Middle East and Central Asia Department

REGIONAL ECONOMIC OUTLOOK

September 2005

International Monetary Fund

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CHAPTER I. RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

The Regional Economic Outlook, covering countries in the Middle East and Central Asia Department (MCD), provides a broad synopsis of recent economic developments, highlighting common macroeconomic trends and policies.[1] In light of recent developments, the Regional Economic Outlook focuses on two topics: the economic consequences of the oil boom on the region's oil exporters, and the policy responses to upward exchange rate pressure in some MCD countries.

A. Overview

Macroeconomic performance in the MCD region continued to be strong in 2004, supported by a favorable external environment and generally underpinned by sound macroeconomic policies. For the region as a whole, real GDP growth averaged 5.9 percent in 2004, somewhat lower than in 2003 but significantly higher than in the period 1998–2002. As a result, real GDP per capita growth in 2003–04 was more than twice the 1998–2002 average. The Commonwealth of Independent States (CIS) countries continued to outperform the rest of the region in 2004, with average real GDP growth of 8.9 percent as compared to 5.6 percent for the non-CIS countries.[2]

Inflation is creeping up, owing to pressures from both domestic and external sources. Average CPI inflation in MCD countries increased from 5.3 percent in 2003 to 6.9 percent in 2004, and building pressures are expected to push it above 8 percent in 2005. The decision of governments in the region to limit the pass-through of the increase in international oil prices to domestic prices has helped contain inflation, but at an increasing fiscal cost.

Abundant liquidity has fueled asset price inflation. Some countries, particularly those in the oil-exporting group, have experienced a boom in stock and real estate markets, triggering in some cases a tightening of prudential regulations.

The fiscal and external current account positions improved for most countries in the region. As a result, government debt has declined substantially as a share of GDP, and official reserves have swelled to almost an 11-month import cover. Notwithstanding this improvement, further fiscal consolidation is still required in some countries to achieve fiscal sustainability and external viability.

[1] **MCD** countries are Afghanistan, Algeria, Armenia, Azerbaijan, Bahrain, Djibouti, Egypt, Georgia, Iran, Iraq, Jordan, Kazakhstan, Kuwait, Kyrgyz Republic, Lebanon, Libya, Mauritania, Morocco, Oman, Pakistan, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tajikistan, Tunisia, Turkmenistan, United Arab Emirates, Uzbekistan, West Bank and Gaza, and Yemen.

[2] The **CIS** countries only include those covered by MCD, namely Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, and Uzbekistan. Due to limited data availability, Turkmenistan was excluded from the analysis.

The short-term outlook remains favorable, but there are significant downside risks. In 2005 and 2006, real GDP growth is projected to remain significantly above trend. However, inflation could turn out higher than forecast, which would require a swift tightening of the macroeconomic policy stance in some countries. There is also the possibility of a severe correction in some equity and real estate markets, posing a risk to financial stability. Global growth could falter if oil prices were to continue their ascent, or if there were an abrupt adjustment of global current account imbalances.

Looking ahead, the region faces several policy challenges. First, the large inflows of foreign exchange in some countries may complicate the conduct of monetary policy. Despite widespread sterilization practices, these countries are facing difficulties in containing broad money growth. Coordination between the fiscal and monetary authorities will be necessary to maintain or restore macroeconomic stability. Second, oil-exporting countries in a healthy fiscal position need to increase quality spending to promote medium-term growth and contribute to a reduction of global financial imbalances (an in-depth analysis of this issue is provided in Chapter II). Third, countries with flexible exchange rate regimes experiencing upward real exchange rate pressure should let their nominal exchange rate appreciate to limit inflationary pressures, while stepping up implementation of structural reforms to increase productivity growth and enhance or maintain external competitiveness (see Chapter III for a detailed analysis). Fourth, in view of rapid asset price inflation in some countries, continued vigilance from supervisory authorities is necessary to minimize the risk of a sharp price correction. Finally, policies are needed to mitigate the impact of oil price volatility by moving toward greater transparency in oil markets and expanding production and refining capacity.

The region's medium-term prospects continue to hinge on progress with structural reforms and the resolution of geopolitical tensions. Recent optimism about the region's prospects should not obscure the fact that the favorable global environment that has supported overall good performance during the past two years may not last. Only fundamental change in the economies of the region, through structural and institutional reforms, can translate into sustained economic growth and adequate employment for the rapidly growing working-age population, a key medium-term policy issue in most countries in the region.

The next section reviews recent economic developments and prospects. Chapter II discusses policy issues related to the management of the large oil revenue in MCD oil-exporting countries, and Chapter III presents the policy response to recent upward pressure on real exchange rates in some countries.

B. Recent Economic Developments and Prospects

This chapter assesses economic performance in the Middle East and Central Asia countries in 2004, as well as prospects for 2005 and 2006.[3] To facilitate the discussion, the countries are divided into three economic groupings: *oil exporters*, *low-income countries*, and *emerging markets*.[4] The suggested groupings were formed on the basis of per capita income, the share of oil in total exports, and access to international capital markets. The groupings are somewhat arbitrary, as some countries might fit into more than one group.

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[3] The analysis reflects data as of end-August 2005.

[4] **Oil exporters** are Algeria, Azerbaijan, Bahrain, Iran, Iraq, Kazakhstan, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syria, and the United Arab Emirates. **Low-income countries** are Afghanistan, Armenia, Djibouti, Georgia, Kyrgyz Republic, Mauritania, Sudan, Tajikistan, Uzbekistan, and Yemen. **Emerging markets** are Egypt, Jordan, Lebanon, Morocco, Pakistan, and Tunisia. Afghanistan is included in the data tables but was excluded from the averages for the country groupings because of incomplete data. Country weights used for aggregation are based on 2003 GDP in purchasing power parity (PPP) terms.

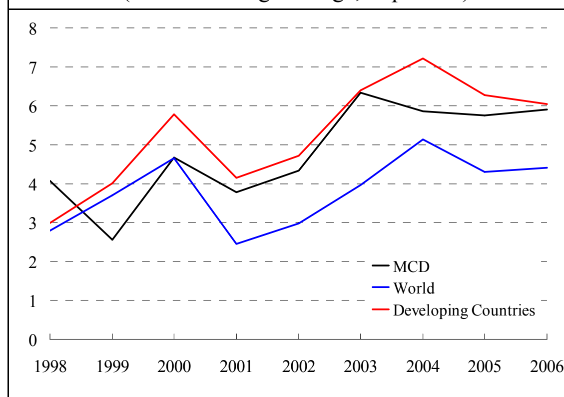
Recent Economic Developments

The region recorded significantly above-trend growth for the second year in a row. Robust global growth, high commodity prices, low international interest rates, and generally accommodative monetary and fiscal policies underpinned average real GDP growth of 5.9 percent in 2004, somewhat lower than in 2003 but significantly higher than the 3.9 percent average in 1998–2002. As a result, real GDP per capita growth increased from an average of 1.8 percent in 1998–2002 to 3.7 percent in 2003–04. Despite this boost in growth, unemployment remains high in a number of countries in the region.

The recent growth performance was not sufficient, however, to align MCD growth with that of the group of all developing countries. During the past five years, real GDP growth averaged 5 percent for the MCD region, compared to 5.7 percent for the group of all developing countries (Figure 1.1). However, MCD countries, like all developing countries, has outpaced global growth since 2000.

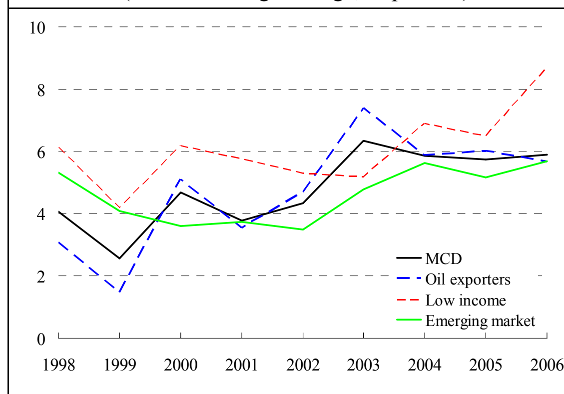
Growth performance varied somewhat across the country groupings and substantially across countries within groups. Growth in the oil-exporting countries decelerated from 7.4 percent in 2003 to 5.9 percent in 2004, following weaker growth in the oil sector, mostly in Bahrain, Oman, and Syria, where hydrocarbon GDP contracted (Figure 1.2). The non-oil sectors of oil-exporting countries continued to expand rapidly in 2004, supported by an oil-related investment boom, particularly in the CIS countries. At the same time, the growth performance of the low-income and emerging market economies strengthened in 2004. The robust growth in low income countries reflects, to a large extent, strong activity in the CIS countries, led by buoyant exports and agricultural production. In the emerging market economies, tourism receipts and inflows of remittances, coupled with generally favorable weather conditions, resulted in strong and relatively broad based growth.

Figure 1.1. Global Real GDP Growth
(Annual average change, in percent)



Sources: Data provided by authorities; and IMF staff estimates and projections.

Figure 1.2. Real GDP Growth in MCD
(Annual average change, in percent)

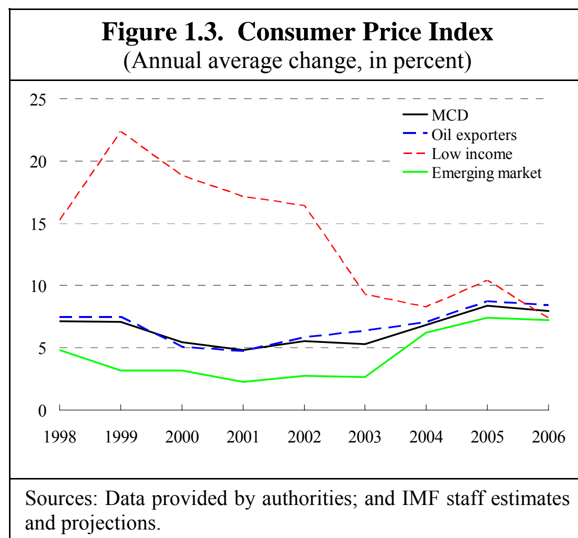


Sources: Data provided by authorities; and IMF staff estimates and projections.

Inflation picked up in 2004 and pressures are building. Average CPI inflation in MCD region increased from 5.3 percent in 2003 to 6.9 percent in 2004, and domestic and external pressures are expected to push inflation up to 8.4 percent in 2005 (Figure 1.3). The main sources of these inflationary pressures differ across country groups. For some oil-exporting countries, like Iran, high inflation resulted from increased spending of oil revenue. In low-income countries, the increase in oil prices has interrupted a healthy downward trend in inflation in the past five

years. The emerging market economies exhibited the largest increase in inflation in 2004, reflecting mainly developments in Egypt and Pakistan. These included the lagged effects of the pass-through of the 2003 depreciation in Egypt, and the impact of food support price increases, and accommodative monetary policy in Pakistan. Despite the large inflows of foreign exchange into the GCC countries, inflation only reached 1.7 percent in 2004 and is projected to peak at 2.2 percent in 2005, thanks to a flexible labor market and prudent monetary policies.[5]

Figure 1.3. Consumer Price Index
(Annual average change, in percent)

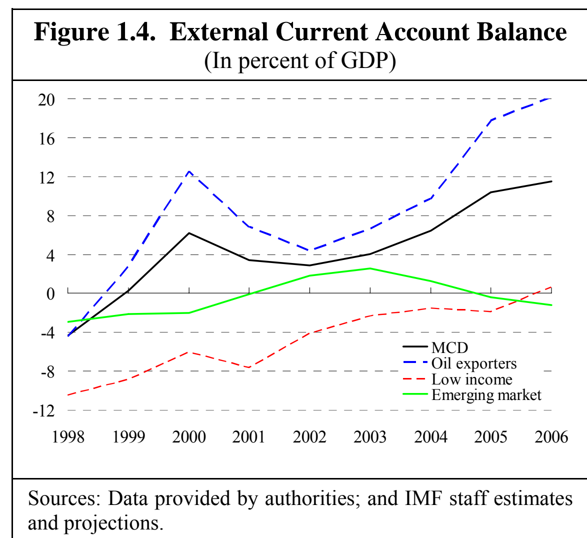


Sources: Data provided by authorities; and IMF staff estimates and projections.

The general decision by governments of the region to limit the pass-through of the sizeable increase in oil prices helped contain inflation, but at an increasing fiscal cost. Estimates for the past three years show that the pass-through was only partial in most countries of the region. The lowest estimates of the degree of pass-through correspond to oil-exporting countries, while full pass-through took place in some oil-importing countries.

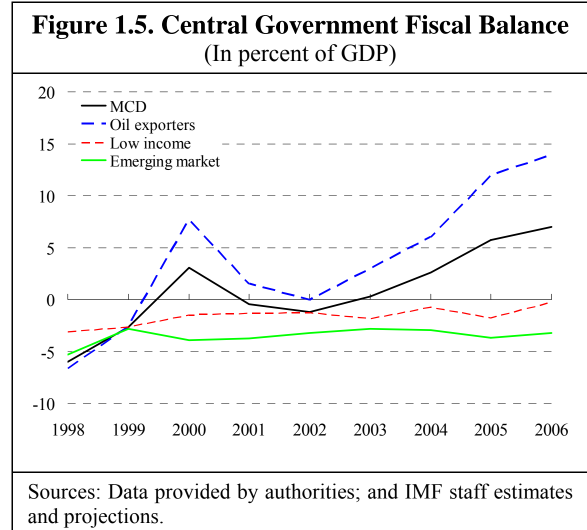
The external and fiscal positions of the countries in the region have generally strengthened. The current account surplus of MCD countries increased markedly, from an average 1.7 percent of GDP during 1998–2002 to 6.4 percent in 2004 (Figure 1.4). This improvement is fully accounted for by the oil exporters, as the current account of the other two groups remained roughly in balance. The overall fiscal balance of MCD countries moved from deficit to a large surplus during the same period (Figure 1.5). Most of the improvement was recorded by the oil-exporting countries, which benefited from both the sharp increase in oil prices and a significant expansion in oil production to meet a surge in world demand.

Figure 1.4. External Current Account Balance
(In percent of GDP)



Sources: Data provided by authorities; and IMF staff estimates and projections.

Figure 1.5. Central Government Fiscal Balance
(In percent of GDP)



Sources: Data provided by authorities; and IMF staff estimates and projections.

The external and fiscal positions of oil exporters has improved considerably. Export revenue growth in oil-exporting countries increased from

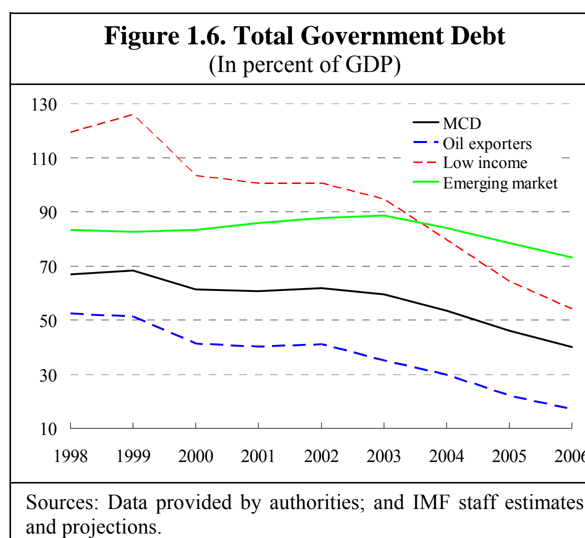
[5]The **GCC** (Gulf Cooperation Council) countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and UAE.

an average of 11 percent during 1998–2002 to 30 percent in 2004, boosting the group's current account surplus to 9.7 percent of GDP and its official reserves to about 13 months of imports. So far, oil-exporting countries have been quite restrained in using their export receipts, spending less than 30 percent of the additional oil revenue and concentrating the additional spending on capital goods, particularly infrastructure and housing. As a result, the central government fiscal position shifted from virtual balance in 1998–2002 to a surplus of 6.0 percent of GDP in 2004, and is projected to strengthen further to 12 percent of GDP in 2005. Moreover, about 30 percent of the additional revenue was earmarked for debt reduction, bringing down total government debt from 41 percent of GDP in 2002 to 22 percent in 2005.

Low-income and emerging market economies have also improved their fiscal and external positions. The strong growth recorded by oil-exporting countries benefited other countries in the region through trade and remittance flows, partially offsetting the negative impact from a higher oil import bill. Low-income countries, in particular, have significantly reduced their external vulnerability during the past five years, with their current account deficit narrowing from 7.4 percent of GDP in 1998–2002 to 1.5 percent in 2004. These countries also made significant inroads in reducing government debt, with total debt declining from more than 100 percent of GDP in 2002 to less than 80 percent in 2004 (Figure 1.6). Despite recent progress, the level of indebtedness remains high in some countries, particularly Djibouti, Kyrgyz Republic, Mauritania, and Sudan. Emerging markets reduced their debt burden moderately, bringing down their total debt-to-GDP ratio from 88 percent in 2002 to 84 percent in 2004. Pakistan achieved the most dramatic reduction, with its government debt declining from 82 percent of GDP in 2002 to 66 percent in 2004. However, in many countries, debt reduction was not achieved by fiscal consolidation alone. Privatization receipts were also an important source of funding.

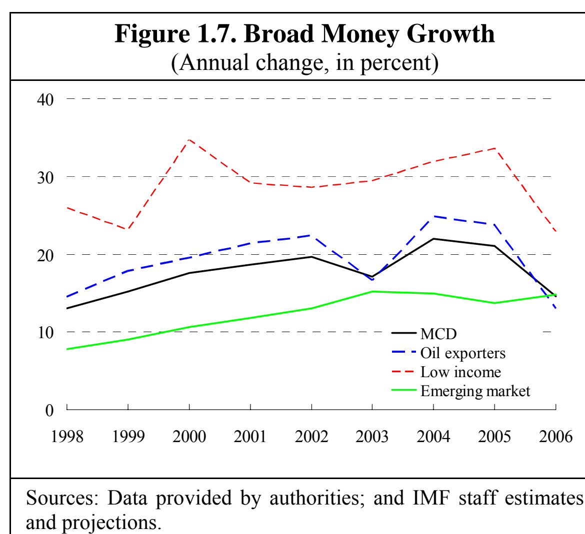
Strong growth in monetary aggregates suggests a relatively accommodative monetary policy stance. Broad money growth was 22 percent in 2004, compared to an average of 16.8 percent during 1998–2002 (Figure 1.7). Monetary expansion was high in Azerbaijan, Iran, Kazakhstan, Qatar, and UAE among the oil exporters; Armenia, Georgia, Mauritania, and Uzbekistan among low-income countries; and Pakistan among emerging markets. In general, these are also countries experiencing inflationary pressures, although the increase in broad money has been driven in part by a process of financial deepening.

Figure 1.6. Total Government Debt
(In percent of GDP)



Sources: Data provided by authorities; and IMF staff estimates and projections.

Figure 1.7. Broad Money Growth
(Annual change, in percent)

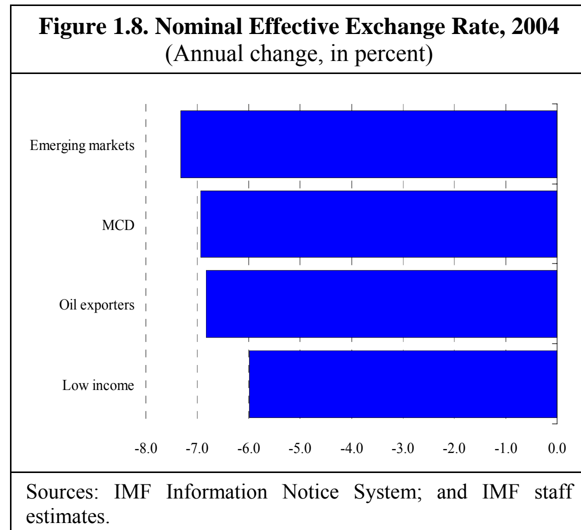


Sources: Data provided by authorities; and IMF staff estimates and projections.

The response of nominal exchange rates to surging exports, rising remittances, and large capital inflows has been muted. About a third of the countries in the region—including

members of the GCC, Lebanon, and Djibouti —have their currencies pegged to the U.S. dollar. In addition, many countries with a managed float regime have resisted an appreciation of their currencies against the U.S. dollar through heavy intervention in the foreign exchange market. As a result, exchange rates in the MCD countries have depreciated on average by 7 percent in nominal effective terms in 2004 (Figure 1.8).

Figure 1.8. Nominal Effective Exchange Rate, 2004
(Annual change, in percent)

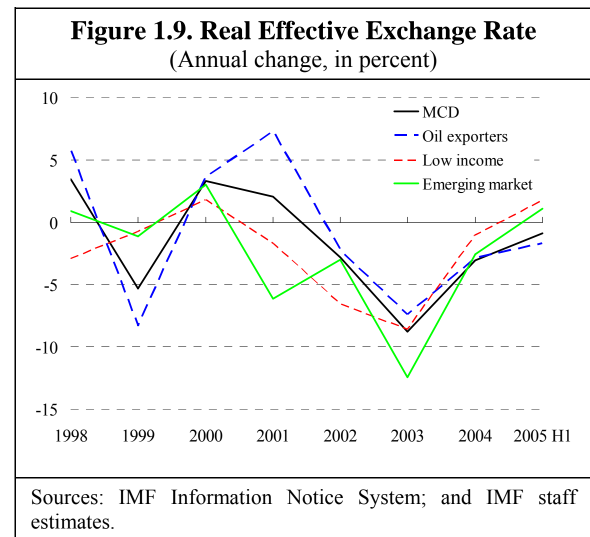


Sources: IMF Information Notice System; and IMF staff estimates.

Insufficient exchange rate flexibility may have contributed to a build up of inflationary pressures in countries that experienced a surge in foreign exchange receipts, by forcing the required adjustment of the real exchange rate mainly through domestic prices. Indeed, real effective exchange rates show appreciation pressures (Figure 1.9). The latter are more apparent in the bilateral real exchange rate versus the U.S. dollar, which shows a trend appreciation that started around 2000 for low-income and oil-exporting countries, and a bit later for the emerging market economies (Figure 1.10). Insufficient upward exchange rate flexibility may have also contributed to worsening global current account imbalances.

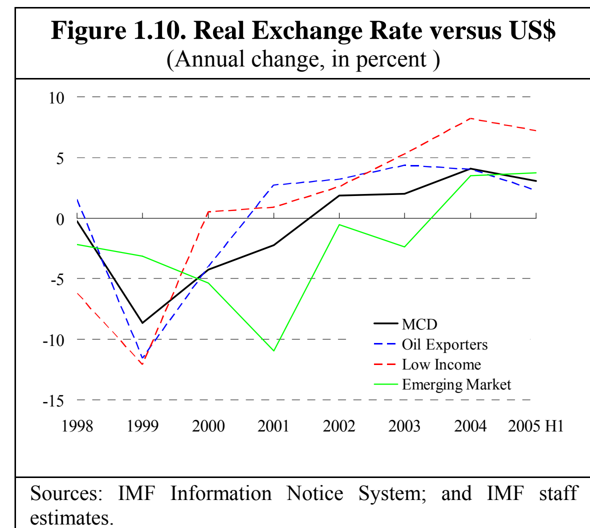
Equity markets in the region have soared, underpinned by strong growth and ample liquidity. Low interest rates, a large pool of liquidity amassed from oil revenue and the repatriation of some funds invested overseas, and

Figure 1.9. Real Effective Exchange Rate
(Annual change, in percent)



Sources: IMF Information Notice System; and IMF staff estimates.

Figure 1.10. Real Exchange Rate versus US$
(Annual change, in percent)

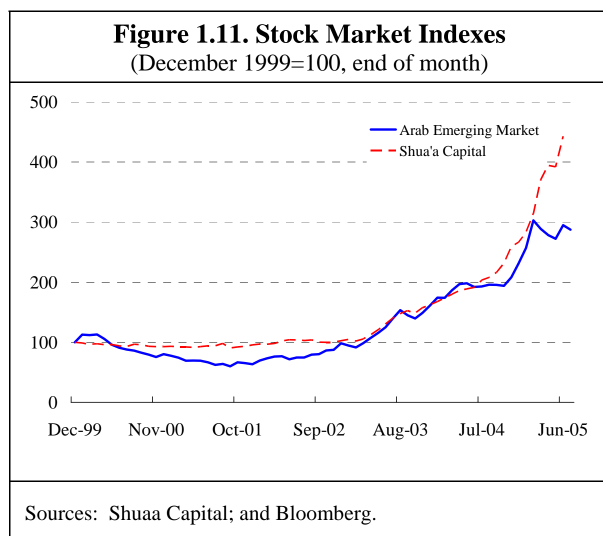


Sources: IMF Information Notice System; and IMF staff estimates.

privatization of state-owned enterprises boosted demand for equities in the region. At the same time, there has been a significant improvement in regulations, a wider range of investment instruments, enhanced market liquidity, and considerable investment in new technologies to enable the markets to move from manual to electronic trading. As a result, equity markets skyrocketed in the past three years, particularly in the Gulf countries, where capital inflows were the largest. The Shua'a capital index—an index of 12 Arab countries—increased by 159 percent from January 2003 to December 2004, and by 66 percent in the first half of 2005 (Figure 1.11). The emerging market index—a weighted index for the six MCD emerging market economies—closely followed the Shua'a index until the end of 2004, but has

remained relatively flat thereafter. While data is scarce, anecdotal evidence also shows that there has been a boom in the real estate markets in many countries.

Figure 1.11. Stock Market Indexes
(December 1999=100, end of month)



Sources: Shuaa Capital; and Bloomberg.

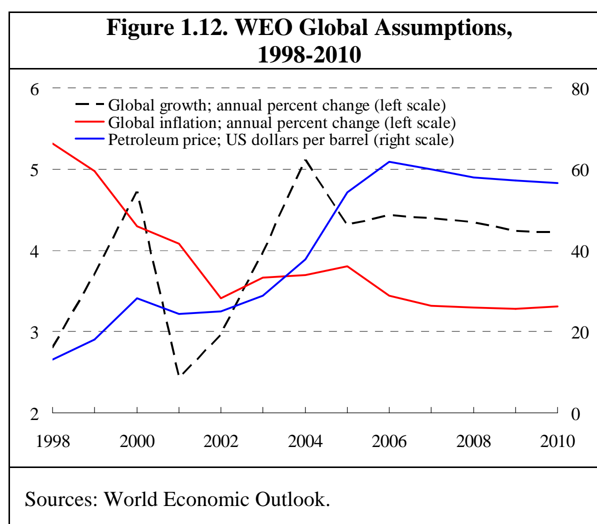
Economic Outlook and Risks

World Economic Outlook[6]

The expansion of the world economy is likely to continue in the remainder of 2005 and in 2006. Following a strong first quarter, global growth appears to have slowed in the second quarter of 2005, in part reflecting the impact of higher oil prices. However, recent data suggests that this soft patch is easing. Consequently, growth is expected to pick up in the second half of the year, with real global GDP projected to grow by 4.3–4.4 percent in both 2005 and 2006 (Figure 1.12). This outlook is underpinned by still accommodative monetary and fiscal policies, the ongoing improvement of corporate balance sheets, and the remarkably good financial environment. While global headline inflation has picked up, underlying inflationary pressures appear to remain generally contained.

[6]More details can be found in the September issue of the *World Economic Outlook*, Chapter I, on which this section is based.

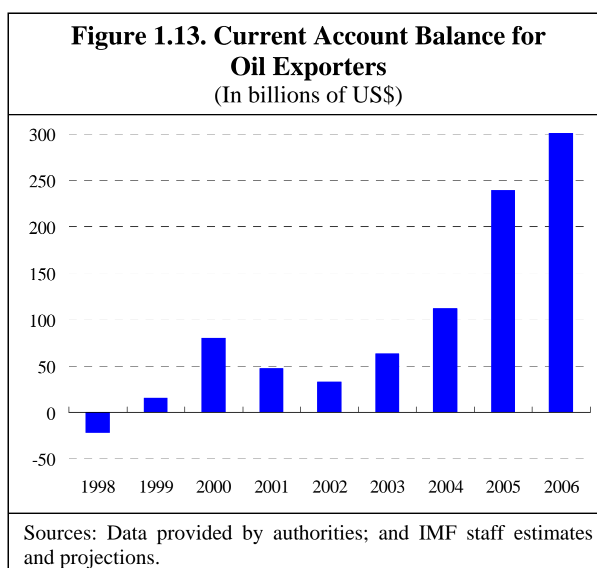
Figure 1.12. WEO Global Assumptions, 1998-2010



Sources: World Economic Outlook.

The expansion remains highly unbalanced, however, as regional current account imbalances are expected to worsen. The current account deficit of the United States is projected to rise to 6 percent of GDP in 2005, with its principal counterparts being the surpluses of Japan, China, the CIS, and the Middle East oil-exporting countries, with the latter measured in U.S. dollar terms now exceeding those of emerging Asia (Figure 1.13).

Figure 1.13. Current Account Balance for Oil Exporters
(In billions of US$)



Sources: Data provided by authorities; and IMF staff estimates and projections.

Short-run risks are biased downward. Global growth could be weakened by a continuation of oil prices near their peak for a protracted period, or a further increase in oil prices, including from hurricane Katrina—which triggered a substantial oil price reaction on the spot and future markets. An abrupt adjustment of global imbalances, a deterioration of financial conditions, and rising protectionist sentiment could also weigh on global growth.

Financial conditions continue to be exceptionally favorable, with long-run interest rates and credit premiums unusually low, and volatility subdued. The prevailing calm reflects both fundamental influences—including strong corporate profitability and balance sheet improvements in the financial and corporate sectors—and abundant liquidity, which continues to encourage a search for yields that bids down risk premia for all asset classes.

Petroleum prices are at record nominal levels. The spot price of West Texas crude oil recently crossed US$70 a barrel for a while. Petroleum prices increased by more than 50 percent from end of December 2004 to mid-September 2005, despite a significant increase in commercial inventories and OPEC's efforts to accommodate the strong demand for crude oil.[7] The persistence of high and volatile oil prices reflects the combined influences of robust global growth, relatively low spare capacity, and refinery bottlenecks and outages. Looking forward, derivative markets suggest increased uncertainty about future oil prices.

Outlook for the MCD region

The short-term outlook remains favorable for MCD countries. Under the assumptions of the global scenario described above, real GDP for the whole MCD region is projected to grow by 5.7 percent in 2005 and 5.9 percent in 2006, a pace similar to that in 2004. While real GDP growth in the low-income and emerging-market economies is projected to slow somewhat in 2005 before rebounding in 2006, growth in the oil-exporting countries is expected to remain strong in 2005 before easing in 2006, in line with the outlook for oil prices. With oil prices expected to decline only gradually, the fiscal and external positions of oil-exporting countries is likely to improve even further, largely offsetting the slight worsening in the rest of the region.

Inflationary pressures are likely to strengthen in the next 18 months, fueled by the robust growth and generally accommodative policies pursued over the past three years. Inflation is projected to rise from 6.9 percent in 2004 to a peak of 8.4 percent in 2005.

There are significant risks to this forecast. Inflation could turn out higher than forecast, requiring tightening of the macroeconomic policy stance in some countries in the region. At the same time, the run-up in asset prices in the past two years may have been excessive and could lead to a major correction in equity and real estate markets, posing a risk to financial stability. In the oil-exporting countries, the recent growth acceleration that is largely driven by the substantial increase in oil prices, could be reversed. On the other hand, persistent high oil prices could ignite (or accelerate) inflation and lower the growth prospects of many low-income and emerging market economies. More generally, growth in the region could end up much weaker than projected if global growth were to falter because of a disorderly resolution to the global current account imbalances, or a spike in global inflation that would necessitate a sharp increase in world interest rates. Finally, the expiration of quotas on textiles and clothing in January 2005 has increased uncertainty about growth prospects in countries that are highly dependent on this sector (Box 1.1) .

[7]The petroleum price referred to here is the average price per barrel of Brent, Dubai Fateh, and West Texas Intermediate crude oil.

Box 1.1 Impact of the Expiry of Textiles and Clothing Quotas on MCD Countries

Some countries in the region depend heavily on exports of textiles and clothing (T&C), with T&C representing a significant share of exports of goods in Pakistan, Tunisia, Morocco, Jordan, and Egypt. For the rest of the region, T&C accounts for less than 5 percent of exports of goods. While exports of Pakistan and Egypt are well diversified geographically, with exports of T&C divided almost evenly between the E.U. and the U.S. markets, exports of Morocco and Tunisia are concentrated in the E.U market and those of Jordan in the U.S. market.

The liberalization of the T&C market and the subsequent surge in Chinese exports seem to have started to hurt exports in the region, although it is too early for an adequate assessment of the impact on MCD countries. Recent data shows that China, and to a lesser extent India, have been the major beneficiaries of the removal of T&C quotas in January 2005. In the first half of 2005, U.S. imports of T&C from China increased by almost 60 percent relative to the same period in 2004, resulting in a significant gain in market share. The same data projects a mixed picture for the T&C sector in the MCD region. Morocco recorded a significant decline in its exports of T&C to the U.S. in the first half of 2005, although its main market is the E.U. Exports to the U.S. from the other four major exporters of T&C seem to have enjoyed relatively strong growth in the first half of 2005.

The viability of the T&C sector will necessitate a large boost in productivity and flexibility in adjusting to the new circumstances. Keeping the T&C sector competitive is a serious challenge for the five major exporters of T&C. Considering the labor intensity of the sector, its adjustment to increased competition could be costly. This will require investment in both physical and human capital, an upgrade in infrastructure, and a consolidation of a generally fragmented sector. During this adjustment period, the most vulnerable countries facing balance of payments problems could request IMF assistance through the Trade Integration Mechanism (TIM).

Top Five MCD Exporters of Textiles and Clothing in 2003

	Share in Total Exports of Goods (in percent)			Percent change
	Exports of T&C	Exports of T&C to the U.S.	Exports of T&C to the E.U.	U.S. Imports in 2005 H1 Relative to 2004 H1
Pakistan	71.4	21.1	21.4	9.9
Tunisia	42.5	0.5	41.4	37.1
Morocco	33.0	0.6	32.0	-16.3
Jordan	23.3	19.9	0.4	23.8
Egypt	8.3	6.9	7.2	1.5
China	*6.1*	*3.6*	*3.5*	*58.4*

Source: Authorities; and World Trade Organization, September 20, 2004.

Policy Issues in the Period Ahead

The appropriate policy mix will depend on the macroeconomic conditions of each country in the region. For countries where inflation is a threat, a tightening of monetary and fiscal policies will be necessary. However, countries that have been hit hard by severe and persistent supply shocks—including the recent spike in oil prices in the case of oil-importing countries, or adverse weather conditions—could accommodate the first round effect of these shocks in order to avoid amplifying their adverse effects on growth. Countries with flexible exchange rate regimes that have experienced a sharp terms of trade gain could let their exchange rates appreciate to ease inflation pressures and contribute to resolving global current account imbalances. In oil-importing countries, subsidies may have to be scaled back if a large component of the increase in oil prices is permanent, as many observers believe, in which case fiscal sustainability may be at risk. Moreover, subsidization of particular commodities generally distorts relative prices and obstructs the efficient allocation of resources. There are more satisfactory mechanisms for helping the poor, including cash transfers.

Notwithstanding recent progress toward debt reduction, further fiscal consolidation is needed to ensure fiscal sustainability in some countries. While debt-to-GDP ratios have declined almost uniformly across the region, the outcome is not necessarily healthier government balance sheets. Indeed, in some low-income and emerging market economies, debt reduction was not achieved mainly through fiscal consolidation but through privatization receipts, leaving the government's net worth broadly unchanged. To ensure sustainability, further fiscal efforts will be needed, particularly in low-income and emerging market economies.

In countries with sufficient fiscal space, additional spending may be accommodated without endangering macroeconomic stability. Given limited resources and competing demands, the composition and efficiency of spending are critical. In this regard, priority should be given to projects with the highest social returns. Fiscal transparency and good governance are also crucial in ensuring that public spending leads to the targeted outcomes. Finally, macroeconomic policy would benefit from a sound medium-term framework to guide policy and ensure consistency of objectives.

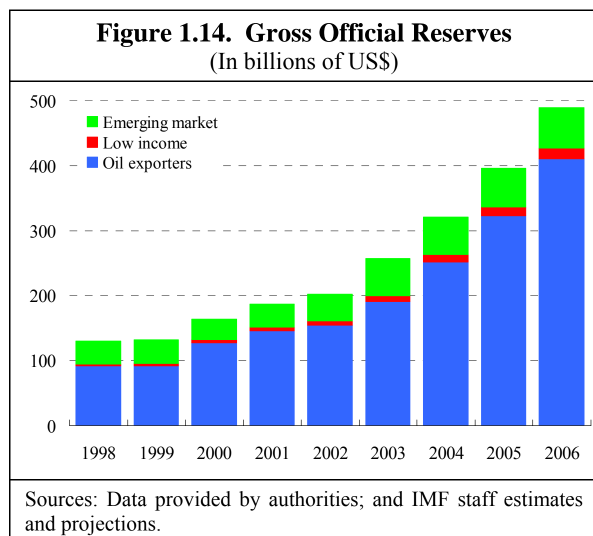
For oil-exporting countries, managing oil revenue will be a central challenge in view of the uncertainty surrounding future oil prices. Policies in this area will affect not only the economies in the region but the global economy as well. To contribute to the adjustment of global imbalances, these countries may need to increase spending on imported goods, which could be facilitated by further liberalizing international trade in some countries. In addition, the inevitable real exchange rate appreciation vis-à-vis the U.S. dollar, the currency of the main debtor country, will help resolve global financial imbalances.

The large inflows of foreign exchange can complicate the conduct of monetary policy. Central banks in the region have been intervening heavily in the foreign exchange market, as evidenced by the large stocks of foreign reserves accumulated during the past two years. Total official reserves stood at US$321 billion as of end-2004 and are expected to reach US$490 billion at end-2006, with the bulk of these reserves held by oil-exporting countries (Figure 1.14).[8] Some countries that experienced large capital inflows have resorted to sterilization to mop up excess liquidity, a policy that may prove costly over time, especially when domestic interest rates are significantly higher than U.S. rates. In some cases, it is becoming increasingly difficult to control broad money growth despite

[8]For the GCC countries, reported reserves only include liquid reserves held by central banks.

heavy sterilization. For these countries, fiscal restraint and better coordination between the fiscal and monetary authorities are necessary to preserve or restore macroeconomic stability.

Figure 1.14. Gross Official Reserves
(In billions of US$)

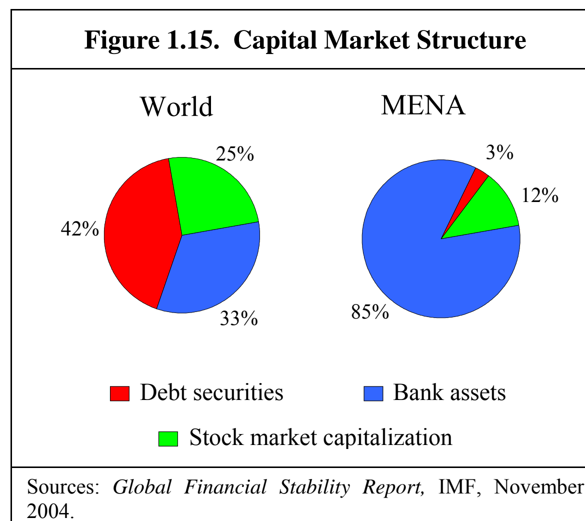


Sources: Data provided by authorities; and IMF staff estimates and projections.

The impact of the large oil-related capital inflows on financial markets needs careful supervision. In particular, continued vigilance from supervisory and regulatory authorities is needed to minimize the impact of a possibly severe correction in asset prices.

It is striking that a region where two-digit unemployment rates are widespread is at the same time a net exporter of capital. This feature of the region's economy, particularly that of the Middle East and North Africa (MENA), is closely related to the level of development of its financial markets.[9] The latter still lag behind those of other regions, making it more difficult to attain the objectives of economic diversification, high growth, and low unemployment. In particular, the concentration of financial intermediation in the banking sector, where government ownership is pervasive, has stifled financial development (Figure 1.15). Although oil exporters accumulated very large amounts of assets, the lack of well-developed financial systems that are capable of deploying those funds within the region implies that oil-related surpluses have often been invested offshore. Some exceptions have recently emerged, including Bahrain and the UAE, which have become international financial centers. But much more remains to be done to transform the region's financial systems into efficient and competitive capital markets, with supervisory and regulatory frameworks that are aligned with international standards. This will entail reducing public ownership and control of financial institutions, strengthening institutional and regulatory frameworks, encouraging financial innovation, building market infrastructure, expanding intra-regional cooperation amongst capital markets, and gradually integrating local markets into the global financial system.

Figure 1.15. Capital Market Structure



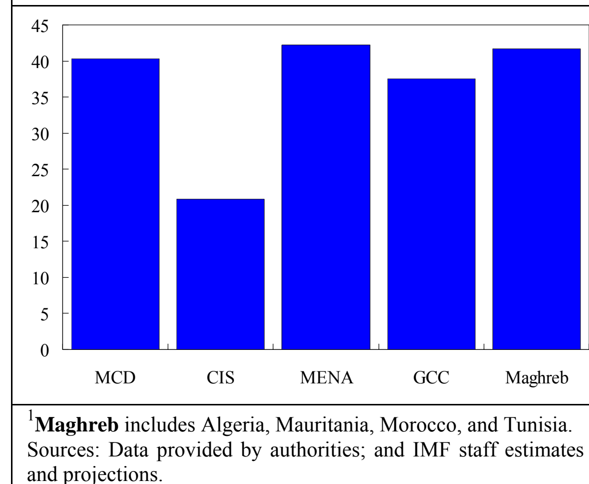
Sources: *Global Financial Stability Report,* IMF, November 2004.

The financial systems in the CIS countries are among the weakest in the region. With the exception of Kazakhstan, financial intermediation in the CIS countries is still underdeveloped, dominated by a fragmented and inefficient banking sector. Credit to the economy, a broad measure of financial development, shows the CIS countries lagging significantly behind the rest of the region (Figure 1.16). In three of the seven CIS countries in MCD—Armenia, Azerbaijan, and Kyrgyz Republic—credit to the private

[9]**MENA** is defined as MCD countries excluding CIS countries.

sector is less than 10 percent of GDP. Macroeconomic stability is critical to the development and performance of the banking sector. In its absence, banks will be geared towards foreign exchange arbitrage or investments in capital markets rather than lending to the real economy. But even as macroeconomic stability is being established, other factors are hindering the development of the banking sector. In particular, state control and the continued use of banks as agents of the government have contributed to the weakness of the CIS banking system. Abolishing the banks' role in tax collection and decreasing state interference are key steps toward a more efficient banking system. Furthermore, the banking sector in CIS countries could benefit from consolidation. Openness to foreign banks could attract strategic investors and bring significant benefits to the domestic banking sector, including increased competition—which should help speed up the restructuring of weak banks—and the introduction of new financial products and risk management practices.

Figure 1.16. Credit to the Private Sector, Average 2000–04[1]
(In percent of GDP)

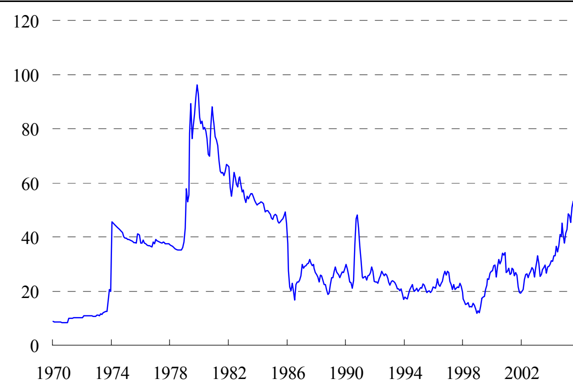


[1]**Maghreb** includes Algeria, Mauritania, Morocco, and Tunisia.
Sources: Data provided by authorities; and IMF staff estimates and projections.

Policies are also needed to mitigate the impact of oil price volatility. Over the past 35 years, oil prices have fluctuated in the range of US$8-96 per barrel in constant 2003 dollars and do not exhibit any clear trend, complicating medium-term forecasting exercises (Figure 1.17). Oil price volatility has a negative impact on macroeconomic stability and growth. This is particularly true for oil-importing developing countries, especially for those where policy frameworks are weak, foreign exchange reserves low, and access to international capital markets limited. For these countries, even a temporary period of higher oil prices can force a substantial adjustment in domestic expenditure, at a considerable cost to growth and poverty reduction. Price volatility can also be harmful to oil exporters, as it constitutes a potential source of fiscal vulnerability and an impediment to sound expenditure planning, especially in countries that do not operate within an appropriate medium-term fiscal framework.

Figure 1.17. Oil Price Deflated by U.S. CPI

(January 1970–July 2005, in US$ per barrel)



Sources: Data provided by authorities; and IMF staff estimates and projections.

Reducing oil price volatility would require a cooperative effort from both producers and consumers. The unpredictability and volatility of oil prices inhibit investments in the oil sector, generating a vicious cycle wherein low or delayed investment activity exacerbates price volatility. In the short run, an adequate increase in oil supply to meet fast-growing demand should dampen fears of shortages and keep prices stable.

Over the medium term, volatility could be reduced if producers, at all levels of the production chain, were to build adequate spare capacity and consumers were to preserve adequate precautionary inventories. Moving toward greater transparency in oil markets, particularly by improving the timeliness and reliability of data on oil demand, supply, and inventories would improve planning and reduce volatility. Oil importers could mitigate the impact of volatility by adhering to a credible and sound medium-term fiscal framework and making greater use of hedging instruments.

The region's medium-term prospects depend critically on the implementation of structural reforms and the resolution of geopolitical tensions. The recent improvement in the region's growth performance has not made a significant dent in unemployment or brought about a sizeable reduction in poverty. Yet, the good macroeconomic performance of the past few years provides an opportunity to address these longstanding problems in the region. In particular, there is fiscal room for the implementation of reforms that would help generate sufficient employment for the rapidly growing working-age population. This would require helping the economies of the region attain even higher growth paths by preserving a stable macroeconomic environment, strengthening the financial system, pushing ahead with institutional reforms, and promoting regional cooperation and further integration into the world economy.

CHAPTER II. RESPONDING TO HIGHER OIL PRICES: POLICIES TO TURN PETRODOLLARS INTO A BLESSING

A. Introduction

High oil prices offer significant development opportunities to oil-exporting economies, but also pose important challenges for macroeconomic policies. Whether oil booms are a blessing or a curse depends, to a large extent, on how oil revenue is managed.[1] To the extent that additional oil resources accrue to the government, these can be used to (i) increase government spending or lower the tax burden; (ii) build up financial assets or reduce debt; and/or (iii) distribute an oil-dividend directly to the population. Experience suggests that too much fiscal expansion can cause problems. By contrast, excessive savings in times of revenue increases can result in missed opportunities to support social and economic development. In fact, not taking advantage of this opportunity may eventually lead to political pressure for a surge in spending. Thus, oil-exporting country governments face the task of choosing the most appropriate use of oil resources, consistent with economic needs and political reality.

High oil prices in recent years have led to substantial additional export receipts for oil-producing countries in the MCD.[2] In fact, the rise in oil prices, which began in 2003, has generated additional oil export receipts equivalent to an annual average of 17½ percent of these countries' total GDP over the last three years.

So far, the economic consequences of this oil boom have been favorable. Oil-producing countries in the MCD have enjoyed robust macroeconomic performance following the recent oil shock. Economic growth has increased from an average of 4½ percent in 1999–2002 to above 7 percent in 2003–05, inflation has remained subdued in most countries, and there has been little upward pressure on real exchange rates. Furthermore, external current account and fiscal balances have improved dramatically in most countries.

Overall, MCD countries appear to have found a good recipe for oil revenue management. This chapter addresses two questions: How have oil-exporting MCD countries handled the higher export receipts? And going forward, how can they best take advantage of the opportunity presented by higher oil revenues to meet their economic challenges?

The main conclusions of this chapter are: First, oil-exporting countries in the MCD region have used oil export receipts prudently and maintained

[1]In this chapter, "oil" is used as a substitute for the more encompassing term "hydrocarbon," since gas is also an important resource in several countries.

[2]See Box 2.1. MCD oil-exporting countries included in this chapter comprise Algeria, Azerbaijan, Bahrain, Iran, Kazakhstan, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Syria is excluded from this chapter in light of the expected substantial decline in oil output over the medium term, (continued…) which means that the proper response to higher oil prices for Syria is fundamentally different from that of other oil exporters. Iraq is also excluded because of lack of data.

Box 2.1. Oil in the Middle East and Central Asia

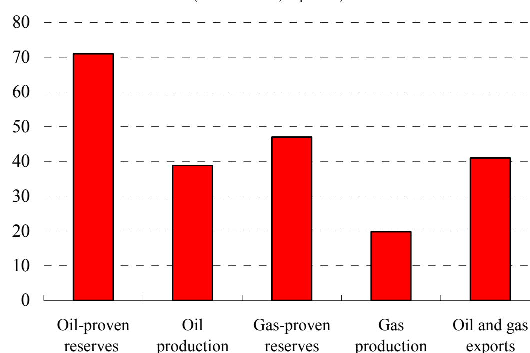
The Middle East and Central Asia (MCD) region has 71 percent of all proven oil reserves in the world, the majority of which is concentrated in Saudi Arabia, Iran, and Iraq (Table a). In addition, almost half of the world's proven gas reserves are in the MCD region, with a large concentration in Iran and Qatar. However, the MCD region's share in global oil production and exports is smaller. MCD's shares of world oil and gas production are 39 percent and 20 percent respectively (Figure a). Furthermore, only 41 percent of world oil exports originate in the MCD region.

Table a. Oil and Gas Reserves and Production, 2004

	Oil		Gas	
	Proven reserves Billion barrels	Production 1000 barrels per day	Proven reserves Trillion cubic meters	Production Million cubic meters per day
Algeria	11.8	1,933	4.5	221.2
Azerbaijan	7.0	318	1.4	11.2
Bahrain	0.1	48	0.1	25.2
Iran	132.5	4,081	27.5	229.6
Kazakhstan	39.6	1,295	3.0	50.4
Kuwait	99.0	2,424	1.6	25.2
Libya	39.1	1,607	1.5	19.6
Oman	5.6	785	1.0	47.6
Qatar	15.2	990	25.8	106.4
Saudi Arabia	262.7	10,584	6.8	173.6
UAE	97.8	2,667	0.5	123.2
Total MCD 1/	843.1	31,157	84.4	1,430.8
World share (in percent)	70.9	38.8	47.0	19.7

Source: BP Statistical Review of World Energy 2005.
1/ Total MCD includes all oil-exporting countries in the region.

Figure a. Oil and Gas in the Middle East and Central Asia, 2004
(share in World, in percent)



Sources: BP Statistical Review of World Energy 2005; and World Economic Outlook.

Oil dependency varies across countries. While in general the oil sector does not dominate domestic output, except in Qatar, exports are not diversified in most MCD countries. Only in UAE do oil exports represent less than 50 percent of total exports (Table b). In most countries in the region, oil revenue constitutes a large share of government revenue.

Table b. Selected Indicators, 2004

	Oil GDP to total GDP	Oil exports to total exports of goods and services	Oil revenue to total government revenue 1/
Algeria	33.7	92.2	71.0
Azerbaijan	30.7	82.7	34.8
Bahrain	13.1	53.8	76.3
Iran	11.5	72.8	61.8
Kazakhstan	17.9	50.5	28.6
Kuwait	41.6	85.5	79.6
Libya	33.7	94.2	85.5
Oman	29.0	76.6	82.6
Qatar	57.8	79.2	60.4
Saudi Arabia	32.4	83.7	84.1
UAE	28.9	44.5	77.2

Source: IMF.
1/ Total revenue excluding grants.

fiscal discipline. Governments have spent less than 30 percent of the additional oil revenue on average. As a result, macroeconomic stability has been largely preserved.

Second, looking forward, managing the higher oil revenues will be a central challenge in addressing both domestic economic needs and global imbalances.

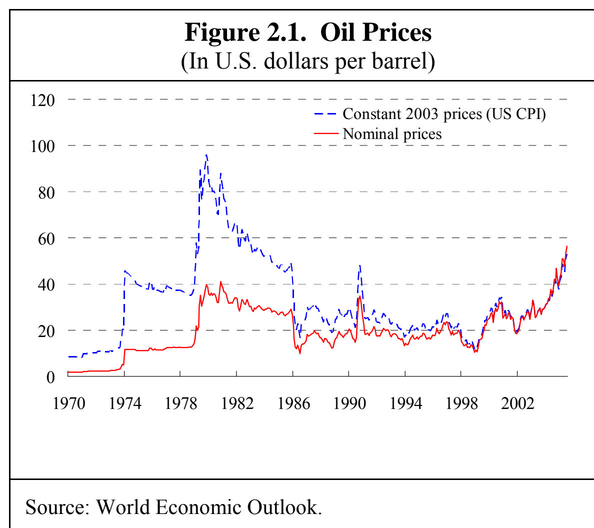
- Increased public spending—particularly in areas that could elicit a supply response—taking into account domestic absorptive capacity, and, in some countries, streamlining the tax system, together with an acceleration of structural and institutional reforms, could place MCD oil-exporting economies on a higher growth path and contribute to reducing unemployment.
- Lower saving is also crucial for MCD countries to play their role in addressing global imbalances, particularly in light of the outlook for sustained high oil prices. In this respect, reducing national savings could take the form of higher spending on tradables as well as possibly financial assistance to countries facing financial difficulties as a result of high oil prices.

The rest of this chapter is organized as follows. Section B estimates the size of the recent oil shock; Section C studies the countries' responses to the higher oil revenue; Section D analyses the domestic macroeconomic outcomes and the global implications of MCD countries' use of the additional oil-export receipts; and Section E discusses policy options and presents some conclusions.

B. Size of the Oil Shock

The size of the current oil-price shock has been smaller than in previous episodes. While at record-high levels in nominal terms, real oil prices in constant 2003 dollars are projected to average $52 per barrel in 2005, compared to $80 per barrel in 1980 (Figure 2.1). Furthermore, the increase in prices during 2003–05 (113 percent) is smaller than in previous episodes (about 250 percent in 1974 and 180 percent in 1979–80).

Figure 2.1. Oil Prices
(In U.S. dollars per barrel)



Source: World Economic Outlook.

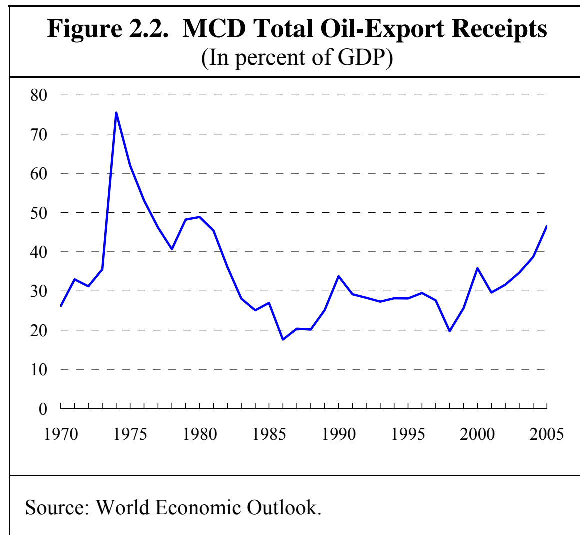
The additional oil export receipts reflect not only higher oil prices, but also significant increases in oil output. Additional oil export receipts are defined as the difference between receipts in 2003–05 and those in 2002. These additional receipts in the MCD countries have increased from $50 billion in 2003 to $126 billion in 2004, and $289 billion in 2005.

While a large part of this increase is related to higher prices, all countries except Oman, have also expanded production to meet rising global demand.[3] The average annual growth in the region's oil output increased from 2.5 percent in 1999-2002 to about 7 percent in 2003-05.

Nevertheless, the magnitude of the additional oil export receipts relative to the size of MCD economies is still smaller than in previous episodes. Notwithstanding the increase in oil export volumes between 1974 and 2005, the additional oil export receipts amounted to an annual average of 17½ percent of GDP in 2003–05, compared to 30 percent in 1974 and 27 percent in 1980 (Figure 2.2). This is partly

[3] In Oman, oil fields are aging and reserves are declining.

Figure 2.2. MCD Total Oil-Export Receipts
(In percent of GDP)



Source: World Economic Outlook.

explained by the decline in these economies' dependency on oil in the last decade.[4]

C. Policy Responses

Overall Use of the Additional Oil Revenue

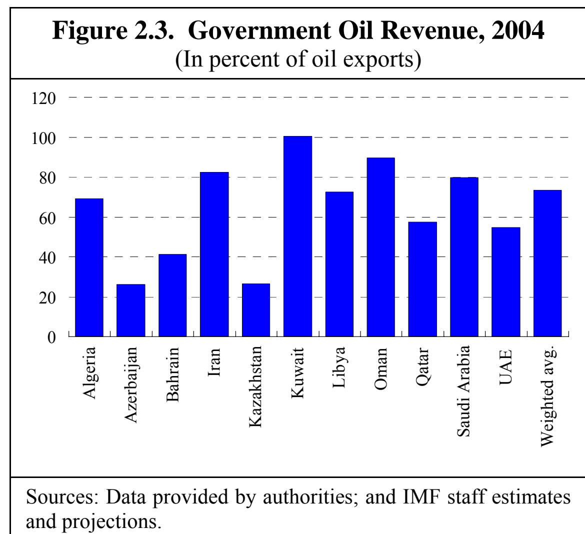
MCD countries are estimated to have saved most of the additional oil GDP. The improvement in the countries' trade balances represented 85 percent of the additional oil GDP, with investment accounting for about 26½ percent (Table 2.1). Public and private consumption declined on average by 2½ and 7½ percent of the additional oil GDP respectively.[5] Given the large government share in the oil sector and thus oil revenue, the impact of the additional oil income is mainly determined by the government's behavior. Thus, since government spending increased only marginally (4 percent of the additional oil GDP), private consumption did not benefit from the additional oil income.

This broad summary, however, obscures differences between countries. As shown in Table 2.1, trade balances have deteriorated in Azerbaijan and Oman, reflecting a strong increase in private investment in Azerbaijan, and higher consumption and public investment in Oman. In Iran, the additional oil GDP has been mostly used to finance private investment.

Fiscal Policy

With the majority of oil export receipts accruing to governments in MCD countries, the conduct of fiscal policy is central to determining the policy response to oil shocks. On average, 73 percent of oil exports accrued to governments as fiscal revenue in 2004 (Figure 2.3). This average masks, however, a large discrepancy between the Middle Eastern countries, where most oil export receipts accrue to governments, and countries such as Azerbaijan and Kazakhstan where only about 25 percent of the oil export receipts accrue to governments. This difference in the distribution of oil receipts is partly explained by the prevalence of state monopolies in Middle Eastern countries versus the more common public-private production sharing arrangements in the new oil exporting countries.

Figure 2.3. Government Oil Revenue, 2004
(In percent of oil exports)



Sources: Data provided by authorities; and IMF staff estimates and projections.

[4] In 2003-05 oil exports represented, on average, 74 percent of total exports and 40 percent of GDP. This compares with 91–64 percent and 89–49 percent, respectively, in the 1974 and 1979-80 episodes.

[5] The magnitude of the decline in private consumption should be analyzed with some caution, as in most countries, private consumption is calculated as a residual and, therefore, contains statistical errors.

Table 2.1. Use of Additional Oil GDP, 2003–05

(Base year = 2002; in percent)

	Additional Oil GDP[1]	Use[2]					
		Net Exports	Public Investment	Private Investment	Changes in Inventories	Public Consumption	Private Consumption[3]
Algeria	18.3	15.0	3.8	2.7	-1.0	1.0	-3.2
Azerbaijan	7.0	-12.8	-0.5	18.7	0.0	-3.9	5.6
Bahrain	2.2	6.5	-3.1	8.3	2.6	-1.2	-3.6
Iran	5.4	2.7	-0.5	2.9	-3.5	-1.5	-1.5
Kazakhstan	15.4	12.9	-7.5	9.4	2.4	2.5	0.5
Kuwait	54.0	49.0	3.2	3.8	0.0	-0.3	-1.8
Libya	141.0	116.9	23.6	..	..	18.8	..
Oman	9.7	-4.2	7.7	2.3	0.0	-0.8	4.7
Qatar	43.9	63.5	6.5	-6.0	1.5	0.8	-19.4
Saudi Arabia	32.9	27.3	4.2	-0.1	-0.2	0.7	0.4
United Arab Emirates	17.0	16.2	-0.7	1.6	0.4	-2.2	2.5
Average[4]	20.6	17.6	1.3	4.4	0.2	-0.5	-1.6
In percent of additional oil GDP		85.5	6.4	21.1	1.0	-2.4	-7.6

Source: IMF staff estimates and projections.

[1]The additional oil GDP is defined as the difference between the ratio of oil GDP to non-oil GDP in 2003-05 and the value of this ratio in the base year.

[2]The use is defined as the difference between the ratio of use to non-oil GDP in 2003-05 and the value of this ratio in the base year.

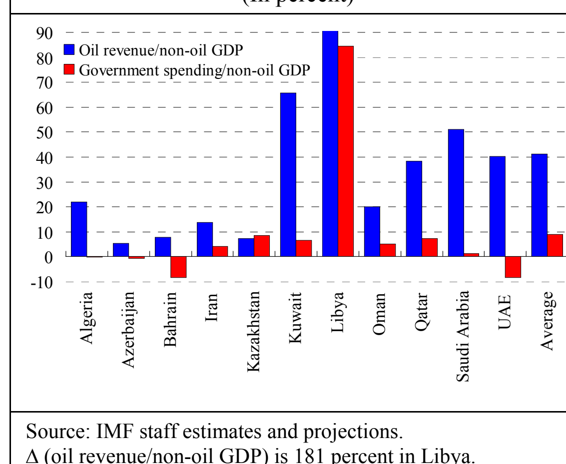
[3]Residual, including errors.

[4]Excluding Libya.

In most countries, government spending policies did not follow the strong growth in oil revenue resulting from the oil shock (Figure 2.4). Whereas the ratio of government oil revenue to non-oil GDP jumped on average from 41 percent in 2002 to a projected 81 percent in 2005, government spending increased only from 56 percent of non-oil GDP in 2002 to 60 percent in 2003, and to 63 percent in 2004–05. In some countries (e.g., Algeria, Azerbaijan, Bahrain, and UAE), government spending in percent of non-oil GDP actually declined between 2002 and 2005. Kazakhstan stood apart from the group by its somewhat looser spending policy.[6]

Figure 2.4. Change in Government Spending Versus Change in Oil Revenue, 2002–05

(In percent)



Source: IMF staff estimates and projections.
Δ (oil revenue/non-oil GDP) is 181 percent in Libya.

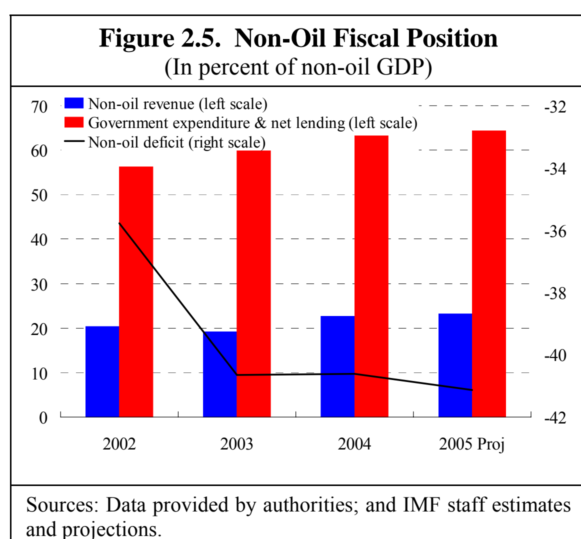
[6]In Libya, the increase in government spending in percent of non-oil GDP is largely due to a decline in non-oil GDP in absolute terms.

As a result, the fiscal position in most countries improved dramatically, with an average overall budget surplus rising from 2 percent of GDP in 2002 to about 15½ percent in 2005. Countries' prudent policies have contributed significantly to reducing fiscal vulnerability.

However, in oil-exporting countries, the overall fiscal position is not an informative indicator of the fiscal stance. Given most governments' high dependency on oil revenues in these countries, government revenue increases sharply during oil price booms. As a result, fiscal positions may improve, even when expenditures rise in an unsustainable fashion. A better indicator of the fiscal stance is the non-oil deficit in relation to non-oil GDP, as it measures the fiscal stimulus, and provides a measure of fiscal vulnerability by delinking the fiscal stance from oil revenues.

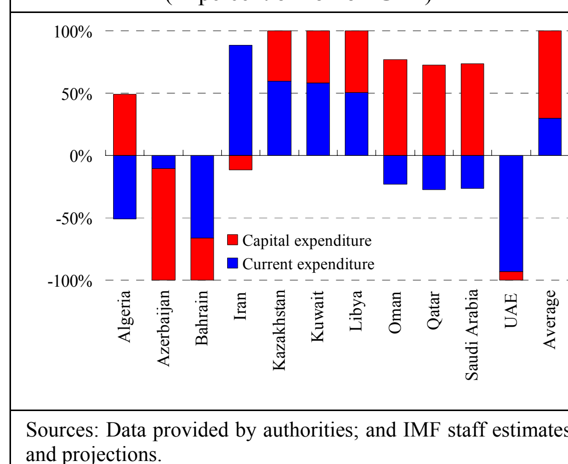
This indicator of the fiscal stance also shows that most countries adopted prudent fiscal policies. The modest increase in spending to non-oil GDP, together with a slight improvement in non-oil revenue to non-oil GDP, has led to a very slight loosening of the non-oil fiscal stance in most countries and provided some fiscal stimulus to domestic demand (Figure 2.5). Thus, the non-oil fiscal deficit relative to non-oil GDP widened, on average, from 36 percent in 2002 to 41 percent in 2005. In Bahrain, Qatar, and in the UAE the fiscal stance was tightened during this period.

Figure 2.5. Non-Oil Fiscal Position
(In percent of non-oil GDP)



Sources: Data provided by authorities; and IMF staff estimates and projections.

Figure 2.6. Composition of the Change in Government Spending Between 2002 and 2005
(In percent of non-oil GDP)



Sources: Data provided by authorities; and IMF staff estimates and projections.

In most countries, the increase in government spending was concentrated in capital expenditures (Figure 2.6). On average, the increase in capital outlays—mainly on infrastructure and housing—accounted for 85 percent of the rise in government spending, with higher current spending (mostly subsidies or social outlays) playing a dominant role only in Iran, Kazakhstan, and Kuwait. Most countries have also increased wages. The wage bill, however, has grown in line with non-oil GDP, except in Azerbaijan and Kazakhstan, where wages were very low to start with (Box 2.2).[7]

Governments in most MCD oil-exporting countries have saved a major part of the additional oil revenue (Figure 2.7). On average, only 26 percent of the additional oil revenue was used to finance the deterioration in the non-oil fiscal balance, while the remaining 74 percent was saved (45 percent to build assets and 29 percent to repay public debt). This behavior, however, was not homogenous across countries, depending on each country's investment needs

[7] The increase in Libya's wage bill relative to non-oil GDP was due to a decline in non-oil GDP in absolute terms.

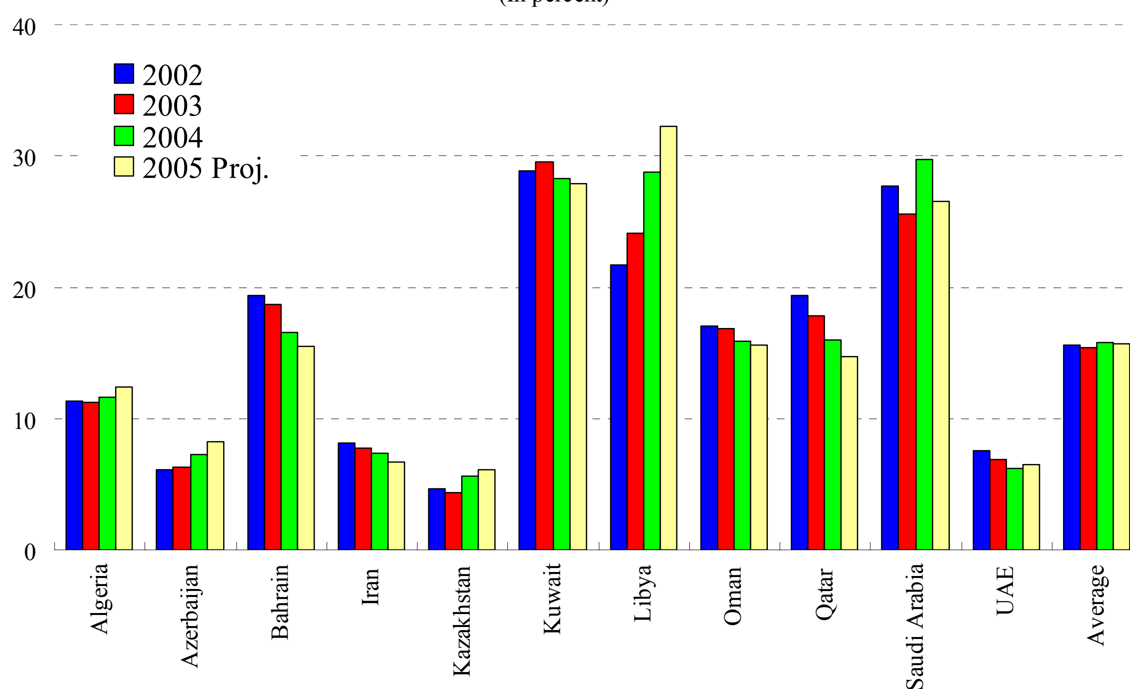
Box 2.2. Wage Increases in MCD Oil-Exporting Countries

Out of the 11 oil-exporting MCD countries considered in this chapter, 7 have increased either the minimum wage or public sector wages or both over 2003–05. Increases ranged from 15 percent to 50 percent. In addition, the Kuwaiti authorities provided handouts of KD 200 (US$ 680) to all citizens in January 2005; Saudi Arabia granted a two-month salary bonus to military and security forces in 2004; and the Iranian authorities raised pensions in late 2004.

- In **Algeria**, the authorities raised the minimum wage by 25 percent on January 1, 2004. To date, most other salaries have not increased correspondingly. However, family allowances and pensions have increased, as these are linked to the minimum wage.
- In **Azerbaijan**, starting from a very low base of less than US$6 per month, the minimum wage increased more than three-fold between December 2002 and January 2005. The minimum wage is currently around US$26. Average public sector wages increased by 25 percent in 2003–04. The wage bill rose by 1 percentage point of GDP over the same period.
- In **Bahrain**, the minimum wage increased by 43 percent in 2002–03.
- In **Iran**, nominal wages increased in fiscal year 2004/05 by 14 percent, less than the average CPI inflation rate of 15.6 percent
- In **Kazakhstan**, wages of civil servants and health and education workers were increased by 30 percent on July 1, 2005, along with large increases in the minimum wage and in pensions.
- In **Saudi Arabia**, the authorities increased wages of government employees by 15 percent on August 23, 2005. This was the first across-the-board salary increase in more than 20 years.
- In the **UAE**, the Federal government raised wages by 25 percent for nationals and 15 percent for foreigners on April 6, 2005. The individual Emirates, including Abu Dhabi, have followed suit with similar increases.

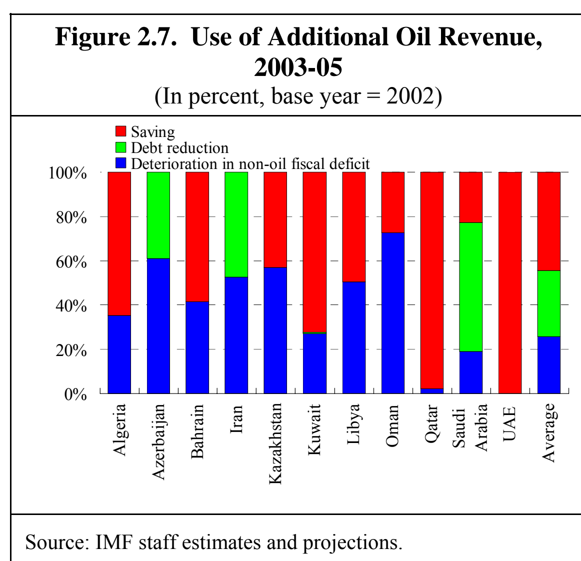
Government Wage Bill/Non-Oil GDP, 2002-05

(In percent)



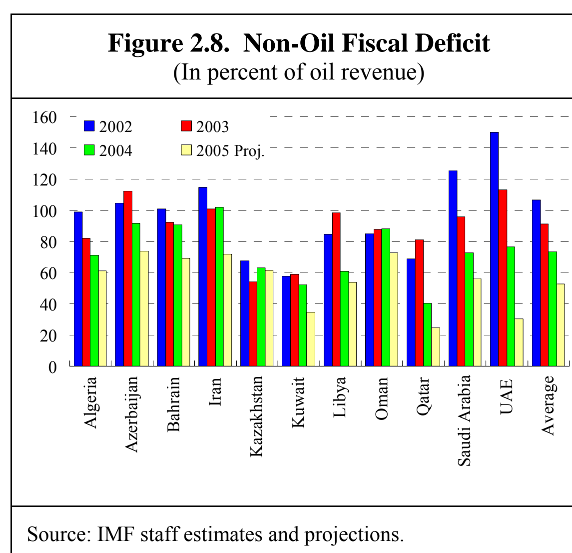
Sources: Data provided by country authorities; and IMF staff estimates and projections.

Figure 2.7. Use of Additional Oil Revenue, 2003-05
(In percent, base year = 2002)



Source: IMF staff estimates and projections.

Figure 2.8. Non-Oil Fiscal Deficit
(In percent of oil revenue)



Source: IMF staff estimates and projections.

and priorities: governments in Azerbaijan, Iran, Kazakhstan, Libya, and Oman used a large part of the additional oil revenue to finance higher non-oil deficits. In contrast, the governments of Qatar and the UAE saved all the additional revenue. In Saudi Arabia, the authorities have mainly reduced public debt.

These developments, however, should be put in context, as the initial fiscal position of individual countries had an impact on the use of the additional oil revenue (Figure 2.8). In some countries, such as Saudi Arabia and the UAE, the non-oil fiscal deficit in 2002 was already larger than oil revenue, suggesting high fiscal vulnerability to oil-price movements. For these countries, the prudent use of the additional oil revenue has helped reduce this vulnerability. In other countries, such as Kazakhstan, the initial fiscal position was less vulnerable to oil-price movements, with less than 70 percent of oil revenue being used to finance the non-oil fiscal deficit in 2002. Thus, in spite of using a large part of the additional oil revenue to finance a larger non-oil fiscal deficit, Kazakhstan has kept the ratio of non-oil fiscal deficit to oil revenue broadly unchanged. In all countries, fiscal vulnerability to negative oil price shocks declined in 2003–05, although Azerbaijan, Iran, and Oman still show a high degree of vulnerability, with a ratio of non-oil fiscal balance to oil revenue of more than 70 percent.

Overall, oil funds appear to have played a positive role in improving oil revenue management. While in most countries there are no formal fiscal rules, all MCD countries with the exception of Saudi Arabia and the UAE have set up oil funds, mainly for stabilization purposes. At the same time, all countries have set conservative oil prices in their budgets—with the objective of smoothing expenditures and increasing savings in the oil funds—which has enhanced fiscal discipline (Table 2.2).

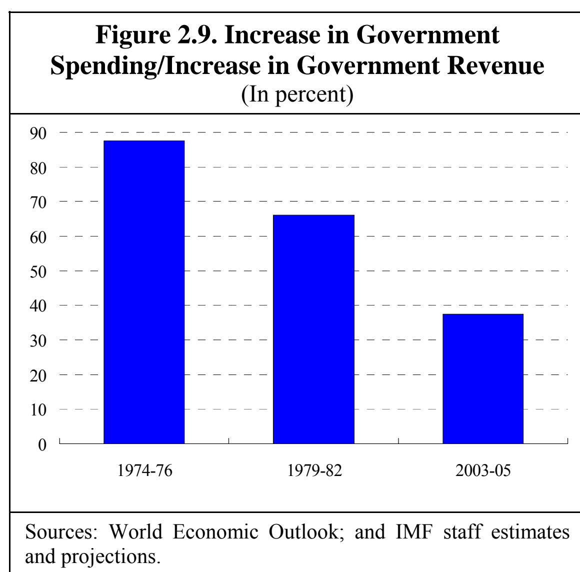
These results and policies should, however, be seen as countries' short-run responses to the oil shock. The responses may differ over time if there are lags in spending or the increases in oil prices persist. However, so far, the annual rates of expenditure growth declined between 2003 and 2005 in most countries (with the exception of Algeria, Azerbaijan, and Bahrain). Finally, the additional oil revenue spent by governments has thus far been much smaller than in previous episodes of rising oil prices (Figure 2.9).

D. Macroeconomic Outcomes and Global Implications

Macroeconomic outcomes

The increase in both oil prices and output has

Figure 2.9. Increase in Government Spending/Increase in Government Revenue
(In percent)



Sources: World Economic Outlook; and IMF staff estimates and projections.

boosted economic activity and prospects for oil-producing countries in the MCD region. Real GDP growth has increased from an average of 4½ percent in 1999–2002 to more than 7 percent in 2003–05 (Table 2.3). Non-oil GDP growth has also increased in most countries. Higher economic growth, in turn, has resulted in a decline in the unemployment rate in all the MCD countries for which data are available.

Higher oil-related inflows, together with prudent policies, have led to stronger external positions. Although imports increased by half of the additional oil export receipts, the average external current account surplus increased from 11 percent of GDP in 1999–2002 to 16 percent in 2003–05. The accumulation of international reserves accounted for 50 percent of the additional oil export receipts, as higher oil exports, together with interest income and remittances were partly offset by higher imports, debt reductions, and outward investments. International reserves rose from an average of 8½ months cover of imports in 1999–2002 to 10½ months in 2003–05.

Broad money and credit growth have started to increase in most countries. However, the current increase in money, averaging 19½ percent per year in 2003–05, is still limited when compared to previous episodes (57 percent in 1974 and about 25 percent in 1980). Inflation has remained subdued, owing mainly to the prudent fiscal policies being pursued. Low inflation could also be explained by the low global inflation in a context characterized in general by fixed exchange rates, and by the fact that an important share of domestic demand is channeled through imports. Finally, flexible labor markets and free movement of capital in the GCC countries are also important factors to take into account when explaining the current price stability in these countries. However, money and credit growth—together with buoyant investor confidence and an apparent increase in investor home bias following September 11—has fueled significant increases in equity and property prices.

So far, the oil shock has not led to a loss of external competitiveness. In the wake of the depreciation of the U.S. dollar against the Euro, domestic currencies, which in most countries are pegged to the U.S. dollar, have depreciated in nominal effective terms, except in Kazakhstan. In light of countries' prudent fiscal policies and the absence of inflationary pressures, real effective exchange rates have also depreciated in most countries, except in Kazakhstan and Qatar in 2004, and, more recently, in Azerbaijan.[8] This outcome contrasts with past episodes of real exchange rate appreciation.

Global Implications

In addition to the negative impact of high oil prices on global growth, the policy responses of oil-exporting countries have implications for global activity. The increase in international oil prices results in a transfer of world income from net importers to net exporters. To the extent that oil exporters save oil-export receipts, and given that oil consumers' propensity to spend is larger than that of oil exporters, there will be a

[8]The situation has turned around in Kazakhstan in 2005, as the real exchange rate has been depreciating in recent months.

Table 2.2. Objectives and Features of Oil Funds

Country	Name of the Fund	Stated Objective (s)	Date Established	Accumulation Rules	Withdrawal Rules	Manager	Fund Savings	Balance As of End-2004
Algeria	Revenue Regulation Fund	Stabilization	2000	Residual hydrocarbon revenue after budget allocation; exceptional advances by the central bank to the Treasury	Transfers to the budget if hydrocarbon revenue outcome less than budgeted; and debt repayment.	...	Domestic Account at the Central Bank	US$ 10,015 Mn (11.8% of GDP)
Azerbaijan	State Oil Fund of Azerbaijan Republic	Stabilization and Saving	1999	All revenues associated with the post-Soviet oil and gas production fields	Withdrawals cannot exceed inflows in a given year. Transfers to the budget to finance selected capital expenditure projects and expenditures related to refugees with parliament approval	International asset management company and State Oil Fund	Abroad	US$ 974 Mn (11.4% of GDP)
Bahrain	Reserve Fund for Strategic Projects	Stabilization	2000	Residual oil revenue after budget allocation	Discretionary transfers to the budget	Ministry of Finance and National Economy	Abroad	US$ 936 Mn (8.5% of GDP)
Iran	Oil Stabilization Fund	Stabilization	2000	Residual oil revenue after budget allocation	Discretionary transfers to the budget with parliament approval. 50 percent of resources can be used for lending to private sector in foreign currency	Ministerial Committee	FX account at the Central Bank	US$ 9,435 Mn (5.9% of GDP)
Kazakhstan	National Fund of the Republic of Kazakhstan	Stabilization and Saving	2001	Saving: 10 percent of the budget baseline revenue. Stabilization: residual oil revenue above the baseline price and royalties generated by a number of identified companies;[1] privatization receipts; and bonus payments.	Subject to the President approval	National Bank of Kazakhstan	Abroad	US$ 5,131 Mn (12.6% of GDP)

Country	Name of the Fund	Stated Objective (s)	Date Established	Accumulation Rules	Withdrawal Rules	Manager	Fund Savings	Balance As of End-2004
Kuwait	General Reserve Fund	Stabilization and Saving	1960	Investment of the residual budgetary surpluses in Kuwait's financial and real estate markets	Discretionary transfers to the budget	Kuwait Investment Authority	Domestic financial and real estate markets	NA
	Reserve Fund for Future Generations	Saving	1976	10 percent of government revenue	Discretionary transfers to the budget with National Assembly approval	Kuwait Investment Authority	International capital markets	NA
Libya	Oil Reserve Fund	Stabilization	1995	Residual oil revenue after budget allocation	Discretionary transfers to the budget	...	Domestic Account at the Central Bank	NA
Oman	State General Reserve Fund	Saving	1980	Since 1998, oil revenue in excess of budgeted amount	Discretionary transfers to the budget	Ministry of Finance	Abroad	NA
	Oil Fund	Oil Sector Investment	1993	Since 1998, market value of 15,000 barrels per day	--	Ministry of Finance	Abroad	NA
Qatar	Stabilization Fund	Stabilization	2000	Residual oil revenue after budget allocation	Lending to the budget	NA	NA	US$ 4,268 Mn (15% of GDP)
	State Reserve Fund	Saving	NA	NA	NA	NA	Abroad	NA
Saudi Arabia	None	--	--	--	--	--	--	...
United Arab Emirates	None	--	--	--	--	--	--	...

[1] Since 2001, the Kazakhstani authorities have reduced the number of identified hydrocarbon companies from 14 to 7.

Table 2.3. MCD—Selected Economic Indicators, 1999–2005[1]

(In percent, unless otherwise indicated)

	Average 1999–2002	2003	2004	2005
Real GDP growth rate	4.3	8.2	6.6	6.9
Real oil GDP growth rate	2.5	9.8	4.5	7.4
Real non-oil GDP growth rate	5.1	7.7	6.9	6.8
Inflation rate	2.1	3.0	4.6	5.6
Variation in the nominal effective exchange rate	-1.6	-8.5	-5.4	...
Variation in the real effective exchange rate	-1.8	-9.0	-4.0	...
External current account balance/GDP	11.2	9.4	14.1	23.7
Reserves (in months of imports of g&s)	8.5	9.5	10.6	10.7
Fiscal Balance/GDP	2.4	3.0	8.4	15.5
Broad money growth	12.3	16.5	23.1	18.4
Growth in credit to the economy	15.3	18.4	26.1	18.1
Memorandum item				
Oil price (US$/barrel)	23.9	28.9	37.8	54.3

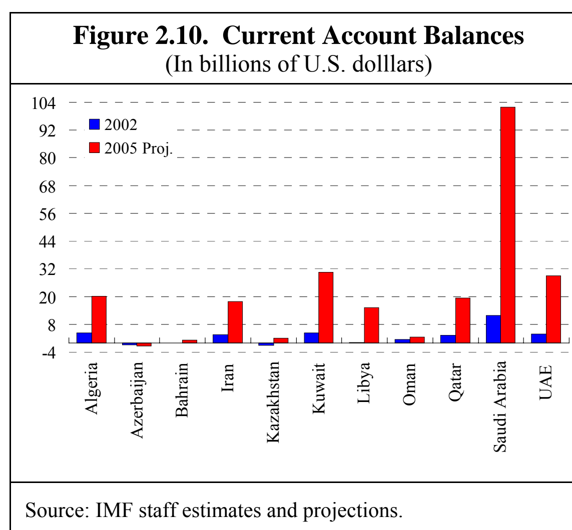
Sources: *World Economic Outlook;* INS; and IMF staff estimates and projections.

[1]Simple averages.

contractionary effect on global aggregate demand, which will result in a lower global growth. Lower global growth, in turn, would have a negative impact on MCD economies through a decline in oil prices, as well as a drop in the demand for the non-oil goods and services of MCD countries. The lower is the propensity of oil exporters to spend the higher would be the negative impact on global aggregate demand. In the current situation, the potential transfer of income from oil importers to MCD oil-exporting countries of an increase in oil prices of US$10 per barrel is estimated at about 0.2 percent of global GDP.

Furthermore, large savings of oil-export receipts would exacerbate external current account imbalances. With a 70 percent saving rate of the additional oil-export receipts, the oil-exporting MCD region is now running a larger external current account surplus in U.S. dollar terms—projected to about US$240 billion at end-2005 (Figure 2.10)—than Emerging Asia, and thus, becoming an increasingly large counterpart to the U.S. current account deficit. Such large saving

Figure 2.10. Current Account Balances
(In billions of U.S. dolllars)



Source: IMF staff estimates and projections.

rates amplify the present risks of a disorderly adjustment of global imbalances over the medium term.

E. Policy Options

Prospects of a period of high oil prices present a unique opportunity for MCD oil-exporting countries to address the challenges of lifting growth and reducing unemployment. While relatively high growth rates have had a positive impact on job creation over the past few years, there is a need to solidify the foundations for stronger and sustained growth. High oil revenues should not prevent governments in the region from moving ahead vigorously with needed market-based reforms, including privatization, deregulation, and liberalization. Governments should also seize the opportunity provided by the buoyant oil revenues to foster the development of the non-oil sector and generate sustainable employment prospects for the rapidly growing labor force. With the current low inflation environment, there is room to gradually increase government spending or, for some countries, to reduce the tax burden without overheating the economy.

Higher spending is also important from a global point of view. In order to contribute to resolving global imbalances, oil-producing countries in the MCD region should reduce savings within a sustainable fiscal framework and allow for a gradual real exchange rate appreciation as appropriate. The resulting additional expenditure would partly offset the negative impact of higher oil prices on global aggregate demand and would reduce global current account imbalances.

Spending priorities or tax cuts should take into consideration individual countries' needs and spending returns. While financing capacity-enhancing reforms would have a lasting impact on growth and productivity, it is also important to address countries' specific needs, which could vary from infrastructure investment to social spending to reducing private sector labor costs.

- In countries with relatively high rates of unemployment, spending on infrastructure as well as on job-creation programs would enhance private sector-led growth.
- In countries with weak social indicators, spending on health and education would likely carry high social returns.
- In countries with a high incidence of poverty, fostering growth and strengthening social protection mechanisms should be a priority.
- Lastly, in countries where the existing debt burden is high, retiring part of that debt would prove beneficial.

Domestic spending should increase gradually, taking into account countries' specific macroeconomic conditions, their absorptive capacities, and long-term sustainability. Thus, the main challenge is to achieve an orderly increase in domestic demand. In countries where inflationary pressures are evident, fiscal prudence is called for. In countries where public spending is already expansionary (as in Kazakhstan, Libya, and Oman), further spending hikes should take account of the economy's absorptive capacity to ensure quality and effectiveness. To this end, governments need to develop well-established budgetary procedures and a medium-term expenditure framework to assess future recurrent spending implications. In countries where the current level of public spending is unsustainable (e.g., Oman), governments should keep in mind the need to gradually move toward sustainability over the medium term. In Oman, where oil revenue accounts for a large portion of total government revenue and oil reserves are declining, a larger share of the additional oil revenue needs to be saved to avoid a disorderly adjustment of the fiscal position in the future. In countries where non-oil tax revenue is relatively high in percent of non-oil GDP, there is also room for streamlining the tax system.

Spending on tradables should also be an option in light of the apparently permanent feature of the current oil boom. While further spending may be needed as a contribution to resolving the rising global imbalances, it would also be important to

direct such spending toward the rest of the world to avoid potential risks of overheating that could result from higher domestic spending. One way to address this issue could be through shifting the composition of the additional government spending toward tradable sectors. Another way, which is applicable to some countries, lies in further liberalizing international trade. In addition, MCD oil-exporting countries could extend financial assistance (directly or through international organizations) to countries facing financial difficulties as a result of higher oil prices.

The implementation of key structural reforms should accompany the higher spending to offset the impact of a potential real exchange rate appreciation on competitiveness in non-oil tradables. In addition, with indications that inflationary pressures may be emerging, country authorities' should monitor closely the implications of higher spending, and stand ready to tighten demand policies if needed.

CHAPTER III. REAL EXCHANGE RATE PRESSURES: POLICY CONSIDERATIONS

A. Introduction

Many transition economies in the Caucasus region and Central Asia (CCA) have experienced upward pressure on their nominal exchange rates over the past two years. Some country authorities have attempted to alleviate this pressure by intervening in the foreign exchange market. In Armenia, Azerbaijan, Georgia, and Kazakhstan, however, *real* exchange rates have started to appreciate, after many years during which there had been no significant increases. These four countries have witnessed robust growth rates and buoyant demand in connection with their ambitious economic reform programs and the global energy boom. Surging foreign exchange inflows related to foreign direct investment, remittances, increased confidence, and energy exports have been important sources of money creation which has been difficult to absorb at times.

For a variety of reasons, upward pressures on real exchange rates (RERs) are not evident in the other Central Asian countries, namely the Kyrgyz Republic, Tajikistan, and Uzbekistan (see Figure 3.1). Data deficiencies in Turkmenistan make it difficult to assess exchange rate pressures in that country. Thus, this paper concentrates on the South Caucasus countries and Kazakhstan (henceforth referred to as the CCA-4).

Other transition countries, such as those in Central and Eastern Europe, have typically experienced strong RER appreciations in the course of the transition process. This reflected an initial disequilibrium, followed by an adjustment in the equilibrium exchange rate induced by productivity gains related to market-based reforms. The appreciation was also driven at times by foreign capital inflows. Strong inflows of foreign exchange present opportunities for financing higher rates of consumption and investment, and for fostering higher growth in real incomes. However, such inflows present major challenges for policymakers, particularly as regards the conduct of monetary policy. They could also damage a country's external position over time in the absence of gains in productivity.

The transition economies in the Caucasus and Central Asia region appear to be undergoing a similar experience. A continued positive external outlook and mounting pressure for domestic spending would suggest that RER appreciation is likely to persist for the foreseeable future. Resistance in some quarters to nominal exchange rate appreciation suggests the need to review the facts and consider the policy options in light of experiences elsewhere.

This chapter (i) examines recent trends in RERs, external indicators, and foreign exchange markets in the CCA-4 to explore the size and sources of RER appreciation at this juncture; (ii) reviews the policy responses adopted by country authorities and their impact on other key indicators; and (iii) discusses the key elements of an appropriate policy response and the priority factors influencing that policy response.

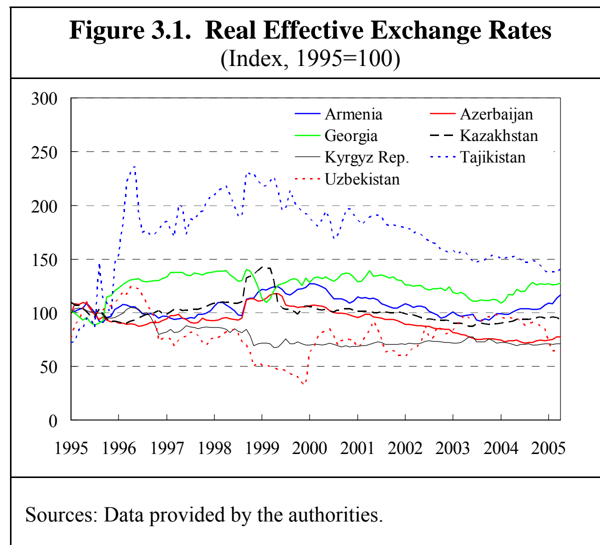
B. Recent Developments

Real Exchange Rates

The Russian devaluation in 1998 resulted in a large shift in the real effective exchange rates

(REERs) of neighboring states (Figure 3.1). This was followed by a period of relative stability between 2000–04. At present, the REERs in most CCA countries remain close to, or are more depreciated than, their 1999 levels (see also Box 3.1, Section D).

Figure 3.1. Real Effective Exchange Rates
(Index, 1995=100)

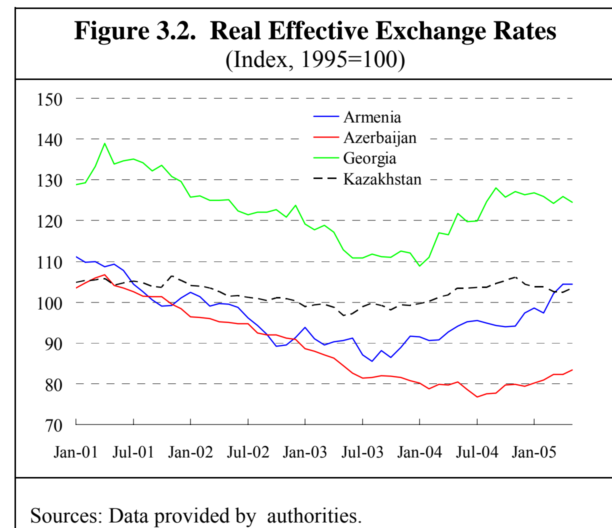


Sources: Data provided by the authorities.

More recent trends indicate that REERs in the CCA-4 bottomed out in late-2003 and began to rise in early 2004 (Figure 3.2). Between January 2004 and May 2005, the REER had appreciated by 14 percent in Armenia and Georgia, and by about 4 percent in Azerbaijan and Kazakhstan.

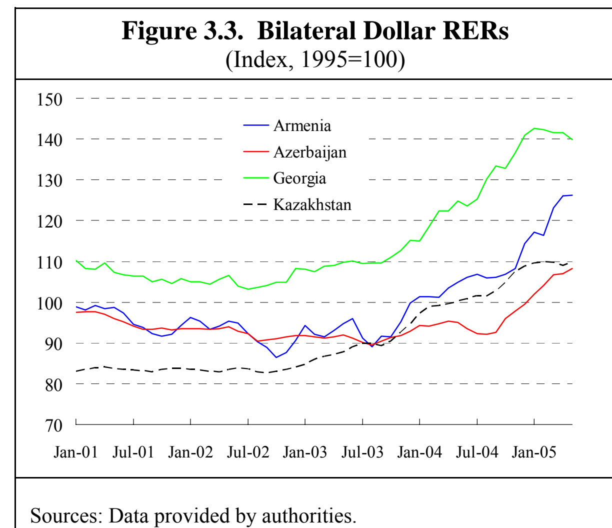
Bilateral real exchange rates (BRERs) with the U.S. dollar and with the Russian ruble have moved in opposite directions (Figures 3.3 and 3.4). The dollar BRERs show a clear appreciation since 2001, while the ruble BRERs depreciated steadily between 1999 and 2003, before stabilizing in 2004 (the ruble BRERs for Armenia and Azerbaijan have appreciated in 2005). Inflation over the period in these four countries was higher than in the United States and lower than in Russia. Given Russia's continued importance as a major trading partner, differentials with Russia have a stronger impact on the REER and export competitiveness than do those with the United States.

Figure 3.2. Real Effective Exchange Rates
(Index, 1995=100)



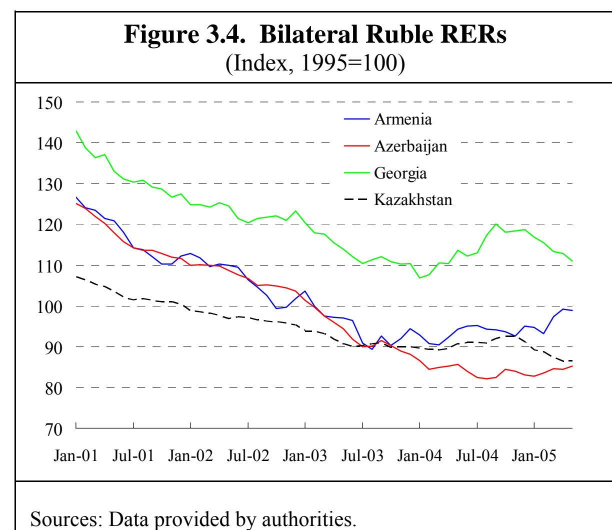
Sources: Data provided by authorities.

Figure 3.3. Bilateral Dollar RERs
(Index, 1995=100)



Sources: Data provided by authorities.

Figure 3.4. Bilateral Ruble RERs
(Index, 1995=100)



Sources: Data provided by authorities.

Sources of Real Exchange Rate Pressures

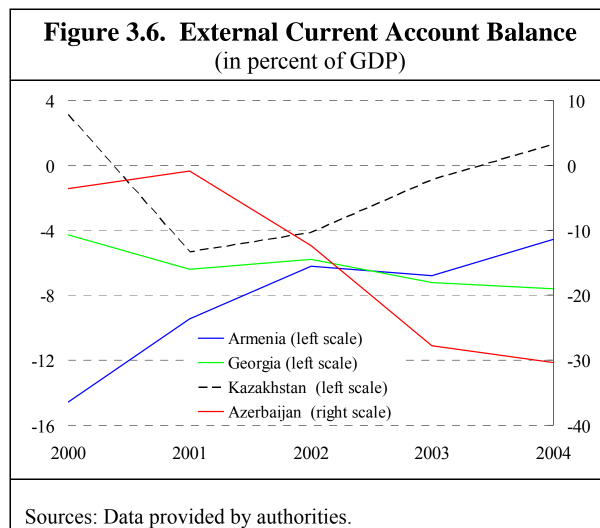
Looking at balance of payments and monetary indicators provides information about the different sources of pressures on exchange rates, and on the likely direction and size of exchange market pressures that can be expected in the near term. In general, foreign exchange inflows increased significantly in 2003 and 2004 and contributed to upward pressure on RERs. Evidence of higher domestic spending as a source of pressure emerged in 2004 and 2005.

Annual real GDP in the CCA-4 grew on average by around 10 percent over the past five years, except in Georgia where growth averaged 6 percent over the same period. The export sector, including non-energy related exports, was an important engine of growth during this period (Figure 3.5). Export growth (in U.S. dollar terms) is forecast to ease in 2005, although it is expected to remain in double digits.

Reflecting the strong export performance, remittance inflows, and favorable terms of trade, current account balances improved between 2001 and 2004 in all the CCA-4 countries except Georgia (Figure 3.6). In Azerbaijan, the large deterioration in the current account deficit was mostly due to oil-related imports financed by surges in FDI; net of these, the current account has been in surplus.

The deficits in Georgia and Armenia are expected to widen slightly in 2005 as import growth outpaces export growth.

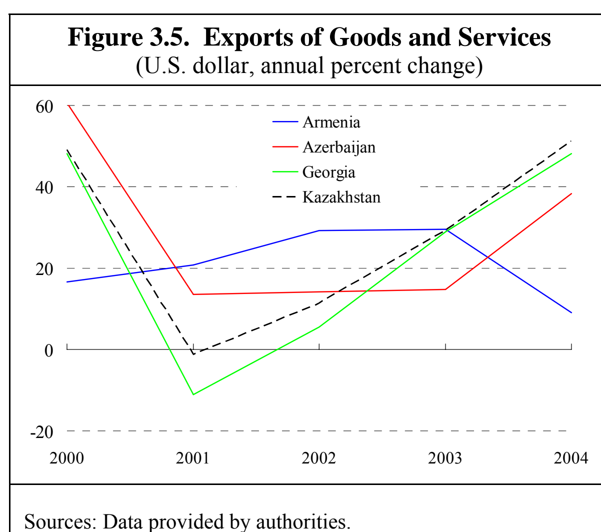
Figure 3.6. External Current Account Balance
(in percent of GDP)



Sources: Data provided by authorities.

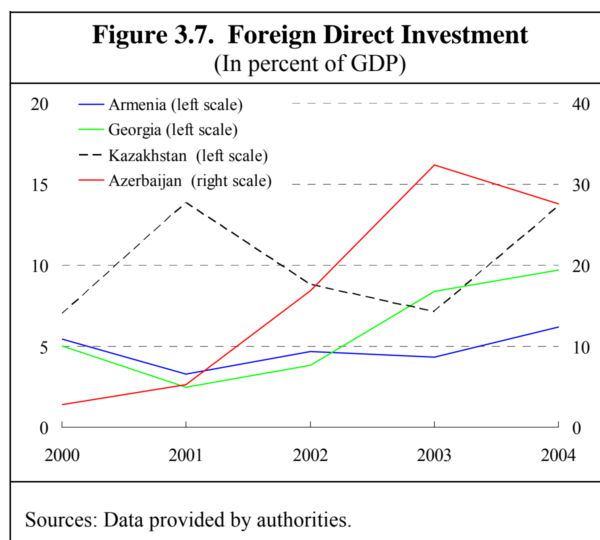
Foreign Direct Investment (FDI) flows and international reserves have been rising in all CCA-4 countries (Figures 3.7 and 3.8). FDI has been driven by investment in the energy sector (including pipelines) and mining (gold), as well as by flows related to privatization in other sectors. The increase in international reserves also reflects strong export growth and remittances.

Figure 3.5. Exports of Goods and Services
(U.S. dollar, annual percent change)



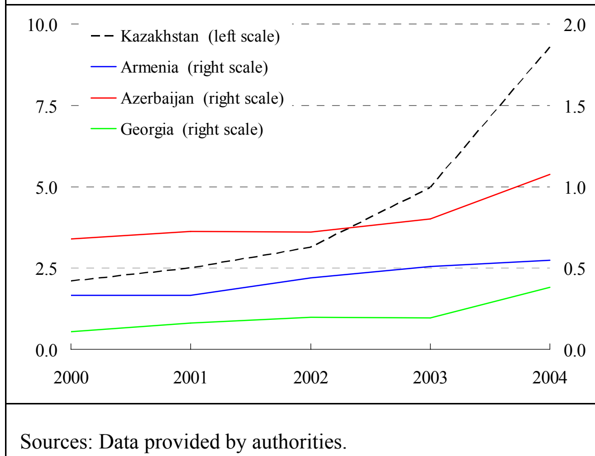
Sources: Data provided by authorities.

Figure 3.7. Foreign Direct Investment
(In percent of GDP)



Sources: Data provided by authorities.

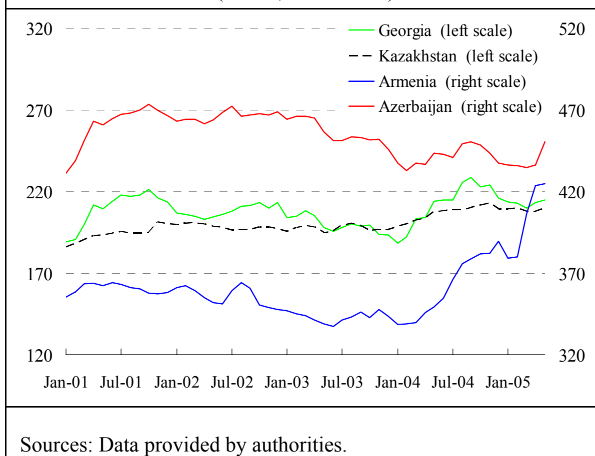
Figure 3.8. Gross Official International Reserves
(in billions of U.S. dollars)



Sources: Data provided by authorities.

The path of the nominal effective exchange rate (NEER) in the CCA-4 reflects these countries' different exchange rate policies. Armenia has been limiting intervention to smoothing volatility; Georgia and Kazakhstan have managed floats, but have actively leaned against nominal appreciation; Azerbaijan had an unofficial dollar peg until February 2005, but now has a flexible regime. In the 15 months to May 2005, the NEER had appreciated by 25 percent in Armenia, 6 percent in Georgia, 4 percent in Kazakhstan, and 3 percent in Azerbaijan (Figure 3.9). (The exchange rate in Azerbaijan began to appreciate significantly only after May 2005.)

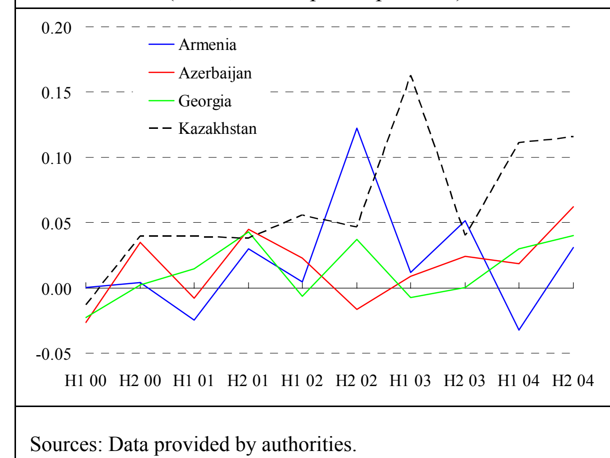
Figure 3.9. Nominal Effective Exchange Rates
(Index, 1995=100)



Sources: Data provided by authorities.

Since most countries permit some combination of exchange rate flexibility and foreign exchange market intervention, efforts to assess trends in the foreign exchange markets should focus on movements in both the exchange rate and reserves. This can be represented in an index of exchange market pressures (EMP), which is designed to detect trend changes in market conditions.[1] The index is a composite measure of changes in foreign reserves (scaled by base money) and changes in nominal exchange rates against the U.S. dollar (Figure 3.10). The indices for the CCA-4 reveal some increase in pressures during the second half of 2004. Pressures are likely to have eased in the first half of 2005, particularly in Kazakhstan, where the currency depreciated slightly, and the sharp accumulation of foreign reserves in late 2004 was partly unwound. This reflected an acceleration in imports, caused in part by the surge in FDI inflows, and increased holding of foreign assets by banks as net open position limits were tightened.

Figure 3.10. Exchange Market Pressures
(Index, > 0 = upward pressure)



Sources: Data provided by authorities.

[1]The EMP summarizes the difference between the growth rates of money supply and demand under managed exchange rate regimes. (See Weymark, 1995 and 1998, and Tanner, 2001).

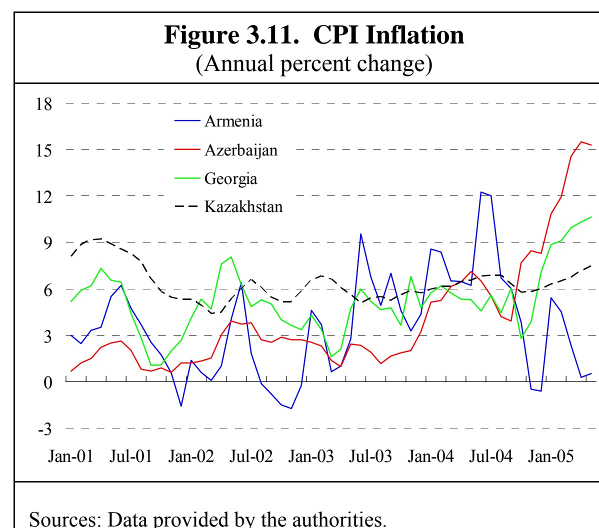
Overall, external inflows have contributed to appreciation pressures over the past 24 months, particularly during 2004. While very recent data suggest an immediate easing in pressure, further RER appreciation is likely to re-emerge in the months ahead based on the favorable external environment, particularly for oil producers, and continued capital inflows related to economic reforms and the transition to market economies.

C. Policy Response and Related Economic Indicators

The recent experience of the CCA-4 countries illustrates the challenges that large inflows pose for the conduct of monetary policy (Figure 3.11). Armenia tightened monetary policy in late-2004 in response to rising inflation and, aided by an exchange rate appreciation, successfully reduced 12-month inflation to below the central bank's target of 3 percent by March 2005. Inflation was contained to below 5 percent in the year to May 2005. Unsterilized intervention had an impact on prices elsewhere. In Azerbaijan, 12-month inflation rose to over 15 percent in May. In Georgia, 12-month inflation peaked at 10.4 percent in April, before decelerating over the summer months to 7.3 percent in August 2005. In Kazakhstan, 12-month inflation edged up to almost 7 percent in 2004, and has averaged about 7.5 percent in the first eight months of 2005, somewhat above the central bank's upper band for the year.

With the exception of Armenia, monetary policy has generally been burdened by efforts to stem upward pressures on exchange rates. Central banks have engaged in large-scale purchases of foreign exchange, sterilized and unsterilized. As a result, monetary policy was fairly accommodative in 2004 and monetary aggregates grew rapidly. Large-scale sterilization operations in Kazakhstan led to rising costs and net losses for the central bank. Azerbaijan and Georgia failed to adequately stem booming domestic demand, and large unsterilized interventions led to excessive

Figure 3.11. CPI Inflation
(Annual percent change)

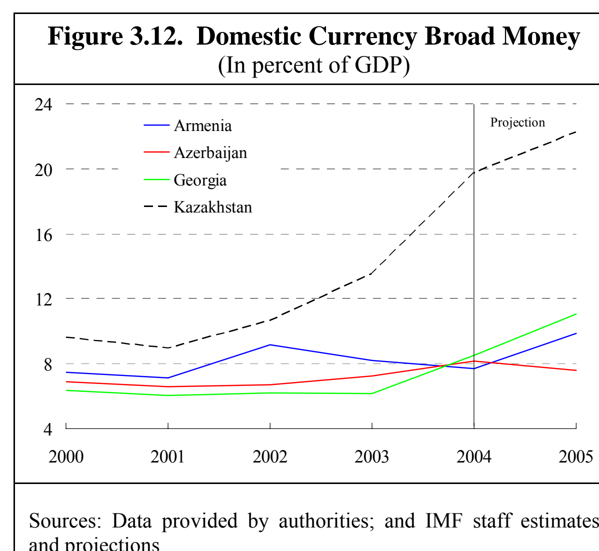


Sources: Data provided by the authorities.

money growth. Monetary policy in Azerbaijan has remained accommodative in 2005. While inflation is higher now in these three countries, the inflationary impact of the loose policy stance was partially offset by a gradual increase in monetization (Figure 3.12). In Armenia, some unsterilized intervention was permitted over the past year in order to offset the contractionary effect of rapid nominal appreciation over the period.

While monetary policy and the degree of exchange rate flexibility can affect movements in

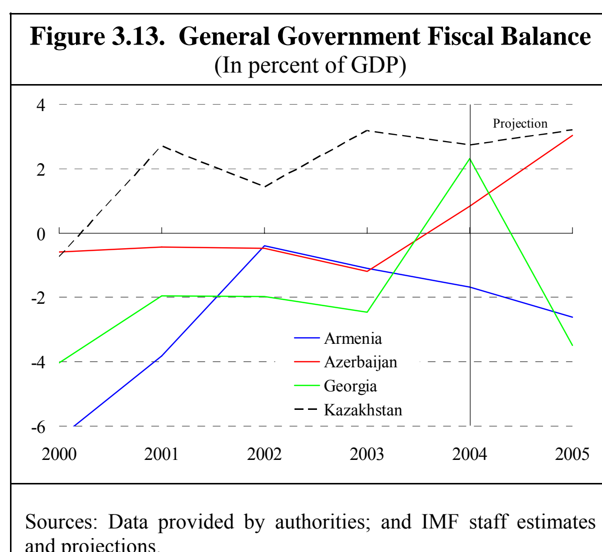
Figure 3.12. Domestic Currency Broad Money
(In percent of GDP)



Sources: Data provided by authorities; and IMF staff estimates and projections

the RER in the short run, fiscal policy is a more powerful macroeconomic tool for influencing the RER over the long run. In all four CCA countries, fiscal policy has been managed prudently in recent years (Figure 3.13). This has helped to limit pressures for RER appreciation. In particular, impressive fiscal tightening in Georgia helped to offset the impact of unsterilized purchases of foreign exchange. In 2005, fiscal stimulus is expected in all four countries. In Kazakhstan, the non-oil fiscal deficit is forecast to rise by about 0.5 percent of GDP to 5.1 percent of GDP in 2005. In Azerbaijan, a surge in oil production will lead to higher spending, but the government intends to keep real consumption out of oil wealth constant. Pressures to increase social spending are high in all countries.

Figure 3.13. General Government Fiscal Balance
(In percent of GDP)



Sources: Data provided by authorities; and IMF staff estimates and projections.

Wages have been rising, albeit from an extremely low base. In Kazakhstan, the wages of civil servants and health and education workers were increased by 30 percent in July 2005, along with large increases in the minimum wage and pensions. In Azerbaijan, the minimum wage was increased by over 300 percent between end-2002 and January 2005, and the average public sector wage rose by 25 percent per year in 2003–04. While these increases are likely to have added to demand pressures, it should be noted that labor costs are low relative to key trading partners.

The banking systems in these countries are being strengthened over time and confidence is increasing. However, the size of the banking system remains small. Total bank assets account for less that 20 percent of GDP in the Caucasus countries, while total deposits represent only about 23 percent of GDP in Kazakhstan. After several years of stagnation, credit to the economy began to surge in 2004 (albeit from a low base), increasing by over 50 percent in Azerbaijan and Kazakhstan, by 38 percent in Armenia, and by 21 percent in Georgia. This is symptomatic of the strong liquidity conditions noted above, and is similar to the experiences in other transition countries.

Since financial intermediation is weak, particularly in the Caucasus countries, where credit to the economy represents on average about 10 percent of GDP, this is a welcome development. However, credit should be monitored closely since the quality of loans could eventually be compromised at these rates of growth. There is no evidence of a deterioration in loan portfolios, although this would only appear after some time, or if credit conditions tightened. There are two other issues related to rapid credit growth. First, a large share of new lending is being concentrated in the construction and real estate sectors. Second, in Azerbaijan and Kazakhstan, banks have increased foreign borrowing abroad to fund domestic credit expansion, while cross-border lending has risen in Kazakhstan. This raises concerns about currency risk, particularly if prudential regulations are weak or if supervisory capacities are overstretched.

The authorities are taking actions to strengthen supervision and prudential regulations, including by tightening asset classification rules, improving corporate governance structures, implementing new rules on loan concentration ratios, and reducing limits on net open positions. Armenia has introduced regulations to discourage the use of foreign currency in domestic transactions.

D. Policy Considerations

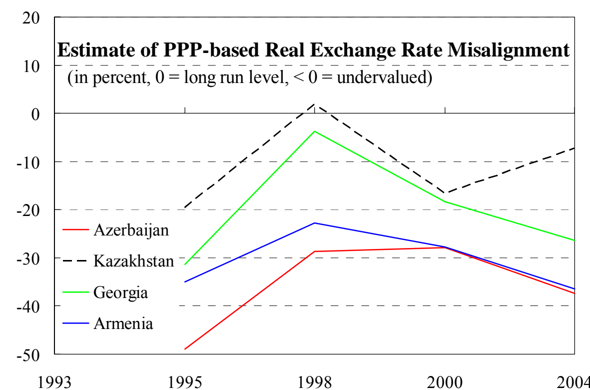
An appreciation in the real exchange rate is often interpreted as a loss of competitiveness for an economy. However, this may not be the correct interpretation when the exchange rate is misaligned, or if the appreciation is driven by a fundamental improvement in productivity. Similar to the early experiences in other transition economies, the RERs in the CCA-4 countries are believed to be significantly undervalued. Box 3.1 presents an estimate of RER misalignment based on an international comparison of price levels. The analysis indicates that the RERs in the CCA-4 countries, which were significantly undervalued in the mid-1990s, continue to be undervalued.

Deviations in RERs from their PPP-based long run level can be attributed to longer term productivity differences (the Balassa-Samuelson effect). Such a fundamental disequilibrium cannot persist indefinitely. In addition to the need for adjustment to correct these undervaluations, the RERs in these countries can also be expected to experience equilibrium appreciations in the future associated with further productivity gains. As noted above, neither of these sources of appreciation are unwarranted, nor should they be interpreted, by themselves, as a loss in competitiveness.

Box 3.1. An Estimate of RER Misalignment

International comparison of price levels is a crude but effective way to obtain an estimate of the deviation of a country's real exchange rate (RER) from its long run "equilibrium" level. The methodology is based on the Balassa-Samuelson hypothesis, which finds a positive correlation between relative productivity differentials (proxied by relative per capita income levels) and the RER (proxied by the relative price level).

Cross country regressions of the price level (relative to the U.S. dollar) on per capita real incomes for samples of over 145 countries were run at different points in time to estimate long-run RERs. For each regression, the vertical distance from a country's actual position to the estimated regression line measured the deviation of the RER from its estimated long-run level. The exercise was undertaken with data obtained from the IMF (shown below), the World Bank, and Penn World Tables. While the regression results were similar across data sets, the Penn data produced much larger estimates of undervaluation, particularly for Kazakhstan and Georgia. *(See also Country Report No. 05/240, Republic of Kazakhstan: Selected Issues, Chapter IV).* However, estimates for any single country should be treated with caution because (i) the data sets are subject to measurement error; (ii) the sample periods are relatively short for long-term equilibrium RER analysis; (iii) the estimated Balassa-Samuelson effect accounts for only about half of the cross country variability of RER deviations; and (iv) per capita incomes are just a proxy for relative rates of productivity.



Source: IMF staff calculations.

Estimates of RER misalignment are plotted here in a simple line chart. The analysis indicates that the RERs of the Caucasus countries, which were significantly undervalued in the mid-1990s, remained as undervalued at end-2004. These findings are consistent with the trends observed in the REERs, and are suggestive of a persistent disequilibrium.

Pressures on the RER could also reflect short-term factors not directly associated with productivity differentials, such as external flows, macroeconomic policies, or cyclical forces. It appears that RERs in the CCA-4 countries are experiencing pressure from both short-term factors and longer-term productivity-related forces. Since these countries operate flexible exchange rate regimes in principle, they would be unwise to resist the associated nominal exchange rate appreciation because the real appreciation will occur anyway in the form of higher inflation.

Fund policy advice to these countries has been, and continues to be, to allow the nominal exchange rate to appreciate, while implementing prudent macroeconomic policies to contain demand pressures, and structural reforms to raise productivity. This advice is based on evidence that the long-term damage caused by higher inflation on resource allocation, investment incentives, financial intermediation, trade, and ultimately, economic growth, is more costly than the short-term repercussions related to nominal exchange rate adjustments. The virtues of this policy approach are well documented. There is also evidence showing how the transition economies that lowered inflation by reducing financial imbalances and implemented comprehensive structural reforms benefited the most in terms of output growth and access to foreign capital.[2]

There is, however, popular resistance in some segments of society to nominal exchange rate appreciation. For this reason, the issue is better framed in a broader context, taking into consideration its implications for strategic sectors of the economy and key political economy sensitivities. This involves, in the CCA-4 cases in particular, the interests of exporters, recipients of remittances, and foreign currency deposit holders. Dollarization is widespread in these countries, with foreign currency deposits ranging from 30–75 percent of total deposits.[3] Together with foreign currency cash holdings ("under the mattress"), foreign currency asset holders remain an important constituency for policymakers to consider.

As noted in Section B, the REER masks the influence of U.S. dollar and ruble exchange rates. There appears to be a tension in the CCA-4 between the role of the ruble BRER, which is a key determinant of competitiveness, and the role of the dollar BRER, which is a critical determinant of personal wealth given the dollar's continued role as a store of value. As these relative prices have tended to head in different directions in the recent past, this further complicates the policy picture.

Thus, these governments face competing policy objectives and the need to consider political economy sensitivities. In this context, greater exchange rate flexibility should be considered in light of the following factors:

(a) **Competitiveness:** Under the circumstances described above, RER appreciation is inevitable. Concerns by exporters about a stronger currency tend to be misplaced, since the end result of both forms of nominal adjustment—a stronger currency or a higher domestic price level—will have the same impact on relative prices. The key issue is the impact of an appreciation in the *real* exchange rate (RER) on exporters' ability to compete globally. On this point, the effect is likely to be benign, at least until the misalignment that is believed to exist (Box 3.1) is eliminated. Certain indicators of competitiveness margins suggest that producers have a sizable window to adjust to a rising RER. For example, average monthly wages are about US$80 per month in the Caucuses, a small fraction of the cost of labor in their major trading partners.[4] As RERs converge with long-run

[2]IMF Occasional Paper No. 175, 1998.

[3]These figures may be somewhat misleading, given the small size of the financial sector.

[4]This is a simple comparison for illustrative purposes. Other production costs in the CCA-4, like

(continued…)

levels, it is essential for country authorities to continue implementing structural reforms that ensure continued gains in productivity.

(b) **Growth:** As noted above, Fund policy advice has been to avoid high inflation because of its negative medium-term impact on growth. Prior research has examined the "threshold effects" in the relationship between inflation and growth. The level at which inflation significantly slows growth is estimated at 7–11 percent for developing countries (Khan and Senhadji).[5] Inflation already exceeds this range in Azerbaijan, and is within this range in Georgia and Kazakhstan. Other research has shown that the costs of reducing inflation are higher and more protracted once inflation expectations become entrenched.

(c) **Monetary policy:** One of the advantages of greater exchange rate flexibility is the ability to insulate money growth, domestic credit, and the banking system from strong foreign exchange inflows. Countries that limit this flexibility have fewer options: sterilization will help curtail the growth of monetary aggregates, but not without costs. Sterilization can raise domestic interest rates above what they would otherwise be, which could provide incentives for further capital inflows if the latter are interest sensitive. It also leads to higher public debt and quasi-fiscal costs, some of which will be borne by the central bank. Nonsterilized intervention could be tolerated as long as the associated money creation does not lead to higher inflation (e.g., if money demand is rising).

(d) **Public finances:** In the short term, a nominal exchange rate appreciation and higher inflation could have both positive and negative effects on the budget balance; the net effect would be case specific. In general, the fiscal stance in the CCA-4 has been relatively conservative, and structural fiscal reforms have been progressing. In view of these fundamentals and the relatively low level of public debt, the implications of RER appreciation appear to be less critical for fiscal policy at this stage. However, the CCA-4 countries will face mounting pressure to increase social spending and public investment in the coming months and years. While higher spending for these purposes is desirable within a framework of fiscal sustainability, it is likely to contribute to further upward pressure on RERs.

(e) **The banking system:** As noted, some of the foreign liquidity flowing into these economies is finding its way into domestic credit. While monetization and deeper financial intermediation are critical development objectives in the CCA-4, the process has to be managed carefully to avoid overtaxing financial systems, particularly those with immature infrastructures and weak prudential oversight. In general, continued efforts to strengthen supervisory and regulatory frameworks should remain a priority.

Credit risks should be monitored closely. The combination of higher inflation and weak credit quality could present a source of vulnerability, particularly given the concentration of new lending in real estate and construction, sectors known to be vulnerable to interest rate changes. IMF Financial System Assessment Program (FSAP) reports had already identified credit risk as the main source of vulnerability to financial systems in Armenia and Kazakhstan.

(f) **Dollarization:** Greater exchange rate flexibility would encourage financial markets to start developing instruments to hedge against uncertainty, and could prevent purely speculative inflows. It would also raise the return to de-dollarization. However, given the size of the dollar assets involved (or the large number of citizens holding at least some savings in dollars), greater exchange rate flexibility should be phased in gradually, conditions permitting. This would allow depositors time to absorb the implications of a flexible exchange rate for their portfolio allocation. It would also make them aware of the

transportation, remain significantly higher than in comparator markets. Moreover, any measure of competitiveness involving labor costs should be discussed in the context of productivity trends, which is beyond the scope of this study.

[5] IMF Working Paper (WP/00/110), 2000.

opportunity cost of holding dollars, and that currency risk is no longer a one-way bet.

(g) **Poverty:** Lower income segments of society tend to suffer disproportionately from high inflation. At the same time, they are often reliant on private foreign currency remittances, which are adversely affected by appreciation. There is some indication, however, that remittances are priced in local currency, i.e., transfers in foreign currency terms rise if the local currency becomes more expensive. These issues would need to be considered in the context of the authorities' poverty reduction strategy.

E. Conclusion

Based on current circumstances and experiences in other transition economies and emerging markets, a further appreciation in the RERs of the CCA-4 countries can be expected in the years ahead. The nominal exchange rate should be allowed to appreciate, or else the RER appreciation will come about through higher inflation, with detrimental effects on trade, growth, and poverty. Monetary policy would need to maintain a sharp focus on price stability, particularly in the context of more expansive public spending programs. The third pillar of a supportive policy response would be structural reforms designed to meet longer-term development objectives and raise productivity. Priorities in that regard would include trade liberalization, financial sector strengthening and restructuring, deregulation, improvements in business climate efficiency, labor market reforms, and governance and anti-corruption measures.

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STATISTICAL APPENDIX

Data and Conventions

The IMF's Middle East and Central Asia Department (MCD) countries are Afghanistan, Algeria, Armenia, Azerbaijan, Bahrain, Djibouti, Egypt, Georgia, Iran, Iraq, Jordan, Kazakhstan, Kuwait, Kyrgyz Republic, Lebanon, Libya, Mauritania, Morocco, Oman, Pakistan, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tajikistan, Tunisia, Turkmenistan, United Arab Emirates (UAE), Uzbekistan, West Bank Gaza, and Yemen.

The statistical appendix tables contain data for 28 of the MCD countries, excluding Iraq, Somalia, Turkmenistan, and West Bank Gaza due to limited data availability. Afghanistan is included in the tables but excluded from the country grouping averages due to incomplete data.

The source for all tables, except for Table 20, is the MCD centralized database, which is regularly updated by each country team. The source for Table 20 is the IMF Information Notice System (INS). Projections are IMF staff estimates.

Country weights used for aggregation are based on 2003 GDP in purchasing power parity (PPP) terms, provided by the World Economic Outlook (WEO).

In Tables 2, 11 and 12 "oil" includes gas, which is also an important resource in several countries.

Period average exchange rates are used to convert nominal GDP for percent of GDP calculations in Tables 4, 16, 21, and 24.

Fiscal data in Tables 9-16 pertain to general government for Azerbaijan, Egypt, Georgia, Kazakhstan, Kyrgyz Republic, Pakistan, Syria, Tajikistan, Tunisia, and Uzbekistan, and central government for all others.

CIS (Commonwealth of Independent States) refers to the CIS countries covered by the MCD department. These countries are Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, and Uzbekistan.

MENA (Middle East and North Africa) refers to the following countries covered by the MCD department: Algeria, Bahrain, Djibouti, Egypt, Iran, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Pakistan, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, UAE, and Yemen.

GCC (Gulf Cooperation Council) includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and UAE.

Maghreb includes Algeria, Mauritania, Morocco, and Tunisia.

Table 1. Real GDP Growth 1/

(Annual change; in percent)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**3.9**	**6.3**	**5.9**	**5.7**	**5.9**
Oil exporters	**3.6**	**7.4**	**5.9**	**6.0**	**5.7**
Algeria	3.6	6.9	5.2	4.8	5.3
Azerbaijan	9.2	11.5	10.2	18.7	23.9
Bahrain	4.8	7.2	5.4	7.1	5.2
Iran	4.2	6.7	5.6	5.7	5.4
Kazakhstan	6.8	9.3	9.4	8.8	7.7
Kuwait	0.8	9.7	7.2	3.2	3.2
Libya 2/	1.9	9.1	4.4	4.3	4.4
Oman	3.6	1.9	4.5	3.8	6.2
Qatar	7.4	8.6	9.3	5.5	7.1
Saudi Arabia	1.5	7.7	5.2	6.0	4.7
Syria	2.3	1.3	3.1	3.8	4.0
UAE 3/	4.0	11.6	7.8	7.5	5.5
Low-income countries	**5.5**	**5.2**	**6.9**	**6.5**	**8.7**
Afghanistan 3/	...	15.7	8.0	13.6	11.2
Armenia	7.9	13.9	10.1	8.0	6.0
Djibouti	1.5	3.2	3.0	3.2	3.8
Georgia	3.6	11.1	6.2	7.5	4.5
Kyrgyz Republic	3.3	7.0	7.1	4.0	5.5
Mauritania	4.9	6.4	6.9	5.4	26.9
Sudan	7.4	4.6	6.9	8.0	13.6
Tajikistan	7.3	10.2	10.6	8.0	7.0
Uzbekistan	3.2	1.6	7.4	5.0	4.0
Yemen	4.3	3.1	2.5	3.7	2.0
Emerging markets	**4.0**	**4.8**	**5.6**	**5.2**	**5.7**
Egypt	5.1	3.1	4.1	4.8	5.0
Jordan	4.3	4.1	7.7	5.0	2.5
Lebanon	1.9	5.0	6.0	0.0	3.0
Morocco	3.6	5.5	4.2	1.0	5.9
Pakistan	3.4	5.7	7.1	7.4	6.5
Tunisia	4.4	5.6	5.8	5.0	5.9
Memorandum items:					
CIS	**6.1**	**8.3**	**8.9**	**9.0**	**8.8**
MENA	**3.7**	**6.2**	**5.6**	**5.4**	**5.6**
Of which					
GCC	**2.4**	**8.2**	**6.0**	**5.9**	**4.9**
Maghreb	**3.5**	**6.6**	**5.0**	**3.8**	**5.7**

1/ Unless otherwise noted, all averages in this document are weighted with 2003 PPP GDP weights.
2/ Data are at factor cost.
3/ None of the tables in this document include Afghanistan in the country group averages due to lack of data availability.

Table 2. Real Oil and Non-Oil GDP Growth

(Annual change; in percent)

	1998-2002 Average	2003	2004	2005	2006
			Non-Oil GDP		
Oil exporters	**4.5**	**6.2**	**6.4**	**6.0**	**5.8**
Algeria 1/	3.6	5.9	6.2	5.5	5.8
Azerbaijan	6.6	16.9	13.4	10.3	8.0
Bahrain	4.4	8.3	8.6	8.1	5.9
Iran	4.7	6.6	5.9	5.5	5.4
Kazakhstan	7.7	8.9	8.5	9.1	8.0
Kuwait	3.4	3.7	5.7	5.0	4.8
Libya 2/	3.4	2.2	2.7	3.0	3.5
Oman	4.4	5.8	8.0	6.0	6.3
Qatar	4.9	11.8	4.0	8.3	8.0
Saudi Arabia	3.2	3.7	5.0	5.7	5.7
Syria	4.4	3.6	8.1	6.5	5.5
UAE 2/	7.0	10.8	9.9	7.7	6.7
			Oil GDP		
Oil exporters	**1.5**	**10.4**	**3.9**	**6.0**	**5.0**
Algeria	3.4	8.8	3.3	3.5	4.3
Azerbaijan	16.8	0.7	2.5	40.3	56.1
Bahrain	7.3	1.1	-11.5	0.3	0.3
Iran	0.6	7.7	3.4	7.2	5.1
Kazakhstan	16.8	11.4	14.0	7.0	6.5
Kuwait	-2.7	19.8	9.5	0.7	1.0
Libya 2/	-1.3	26.9	7.9	6.8	6.2
Oman	2.1	-5.9	-3.2	-1.5	5.9
Qatar	9.8	6.3	13.5	3.4	6.5
Saudi Arabia	-1.8	17.2	5.7	6.8	2.6
Syria	-3.4	-6.6	-16.4	-9.6	-4.5
UAE 2/	-1.3	13.6	2.9	7.0	2.5

1/ Real non-oil GDP growth data are slightly different from official statistics because of different methodologies used by IMF staff and Algerian authorities.

Table 3. Per Capita Real GDP Growth

(Annual change; in percent)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**1.8**	**4.1**	**3.7**	**3.6**	**3.5**
Oil exporters	**1.4**	**5.0**	**3.6**	**3.7**	**2.9**
Algeria	2.0	5.3	4.8	3.3	3.8
Azerbaijan	8.3	10.6	9.3	17.8	...
Bahrain	1.4	4.0	2.4	4.0	2.2
Iran	2.5	4.9	3.8	3.9	3.7
Kazakhstan	8.0	8.7	8.5	7.9	6.8
Kuwait	-1.0	4.3	3.1	-0.3	-0.3
Libya 1/	-2.6	7.0	2.3	2.2	2.4
Oman	2.2	0.5	2.4	1.7	4.1
Qatar	1.8	3.2	3.9	0.2	1.7
Saudi Arabia	-0.9	5.1	2.2	4.0	2.1
Syria	-0.2	-1.1	0.6	1.3	1.6
UAE 1/	-3.5	3.7	0.2	-0.1	-2.0
Low-income countries	**3.7**	**3.2**	**5.0**	**4.5**	**6.6**
Afghanistan	...	12.6	5.2	10.3	8.0
Armenia	9.8	13.8	9.0	5.6	3.6
Djibouti	-0.9	1.4	1.2	1.4	2.0
Georgia	4.5	11.8	6.9	7.5	4.5
Kyrgyz Republic	2.1	6.0	6.0	3.0	4.5
Mauritania	-3.7	0.5	3.9	2.5	23.3
Sudan	5.0	1.8	4.2	5.3	10.7
Tajikistan	6.5	9.5	9.9	7.4	6.4
Uzbekistan	1.8	0.4	6.2	3.8	2.8
Yemen	1.3	0.1	-0.5	0.6	-1.0
Emerging markets	**2.1**	**2.8**	**3.8**	**3.3**	**3.9**
Egypt	3.0	1.1	2.1	2.7	2.9
Jordan	1.3	1.2	4.7	2.1	-0.3
Lebanon	-0.1	2.9	3.9	-2.0	1.0
Morocco	2.2	4.3	3.1	-0.1	4.8
Pakistan	1.2	3.4	5.1	5.4	4.5
Tunisia	3.2	4.5	5.3	3.6	4.6
Memorandum items:					
CIS	**6.3**	**7.7**	**8.0**	**8.0**	**5.4**
MENA	**1.3**	**3.8**	**3.3**	**3.2**	**3.3**
Of which					
GCC	**-1.0**	**4.3**	**2.0**	**2.6**	**1.3**
Maghreb	**1.6**	**5.1**	**4.1**	**2.3**	**4.3**

1/ Data are at factor cost.

Table 4. Nominal Gross Domestic Product 1/

(In billions of U.S. dollars)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**831.2**	**998.2**	**1178.3**	**1448.4**	**1646.3**
Oil exporters	**542.3**	**684.9**	**818.5**	**1037.8**	**1185.2**
Algeria	52.7	68.0	84.8	105.0	119.0
Azerbaijan	5.2	7.3	8.5	13.1	18.5
Bahrain	7.4	9.7	11.0	13.3	14.6
Iran	106.2	133.7	161.5	203.3	242.2
Kazakhstan	20.7	30.9	40.7	54.0	64.6
Kuwait	32.4	41.7	51.8	68.4	77.2
Libya	28.3	23.4	28.0	37.7	41.7
Oman	18.0	21.7	24.8	30.5	34.4
Qatar	15.6	23.6	28.5	38.3	45.2
Saudi Arabia	173.6	214.9	250.9	314.2	349.4
Syria	18.5	21.4	23.7	26.3	27.6
UAE	63.8	88.5	104.2	133.8	150.9
Low-income countries	**44.7**	**55.4**	**67.8**	**83.3**	**99.8**
Afghanistan	4.1	4.6	6.0	7.1	8.6
Armenia	2.0	2.8	3.5	4.2	4.6
Djibouti	0.6	0.6	0.7	0.7	0.7
Georgia	3.2	4.0	5.2	6.3	7.1
Kyrgyz Republic	1.5	1.9	2.2	2.5	2.7
Mauritania	1.1	1.3	1.5	1.9	3.0
Sudan	12.4	17.4	21.6	27.6	35.4
Tajikistan	1.1	1.6	2.1	2.4	2.6
Uzbekistan	13.4	10.1	11.9	14.7	18.1
Yemen	8.6	11.1	13.1	15.9	16.9
Emerging markets	**244.2**	**257.8**	**292.0**	**327.4**	**361.3**
Egypt	90.3	69.2	77.0	90.7	102.2
Jordan	8.6	10.2	11.5	12.5	13.9
Lebanon	17.1	19.9	21.8	22.2	23.3
Morocco	34.9	43.8	50.0	51.6	54.4
Pakistan	73.1	89.8	103.4	119.7	134.3
Tunisia	20.2	25.0	28.2	30.6	33.1
Memorandum items:					
CIS	**47.2**	**58.5**	**74.2**	**97.1**	**118.3**
MENA	**783.2**	**935.1**	**1098.1**	**1344.2**	**1519.5**
Of which:					
GCC	**310.8**	**400.1**	**471.2**	**598.4**	**671.6**
Maghreb	**137.2**	**161.6**	**192.6**	**226.8**	**251.2**

1/ Simple averages.

Table 5. Consumer Price Index

(Annual change; year average; in percent)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**6.0**	**5.3**	**6.9**	**8.4**	**7.9**
Oil exporters	**6.1**	**6.4**	**7.0**	**8.7**	**8.4**
Algeria	2.7	2.6	3.6	3.5	4.2
Azerbaijan	-0.6	2.2	6.7	12.7	10.5
Bahrain	-0.8	1.6	4.9	3.7	1.6
Iran	15.6	15.6	15.6	18.5	18.5
Kazakhstan	8.7	6.4	6.9	7.4	7.1
Kuwait	1.5	1.0	1.8	1.8	1.8
Libya	-3.1	-2.1	-1.0	1.8	2.5
Oman	-0.3	0.2	0.8	1.9	1.1
Qatar	1.8	2.3	6.8	3.0	2.8
Saudi Arabia	-0.5	0.6	0.3	1.0	1.0
Syria	-0.5	0.1	4.6	10.0	5.0
UAE	2.2	3.1	4.6	6.0	4.5
Low-income countries	**18.0**	**9.3**	**8.3**	**10.4**	**7.4**
Afghanistan	...	35.4	13.3	12.3	8.9
Armenia	2.5	4.7	7.0	1.7	3.0
Djibouti	1.3	2.0	-6.3	3.0	2.2
Georgia	7.4	4.8	5.7	8.0	6.0
Kyrgyz Republic	14.8	3.1	4.1	5.0	3.6
Mauritania	4.8	5.5	10.4	13.5	7.2
Sudan	10.9	7.7	8.4	7.5	7.0
Tajikistan	30.9	16.4	7.1	5.5	5.5
Uzbekistan	40.5	14.8	8.8	20.0	9.2
Yemen	10.9	10.8	12.5	10.3	11.4
Emerging markets	**3.2**	**2.7**	**6.2**	**7.4**	**7.2**
Egypt	3.2	3.2	8.1	8.8	8.0
Jordan	1.6	1.6	3.4	3.7	8.4
Lebanon	1.2	1.3	3.0	2.0	2.0
Morocco	1.8	1.2	1.5	2.0	2.0
Pakistan	4.2	2.9	7.4	9.9	9.8
Tunisia	2.7	2.8	3.6	2.9	2.5
Memorandum items:					
CIS	**14.5**	**7.6**	**7.1**	**10.3**	**7.5**
MENA	**5.2**	**5.1**	**6.8**	**8.2**	**8.0**
Of which					
GCC	**0.3**	**1.2**	**1.7**	**2.2**	**1.8**
Maghreb	**1.8**	**1.7**	**2.5**	**2.9**	**3.2**

Table 6. Broad Money

(Annual change; in percent)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**16.8**	**17.1**	**22.0**	**21.0**	**14.6**
Oil exporters	**19.1**	**16.6**	**24.8**	**23.7**	**13.0**
Algeria	22.5	15.6	12.0	16.0	17.6
Azerbaijan	14.7	29.8	47.5	32.0	25.0
Bahrain	10.1	6.3	4.2	11.0	7.4
Iran	27.1	24.6	31.8	40.3	...
Kazakhstan	38.6	27.0	68.2	30.0	23.5
Kuwait	4.9	2.7	17.6	-4.3	7.8
Libya	8.0	9.5	7.9	15.3	21.7
Oman	6.3	2.5	4.0	18.9	5.7
Qatar	12.3	4.8	20.8	20.0	12.6
Saudi Arabia	7.0	8.2	17.2	11.9	8.6
Syria	17.0	7.7	10.3	11.8	9.8
UAE	12.4	16.1	23.2	15.0	5.7
Low-income countries	**28.3**	**29.4**	**31.9**	**33.6**	**22.9**
Afghanistan	37.4	37.7	42.4	28.3	23.7
Armenia	25.5	10.4	22.3	23.0	16.5
Djibouti	7.5	17.8	13.9	13.7	14.5
Georgia	19.0	22.8	42.6	31.8	21.7
Kyrgyz Republic	21.7	33.5	32.0	12.1	13.8
Mauritania	9.7	103.3	47.6	...	...
Sudan	28.3	30.3	26.9	31.9	27.0
Tajikistan	41.6	29.2	14.3	19.7	18.5
Uzbekistan	38.6	28.2	47.3	52.9	21.1
Yemen	17.5	20.0	15.0	18.7	...
Emerging markets	**10.5**	**15.2**	**15.0**	**13.7**	**14.8**
Egypt	11.2	16.9	13.2	13.3	16.3
Jordan	8.6	12.4	11.7	6.0	6.6
Lebanon	10.3	13.6	10.2	-2.0	5.1
Morocco	9.0	8.6	8.2	8.4	7.0
Pakistan	10.4	18.5	20.4	18.9	18.9
Tunisia	10.8	6.4	10.5	7.6	9.3
Memorandum items:					
CIS	**32.8**	**26.8**	**53.8**	**33.6**	**22.2**
MENA	**15.3**	**16.2**	**19.0**	**19.8**	**13.7**
Of which					
GCC	**8.1**	**8.7**	**17.2**	**12.0**	**7.9**
Maghreb	**15.1**	**12.7**	**10.7**	**12.5**	**13.9**

Table 7. Broad Money

(In percent of GDP)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**52.2**	**56.5**	**57.9**	**56.7**	**57.2**
Oil exporters	**49.7**	**52.6**	**53.3**	**50.6**	**48.0**
Algeria	56.7	63.8	61.5	57.1	56.5
Azerbaijan	11.8	14.3	17.9	16.3	14.4
Bahrain	78.4	75.8	69.5	63.7	62.5
Iran	48.1	51.1	52.9	54.6	...
Kazakhstan	15.1	21.1	29.5	30.3	32.1
Kuwait	86.0	79.6	76.3	55.3	52.8
Libya	65.1	47.4	42.0	36.5	40.1
Oman	35.6	33.9	30.8	29.9	28.0
Qatar	61.3	53.2	53.3	47.6	45.4
Saudi Arabia	49.6	51.2	51.3	45.9	44.8
Syria	65.5	83.9	82.3	80.5	81.4
UAE	55.5	60.4	63.3	56.7	53.1
Low-income countries	**14.4**	**17.1**	**18.3**	**19.1**	**17.8**
Afghanistan	10.1	11.3	12.8	13.1	13.5
Armenia	13.0	14.4	15.1	16.7	17.8
Djibouti	56.1	69.7	74.8	80.0	86.4
Georgia	9.6	12.4	15.2	17.1	18.7
Kyrgyz Republic	13.0	17.5	20.6	21.0	21.8
Mauritania	13.2	24.3	31.1	...	...
Sudan	11.5	16.2	16.7	18.0	18.0
Tajikistan	7.9	8.2	7.2	7.3	7.6
Uzbekistan	12.8	10.5	12.5	14.9	15.6
Yemen	35.1	39.2	37.9	35.7	...
Emerging markets	**64.5**	**74.0**	**74.8**	**75.0**	**75.5**
Egypt	78.0	92.0	91.7	90.5	91.9
Jordan	118.5	131.4	129.5	126.1	121.0
Lebanon	189.0	215.7	217.3	208.8	208.8
Morocco	80.0	90.1	92.2	97.2	96.3
Pakistan	38.1	43.8	45.2	45.5	46.3
Tunisia	57.5	60.4	61.3	61.3	61.2
Memorandum items:					
CIS	**13.4**	**16.5**	**21.7**	**22.5**	**23.5**
MENA	**55.9**	**61.2**	**61.6**	**60.0**	**61.5**
Of which					
GCC	**53.9**	**54.8**	**54.8**	**48.1**	**46.4**
Maghreb	**63.5**	**67.8**	**66.9**	**66.0**	**65.9**

Table 8. Change in Stock of Credit to the Economy

(In percent of GDP)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**1.3**	**1.5**	**2.2**	**-1.4**	**-0.9**
Oil exporters	**1.6**	**2.5**	**3.9**	**-2.3**	**-1.0**
Algeria	0.3	-1.7	-1.0	-2.9	-1.4
Azerbaijan	-1.2	1.2	3.0	0.0	-1.7
Bahrain	1.1	-2.5	4.4	-3.5	2.1
Iran	2.7	8.3	7.6	-1.6	...
Kazakhstan	3.0	3.8	6.1	0.8	1.5
Kuwait	4.1	3.1	-4.1	-13.9	-3.6
Libya	0.3	-3.7	-3.6	-8.8	1.1
Oman	0.7	-1.7	-2.4	-3.7	-7.3
Qatar	-1.1	1.9	2.7	-5.4	-1.6
Saudi Arabia	1.5	-0.7	5.0	-0.7	-0.2
Syria	-1.5	2.9	-0.1	0.5	-0.2
UAE	1.0	-2.1	3.1	-4.7	-3.6
Low-income countries	**-1.2**	**-0.9**	**0.2**	**0.0**	**0.0**
Afghanistan	...	...	...	...	...
Armenia	0.2	-0.9	1.2	1.4	0.7
Djibouti	-0.2	-2.0	-1.5	-0.9	-0.4
Georgia	1.0	0.6	0.4	1.1	0.7
Kyrgyz Republic	0.1	0.6	2.3	0.3	2.1
Mauritania	1.5	2.8	0.1	...	...
Sudan	0.5	1.8	1.2	0.9	0.0
Tajikistan	2.8	-4.1	3.2	-2.4	-1.3
Uzbekistan	-18.0	-6.5	-2.9	-1.9	-0.6
Yemen	0.4	0.6	0.8	0.0	...
Emerging markets	**1.2**	**0.2**	**-0.3**	**-0.1**	**-0.9**
Egypt	3.1	-1.8	-5.7	-5.9	-5.3
Jordan	0.5	-1.9	2.5	6.4	1.0
Lebanon	3.6	-5.4	-3.2	-1.6	1.9
Morocco	1.3	1.5	0.8	3.5	-0.7
Pakistan	0.0	2.1	3.4	2.3	2.5
Tunisia	-0.6	-0.8	0.9	1.9	-2.1
Memorandum items:					
CIS	**0.1**	**0.5**	**3.0**	**0.1**	**0.5**
MENA	**1.4**	**1.6**	**2.2**	**-1.5**	**-0.9**
Of which					
GCC	**1.4**	**-0.7**	**3.3**	**-3.0**	**-1.6**
Maghreb	**0.4**	**-0.9**	**-0.5**	**-1.2**	**-1.0**

Table 9. Central Government Fiscal Balance

(In percent of GDP)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**-1.5**	**0.3**	**2.6**	**5.7**	**7.0**
Oil exporters	**0.0**	**3.0**	**6.0**	**12.0**	**13.8**
Algeria	1.5	4.6	7.4	11.7	16.0
Azerbaijan 1/	-2.0	-1.2	0.8	3.0	5.3
Bahrain	-0.6	-2.0	2.0	7.9	10.5
Iran	0.1	-0.1	-0.4	6.8	7.2
Kazakhstan 1/	-3.9	3.2	2.7	3.2	2.2
Kuwait	21.1	19.9	25.6	36.5	41.5
Libya	5.4	10.7	19.6	24.4	24.8
Oman	3.4	4.4	4.7	11.1	13.4
Qatar	0.7	4.3	17.6	23.0	23.9
Saudi Arabia	-4.3	1.2	9.6	17.5	20.7
Syria 1/	-1.0	-2.7	-5.3	-4.5	-5.2
UAE	1.3	13.0	18.3	24.6	28.4
Low-income countries	**-2.0**	**-1.8**	**-0.7**	**-1.8**	**-0.3**
Afghanistan	-0.1	-3.0	-1.2	-0.6	-1.5
Armenia	-4.5	-1.1	-1.7	-2.6	-2.9
Djibouti	-1.7	-5.0	-3.2	-2.8	-3.2
Georgia 1/	-4.2	-2.5	2.3	-3.5	-3.3
Kyrgyz Republic 1/	-8.4	-5.4	-4.2	-4.6	-3.5
Mauritania	-0.7	-36.4	-23.0	-5.6	3.1
Sudan	-0.8	0.9	1.2	-0.2	2.7
Tajikistan 1/	-1.5	0.9	0.1	0.0	0.0
Uzbekistan 1/	-2.5	0.1	0.4	-2.6	-2.3
Yemen	0.6	-5.2	-3.5	-2.4	-2.9
Emerging markets	**-3.8**	**-2.8**	**-3.0**	**-3.7**	**-3.2**
Egypt 1/	-1.5	-2.4	-2.5	-3.1	-2.8
Jordan	-4.5	-1.0	-1.7	-6.0	-3.0
Lebanon	-17.6	-13.2	-8.5	-8.1	-7.9
Morocco	-4.7	-5.3	-4.9	-5.4	-3.7
Pakistan 1/	-4.0	-1.6	-2.5	-3.3	-3.4
Tunisia 1/	-3.0	-3.4	-2.5	-2.8	-2.0
Memorandum items:					
CIS	**-3.5**	**0.9**	**1.3**	**0.8**	**0.8**
MENA	**-1.3**	**0.6**	**2.6**	**6.1**	**7.6**
Of which					
GCC	**-0.4**	**5.2**	**12.4**	**19.9**	**23.2**
Maghreb	**-0.4**	**0.9**	**3.7**	**6.2**	**8.9**

1/ General government.

Table 10. Central Government Total Revenue Excluding Grants

(In percent of GDP)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**26.7**	**28.7**	**30.8**	**31.9**	**32.4**
Oil exporters	**30.5**	**33.9**	**36.8**	**38.7**	**39.4**
Algeria	33.1	36.9	36.2	39.2	40.6
Azerbaijan 1/	20.8	26.7	27.3	25.8	23.6
Bahrain	28.9	30.9	28.3	31.9	33.1
Iran	25.9	27.6	30.4	32.1	31.9
Kazakhstan 1/	20.9	25.4	26.0	25.7	25.0
Kuwait	65.7	62.6	65.1	68.2	71.2
Libya	42.8	55.2	61.1	65.2	66.2
Oman	42.4	45.4	47.4	47.9	49.9
Qatar	36.5	35.8	48.2	48.4	47.2
Saudi Arabia	30.0	34.5	41.8	44.3	46.2
Syria 1/	28.4	30.4	27.9	28.4	27.8
UAE	36.9	41.1	42.7	44.7	46.6
Low-income countries	**20.4**	**22.2**	**24.2**	**24.9**	**27.3**
Afghanistan	3.2	4.5	4.5	5.2	5.2
Armenia	16.1	14.6	15.0	15.4	15.9
Djibouti	24.0	28.2	29.0	29.0	28.8
Georgia 1/	15.1	15.7	20.5	20.5	21.3
Kyrgyz Republic 1/	20.0	21.7	22.3	22.3	22.7
Mauritania	23.6	24.1	25.4	23.1	23.5
Sudan	9.6	16.4	19.8	23.0	29.0
Tajikistan 1/	14.1	17.0	17.3	17.9	18.1
Uzbekistan 1/	36.7	32.0	31.6	29.6	30.0
Yemen	31.9	32.6	35.3	34.3	33.2
Emerging markets	**21.2**	**21.7**	**21.6**	**21.3**	**21.2**
Egypt 1/	27.9	27.0	26.7	26.2	26.5
Jordan	26.1	23.1	25.5	27.7	28.1
Lebanon	19.0	22.0	22.8	23.0	23.2
Morocco	25.8	24.5	25.1	26.6	26.1
Pakistan 1/	13.7	14.6	14.0	13.3	12.9
Tunisia 1/	29.4	29.5	29.7	28.9	29.0
Memorandum items:					
CIS	**23.3**	**25.3**	**26.0**	**25.3**	**24.8**
MENA	**27.1**	**29.2**	**31.1**	**32.4**	**33.0**
Of which					
GCC	**35.3**	**38.8**	**44.1**	**46.4**	**48.2**
Maghreb	**31.6**	**34.5**	**35.1**	**37.2**	**37.9**

1/ General government.

Table 11. Central Government Non-Oil Fiscal Balance

(In percent of GDP)

	1998-2002 Average	2003	2004	2005	2006
Oil exporters	**-18.8**	**-20.3**	**-19.8**	**-17.9**	**-16.4**
Algeria	-20.2	-21.1	-18.3	-18.4	-16.4
Azerbaijan 1/	-8.5	-10.8	-8.7	-8.6	-7.7
Bahrain	-16.8	-17.3	-19.6	-18.0	-16.9
Iran	-14.0	-16.8	-19.2	-17.3	-15.1
Kazakhstan 1/	-4.2	-3.1	-4.7	-5.1	-5.6
Kuwait	-23.0	-28.2	-26.2	-19.2	-16.6
Libya	-22.2	-36.6	-32.7	-33.8	-34.2
Oman	-29.6	-30.9	-34.4	-29.3	-28.8
Qatar	-24.4	-18.7	-11.6	-7.4	-6.0
Saudi Arabia	-26.8	-27.5	-25.5	-22.5	-21.3
Syria 1/	-14.2	-17.9	-18.0	-16.8	-17.1
UAE	-23.1	-19.8	-14.7	-10.7	-8.0

1/ General government.

Table 12. Central Government Non-Oil Revenue

(In percent of GDP)

	1998-2002 Average	2003	2004	2005	2006
Oil exporters	**11.8**	**10.6**	**11.0**	**8.8**	**9.2**
Algeria	11.4	11.3	10.5	9.2	8.1
Azerbaijan 1/ 2/	14.6	17.1	17.8	14.2	10.7
Bahrain	9.7	8.0	6.7	6.1	5.8
Iran	11.7	10.9	11.6	8.1	9.6
Kazakhstan 1/	18.0	19.7	18.6	17.4	17.2
Kuwait	21.6	14.5	13.3	12.6	13.1
Libya	15.2	7.9	8.9	7.0	7.2
Oman	9.4	10.1	8.2	7.5	7.7
Qatar	11.4	12.8	19.1	18.0	17.3
Saudi Arabia	7.5	5.8	6.6	4.2	4.1
Syria 1/	15.1	15.2	15.2	16.0	16.0
UAE	12.5	8.4	9.7	9.4	10.2

1/ General government.
2/ Including tax credits granted to the State Oil Company for underpayments by domestic consumers for energy deliveries.

Table 13. Central Government Total Expenditure and Net Lending

(In percent of GDP)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**28.3**	**28.7**	**28.6**	**26.4**	**25.5**
Oil exporters	**30.3**	**30.8**	**30.9**	**26.7**	**25.6**
Algeria	31.7	32.4	28.8	27.5	24.6
Azerbaijan 1/	22.9	28.5	26.5	23.3	18.4
Bahrain	27.7	25.8	26.8	24.4	23.0
Iran	25.7	27.7	30.8	25.3	24.7
Kazakhstan 1/	23.4	22.2	23.3	22.5	22.8
Kuwait	44.6	42.7	39.4	31.7	29.7
Libya	37.4	44.5	46.6	40.7	41.4
Oman	38.4	39.6	39.0	36.9	36.5
Qatar	35.8	31.4	30.7	25.5	23.3
Saudi Arabia	34.4	33.3	32.1	26.8	25.5
Syria 1/	27.3	32.8	33.1	32.5	33.0
UAE	35.1	27.8	24.2	19.8	18.1
Low-income countries	**22.9**	**24.8**	**25.6**	**27.3**	**28.2**
Afghanistan	8.5	14.0	13.9	15.9	14.9
Armenia	22.4	18.9	17.3	18.5	20.3
Djibouti	32.4	36.6	38.1	36.5	34.4
Georgia 1/	19.8	18.7	19.5	25.2	25.9
Kyrgyz Republic 1/	30.2	27.4	27.1	27.4	27.2
Mauritania	24.3	52.0	46.7	28.7	20.4
Sudan	10.7	15.5	19.0	23.3	26.3
Tajikistan 1/	16.8	18.8	20.9	22.6	22.8
Uzbekistan 1/	39.2	33.9	32.0	32.7	32.6
Yemen	32.2	38.2	39.0	37.4	36.8
Emerging markets	**25.7**	**25.6**	**25.2**	**25.5**	**24.8**
Egypt 1/	30.1	30.1	29.9	30.0	29.8
Jordan	34.8	35.9	37.4	39.4	33.1
Lebanon	36.7	35.2	31.3	31.1	31.1
Morocco	30.5	29.9	30.0	32.0	29.8
Pakistan 1/	18.7	17.6	16.9	16.8	16.6
Tunisia 1/	32.4	32.8	32.2	31.7	31.0
Memorandum items:					
CIS	**26.3**	**25.2**	**25.0**	**24.9**	**24.4**
MENA	**28.5**	**28.9**	**28.9**	**26.5**	**25.6**
Of which					
GCC	**35.5**	**33.2**	**31.5**	**26.4**	**25.0**
Maghreb	**32.1**	**33.5**	**32.1**	**31.0**	**29.0**

1/ General government.

Table 14. Central Government Wages and Salaries

(In percent of GDP)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**9.7**	**8.2**	**8.2**	**7.3**	**6.9**
Oil exporters	**10.4**	**8.2**	**8.2**	**6.8**	**6.3**
Algeria	8.1	7.2	7.2	6.8	6.2
Azerbaijan 1/	4.6	4.4	5.1	4.9	3.9
Bahrain	14.8	14.1	12.8	11.0	10.5
Iran	8.9	5.9	5.4	4.6	4.2
Kazakhstan 1/	3.4	3.2	3.8	3.9	3.9
Kuwait	15.9	14.4	12.5	10.0	9.3
Libya	13.5	9.3	9.9	7.5	7.1
Oman	9.2	9.1	8.4	7.3	6.8
Qatar	10.6	7.3	6.1	4.6	4.0
Saudi Arabia	17.0	14.8	15.7	11.9	11.2
Syria 1/	4.3	5.6	6.3	6.0	6.0
UAE	6.0	4.8	4.2	3.8	3.5
Low-income countries	**4.4**	**4.9**	**5.2**	**5.2**	**5.2**
Afghanistan	...	6.5	6.6	6.3	5.8
Armenia	2.7	2.2	2.1	2.2	1.4
Djibouti	15.1	14.3	13.9	13.5	11.5
Georgia 1/	3.0	3.1	3.1	3.8	3.4
Kyrgyz Republic 1/	5.0	5.7	5.9	6.1	6.3
Mauritania	5.1	4.7	4.4	5.2	3.5
Sudan	3.4	4.2	4.9	4.8	5.0
Tajikistan 1/	3.5	2.7	2.7	3.8	4.3
Uzbekistan 1/	6.7	6.5	6.2	6.2	6.2
Yemen	7.1	7.0	7.1	6.2	6.7
Emerging markets	**9.2**	**9.5**	**9.4**	**9.5**	**9.2**
Egypt 1/	6.9	7.6	7.6	7.4	7.5
Jordan	6.1	5.8	5.4	5.5	5.4
Lebanon	8.1	7.4	7.0	6.9	6.7
Morocco	12.0	12.7	12.8	13.5	12.5
Pakistan 1/	...	...	...	...	...
Tunisia 1/	11.8	12.4	12.3	12.1	11.9
Memorandum items:					
CIS	**4.4**	**4.1**	**4.4**	**4.5**	**4.3**
MENA	**10.0**	**8.7**	**8.6**	**7.6**	**7.2**
Of which					
GCC	**13.9**	**12.1**	**12.2**	**9.5**	**9.0**
Maghreb	**10.3**	**9.7**	**9.8**	**9.5**	**8.9**

1/ General government.

Table 15. Central Government Gross Domestic Debt

(In percent of GDP)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**35.8**	**33.6**	**30.4**	**26.5**	**23.0**
Oil exporters	**34.7**	**26.9**	**21.6**	**15.5**	**11.4**
Algeria	24.9	18.7	16.4	13.4	11.4
Azerbaijan 1/	0.4	0.3	0.0	0.3	0.2
Bahrain	24.4	25.0	17.0	14.4	13.5
Iran	14.2	10.4	9.5	7.3	5.9
Kazakhstan 1/	2.9	3.6	4.2	3.5	2.9
Kuwait	40.8	26.4	19.5	14.0	11.9
Libya	51.6	27.4	1.7	1.3	1.1
Oman	7.8	9.4	9.0	7.4	6.7
Qatar	35.2	24.2	18.3	13.6	11.5
Saudi Arabia	96.7	82.0	65.0	42.7	27.3
Syria 1/	5.2	7.9	11.0	15.0	19.6
UAE	5.5	6.6	8.4	6.6	2.8
Low-income countries	**4.4**	**4.4**	**4.3**	**3.9**	**3.5**
Afghanistan	0.0	0.0	0.0	0.0	0.0
Armenia	2.2	2.6	2.3	2.5	2.6
Djibouti	33.7	28.8	26.1	22.5	19.5
Georgia 1/	16.1	15.3	11.2	8.4	7.5
Kyrgyz Republic 1/	11.4	8.1	7.0	6.2	3.9
Mauritania 2/	8.2	20.9	35.3	31.1	19.3
Sudan	0.6	2.1	2.3	2.3	2.1
Tajikistan 1/	5.3	3.2	2.5	2.2	2.0
Uzbekistan 1/	0.8	0.5	0.4	0.3	0.3
Yemen	14.1	7.9	5.5	5.9	8.4
Emerging markets	**44.5**	**50.0**	**49.7**	**48.3**	**45.7**
Egypt 1/	54.7	72.1	76.6	76.2	73.2
Jordan	21.1	25.2	25.5	22.4	21.6
Lebanon	97.1	89.5	78.3	78.8	74.3
Morocco	46.3	50.1	49.9	55.0	54.8
Pakistan 1/	41.3	37.7	33.8	29.1	25.3
Tunisia 1/	22.0	21.5	22.0	22.1	21.5
Memorandum items:					
CIS	**3.6**	**3.3**	**3.2**	**2.7**	**2.3**
MENA	**38.0**	**36.0**	**32.5**	**28.1**	**24.4**
Of which					
GCC	**64.0**	**54.1**	**43.4**	**29.1**	**18.9**
Maghreb	**33.2**	**28.6**	**24.6**	**24.6**	**23.4**

1/ General government.

2/ There is a break in the series due to the transfer of foreign exchange losses of the banking system to claims on the government in 2004.

Table 16. Total Government Debt

(In percent of GDP)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**63.7**	**59.6**	**53.5**	**46.1**	**40.1**
Oil exporters	**45.1**	**35.0**	**29.6**	**22.1**	**16.9**
Algeria	64.7	43.8	38.2	29.4	23.5
Azerbaijan 1/	19.0	20.0	18.5	13.3	10.5
Bahrain	29.0	37.1	28.6	24.8	23.5
Iran	19.1	14.9	13.4	11.0	9.6
Kazakhstan 1/	18.8	15.4	12.4	9.5	8.1
Kuwait	43.6	27.6	20.4	14.0	11.9
Libya	...	...	...	...	...
Oman	27.4	16.4	15.4	11.1	9.5
Qatar	76.1	54.3	42.2	30.2	24.4
Saudi Arabia	96.7	82.0	65.0	42.7	27.3
Syria 1/	26.5	27.2	31.8	40.9	43.7
UAE	5.5	6.6	8.4	6.6	2.8
Low-income countries	**110.0**	**94.5**	**79.5**	**64.4**	**54.2**
Afghanistan	...	...	...	...	...
Armenia	46.0	41.8	35.6	31.7	30.4
Djibouti	87.5	91.0	88.9	86.9	87.2
Georgia 1/	67.3	61.6	46.9	37.3	32.7
Kyrgyz Republic 1/	109.6	103.3	95.6	83.3	76.3
Mauritania	186.5	154.7	158.4	130.7	80.4
Sudan	179.9	149.9	123.7	97.6	81.7
Tajikistan 1/	106.3	69.5	43.6	40.8	39.2
Uzbekistan 1/	29.1	38.5	33.9	27.2	21.0
Yemen	75.8	52.8	44.3	38.4	39.5
Emerging markets	**84.5**	**88.6**	**84.1**	**78.5**	**73.1**
Egypt 1/	83.2	112.1	112.7	106.0	99.3
Jordan	106.8	100.0	91.0	81.3	73.3
Lebanon	120.3	126.3	111.3	111.6	106.0
Morocco	92.7	83.0	78.0	81.4	79.2
Pakistan 1/	84.0	74.3	66.1	57.8	51.9
Tunisia 1/	60.4	63.0	60.9	57.3	54.5
Memorandum items:					
CIS	**36.7**	**30.5**	**25.6**	**20.7**	**17.6**
MENA	**65.7**	**60.9**	**55.0**	**47.4**	**41.5**
Of which					
GCC	**67.3**	**56.2**	**45.1**	**30.3**	**19.9**
Maghreb	**74.2**	**60.8**	**56.1**	**51.6**	**46.7**

1/ General government.

Table 17. Exports of Goods and Services Growth (U.S. dollars)

(Annual change; in percent)

	1998-2002 Average	2003	2004	2005	2006
Middel East and Central Asia	**9.0**	**21.2**	**26.7**	**31.6**	**15.6**
Oil exporters	**11.0**	**24.1**	**30.0**	**41.3**	**14.9**
Algeria	10.9	30.1	30.9	45.0	22.4
Azerbaijan	20.6	14.8	38.4	55.7	73.7
Bahrain	8.8	17.2	15.2	31.6	12.3
Iran	14.3	21.0	28.2	42.3	9.5
Kazakhstan	10.2	29.2	51.3	38.4	15.6
Kuwait	5.1	32.9	34.2	45.0	15.0
Libya	9.5	47.3	35.6	47.6	11.1
Oman	11.3	5.4	15.1	28.9	16.4
Qatar	23.8	21.6	37.9	46.1	21.0
Saudi Arabia	7.5	27.5	33.3	46.6	17.3
Syria	8.3	-10.0	2.5	9.9	0.5
UAE	6.6	27.2	21.8	31.4	10.7
Low-income countries	**15.2**	**25.0**	**34.0**	**28.9**	**37.8**
Afghanistan	...	49.1	-12.5	15.1	4.6
Armenia	16.4	29.5	9.0	6.3	8.4
Djibouti	3.3	8.9	-0.8	5.2	4.9
Georgia	10.8	28.9	48.1	11.1	8.4
Kyrgyz Republic	-0.5	16.4	26.4	3.7	5.3
Mauritania	-2.2	-6.7	26.5	33.8	243.5
Sudan	33.7	30.9	46.3	49.5	70.9
Tajikistan	1.0	23.2	22.9	3.5	9.1
Uzbekistan	-5.3	26.4	28.1	10.0	-0.1
Yemen	14.5	9.2	18.4	43.5	-0.5
Emerging markets	**4.2**	**15.3**	**19.4**	**15.4**	**12.0**
Egypt	2.1	14.0	27.5	26.5	18.1
Jordan	14.2	6.1	24.1	9.8	8.9
Lebanon	7.6	19.5	14.2	3.4	11.1
Morocco	5.2	16.7	16.4	2.9	5.5
Pakistan	4.8	16.4	14.0	14.0	11.1
Tunisia	3.1	14.7	19.5	7.8	5.6
Memorandum items:					
CIS	**8.1**	**25.9**	**40.3**	**29.0**	**19.0**
MENA	**9.1**	**20.7**	**25.4**	**31.8**	**15.3**
Of which					
GCC	**8.1**	**25.8**	**29.6**	**41.8**	**15.8**
Maghreb	**7.8**	**25.8**	**25.8**	**28.2**	**16.8**

Table 18. Imports of Goods and Services Growth (U.S. dollars)

(Annual change; in percent)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**4.7**	**17.2**	**25.0**	**19.3**	**11.1**
Oil exporters	**7.0**	**19.1**	**23.4**	**17.7**	**9.9**
Algeria	7.3	12.1	34.3	14.8	11.6
Azerbaijan	10.4	52.9	32.2	6.0	-3.9
Bahrain	5.8	11.6	13.2	33.6	11.4
Iran	12.1	33.3	20.3	16.7	11.3
Kazakhstan	8.2	14.9	41.3	28.4	15.3
Kuwait	2.0	16.3	6.7	5.1	5.9
Libya	5.6	-1.7	17.4	20.3	6.8
Oman	4.7	10.0	28.5	19.1	16.7
Qatar	3.7	0.2	10.2	11.9	9.0
Saudi Arabia	0.1	10.2	19.7	22.1	8.4
Syria	6.0	-0.9	24.3	6.0	4.0
UAE	5.0	20.5	18.0	17.5	7.3
Low-income countries	**5.3**	60.2	**29.8**	**24.7**	**16.4**
Afghanistan	...	27.0	2.5	17.6	6.1
Armenia	3.3	26.4	7.7	10.9	7.9
Djibouti	6.7	31.9	11.0	3.8	20.8
Georgia	0.4	15.7	46.0	25.1	-0.4
Kyrgyz Republic	0.2	41.3	30.1	9.5	7.5
Mauritania	2.6	15.2	25.5	15.1	14.5
Sudan	15.7	22.9	38.1	40.0	32.0
Tajikistan	2.0	8.9	27.1	8.2	7.4
Uzbekistan	-8.0	14.6	27.5	13.8	3.9
Yemen	5.8		7.7	17.9	10.6
Emerging markets	**0.8**	**14.1**	**26.9**	**21.1**	**12.0**
Egypt	0.2	0.2	18.8	23.6	17.5
Jordan	6.6	9.1	35.0	18.9	5.9
Lebanon	-1.0	11.3	26.5	5.3	6.5
Morocco	4.7	19.8	23.3	12.2	6.6
Pakistan	-1.0	23.6	36.2	26.2	11.4
Tunisia	3.8	14.4	16.9	8.4	6.3
Memorandum items:					
CIS	**3.9**	**20.9**	**34.8**	**19.7**	**8.4**
MENA	**4.8**	**16.9**	**24.1**	**19.3**	**11.3**
Of which					
GCC	**1.8**	**12.3**	**18.4**	**19.5**	**8.7**
Maghreb	**5.8**	**13.2**	**26.5**	**13.8**	**8.9**

Table 19. Terms of Trade

(Annual change; in percent)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**4.7**	**2.5**	**5.6**	**12.9**	**4.8**
Oil exporters	**10.1**	**4.0**	**14.0**	**29.6**	**10.5**
Algeria	11.4	9.3	11.4	35.2	18.2
Azerbaijan	17.9	5.4	9.1	17.0	9.6
Bahrain	4.7	-0.2	11.2	18.3	8.2
Iran	...	...	...	...	...
Kazakhstan	4.9	2.2	11.7	18.3	5.6
Kuwait	16.2	0.4	13.0	50.7	15.6
Libya	...	...	...	...	...
Oman	...	...	...	...	...
Qatar	...	...	...	...	...
Saudi Arabia	11.1	2.4	21.3	36.1	8.6
Syria	3.2	0.6	-4.4	-6.3	0.0
UAE	...	...	...	...	...
Low-income countries	**1.9**	**3.7**	**7.2**	**8.7**	**3.8**
Afghanistan	...	...	...	...	...
Armenia	-1.7	0.9	-0.1	-2.6	-0.9
Djibouti	-2.4	-0.8	1.6	-4.2	-2.2
Georgia	-1.2	-8.5	-7.7	0.7	1.9
Kyrgyz Republic	3.3	2.7	0.5	0.1	-1.0
Mauritania	-0.9	-11.7	1.5	5.0	6.0
Sudan	0.7	7.1	13.8	13.0	4.5
Tajikistan	-6.4	2.4	4.1	-8.0	-2.4
Uzbekistan	2.9	5.6	-0.2	0.5	2.0
Yemen	12.8	2.3	22.3	39.0	14.7
Emerging markets	**0.2**	**0.9**	**-2.3**	**-1.1**	**-0.1**
Egypt	2.5	2.2	2.7	7.2	2.5
Jordan	-2.8	-9.4	-1.2	-10.1	-3.2
Lebanon	1.7	-11.2	-6.3	-4.9	-0.5
Morocco	-0.3	5.7	-10.8	-4.6	-2.2
Pakistan	-1.0	0.0	-3.6	-5.9	-1.5
Tunisia	-1.1	-1.5	0.1	0.2	1.4
Memorandum items:					
CIS	**5.1**	**2.6**	**6.4**	**10.7**	**4.3**
MENA	**4.6**	**2.5**	**5.5**	**13.2**	**4.9**
Of which					
GCC	**11.5**	**2.0**	**20.0**	**37.1**	**9.4**
Maghreb	**5.4**	**6.0**	**2.5**	**16.4**	**8.9**

Table 20. Real Effective Exchange Rate

(CPI based; annual percent change; increase indicates appreciation)

	1998-2002 Average	2003	2004
Middle East and Central Asia	**0.1**	**-8.8**	**-3.1**
Oil exporters	**1.2**	**-7.4**	**-2.9**
Algeria	-2.1	-10.7	0.7
Azerbaijan	-2.8	-10.8	-3.2
Bahrain	0.4	-8.4	-5.6
Iran	5.9	-3.5	-0.5
Kazakhstan	-2.2	-3.0	4.9
Kuwait	2.5	-7.9	-5.4
Libya	-15.3	-17.5	-14.1
Oman	0.0	-11.6	-9.6
Qatar	2.0	-7.5	2.7
Saudi Arabia	0.0	-9.9	-7.6
Syria	0.0	-7.5	-3.9
UAE	3.7	-7.7	-5.1
Low-income countries	**-2.0**	**-8.6**	**-1.0**
Afghanistan	...	...	...
Armenia	-1.7	-6.9	4.7
Djibouti	2.7	-10.4	-5.2
Georgia	-1.8	-6.4	5.4
Kyrgyz Republic	-1.8	3.5	-3.4
Mauritania	-5.3	-6.3	-0.4
Sudan	1.1	-3.7	0.5
Tajikistan	-2.1	-9.4	-2.2
Uzbekistan	-10.3	-21.5	-7.5
Yemen	6.2	-5.6	2.3
Emerging markets	**-1.3**	**-12.4**	**-2.6**
Egypt	-1.8	-29.1	-3.6
Jordan	2.7	-7.9	-4.2
Lebanon	3.1	-12.0	-6.4
Morocco	0.4	-2.0	-0.9
Pakistan	-2.1	-5.1	-1.9
Tunisia	-0.8	-4.2	-3.1
Memorandum items:			
CIS	**-3.9**	**-8.2**	**0.7**
MENA	**0.5**	**-9.3**	**-2.9**
Of which			
GCC	**1.0**	**-9.3**	**-6.6**
Maghreb	**-2.9**	**-8.1**	**-2.2**

Source: IMF Information Notice System (INS).

Table 21. External Current Account Balance

(In percent of GDP)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**1.7**	**4.0**	**6.4**	**10.4**	**11.5**
Oil exporters	**4.4**	**6.6**	**9.7**	**17.7**	**20.1**
Algeria	7.1	13.0	13.1	19.1	23.6
Azerbaijan	-12.1	-27.7	-30.3	-10.2	14.3
Bahrain	-0.2	2.1	3.8	9.2	11.8
Iran	5.0	0.6	2.5	8.7	7.9
Kazakhstan	-2.1	-0.9	1.3	3.9	2.8
Kuwait	20.3	17.5	29.2	44.8	50.2
Libya	8.2	15.5	23.6	39.5	41.7
Oman	1.2	4.0	1.7	8.3	9.5
Qatar	8.0	29.0	41.0	50.3	55.6
Saudi Arabia	2.1	13.1	20.5	32.4	37.3
Syria	4.5	6.0	1.9	0.7	-0.1
UAE	7.0	8.7	11.8	21.8	25.4
Low-income countries	**-7.4**	**-2.3**	**-1.5**	**-1.9**	**0.6**
Afghanistan	-3.5	3.1	0.7	0.8	-0.8
Armenia	-13.8	-6.8	-4.6	-5.4	-5.9
Djibouti	1.3	6.6	-0.6	-0.7	-1.7
Georgia	-6.9	-7.2	-7.6	-10.2	-6.5
Kyrgyz Republic	-9.3	-3.0	-2.8	-4.9	-4.9
Mauritania	-2.1	-7.5	-16.8	-19.0	14.7
Sudan	-14.6	-7.8	-6.2	-6.0	-0.8
Tajikistan	-6.2	-1.3	-4.0	-4.9	-4.4
Uzbekistan	0.0	8.7	10.0	7.8	5.4
Yemen	4.8	-0.1	2.0	7.6	4.5
Emerging markets	**-1.1**	**2.5**	**1.3**	**-0.4**	**-1.2**
Egypt	-1.1	2.8	4.4	4.6	3.4
Jordan	2.3	11.3	-0.4	-12.3	-13.5
Lebanon	-20.0	-12.5	-16.0	-16.9	-16.5
Morocco	1.3	3.6	2.2	-1.6	-2.8
Pakistan	-0.5	3.4	0.2	-1.7	-2.3
Tunisia	-3.5	-2.9	-2.0	-2.6	-2.6
Memorandum items:					
CIS	**-4.4**	**-3.4**	**-2.5**	**0.7**	**3.3**
MENA	**2.3**	**5.3**	**6.8**	**11.0**	**12.2**
Of which					
GCC	**4.6**	**12.3**	**18.6**	**29.7**	**34.1**
Maghreb	**3.9**	**8.1**	**8.8**	**12.2**	**14.6**

Table 22. Gross Official Reserves 1/

(In billions of U.S. dollars)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**163.0**	**257.6**	**321.3**	**395.5**	**489.8**
Oil exporters	**121.9**	**191.0**	**251.4**	**322.8**	**410.1**
Algeria	12.9	32.9	43.1	59.2	85.1
Azerbaijan	0.7	0.8	1.1	1.3	1.7
Bahrain	1.2	1.4	1.6	1.7	1.9
Iran	12.4	24.4	33.0	54.8	65.4
Kazakhstan	2.3	5.0	9.3	9.8	11.0
Kuwait	7.1	7.7	8.4	9.7	11.3
Libya	11.1	18.9	23.8	33.8	46.0
Oman	2.6	3.6	3.6	3.8	4.5
Qatar	1.3	2.9	3.4	4.2	4.5
Saudi Arabia 2/	45.2	59.8	86.7	103.1	133.6
Syria	12.5	18.5	18.9	19.1	19.2
UAE	12.7	15.1	18.6	22.1	25.9
Low-income countries	**5.1**	**8.9**	**11.7**	**13.6**	**16.2**
Afghanistan	0.4	0.7	1.3	1.6	2.0
Armenia	0.4	0.5	0.5	0.6	0.7
Djibouti	0.1	0.1	0.1	0.1	0.1
Georgia	0.1	0.2	0.4	0.5	0.5
Kyrgyz Republic	0.2	0.4	0.6	0.5	0.5
Mauritania	0.3	0.2	0.0	0.1	0.3
Sudan	0.1	0.5	1.3	2.0	3.6
Tajikistan	0.1	0.1	0.2	0.2	0.2
Uzbekistan	1.2	1.7	2.1	2.4	2.5
Yemen	2.5	4.4	5.1	5.6	5.8
Emerging markets	**36.0**	**57.7**	**58.2**	**59.1**	**63.5**
Egypt	16.0	14.3	13.9	16.3	19.1
Jordan	2.4	4.7	4.8	4.2	3.5
Lebanon	5.7	10.2	9.5	8.1	8.0
Morocco	6.6	13.7	16.3	14.9	15.2
Pakistan	3.3	11.8	9.8	11.5	12.9
Tunisia	2.0	2.9	4.0	4.2	4.7
Memorandum items:					
CIS	**5.0**	**8.6**	**14.2**	**15.3**	**17.1**
MENA	**157.9**	**248.2**	**305.8**	**378.7**	**470.7**
Of which					
GCC	**70.1**	**90.5**	**122.2**	**144.7**	**181.7**
Maghreb	**32.9**	**68.7**	**87.2**	**112.2**	**151.4**

1/ Simple averages.
2/ Saudi Arabia Monetary Agency net foreign assets.

Table 23. Gross Official Reserves 1/

(In months of imports)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**7.7**	**9.8**	**10.7**	**11.1**	**12.5**
Oil exporters	**9.6**	**12.4**	**13.0**	**14.8**	**17.2**
Algeria	12.3	24.3	23.7	28.4	36.6
Azerbaijan	3.5	2.0	2.0	2.3	3.2
Bahrain	3.1	2.7	2.7	2.2	2.2
Iran	6.9	7.5	8.4	11.9	12.8
Kazakhstan	3.1	4.5	5.9	4.9	4.7
Kuwait	6.8	5.7	5.8	6.4	7.0
Libya	21.7	25.8	27.6	32.7	41.6
Oman	4.6	5.2	4.1	3.6	3.7
Qatar	2.6	5.1	5.4	6.0	5.9
Saudi Arabia 2/	10.6	12.1	14.7	14.3	17.1
Syria	35.0	45.0	37.0	35.3	34.1
UAE	3.8	3.1	3.3	3.3	3.6
Low-income countries	**2.9**	**4.1**	**4.9**	**4.8**	**5.4**
Afghanistan	1.8	2.0	3.5	3.7	4.2
Armenia	4.3	4.4	4.3	4.5	4.3
Djibouti	-6.5	-7.1	-5.9	-6.1	-5.5
Georgia	1.3	1.3	1.7	1.7	1.9
Kyrgyz Republic	4.2	5.3	6.0	5.0	4.8
Mauritania	5.5	2.7	0.4	0.8	2.9
Sudan	0.5	1.9	3.5	3.7	5.0
Tajikistan	1.2	1.4	1.6	1.6	1.6
Uzbekistan	4.7	6.4	6.5	6.3	6.5
Yemen	8.5	11.6	12.4	11.6	10.7
Emerging markets	**5.6**	**8.7**	**6.6**	**6.0**	**5.9**
Egypt	9.0	8.8	7.2	6.8	6.8
Jordan	5.1	8.2	6.1	4.5	3.5
Lebanon	8.6	13.9	10.3	8.3	7.7
Morocco	6.4	10.3	9.9	8.1	7.8
Pakistan	3.1	8.9	5.4	5.0	5.1
Tunisia	2.6	3.0	3.5	3.3	3.6
Memorandum items:					
CIS	**3.4**	**4.3**	**5.0**	**4.5**	**4.6**
MENA	**8.1**	**11.1**	**10.7**	**11.7**	**13.2**
Of which					
GCC	**8.0**	**8.9**	**10.4**	**10.2**	**11.9**
Maghreb	**10.3**	**17.2**	**17.1**	**19.3**	**23.9**

1/ Calculated using current year's imports.
2/ Saudi Arabia Monetary Agency net foreign assets.

Table 24. Total Gross External Debt

(In percent of GDP)

	1998-2002 Average	2003	2004	2005	2006
Middle East and Central Asia	**38.8**	**36.1**	**32.4**	**27.6**	**24.7**
Oil exporters	**25.4**	**21.1**	**19.8**	**16.5**	**14.7**
Algeria	49.7	34.3	25.7	18.4	15.0
Azerbaijan	18.6	19.7	18.6	13.0	10.2
Bahrain	25.9	31.2	29.6	26.3	25.5
Iran	9.4	9.0	9.8	8.6	8.0
Kazakhstan	58.7	74.1	78.6	66.0	58.3
Kuwait	33.3	29.7	24.7	18.5	16.8
Libya	...	...	...	...	...
Oman	35.8	18.8	17.7	12.8	11.0
Qatar	100.8	58.2	55.2	44.9	39.5
Saudi Arabia	16.1	11.1	10.3	9.0	8.6
Syria	21.4	19.3	20.7	25.9	24.2
UAE	29.5	18.7	15.1	11.9	10.7
Low-income countries	**107.6**	**91.6**	**76.8**	**61.9**	**52.3**
Afghanistan	12.7	13.5	12.1	12.8	12.8
Armenia	43.8	39.1	33.3	29.2	27.8
Djibouti	53.8	62.2	62.9	64.4	67.7
Georgia	53.4	48.7	39.0	32.5	30.1
Kyrgyz Republic	117.3	98.3	95.2	81.5	76.4
Mauritania	184.9	147.3	123.1	99.7	60.9
Sudan	179.3	147.9	121.4	95.4	79.6
Tajikistan	101.7	66.3	41.1	37.6	36.3
Uzbekistan	32.1	41.2	37.7	31.0	24.9
Yemen	61.7	44.9	38.8	32.5	31.0
Emerging markets	**47.3**	**46.4**	**42.2**	**37.2**	**34.7**
Egypt	31.0	41.5	37.6	31.6	28.5
Jordan	85.7	74.8	65.5	59.0	51.7
Lebanon	141.2	176.6	185.6	176.7	179.5
Morocco	51.6	38.4	33.2	30.2	28.0
Pakistan	47.8	39.1	34.0	29.8	27.6
Tunisia	59.0	64.8	63.8	57.2	55.0
Memorandum items:					
CIS	**50.5**	**57.2**	**56.6**	**47.3**	**41.5**
MENA	**38.1**	**33.1**	**29.5**	**25.2**	**22.9**
Of which					
GCC	**25.0**	**16.9**	**15.2**	**12.4**	**11.5**
Maghreb	**53.9**	**42.6**	**36.2**	**30.1**	**26.7**