9.7 percent and reduce transport time by more than one-third. In turn, a 10 percent decrease in trade time is associated with a 12 percent increase in FDI (World Bank 2019b). Of course, countries need to ensure that the benefits of infrastructure projects outweigh their costs, including the costs of higher debt.

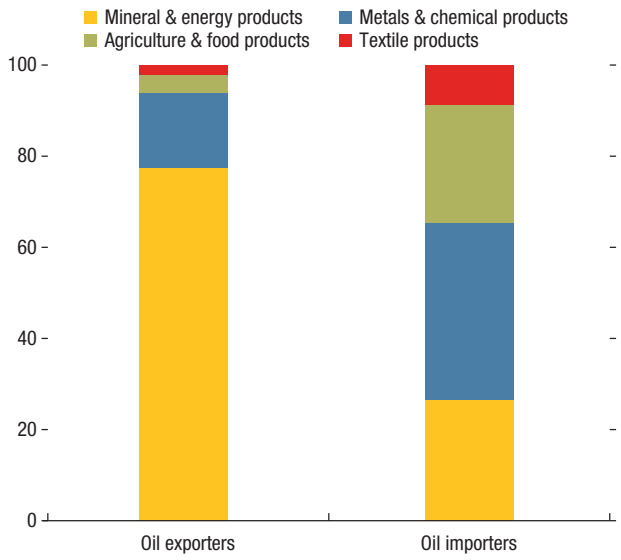
Second, reducing impediments to trade could increase integration into GVCs. Trade liberalization could expand trade in intermediate goods and facilitate downstream diversification. Greater trade could also encourage the adoption of productivity-enhancing technologies, improving the environment for e-commerce and telecommunications.

Third, policies to attract foreign investment—such as those that reduce expropriation risks and streamline entry procedures—are critical to develop the capital, technology, and managerial know-how to integrate into GVCs. Rule of law and contract enforcement would also promote integration into GVCs by fostering innovation and protecting intellectual property rights (World Bank 2019a).

Comparative Advantage

CCA countries need to develop and exploit new sources of comparative advantage, foster diversification, promote more inclusive growth, and accelerate income convergence. This means allocating resources toward more dynamic and productive sectors to diversify exports. Given limits to upgrading the quality of commodities, CCA countries could consider developing manufacturing and agribusiness where quality increases more rapidly (Henn, Papageorgiou, and Spatafora 2015). Revealed comparative advantage (RCA) analysis suggests sectors in which CCA countries have advantages (Figure 3.9).[3] These include mineral, metal, and chemical products for oil and gas exporters and agricultural products and textiles for oil and gas importers. There is the potential for further exports from sectors with high RCAs. Removing impediments to growth

Figure 3.9. Sector Concentration of Exports
(Percent, as a share of goods with RCA > 1)



Sources: United Nations Comtrade; and IMF staff calculations.
Note: RCA = revealed comparative advantage. Minerals and energy products include mineral fuels, oils, ores, and slag ash. Metals and chemical products include metals such as copper, zinc, aluminum, iron, steel, precious metals, and chemicals, including fertilizers and inorganic chemicals. Agriculture and food products include animal and plant products and produce, such as cereals, beverages, tobacco, vegetables, trees, edible fruits, and products of the milling industry; starch, and malt. Textiles include cotton, silk, apparel, and clothing.

[3]RCA measures the extent to which a given category of exports makes up a larger share of a country's exports relative to world exports. Specifically: Country c's RCA in product i = $\frac{X_i^c / \sum_i X_i^c}{X_i^W / \sum_i X_i^W}$ in which: x_i^c = exports of product i by country c, and W denotes similar values for the world. RCA >1 suggests a comparative advantage in product i.

and boosting the quality of human capital would support greater inclusivity, diversification of production, and higher-value-added exports.

Reforming SOEs and Promoting Private Sector Jobs

State-owned enterprises in the CCA region share many of the problems of SOEs elsewhere, including requirements to provide public services, overstaffing, insufficient oversight, loss-making, and potential fiscal costs. Compared to other regions, SOEs in the CCA tend to be involved in a broader range of quasi-fiscal activities, including noncore activities such as hospitals, tourism, and schools, and have weaker financial reporting.

State-owned enterprises can provide public goods and effectively manage public assets given transparent and sound corporate governance. But SOEs can be inefficient or make losses if they lack proper incentives, good governance, or hard budget constraints. Research suggests that price and governance reforms can improve SOE financial performance as measured by return on equity (Baum and others, forthcoming).

Governments should reform SOEs that create fiscal risks, lack profitability or financial stability, or rely heavily on government subsidies or guarantees. This should be done by strengthening corporate governance, improving management, hardening budget constraints, improving incentives (for example, pricing and accountability), and reducing subsidies. To mitigate risks and improve transparency and oversight, policymakers should separate SOE ownership from supervisory functions, compensate SOEs for service mandates, create independent boards, hire professional managers and hold them accountable for financial and operational plans (including by fixing annual and midterm objectives), implement international accounting standards, and regularly publish reports on financial and operational performance, including financial and fiscal risk statements. Where SOEs operate in commercial markets, policymakers should make them compete with private firms and consider privatization (IMF 2016b).

To absorb new workers and boost inclusive growth, countries should pursue policies that promote efficient operation of labor markets, provide appropriate protection to workers, and remove impediments to job creation. On the supply side, this means boosting the quality of education and ensuring that workers have the right skills, especially for sectors that are growing and adapting to new technologies. On the demand side, taxes and regulations should not make hiring too costly. Structural measures should focus on policies, such as employment or social insurance and active labor market policies, that protect workers while promoting flexible labor markets (IMF 2019c).

To promote private sector development, governments should remove excessive regulation and give attention to areas identified as constraints to doing business. These include access to finance, taxes and regulation, inflation, and weak governance.

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CCA Region: Selected Economic Indicators, 2000–20

(Percent of GDP, unless otherwise indicated)

	Average 2000–15	2016	2017	Projections 2018	2019	2020
CCA						
Real GDP (annual growth)	7.8	2.3	4.0	4.2	4.4	4.4
Current Account Balance	0.6	−5.9	−2.3	0.3	−1.3	−1.7
Overall Fiscal Balance	1.9	−2.5	−2.8	2.1	0.6	0.1
Inflation (year average; percent)	8.9	10.5	9.4	8.3	7.6	7.6
CCA oil and gas exporters						
Real GDP (annual growth)	8.0	2.1	3.8	4.1	4.3	4.4
of which non-oil growth	8.3	1.5	3.4	3.0	5.1	4.6
Current Account Balance	1.9	−5.6	−1.9	1.5	−0.5	−1.0
Overall Fiscal Balance	2.7	−2.1	−2.6	2.6	1.0	0.5
Inflation (year average; percent)	9.2	11.6	10.0	9.0	8.1	7.9
CCA oil and gas importers						
Real GDP (annual growth)	6.2	3.5	6.0	5.2	4.9	4.5
Current Account Balance	−9.0	−8.3	−4.7	−7.9	−7.1	−6.7
Overall Fiscal Balance	−2.9	−5.4	−4.3	−2.1	−2.6	−2.6
Inflation (year average; percent)	7.0	1.8	4.6	2.7	3.8	4.5

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

CCA oil and gas exporters: Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.

CCA oil and gas importers: Armenia, Georgia, the Kyrgyz Republic, and Tajikistan.

4. Capital Flows to MENAP and the CCA: Opportunities and Risks

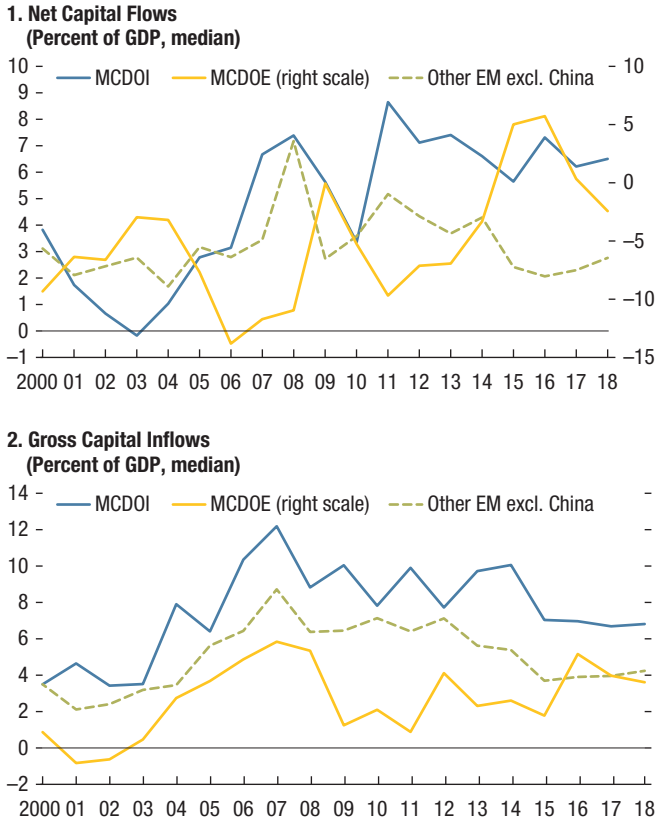
Capital flows to the Middle East and Central Asian countries have been resilient even as global financial conditions tightened in 2014–16. Such flows have helped finance current account and fiscal deficits, allowing for more gradual policy adjustments. As the region has become more integrated into global financial markets, portfolio and bank flows have nearly doubled over the last decade; foreign direct investment (FDI) has almost halved, however, reflecting weaker fundamentals. Governments need to seize the benefits of capital inflows while mitigating risks stemming from global financial market volatility, especially global risk sentiment, to which the region is twice as sensitive compared to other emerging market economies. This means revitalizing FDI by easing restrictions and promoting macroeconomic stability in the near term and boosting potential growth over the medium term. Ensuring fiscal sustainability, utilizing macroprudential tools, and, where appropriate, allowing for more flexible exchange rates can help contain the risks from capital flow volatility. Deepening and developing domestic financial markets, especially through strengthening legal frameworks, remains a key priority.

Changing Capital Flow Patterns Call for Policy Response

Median net capital flows to countries in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) and those in the Caucasus and Central Asia (CCA) have increased since the global financial crisis. Oil exporters have typically been acquiring foreign assets resulting in net outflows (Figure 4.1; Box 4.1). Only in 2015–17, as they slowed foreign assets accumulation and attracted inflows to finance fiscal deficits, did the median oil exporter have net capital inflows. Resilient capital inflows to oil importers ensured that net capital flows have been consistently positive and higher, as a share of GDP, compared to other emerging market economies.[1]

Gross capital inflows to the MENAP and the CCA region declined in the aftermath of the global financial crisis along with other emerging market peers, although they were less volatile during the

Figure 4.1. Capital Flows

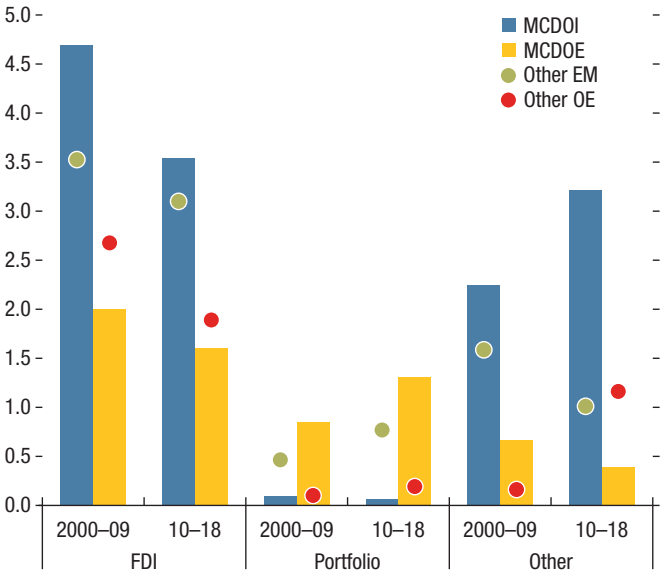


Sources: National authorities; and IMF staff calculations.
Note: MCD = Middle East and Central Asia; MCDOE = MCD oil-exporting countries; MCDOI = MCD oil-importing countries; other EM = other emerging market economies excluding MCD emerging market economies.

Prepared by Sergejs Saksonovs and Ling Zhu, with research assistance provided by Oluremi Akin-Olugbade.

[1]"Capital inflows" refers to net incurrence of foreign liabilities. "Capital outflows" refers to net acquisition of foreign assets. Both items can be negative when repayment of liabilities exceeds their incurrence or sales of foreign assets exceed their acquisition.

Figure 4.2. Composition of Inflows
(Percent of GDP, average of median over time)



Sources: National authorities; and IMF staff calculations.
Note: FDI = foreign direct investment; MCDOE = Middle East and Central Asia oil-exporting countries; MCDOI = Middle East and Central Asia oil-importing countries; other EM = other emerging market economies; other OE = other oil exporters.

tightening of global financial conditions (IMF 2016a).[2] Oil exporters had the most significant decline, driven by lower bank flows and FDI from a 2003–08 average of 3.8 percent of GDP to an average of 2.6 percent of GDP a year since 2012. The decline for oil importers (from 8.3 to 7.9 percent of GDP) was much less pronounced than for oil exporters or other emerging market economies.

Gross inflows to the region are evenly split between oil importers and exporters and relatively concentrated, with the top three countries in both groups accounting for slightly more than one-half of total flows.[3] The composition of inflows has changed (Figure 4.2) with FDI falling and portfolio and other (bank) inflows rising. Nearly two-thirds of these increased portfolio and bank inflows went to five countries (Lebanon, Morocco, Pakistan, Qatar, and Saudi Arabia).[4]

Capital inflows can finance investment and help growth but also entail risks to financial and macroeconomic stability (IMF 2012). This chapter focuses on capital inflows in the region and seeks to answer two questions:

- *How can the region attract more stable and growth-enhancing capital inflows?*
- *What could be done to mitigate risks from capital inflow volatility?*

Declining FDI Offset by Higher Portfolio and Bank Flows

There has been a global decline in FDI owing to lower returns and a less-favorable investment policy climate.[5] However, the MENAP and CCA countries (especially oil exporters, which have experienced a larger decline compared to peers) have been affected more strongly, reflecting weak growth prospects and geopolitical tensions in the region.

Figure 4.2 shows that declining FDI was offset by the rising importance of portfolio inflows (for oil exporters) and bank flows (for oil importers).[6] A sizable share of these inflows (at least one-third in 2018) went to the official sector, helping finance fiscal deficits not only in oil-importing countries (Egypt, Lebanon, Pakistan), but also in oil exporters (Bahrain, Oman).[7]

[2]This chapter excludes: Djibouti, Libya, Somalia, Syria, and Tajikistan from the analysis due to lack of data on capital inflows.

[3]For oil exporters these are Kazakhstan, Saudi Arabia, and United Arab Emirates; for oil importers these are Egypt, Lebanon, and Morocco.

[4]Other inflows are henceforth called bank flows since nonresident deposits in domestic banks as well as loans from foreign banks to domestic companies are likely to be the most important quantitatively. However, government borrowing, and direct supplier credit could also play a role.

[5]UNCTAD (2019) reports that in 2018, some 55 economies introduced at least 112 measures affecting foreign investment. More than one-third of these measures introduced new restrictions or regulations—the highest number for two decades. Box 1.4 in IMF (2019a) explores the possible role of multinational corporations in driving FDI.

[6]More broadly, portfolio inflows have also increased in other emerging market economies, reflecting the impact of unconventional monetary policies in advanced economies.

[7]Based on net reporting of financial account transactions in the balance of payments for the government sector.

Between 2016 and 2018, portfolio inflows to the MENAP and the CCA regions reached their highest levels—accounting for about 20 percent of the total portfolio inflows to emerging market economies, up from merely 5 percent before the global financial crisis.[8] Cumulative portfolio inflows in that period reached $164 billion, of which nearly three-quarters went to Egypt, Oman, Qatar, and Saudi Arabia, with official-sector flows being the majority in Egypt and Oman.

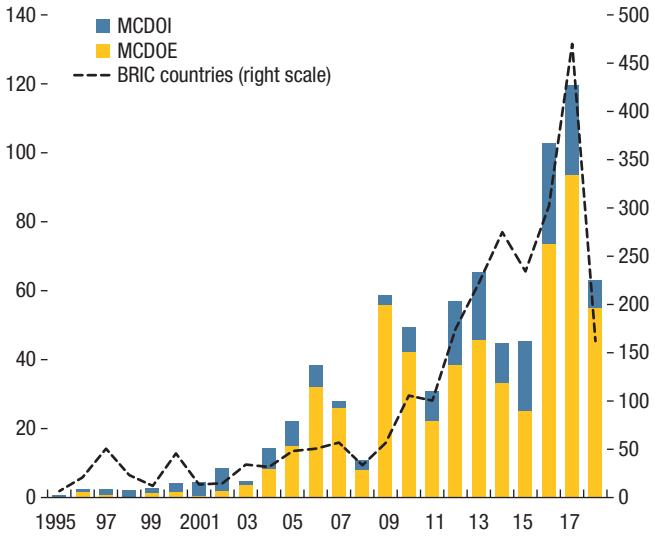
The region benefited from subdued global uncertainty (measured by the Chicago Board Options Exchange Volatility Index)—a key driver of portfolio inflows to the region (Box 4.2)—offsetting tighter global financial conditions. Overall, favorable conditions also facilitated official debt issuance—a key destination of portfolio inflows—mostly by oil exporters, peaking in 2017 (Figure 4.3). Oil-exporting countries have been the largest Eurobond issuers among emerging market economies, borrowing some $74 billion during 2018 through the first half of 2019 (about 25 percent of total gross issuance during that period, according to market analysts).

Bank flows to oil importers remain higher as a share of GDP than those to other emerging market economies, reflecting the dominance of banks in local financial markets. The large bank inflows are associated with an increase in holdings of government liabilities by local banks in oil-importing countries.

The decline in bank flows to oil exporters largely reflects net outflows from countries affected by sanctions and conflict (Iran, Yemen). Survey evidence shows that about one-third of banks in the region experienced a decline in correspondent banking relationships (due to de-risking) amid tighter antimoney laundering and combating the financing of terrorism (AML/CFT) scrutiny. However, the aggregate effect on bank flows appears to have been negligible since most banks found alternative arrangements primarily by opening replacement accounts or increasing the volume of transactions through remaining accounts (Arab Monetary Fund, IMF, and World Bank 2019).

[8]Although detailed data on the region are often unavailable, the vast majority of inflows are likely to be debt.

Figure 4.3. Total Debt Issuance
(US$ billions)



Source: Bloomberg Finance L.P.
Note: BRIC = Brazil, Russia, India, and China; MCDOE = Middle East and Central Asia oil-exporting countries; MCDOI = Middle East and Central Asia oil-importing countries.

Capital Inflows Financed Higher Current Account and Fiscal Needs

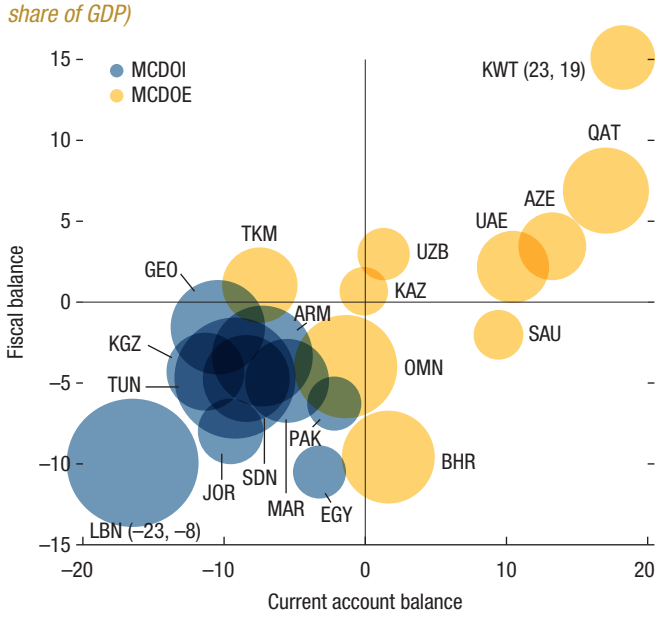
Current account balances have deteriorated especially strongly in oil importers—with median deficit from 2010 to 2018 increasing by 4.4 percentage points of GDP compared to 2000–09, owing to both lower savings and higher investment. Fiscal balances have also deteriorated, especially in oil-exporting countries, with the median postcrisis balance during 2009–18 worsening to a deficit of 0.1 percent of GDP, reflecting lower oil prices since 2014 and increased government spending.

Capital inflows have proved important in meeting fiscal financing and balance of payments needs

in countries without large buffers. For example, portfolio inflows have helped finance deficits in Egypt following exchange rate liberalization. Oil-exporting countries also benefited: examples include Bahrain and Oman, where inflows helped meet large government financing needs while fiscal consolidation measures were underway (Figure 4.4). Without these inflows, further depletion of reserves or more abrupt adjustments would have been required to alleviate the imbalances.

In countries with large buffers, capital inflows have provided an economical way to finance their deficits. These countries (Qatar, Saudi Arabia, United Arab Emirates) have been able to borrow from international capital markets at relatively low rates, without resorting to liquidating foreign assets which may have had higher returns than the countries' cost of borrowing.

Figure 4.4. Fiscal and Current Account Balances 2010–18
(Average, bubble sizes are size of portfolio and other investments as a share of GDP)



Sources: National authorities; and IMF staff calculations.
Note: MCDOE = Middle East and Central Asia oil-exporting countries; MCDOI = Middle East and Central Asia oil-importing countries. Country abbreviations are International Organization for Standardization (ISO) country codes.

Reliance on Bank and Portfolio Inflows Entails Risks

Capital inflows can provide significant benefits for countries by facilitating smoothing of consumption and diversification of risks, as well as financing of investment (IMF 2016b). The changing composition of capital inflows matters because FDI inflows have a higher growth impact than portfolio inflows (Baharumshah, Slesman, and Devadason 2017).

Higher portfolio and bank flows also expose recipient economies to risks because they can be more volatile (Eichengreen, Gupta, and Masetti 2018) than FDI and prone to sudden stops. This is important for a region where portfolio inflows are found to be almost twice as sensitive to changes in uncertainty compared to other emerging market economies, reflecting lower government and corporate transparency (Box 4.2).

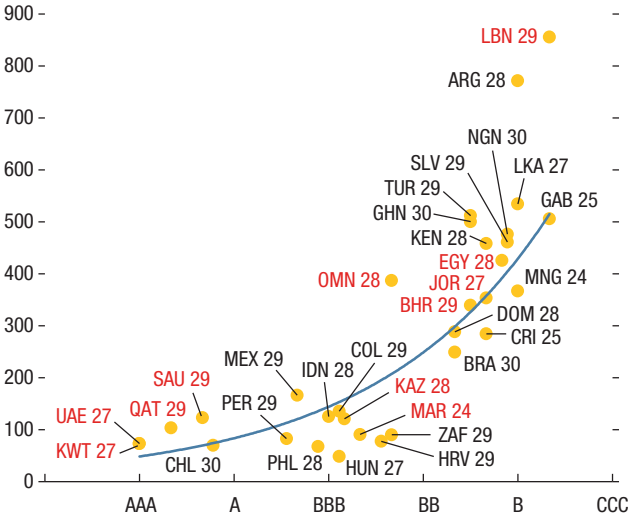
Rising bank and portfolio flows have contributed to an increase in both private and public external indebtedness in the region. For oil-exporting countries, the GDP-weighted average of private external debt has increased by 8.4 percent of GDP in the last four years.[9] This reflects an increase in bank debt in Qatar (to offset declining public sector deposits) and Saudi Arabia. Public debt has increased even faster in oil-importing countries, with the largest increase in Egypt, Lebanon, and Jordan.

The share of short-term external debt has also increased in some countries over the last four years (rising to 83 percent in Lebanon, 77 percent in Algeria, 62 percent in Qatar) suggesting potentially higher vulnerabilities.

The increase in indebtedness has come at a relatively high cost. MENAP sovereign spreads tend to be higher than those of other emerging market economies of comparable ratings, likely reflecting impacts of elevated debt (Lebanon) and bouts of geopolitical instability (Figure 4.5).

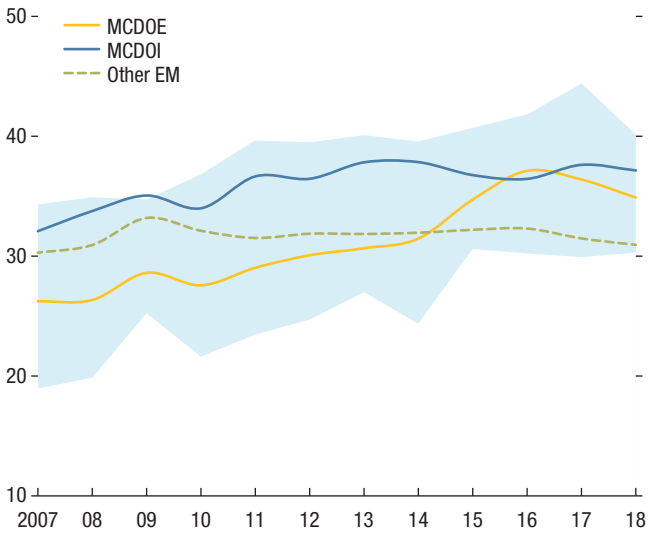
[9]Even if the government (and the economy as a whole) has a positive net foreign asset position, private sector debt can create vulnerabilities, especially if there is a currency mismatch.

Figure 4.5. Sovereign Spreads vs. Rating
(Basis points; maturity year in data labels)



Source: Bloomberg Finance, L.P.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 4.6. Composite Risks[1]
(Average, index 0–50, higher the riskier)



Sources: *IMF International Country Risk Guide*; and IMF staff calculations.
Note: Composite risk index is rebased to be from 0 to 50. MCDOE = Middle East and Central Asia oil-exporting countries; MCDOI = Middle East and Central Asia oil-importing countries; and other EM = other emerging market economies. Shaded area indicates interquartile range of composite risks index across MCD countries.
[1]Use of indicator should be considered carefully, as estimates reflect relative and not absolute performance. Uncertainty bands around estimates are not provided.

As highlighted in Global Developments section, the global outlook is that of lower growth and rising uncertainty, including due to unresolved trade tensions. Since inflows to the region are highly sensitive to changes in global uncertainty, there are risks of capital inflows falling or even reversing. Though adverse economic impacts are likely to be limited in oil exporters with large buffers (for example, Qatar and Saudi Arabia), reversals of inflows could amplify the harmful effects of oil price declines—a larger risk for the oil exporters—on current account and fiscal balances, placing their buffers under pressure. The adverse impacts in other countries with smaller buffers could be significant. The outlook thus raises the urgency of having a comprehensive set of policies to revitalize FDI and mitigate potential risks of disruptive capital flows.

Attracting Stable Capital Inflows That Increase Growth

Unlike portfolio inflows, FDI inflows are driven more by domestic factors than by global factors (see Online Annex 4.1). Economic conditions have deteriorated in the region over the last decade, with growth slowing more than in peer countries, and economic and political risks rising faster (Figure 4.6).

Slower growth and higher risks in the region can explain about half of the postcrisis decline in FDI among oil exporters and 20 percent of the decline in oil importers. A key condition for revitalizing FDI is thus a credible framework to boost potential growth and reduce country-specific risks. This will require not only preserving macroeconomic stability and continued structural reforms, but also improving security in countries affected by armed conflicts and ensuring that growth is inclusive to maintain social cohesion (see Chapter 2). Policy adjustments by countries like Egypt have improved domestic conditions, attracting larger FDI inflows, although more effort is needed to deliver structural reforms for higher medium-term growth (see Box 2.1).

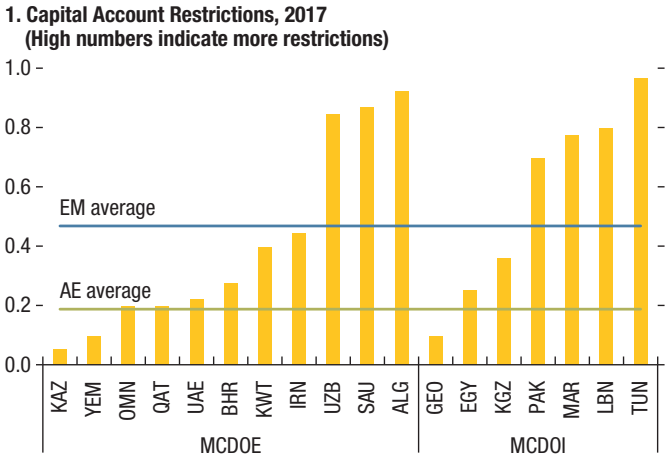
Besides growth and risks, MENAP and CCA countries are broadly comparable to peers in some key determinants of FDI (for example, inflation and trade openness), but lag in others—most notably in the control of corruption, human capital, and capital account restrictions—with the gaps being larger in oil-importing countries.

In the near term, policymakers can attract FDI through removing restrictions and increasing investment opportunities—for example, by opening up the services sector (Figure 4.7).[10] The recent easing of travel restrictions for foreign investors in Uzbekistan and allowing 100 percent foreign ownership in more sectors of the economy in several of the Gulf Cooperation Council (GCC) countries are steps in the right direction.

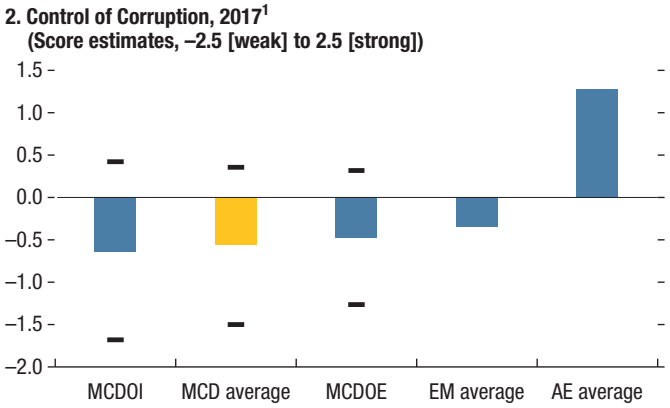
The effectiveness of capital account liberalization measures depends on domestic institutional quality, including control of corruption (Habib and Zurawicki 2002). The perception of corruption could explain a constrained ability to attract foreign direct investment despite having liberalized capital accounts in some countries. Therefore, further strengthening institutional quality remains a reform priority.

Over the longer term, increasing skills through better education and training will be critical to attracting FDI flows to higher-value-added sectors. Education quality and median tertiary school enrollment in oil importers have lagged those of the broader emerging market sample. Oil-exporting countries have fared better, reflecting higher income per capita, but there is still significant room for improvement in education quality (IMF 2018).

Figure 4.7. Capital Account Openness and Institutional Quality



Sources: IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions*; and IMF staff calculations.



Sources: Worldwide Governance Indicators; and IMF staff calculations.
Note: AE = advanced economies; EM = emerging market economies; MCDOE = Middle East and Central Asia oil-exporting countries; and MCDOI = Middle East and Central Asia oil-importing countries. Country abbreviations are International Organization for Standardization (ISO) country codes.
[1]Use of indicators should be considered carefully, as they are derived from perceptions-based data, and estimates reflect relative and not absolute performance. Ranges are for 90 percent confidence interval, and confidence intervals for peer groups are negligible.

Mitigating Potential Risks

The priority in mitigating risks from capital flow volatility is to address the large fiscal and current account deficits, which could trigger costly adjustments during a sudden stop episode (Eichengreen and Gupta 2016). As noted in IMF (2012), macroeconomic policies must play a key role in dealing with inflow surges. Hence fiscal consolidation in the region should continue. Lowering interest rates (where inflationary pressures are absent) and intervening to accumulate reserves, where they are inadequate

[10]Data on de facto financial openness (measured as the sum of external assets and liabilities to GDP) for MENAP countries are limited. Available data suggest that three out of six oil exporters and four out of 10 oil importers exceeded emerging market average in 2017 or 2018.

could also help mitigate risks. Strengthening financial supervision and regulation, including on nonbank financial institutions, as well as utilizing macroprudential tools could help ensure financial stability and build resilience against volatile capital flows (IMF 2017a).[11]

In countries for which large capital inflows put pressure on real exchange rates, greater nominal exchange rate flexibility, when supported by sound macroeconomic policies, could act as a shock absorber by dampening real exchange rate fluctuations (Combes, Tidiane, and Plane 2011). For example, countries with more flexible exchange rates experienced smaller real appreciation during the emerging market inflow surge episode before the global financial crisis (IMF 2007). Inflexible exchange rates, on the other hand, could exacerbate capital flow volatility—especially when macroeconomic policy adjustments are lacking—and amplify vulnerabilities by encouraging borrowing in foreign currencies (Magud, Reinhart, and Vesperoni 2014).

Deeper domestic financial markets can also mitigate the impact of volatile capital inflows. For example, in Chile, domestic institutional investors account for nearly half of financial sector assets and provide more stable sources of funding to domestic borrowers. Similarly, in Malaysia, active domestic investors would buy large amounts of domestic equities and bonds, when foreign investors—often responding to global turmoil—liquidate their holdings (Kyobe and others 2015).

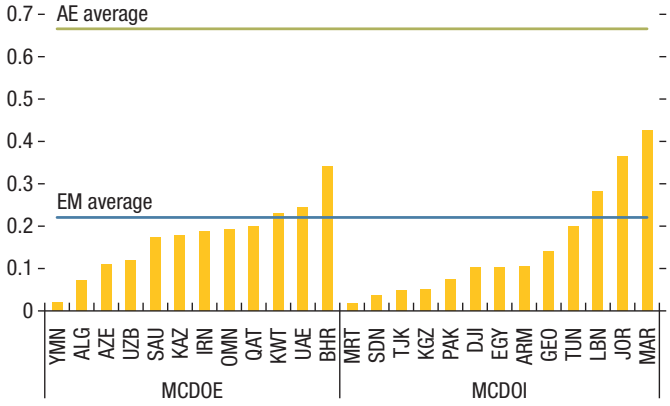
The depth of financial institutions in the region varies but scope for improvement is large (Figure 4.8).[12] Although, on average, financial development is higher in oil exporters than in oil importers, most countries are below the emerging market average, and all countries are below the advanced economy average.

[11]See Prasad, Monem, and Martinez (2016) for an overview of the use of macroprudential policies in the MENAP region.

[12]The index is based on stock market capitalization, stocks traded, government international debt securities, and total debt securities of financial and nonfinancial corporations (Svirydzenka 2016).

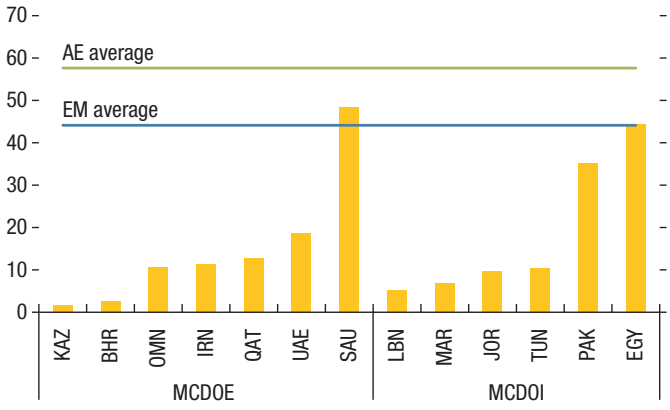
Figure 4.8. Financial Institution and Market Development

1. Financial Institution Depth, 2017 (Index)



Sources: IMF, Financial Development Index; and IMF staff calculations.

2. Stock Market Turnover Ratio (Percent)



Sources: World Bank; and IMF staff calculations.
Note: AE = advanced economies; EM = emerging market economies; MCDOE = Middle East and Central Asia oil-exporting countries; and MCDOI = Middle East and Central Asia oil-importing countries. Country abbreviations are International Organization for Standardization (ISO) country codes.

The largest gaps are in market liquidity and domestic institutional investor size. Despite large market capitalization in some countries, stock market turnover ratios are very low compared to other emerging market economies—with the exception of Saudi Arabia—reflecting small investor bases. The small domestic institutional investor size in turn reflects the dominance of

banks in the financial system.[13] Developing regional financial markets (for example, the joint stock market in the Baltic countries) could help increase the investor base.

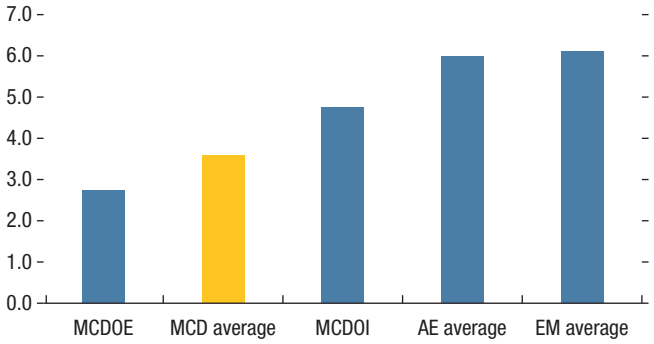
Governments can foster financial market development by having a deep and liquid government bond market. A government yield curve—established by gradual extension of government bond maturities and regular issuances at varying tenors—can serve as a benchmark for pricing of corporate bonds (see IMF 2013).

The recent inclusion of GCC countries in the global sovereign bond index is welcome as they could help expand the investor pool and increase market liquidity. However, it may raise market volatility since benchmark investors are more sensitive to global factors (Cerutti, Classens, and Puy 2015), as observed in recent emerging market outflow episodes (IMF 2019b), underscoring the need to expand domestic investor base.

The rule of law is a precondition to financial market development—stronger legal protection can encourage greater market participation, allowing for spontaneous and organic growth of financial markets (Chami, Fullenkamp, and Sharma 2009). Hence further strengthening legal systems, which lag behind peer averages (Figure 4.9), is crucial. Recent efforts by Bahrain, Saudi Arabia, and the United Arab Emirates to modernize bankruptcy laws are welcome. Developing laws on the use of collateral could lower transaction costs and facilitate lending.

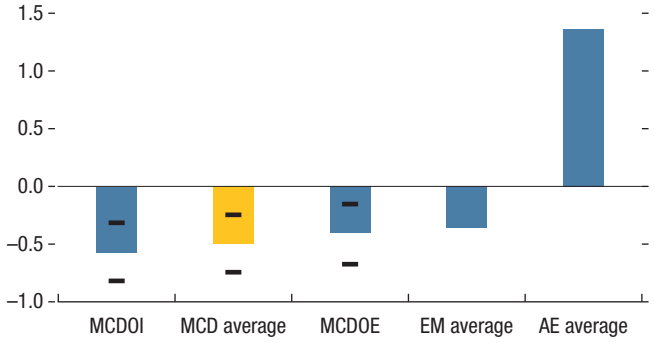
Figure 4.9. Governance[1]

1. Strength of Legal Rights[2]
(Index, 0 [weak] to 12 [strong] performance of measure, 2018)



Sources: World Bank Doing Business Database; and IMF staff calculations.

2. Rule of Law[3]
(Index, –2.5 [weak] to 2.5 [strong] governance performance)



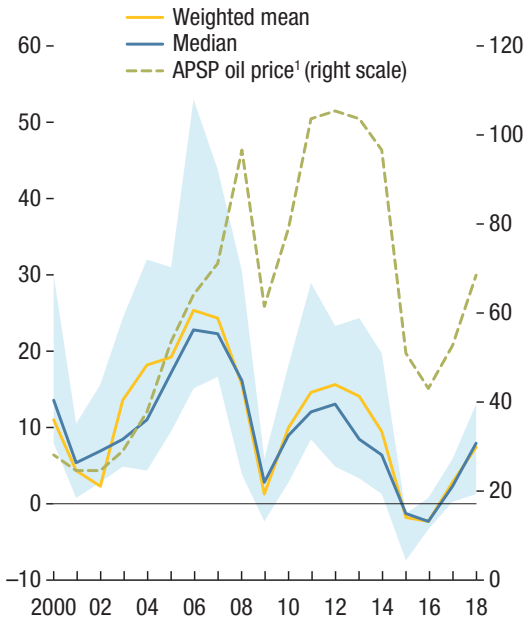
Sources: Worldwide Governance Indicators; and IMF staff calculations.
Note: AE = advanced economies; EM = emerging markets economies; MCDOE = Middle East and Central Asia oil-exporting countries; and MCDOI = Middle East and Central Asia oil-importing countries.
[1]Use of indicators should be considered carefully, as they are derived from perceptions based data and estimates reflect relative and not absolute performance.
[2]Confidence intervals are not available for this indicator.
[3]Ranges are for 90 percent confidence interval, and confidence intervals for peer groups are negligible.

[13]In GCC countries, whose financial markets are the deepest in the region, domestic institutional investor assets—consisting of pension funds, mutual funds, and insurance companies—account for less than the half of GDP. In contrast, institutional investors' assets exceed 100 percent of GDP in both Chile and Malaysia.

Box 4.1. Capital Outflows from the MENAP and the CCA

Capital outflows from the Middle East, North Africa, Afghanistan, and Pakistan region and the Caucasus and Central Asia have declined since the mid-2000s. As oil prices fell, net purchases of foreign assets by oil exporters reached their minimum in 2015–16 owing to disposal of foreign assets by Algeria, Iraq, and Saudi Arabia. In Algeria and Iraq, the decline was entirely due to a decline in official reserves, while in Saudi Arabia, other types of outflows offset an even larger decline in reserves. Since then, foreign asset purchases have recovered only tenuously, with oil exporters spending their oil revenues to service domestic needs.

Figure 4.1.1. MCDOE: Net Capital Outflows
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: APSP = average petroleum spot price; and MCDOE = Middle East and Central Asia oil-exporting countries. APSP is the average of UK Brent, Dubai Fateh, and West Texas Intermediate crude oil prices.
[1]US dollars a barrel.

Oil importers have also significantly reduced their foreign asset acquisition, with the median falling from 3.6 percent of GDP in 2000–09 to 1.5 percent of GDP in 2010–18. This trend was the result of nearly continuous reduction in foreign assets in Lebanon and more sporadic declines in, for example, Egypt and Pakistan, where domestic vulnerabilities have increased.

Besides official reserves, private assets can also be a buffer if there is a sudden stop in capital inflows or other shocks to the balance of payments. Residents may sell foreign assets to exploit opportunities in the domestic market. Hence declining accumulation of foreign assets may increase vulnerabilities stemming from volatility of inflows. This is especially true for oil importers, where net foreign asset positions are negative.

This box was prepared by Sergejs Saksonovs.

Box 4.2. Driver of Portfolio Inflows—Push Factors

We estimate a push-pull factor model on a panel of 11 Middle East, North Africa, Afghanistan, and Pakistan (MENAP) and Caucasus and Central Asia (CCA) countries and 29 other emerging market economies from 1990 to 2018. Consistent with Eichengreen, Gupta, and Masetti (2018), we find portfolio inflows to be driven mostly by global push factors—the Chicago Board Options Exchange Volatility Index (VIX), which reflects global uncertainty, and real US interest rate (proxy for global financial conditions). However, the impact of push factors differs for MENAP and CCA countries compared to other emerging market economies. Portfolio inflows to the region are almost twice as sensitive to changes in global uncertainty as those in other countries. A possible explanation is relatively weaker government and corporate transparency in the region, which leads to larger outflows during crises (Gaston Gelos and Wei 2005).

Moreover, we find that portfolio flows to the region depend on oil prices. First, higher oil prices increase portfolio inflows to the region, most likely by improving its risk profile. Second, higher oil prices dampen the impact of global financial conditions. This may reflect that some of the capital inflows to MENAP and CCA countries are regional flows—from the oil-exporting countries, whose liquidity conditions are driven more by oil prices than US monetary policy (IMF 2017b). For example, the Coordinated Portfolio Investment Survey reveals that at least two-thirds of Bahrain's portfolio liabilities are held in other Gulf Cooperation Council economies.

Table 4.2.1. Impact of Push Factors on Portfolio Inflows/GDP, 1990–2018

	(1) EMs	(2) MENAP and CCA
Log of VIX	–0.592*	–1.267**
	(0.319)	(0.518)
Real US interest rate	–0.145***	–0.713^
	(0.051)	(0.528)
Log of real oil price		0.765*
		(0.380)
*Log of VIX * MENAP dummy*	–1.298*	
	(0.698)	
*Real US interest rate * MENAP dummy*	0.192**	
	(0.072)	
*Real US interest rate * log of real oil price*		0.211^
		(0.131)

Source: IMF staff calculations.

Note: All regressions include lagged real GDP growth, lagged composite risk index, global financial crisis dummies, and country fixed effects. Robust standard errors clustered at country levels are reported in parentheses. CCA = Caucasus and Central Asia; EMs = emerging market economies; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; VIX = Chicago Board Options Exchange Volatility Index.

***$p < 0.01$, **$p < 0.05$, *$p < 0.1$, ^$p < 0.2$.

This box was prepared by Ling Zhu.

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5. Fiscal Institutions and Fiscal Outcomes

Countries in the Middle East and Central Asia are facing significant fiscal challenges, amid volatile oil prices, subdued growth, and conflicts. Weak fiscal institutions have contributed to spending inefficiencies, rising debt and deficits, and procyclical fiscal policy, especially in countries in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region. Improving fiscal transparency, establishing credible medium-term fiscal frameworks (MTFFs), strengthening public financial management (PFM), enhancing procurement, and moving toward fiscal rules would help mitigate these vulnerabilities over time.

A Challenge with Limited Fiscal Policy Options

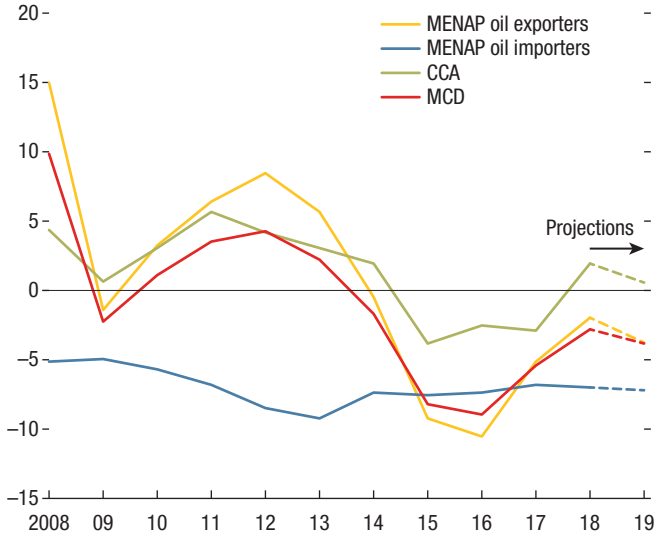
Fiscal balances have deteriorated sharply in most countries in the Middle East and Central Asia since the onset of the global financial crisis in 2008 (Figure 5.1). The combined negative effects of low growth, shocks to oil prices, and rising spending needs, particularly in countries affected by the Arab uprisings, have resulted in diminished fiscal buffers and rising public debt burdens.

Fiscal vulnerabilities have emerged despite recent consolidation efforts across the region. This has left many countries exposed to external uncertainties, including those related to the global slowdown and trade tensions and to domestic pressures from stalled growth prospects, the need to preserve intergenerational equity, and rising social tensions in some countries (see Global Developments).

In particular, MENAP oil importers face elevated public debt levels, and their financing costs are now a source of acute fiscal stress (see Chapter 2). Fiscal policies in MENAP oil exporters have remained largely procyclical,[1] including in response to volatile international oil prices (see Chapter 1), while countries in the Caucasus and Central Asia (CCA), particularly oil exporters, are running down fiscal buffers to stave off challenges to growth (see Chapter 3).

Going forward, MENAP and CCA countries face the difficult challenge of reducing fiscal vulnerabilities to strengthen economic resilience while fostering higher and more inclusive growth through structural reforms. Elevated global growth and trade uncertainties only make this challenge more difficult, and prospects for lower and more volatile oil prices will weigh on MENAP oil exporters in particular.

Figure 5.1. Overall Fiscal Balances 2008–19
(Percent of GDP, weighted averages)



Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MCD = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan. Country-specific weights correspond to GDP in US dollars.

Prepared by Qiaoe Chen, Moussé Sow, and Iulia R. Teodoru. Jorge de Léon Miranda provided useful research assistance.

[1]Manasse (2006), and Alesina, Campante, and Tabellini (2008) have emphasized the suboptimal nature of procyclical fiscal policy, which can exacerbate business cycle fluctuations and amplify macroeconomic instability.

Ensuring well-developed and credible fiscal institutions can not only help ease the burden of adjustment, but also reduce fiscal vulnerabilities on a lasting basis.[2] For instance, the procyclicality of fiscal policy in developing countries is associated with lower-quality fiscal institutions (Frankel, Vegh, and Vuletin 2013). A lack of well-designed fiscal frameworks makes it difficult for countries to adhere to prudent debt targets over the economic cycle (OECD 2015), while low fiscal transparency and poor quality of procurement lead to inefficiencies and worse fiscal outcomes (Jarvis and others, forthcoming). In contrast, by increasing the credibility of fiscal policy and the difficulty of deviating from appropriate policies, credible MTFFs are associated with successful fiscal consolidation (IMF 2010).[3]

Against this backdrop, this chapter examines gaps in the Middle East and Central Asia region's fiscal institutions and estimates the impact of fiscal institutions on fiscal outcomes. The analysis emphasizes the role of fiscal institutions in (1) strengthening fiscal discipline and ensuring long-term sustainability, (2) building resilience by enhancing the ability of fiscal policy to stabilize the economy, and (3) improving the predictability of fiscal policy by lowering its volatility.

Weak Fiscal Institutions in the Middle East and Central Asia

Measures of key fiscal institutions in MENAP and CCA countries tend to be weaker compared with peers, though regional variations illustrate important differences (Figure 5.2).

In particular, MENAP oil exporters have much lower *budget transparency* compared to other oil-exporting countries, with measures for Algeria, Iraq, Qatar, and Saudi Arabia not improving between 2012 and 2017 (Figure 5.3).[4] In contrast, despite relatively low levels, there have been notable improvements in budget transparency in some MENAP and CCA oil importers in recent years. Improvements in budget transparency seem to be positively associated with revenue mobilization (Figure 5.4).

Most MENAP oil exporters register very low nonresource tax revenues mainly because of large resource revenues. In MENAP oil importers, tax systems suffer low progressivity and complexity, with multiple tax exemptions and rates, making tax administration more difficult (Jewell and others 2015).[5]

MENAP oil exporters score higher than other oil exporters on the *MTFF indicator*, which includes the presence of a multiyear perspective in fiscal planning, expenditure policy, and budgeting.[6] However, this stronger performance does not necessarily reflect stronger MTFFs, as it is largely driven by favorable elements of frameworks in Algeria (where there is high predictability of funds available for commitments of expenditure) and Kuwait (where there is parliamentary scrutiny of the annual budget law). Similarly, MENAP oil importers score high on the MTFF indicator due to better frameworks in just two countries, Jordan and Morocco. In contrast, most CCA countries fare well in terms of MTFF.

Countries in the Middle East and Central Asia, in particular those in the CCA region, perform poorly on *public procurement* but score relatively well compared to emerging market economies on measures of *public financial management*. However, fragile states and conflict-affected countries face significant challenges in developing

[2]Fiscal institutions refer to the organizational and procedural arrangements through which decisions on fiscal matters are taken, or that provide input into such decision making.

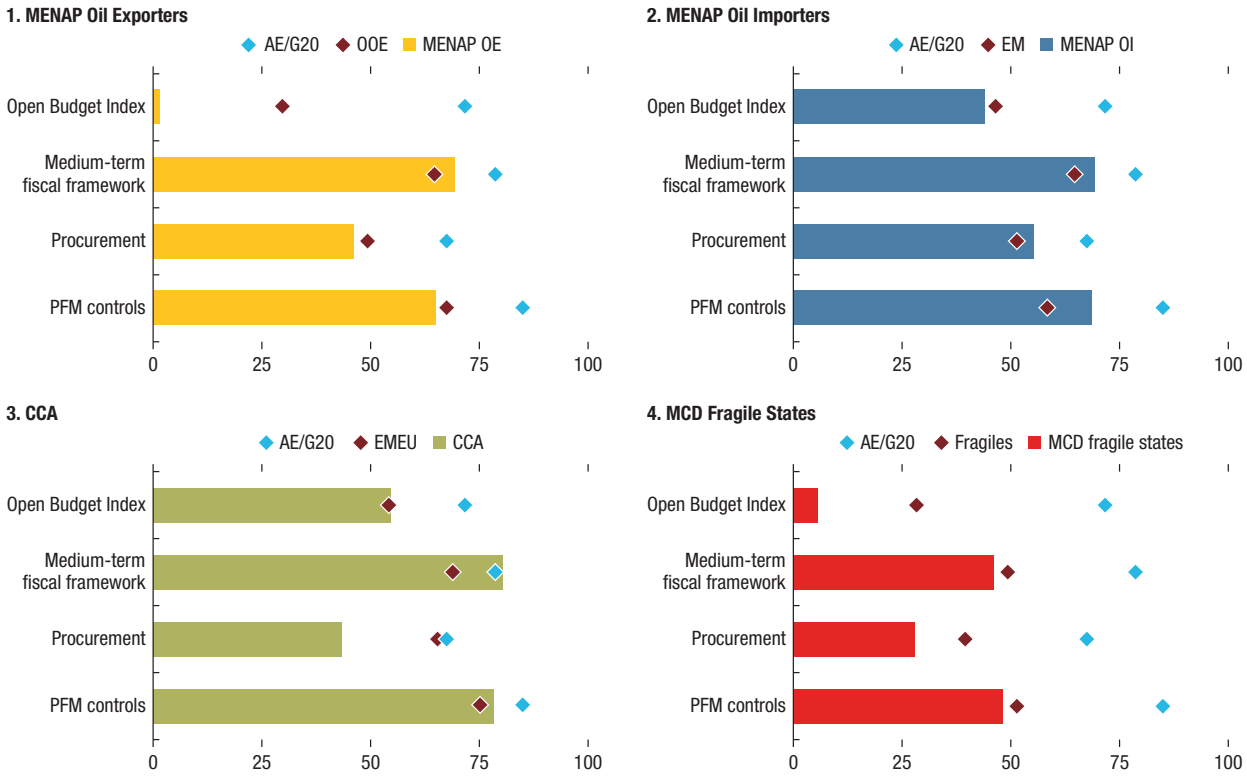
[3]Medium-term fiscal frameworks (MTFFs) include mechanisms to formulate multiyear fiscal objectives and ensure effective implementation.

[4]Transparency is measured using the Open Budget Index, which is available for 2012 and 2017, and covers only Algeria, Iraq, Qatar, and Saudi Arabia among MENAP oil exporters.

[5]An alternative revenue institutions indicator is used, but due to limited data availability, only five countries in the region (Azerbaijan, Armenia, Georgia, Mauritania, and Morocco) are assessed with slightly weaker performance than their peers.

[6]The MTFF indicator is based on Public Expenditure and Financial Accountability (PEFA) assessments. These cover 115 countries, mostly emerging market economies and low-income countries. Out of 31 countries in the Middle East and Central Asia, data are available for only 23 countries.

Figure 5.2. Fiscal Institutions Indicators
(Index, 100 is best)



Sources: Public Expenditure and Financial Accountability; Open Budget Initiative; and IMF staff calculations.
Note: The Open Budget Initiative medium-term fiscal framework and PFM controls indicators, where 4 is best score, have been indexed to 100. For the procurement indicator, where 1 is best, the indicator has been indexed to 100. MENAP oil exporters and oil importers aggregates exclude fragile states. Fragile states in MCD include Afghanistan, Djibouti, Iraq, Lebanon, Libya, Somalia, Sudan, Syria, Tajikistan and Yemen. AE = advanced economies; CCA = Caucasus and Central Asia; EM = emerging Market economies; EMEU = emerging Europe countries; Fragiles = other fragile states; G20 = G20 countries; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; MENAPOE = MENAP oil-exporting countries; MENAPOI = MENAP oil-importing countries; OOE = other oil-exporting countries; PFM = Public Financial Management.

strong fiscal institutions across the board. Apart from the difficulty of conducting fiscal policy in conflict economies, this reflects their limited administrative capacity (IMF 2017).

IMF staff assessments of improvements in fiscal institutions, which supplement the results in Figure 5.2, indicate that more than 80 percent of CCA countries and half of MENAP oil exporters have MTFFs (Table 5.1). A majority of MENAP oil importers do not have a formal MTFF. While most countries have IMF-supported programs, these may not prove sufficient in anchoring fiscal policy in a medium-term perspective.

The quality of frameworks varies across countries.[7] Deficiencies in MTFFs reflect either incompleteness or weak implementation, with frequent breaches of fiscal targets in a few MENAP and CCA countries (Algeria, Iran, Jordan, Pakistan, Tajikistan). Such weaknesses in MTFFs are also associated with higher volatility of fiscal policy and rising public debt burdens (Egypt, Pakistan).

In addition, while *fiscal rules* are prominent in peer countries, including in other oil exporters, only one-quarter of MENAP and CCA countries

[7]For example, based on the MTFF indicator, Georgia has the highest scores in all four aspects, while Egypt has no formal MTFF, and fares poorly in all aspects. In the IMF staff survey, the assessment of MTFF has a broader scope than the MTFF indicator.

Table 5.1. Survey: MTFF and Fiscal Rules in MCD Countries

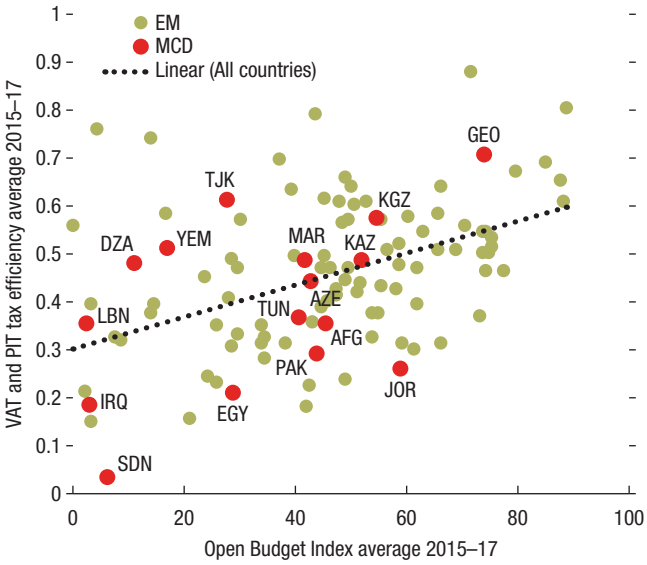
	Number of countries	MTFF in place	Government/independent monitoring entity	Fiscal rules
		(% of the group)		*(number of)*
Oil exporters	8	50.0	50.0	2
Oil importers	6	33.3	33.3	1
Caucasus and central Asian countries	6	83.3	50.0	4
Fragile states	7	28.6	28.6	2
Total	**27**	**48.1**	**40.7**	**9**

Source: IMF staff calculations.
Note: MCD = Middle East and Central Asia; MTFF = medium-term fiscal framework.

Figure 5.3. Change in the Open Budget Index, 2012–17
(Index)

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

Figure 5.4. Open Budget Index and Tax Efficiency, 2015–17
(Index)



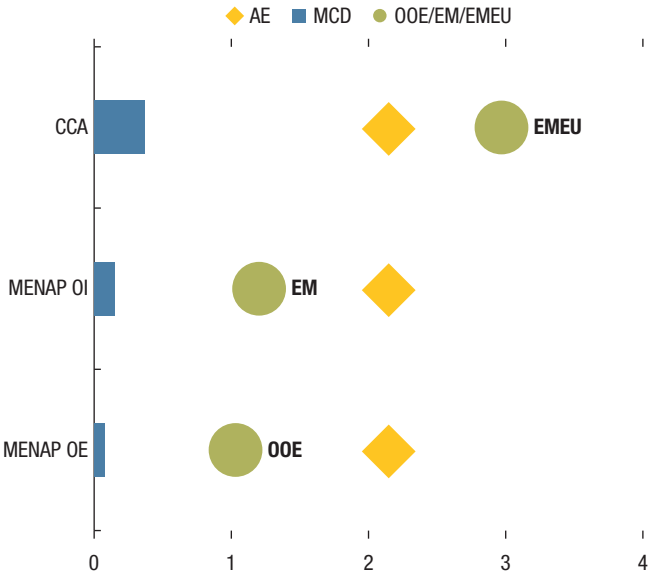
Sources: International Budget Partnership; national authorities; and IMF staff calculations.
Note: EM = emerging market economies; MCD = Middle East and Central Asia; PIT = personal income tax; VAT = value-added tax. Country abbreviations are International Organization for Standardization (ISO) country codes.

(Algeria, Armenia, Azerbaijan, Georgia, Iran, Kazakhstan, Pakistan) have adopted fiscal rules, particularly budget balance or debt rules (Figure 5.5). Spending increases and low revenue mobilization efforts have weakened compliance with fiscal rules. Armenia and Georgia have amended their fiscal rules, in collaboration with IMF capacity development, to reduce the procyclical bias and avoid abrupt fiscal adjustments, while increasing flexibility (Box 5.1). Somalia plans to introduce a debt rule.

How Could Fiscal Institutions Influence Fiscal Outcomes?

How much could MENAP and CCA countries benefit from strengthening fiscal institutions? Overall, estimates indicate that fiscal outcomes in the Middle East and Central Asia could improve notably with stronger fiscal institutions (Figure 5.6; see Box 5.2 for a discussion on the

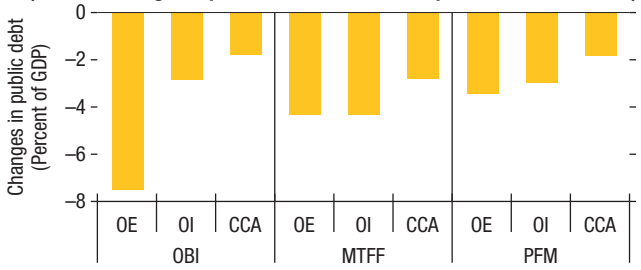
Figure 5.5. Average Number of Numerical Fiscal Rules
(Number of fiscal rules per country in the subregion)



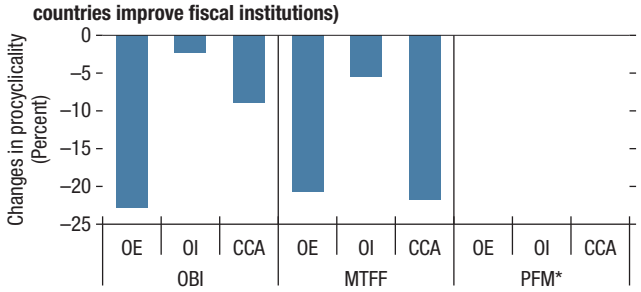
Sources: National authorities; and IMF staff calculations.
Note: The emerging market comparator for each MCD subregion varies.
AE = advanced economies; CCA = Caucasus and Central Asia; EM = emerging market economies; EMEU = emerging Europe; MCD = Middle East and Central Asia; MENAP = Middle East and North Africa, Afghanistan, and Pakistan; OE = oil-exporting countries; OI = oil-importing countries; OOE = other oil-exporting countries.

Figure 5.6. Effects of Quality of Fiscal Institutions on Fiscal Outcomes

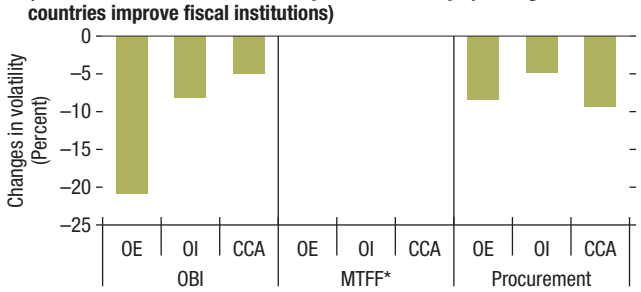
1. Disciplinary Effect
(Potential changes in public debt as countries improve fiscal institutions)



2. Stabilization Effect
(Potential reduction in the procyclicality of government spending as countries improve fiscal institutions)



3. Predictability Effect
(Potential reduction in the volatility of discretionary spending as countries improve fiscal institutions)



Source: IMF staff calculations.
Note: The reported coefficients are significant at 90–99 percent confidence bands.
*The effect for these indicators is not statistically significant. Disciplinary effect corresponds to a decline in gross public debt. The stabilizing effect corresponds to the reduction of the procyclicality of government spending. The predictability effect corresponds to the reduction in the volatility of discretionary spending.
CCA = Caucasus and Central Asia; MTFF = medium-term fiscal framework; OBI = Open Budget Index; OE = oil-exporting countries; OI = oil-importing countries; PFM = public financial management.

empirical methodology employed).[8] Specifically, adopting best practices[9] for fiscal transparency, MTFF, PFM, and procurement could improve fiscal outcomes by increasing accountability and limiting discretionary and politically motivated changes in fiscal policy.

- A slower pace of public debt accumulation over the medium term—by more than 4 percent of GDP and close to 5 percent of GDP in the Gulf Cooperation Council (GCC) and non-GCC oil-exporting countries, respectively, compared to the current level of debt.

- Across all MENAP oil exporters, procyclicality of fiscal policy could be reduced by 30 percent, and the volatility of government spending could be lowered by as much as 19 percent, improving the overall predictability of fiscal policy.

[8]Given the small sample and multicollinearity concerns, regressions are run separately for individual fiscal institutions and are not additive. The results are counterfactual with other conditions unchanged.

[9]Adoption of a best practice would mean improving a country's fiscal institution to the level seen in an economy operating at the frontier of that institution.

- In MENAP oil importers, a slower pace of debt accumulation—by about 3½ percent of GDP—and a 14 percent lower volatility of fiscal policy.
- In the CCA, a slower pace of debt accumulation—by 2 percent of GDP—while the procyclicality of fiscal policy would be strongly reduced by more than 20 percent, and the volatility of fiscal policy lowered by about 8 percent.

Improvements in fiscal institutions take time and may be hindered by administrative capacity and political constraints. MENAP and CCA countries improved their MTFFs by 10 percent over four years, whereas improvements took more than five years in other countries. Therefore, the sizable benefits associated with enhancing fiscal institutions would be reaped only over the medium or long term.

Findings for a broader sample of countries suggest that adoption of numerical fiscal rules, if accompanied by procedural rules and monitoring and enforcement mechanisms, is associated with less procyclical fiscal policy. Similarly, greater transparency and credible MTFFs are associated with enhanced domestic nonresource revenue mobilization (see Box 5.2).

Enhancing Fiscal Discipline

Improving fiscal transparency (by closing the gap with the best-performing economies), adopting credible MTFFs, and strengthening PFM systems could help reduce the pace of public debt accumulation, helping MENAP oil importers to contain large debt burdens and MENAP oil exporters to continue to gradually consolidate their fiscal positions. Specifically, in Algeria and Oman, debt accumulation could be lower by 4.5 and 6 percent of GDP, respectively, compared to their current levels of debt, while in Qatar and Saudi Arabia it could be lower by 5 percent of GDP. Egypt, Lebanon, and Pakistan, which have rising debt burdens, could slow public debt buildup by about 4 percent of GDP.

Improving transparency and strengthening PFM, combined with a credible MTFF, could slow debt accumulation, on average, in Armenia, the Kyrgyz Republic, and Tajikistan by 2 percent of GDP.

Stronger fiscal discipline could also benefit fragile countries, notwithstanding limited capacity. In Iraq, Lebanon, Sudan, and Yemen, debt accumulation could be slower by about 6 percent of GDP.

Limiting the Procyclicality of Fiscal Policy

Improving the transparency of the budget cycle and adopting a credible MTFF also reduces procyclical fiscal policy, helping to stabilize the economy.[10] This is particularly the case for MENAP oil exporters and CCA countries. Procyclicality of fiscal policy can be reduced by more than 30 percent compared to the degree observed in recent years in Algeria, Qatar, and Saudi Arabia. Indeed, by reducing pressures to increase spending or cut taxes during upswings, a credible MTFF enables policymakers to implement countercyclical fiscal policy and reduce the bias toward deficits. MTFFs also raise awareness about policy actions that are destabilizing in the medium term and highlight the need for sustainable actions. Similarly, Azerbaijan and Uzbekistan could lower the procyclicality of fiscal policy by more than 20 percent.

Improving the Predictability of Fiscal Policy

Improving fiscal institutions, in particular the transparency of the budget cycle and procurement systems, can enhance the predictability of fiscal policy by lowering the volatility of discretionary government spending. In Bahrain and Oman,

[10]In this chapter, procyclicality is measured as a change in discretionary government spending vis-à-vis the output gap. Procyclicality measured alternatively as a change in government spending induced by the changes in oil prices—relevant particularly for MENAP oil exporters and highlighted in Chapter 1—yields similar outcomes.

volatility of fiscal policy could be reduced by about 10 percent. The potential benefits of improved transparency and procurement systems is even higher in MENAP oil importers (Egypt, Mauritania, Pakistan) and CCA countries (Azerbaijan, Tajikistan, Uzbekistan), where fiscal policy volatility could be lowered by 11 percent and 13 percent, respectively.

Strengthening the PFM and Procurement Systems

Effective PFM controls, combined with compliance with rules governing internal budget procedures and high quality and comprehensive audits of rules and procedures, would contribute to mitigating the overall rise in public debt. In particular, strengthening PFM controls—such as limiting the unreported extra-budgetary expenditure, improving tax payment efficiency, and boosting oversight of fiscal risks from public enterprises—in line with best practice standards for MENAP oil exporters and importers could lower public debt by about 3–3½ percent of GDP.

Moving toward Well-Designed Fiscal Rules

Empirical evidence shows that well-designed fiscal rules can strengthen fiscal discipline and reinforce the stabilizing capacity of fiscal policy. For MENAP oil exporters facing volatile oil prices and declining fiscal buffers, budget balance rules and expenditure rules may seem more appropriate to reduce procyclicality while ensuring intergenerational equity. For MENAP oil importers, budget balance rules and debt rules may help contain the rapid rise of public debt while allowing fiscal policy to respond to shocks (see Box 5.1).

However, the mere adoption of fiscal rules, without strong fiscal institutions to ensure compliance, is unlikely to improve fiscal outcomes. In this regard, procedural rules and enforcement and monitoring mechanisms could facilitate the implementation of fiscal rules. Additionally, independent bodies that provide key macroeconomic assumptions and monitor compliance with rules are crucial. Moreover, comprehensive and robust PFM systems are preconditions for the adoption of fiscal rules (IMF 2018c, 2019b).

A Call for Stronger Institutions for Improved Policy Outcomes

MENAP and CCA countries are facing significant challenges with narrowing policy options to contain pressures. Fiscal consolidation efforts need to regain momentum to rebuild buffers and ensure long-term macroeconomic sustainability. MENAP oil exporters should avoid procyclical fiscal policies to strengthen the effectiveness of fiscal policy and insulate economies from global oil price volatility. MENAP oil importers should reduce precariously high levels of public debt to create space to address growth weaknesses. CCA countries should rebuild fiscal buffers to enhance macroeconomic stability and reduce vulnerabilities to external shocks. Despite recent progress, further strengthening fiscal institutions would help address these challenges.

- Countries with low transparency scores (Algeria, Iraq, Qatar, Saudi Arabia) would benefit from transparency initiatives, which would help reinforce fiscal discipline and reduce the procyclicality and volatility of fiscal policy, including by improving accountability and reducing the discretionary power to raise spending. In this regard, Saudi Arabia has taken important steps to improve transparency in recent years, including publishing more comprehensive budget statements and quarterly budget performance reports and audited financial statements for the first time (including for the state oil company). Further gains could be made by providing more detailed data on budget projections, outturns, and fiscal risks and by broadening the institutional coverage of fiscal reporting. Tunisia and Uzbekistan have recently undertaken fiscal transparency

evaluations, in collaboration with IMF capacity development, with recommendations aimed at improving fiscal reporting. To further improve transparency, Uzbekistan intends to participate to the 2021 Open Budget Index assessment for the first time.

- Adopting a comprehensive approach to analyze assets and liabilities of the public sector would enhance transparency. Better balance sheet management would enable countries to increase revenues, reduce risks, and improve fiscal policymaking, especially in MENAP and CCA countries with large sovereign wealth funds and state-owned enterprises. In this regard, the IMF encourages countries to undertake Fiscal Transparency Evaluations to help compile public sector balance sheets and assess the main risks to the fiscal outlook.
- Building a credible MTFF, with a clear understanding of fiscal challenges, would enhance fiscal discipline and reduce the pace of debt accumulation. It would also mitigate procyclicality, particularly in MENAP oil exporters. Algeria and Pakistan would benefit from ensuring compliance with existing MTFFs, and efforts to bolster fiscal policy frameworks (for example, in Qatar and the United Arab Emirates) via explicit fiscal anchors would also help to reduce procyclical fiscal policies.
- Stronger PFM systems and effective procurement processes and controls, which limit unreported extrabudgetary expenditures and reinforce oversight of fiscal risks, would help slow debt accumulation and limit unplanned changes in government spending. In this regard, Mauritania's and Algeria's recently adopted Organic Budget Laws are welcome steps toward improving PFM systems and enhancing the formulation of multiyear budgets. Kuwait passed a new procurement law to promote competition and transparency as well as participation of small- and medium-sized enterprises. It establishes dedicated procurement bodies and introduces modern approaches to evaluating bids, life-cycle costing, and complaints. The new tendering and procurement law in Saudi Arabia should improve the efficiency of public investment and transparency of tenders. In line with IMF recommendations, Azerbaijan and Uzbekistan recently passed legislation and regulations to establish e-procurement and increased transparency of bidding and contracting. Armenia plans to strengthen its public investment management framework to facilitate prioritization of investment projects.
- Fiscal rules reinforce fiscal discipline and build resilience. Moving toward flexible yet effective fiscal rules could help preserve fiscal discipline. Well-defined escape clauses, as well as monitoring and enforcement mechanisms, could assist in ensuring intergenerational equity, particularly important in MENAP oil exporters, and alleviate debt burdens, of concern in MENAP oil importers. Algeria, Azerbaijan, and Pakistan could reap further gains by fostering compliance with existing rules, while the Kyrgyz Republic should consider a lower cap for public debt when calibrating its fiscal rule.
- Revenue institutions can strengthen overall tax administration and foster domestic nonresource revenue mobilization, especially important for MENAP and CCA oil exporters. Revenue institutions can be strengthened by aligning them with good practices for internal management, improving procedures that regulate tax officials' discretionary powers, developing core tax procedures and capabilities. Easing filing and payment procedures via electronic filing, and implementing modern organizational structures and compliance risk management approaches. Having a credible medium-term fiscal framework, for example by implementing a medium-term revenue strategy focused on tax system reform, can also boost nonresource revenue mobilization (IMF, OECD, UN, and World Bank 2016).

Box 5.1. Lessons from Fiscal Reforms in Georgia

Georgia has undertaken major reforms to enhance the effectiveness of fiscal policy by strengthening fiscal institutions, reducing corruption, and improving the business climate. These reforms led to significant improvements in fiscal outcomes.

Since 2003, Georgia has enacted significant reforms of the public sector and fiscal institutions. The government undertook measures to fight corruption, including by improving fiscal institutions.[1] These consisted of (1) adopting a new budget law, which strengthened the medium-term fiscal framework by consolidating budget legislation, unifying central and local budgets, accelerating the budget approval and execution processes, and introducing program budgeting; (2) adopting numerical fiscal rules (debt, budget balance, and expenditure rules) in 2011 and enhancing them in 2018;[2] (3) streamlining tax policy and strengthening tax administration with the introduction of e-government taxpayer services and procurement; and (4) improving the coverage, analysis, and reporting of fiscal risks.

Stronger fiscal institutions have helped deliver better fiscal outcomes. Fiscal transparency, measured by the Open Budget Index, has improved markedly. Tax revenues rose and the efficiency of revenue collection has been higher than among peers. The government streamlined the types of taxes from 21 to 6, vastly improved taxpayer services, and restructured Georgia's Revenue Service. The adoption of flexible fiscal rules helped foster fiscal discipline, limited the rise in public debt, and reduced the volatility of government expenditure. The IMF supported Georgia in these reforms through financing arrangements and intensive capacity development.

Going forward, there is still scope for further reforms of fiscal institutions. Efficiency of spending could be enhanced, and a more binding medium-term budget framework would help enforce medium-term spending priorities. The government could improve the oversight and management of public investment and state-owned enterprises in line with the Public Investment Management Assessment recommendations. Further modernization of tax policy and revenue administration would help ensure sustainable revenues and could be achieved by a medium-term revenue strategy for comprehensive tax system reform.

This box was prepared by Iulia R. Teoduro.

[1]The October 2019 *Fiscal Monitor* discusses in depth other key reforms that have reduced and contained corruption in Georgia.

[2]Fiscal rules limit public debt to 60 percent of GDP, the budget balance to 3 percent of GDP, and expenditures to 30 percent of GDP. The revisions entailed eliminating the expenditure ceiling, which had a procyclical bias, clarifying the scope of the deficit and the public debt under the rule, and defining escape clauses.

Box 5.2. Fiscal Institutions and Fiscal Performance: Empirical Setting

This box discusses the models developed to investigate links between fiscal institutions and fiscal performance. Fiscal institutions are measured using the transparency of the budget cycle, the adoption of a credible medium-term fiscal framework, and the introduction of fiscal rules. We focus on the role of these institutions in limiting increases in public debt (*disciplinary effect*), reducing the procyclicality of fiscal policy (*stabilizing effect, building resilience*), and lowering volatility of fiscal policy (*improving predictability*).

To explore the disciplinary effect of fiscal institutions, we posit the following empirical specification:

$$\Delta D_{it} = \alpha + \beta_1 FI_{it} + \beta_2 FI_{it} \times I_{\{=1 if MCD\}} + \sum_{k=1}^{K} \delta_k Z_{k,it} + \varepsilon_{it}. \quad (1)$$

Following Dabla-Norris and others (2010), the left hand-side variable is the change in gross public debt (ΔD_{it}) in percent of GDP, with i and t indicating panel and time dimensions. Our primary explanatory variable is an indicator of fiscal institutions (FI_{it}), mainly an indicator of transparency and the existence of a medium-term fiscal framework, and also the quality of the procurement process and public financial management system. Equation 1 is supplemented with additional control variables influencing changes in the public debt (that is, non-oil primary balance, real GDP growth, and inflation) to address possible omitted variable bias, and to isolate country-specific and time-invariant characteristics. We focus on β_1 and β_2, which measure the effect of financial institutions on the changes in public debt.

The stabilizing capacity of fiscal institutions is empirically tested using a two-step approach. We first estimate the cyclicality of fiscal policy (Equation 2).

$$\Delta LogG_{it} = \alpha_{it} + \beta \Delta Y_{it} + \sum_{j=1}^{J} \delta_j X_{j,it} + \varepsilon_{it}. \quad (2)$$

Subscripts i and t refer to the country and time dimensions. $\Delta LogG_{it}$ represents the first differences of the logarithm of real public spending, and ΔY_{it} is the real GDP growth rate. Equation 2 describes the fiscal reaction function, which captures changes in government spending in reaction to the business cycle. The business cycle comoves with the oil price cycle (see Chapter 1). Equation 2 includes a set of controls ($X_{j,it}$: real GDP per capita, financial development, terms of trade, inflation) influencing government spending. Following Aghion and Marinescu (2007), we compute the time-varying and country-specific coefficients of procyclical ($\hat{\beta} > 0$) or countercyclical fiscal policy ($\hat{\beta} < 0$). After estimating the cyclical reaction of fiscal policy ($\widehat{\beta_{it}}$), we assess the impact of FIs on the pro- or countercyclical nature of fiscal policy (Equation 3).

$$\widehat{\beta_{it}} = \alpha_i + \delta_1 FI_{it} + \delta_2 FI_{it} \times I_{\{=1 if MCD\}} + \sum_{k=1}^{K} \lambda_k Z_{k,it} + \varepsilon_{it}. \quad (3)$$

We focus on coefficients δ_1 and δ_2, which measure the effect of *FI*s on the cyclical nature of fiscal policy. Negative δ_1 and δ_2 imply that *FI*s are associated with lower procyclicality of fiscal policy.

Once again, we develop a two-stage approach in exploring the effectiveness of fiscal institutions in reducing the volatility of fiscal policy. First, we isolate changes in nonessential government spending using the following specification.

$$\Delta LogG_{it} = \alpha_{it} + \beta \Delta Y_{it} + \sum_{j=1}^{J} \delta_j X_{j,it} + \omega_{it}. \quad (4)$$

$\Delta LogG_{it}$ is the first difference of the logarithm of real government spending and ΔY_{it}, real GDP growth, captures the impact of the state of the economy on changes in spending. Equation 4 includes a set of controls (Xj,it: oil price volatility, real GDP growth volatility, inflation) influencing government spending. In this empirical setup, the residuals ($\widehat{\omega_{it}}$) play an important role as they capture the discretionary changes in government spending, driven neither by the business cycle nor by automatic stabilizers. The volatility of fiscal policy is calculated as a standard deviation of the residuals in country i, using periods of five years (σ_i^t), since we want to isolate the noise that might exist in the short term.

Box 5.2 *(continued)*

In the second stage, we estimate the impact of fiscal institutions on the volatility of fiscal policy using Equation 5.

$$\sigma_i^t = \alpha_i + \delta_1 FI_{it} + \delta_2 FI_{it} \times I_{\{=1 if MCD\}} + \lambda_k Z_{k,it} + \varepsilon_{it}. \quad (5)$$

δ_1 and δ_2 are our coefficients of interest. They are expected to be negative, predicting that fiscal institutions reduce the volatility of fiscal policy.

This role of fiscal rules in limiting the rise in public debt and reducing procyclicality is tested using Equation (6).

$$\Delta Y_{it} = \alpha + \beta_1 FI_{it} + \beta_2 (FR_{it} \times PR_{it}) + \sum_{k=1}^{K} \delta_k Z_{k,it} + \varepsilon_{it}. \quad (6)$$

The dependent variable ΔY_{it} is the change in public debt (ΔD_{it}), or the cyclical coefficients of fiscal policy ($\widehat{\beta_{it}}$) derived from Equation 3. Subscripts i and t are the panel and time dimensions. Our main explanatory variable is a dummy variable capturing the presence of a fiscal rule (FR_{it}). An interaction term ($FR_{it} \times PR_{it}$) captures the presence of a procedural rule, monitoring and enforcement bodies, the existence of escape clauses, or rules excluding investment spending in the calculation of the fiscal balance.

Equation 7 describes the econometric model used to estimate the role of fiscal institutions in influencing domestic revenue mobilization. The dependent variable is the ratio of total revenue to GDP, or nonresource revenue to GDP (Rev_{it}), with i and t the panel and time dimensions. Explanatory variables include GDP per capita, openness to trade, and political and institutional variables.

$$Rev_{it} = \alpha_i + \delta_1 FI_{it} + \delta_2 FI_{it} \times I_{\{=1 if MCD\}} + \lambda_k Z_{k,it} + \mu_k Pol_{k,it} + \varepsilon_{it}. \quad (7)$$

The sample covers 114 countries across all income groups and regions, including 31 Middle East and Central Asia countries. The panel is unbalanced due to significant data limitations, in particular regarding the indicators of fiscal institutions (Open Budget Index, medium-term fiscal framework, procurement, Public Financial Management). Given that fiscal institutions change slowly, we use five-year averages of all variables. Equations 1, 3, 5, and 6 are estimated using the Driscoll and Kraay (1998) method, which produces heteroscedastic-consistent standard errors robust to very general forms of spatial and temporal dependence. Equation 7 is estimated using the fixed effects method with robust standard errors. All specifications include control variables to reduce potential omitted variable bias. These include macroeconomic and structural (*GDP per capita, inflation, financial development, openness to trade, terms of trade, real GDP growth volatility, oil price volatility, non-oil primary balance*) and political and institutional variables (*strength of democracy, rule of law, government effectiveness, etc.*). Country fixed effects are introduced to alleviate concerns about cross-sectional dependence. Following Alesina and Perotti (1999), fiscal institutions are assumed to be costly to change and stable at least over the short to medium term. Therefore, the causality runs from fiscal institutions to fiscal outcomes, mitigating the endogeneity bias induced by reverse causality.

This box was prepared by Moussé Sow.

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