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Economic Prospects and Policy Challenges for the GCC Countries

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INTERNATIONAL MONETARY FUND

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Executive Summary

The already sluggish global recovery has suffered new setbacks and uncertainty weighs heavily on prospects. The euro area crisis intensified in the first half of 2012 and growth has slowed across the globe, reflecting financial market tensions, extensive fiscal tightening in many countries, and high uncertainty about medium-term prospects. Activity is forecast to remain tepid and bumpy, with a further escalation of the euro-area crisis or a failure to avoid the "fiscal cliff" in the United States entailing significant downside risk.

In the MENA region, many countries are going through difficult transitions. Changes of government in Egypt, Libya, Tunisia and Yemen were accompanied by varying degrees of social unrest and associated disruptions to economic activity, and the conflict in Syria has continued to intensify. Social instability and political uncertainties—although in several cases having receded in recent months—remain substantial, and the near-term growth outlook for the countries in transition is generally subdued. The medium-term reform agenda necessary to lay the basis for inclusive private sector led growth has yet to be tackled. The IMF is engaging closely with these countries—including through financing programs in Yemen, Jordan and Morocco—but additional financing needs remain large. Stronger cooperation with GCC countries who are major financiers for these countries could be of great benefit.

The GCC economies are enjoying high growth. The combination of historically high oil prices, expanded oil production, expansionary fiscal policies, and low interest rates is supporting buoyant economic activity. Fiscal and external surpluses are large, inflation is moderate, and prospects for growth remain positive. At the same time, however, the economies remain dependent on hydrocarbon extraction and rising government spending has raised breakeven oil prices, implying heightened vulnerabilities.

Risks to the GCC stemming from exposure to Europe are limited, but the impact via oil demand and prices could be substantial. A rapid deterioration in the global economy could bring about developments similar to what the region experienced in 2009, including a sharp fall in oil prices and disruptions to capital flows. Although most GCC countries have sufficient savings to cushion even a sizeable shock, a prolonged drop in oil prices could test available buffers.

The strong baseline outlook for the GCC economies implies diminishing need for near-term policy stimulus. Most GCC countries can plan to reduce the growth rate in government spending in the period ahead, which would help prevent any prospect of overheating and also improve long-term fiscal positions. With low inflation, the accommodative monetary stance as implied by the region's currency pegs remains appropriate.

Given the uncertain global outlook, however, continued emphasis on reducing vulnerabilities will be important alongside greater focus on strengthening the foundations for longer-term growth and diversification. This includes: (i) reducing fiscal risks and improving the fiscal outlook by containing increases in spending on entitlements that are hard to reverse and instead prioritizing growth-enhancing investments in infrastructure; (ii) strengthening fiscal frameworks and institutions; (iii) bolstering the financial sector, including through continuing to enhance supervision and macropudential policy frameworks and by deepening domestic debt markets; and (iv) advancing private sector job creation for nationals.

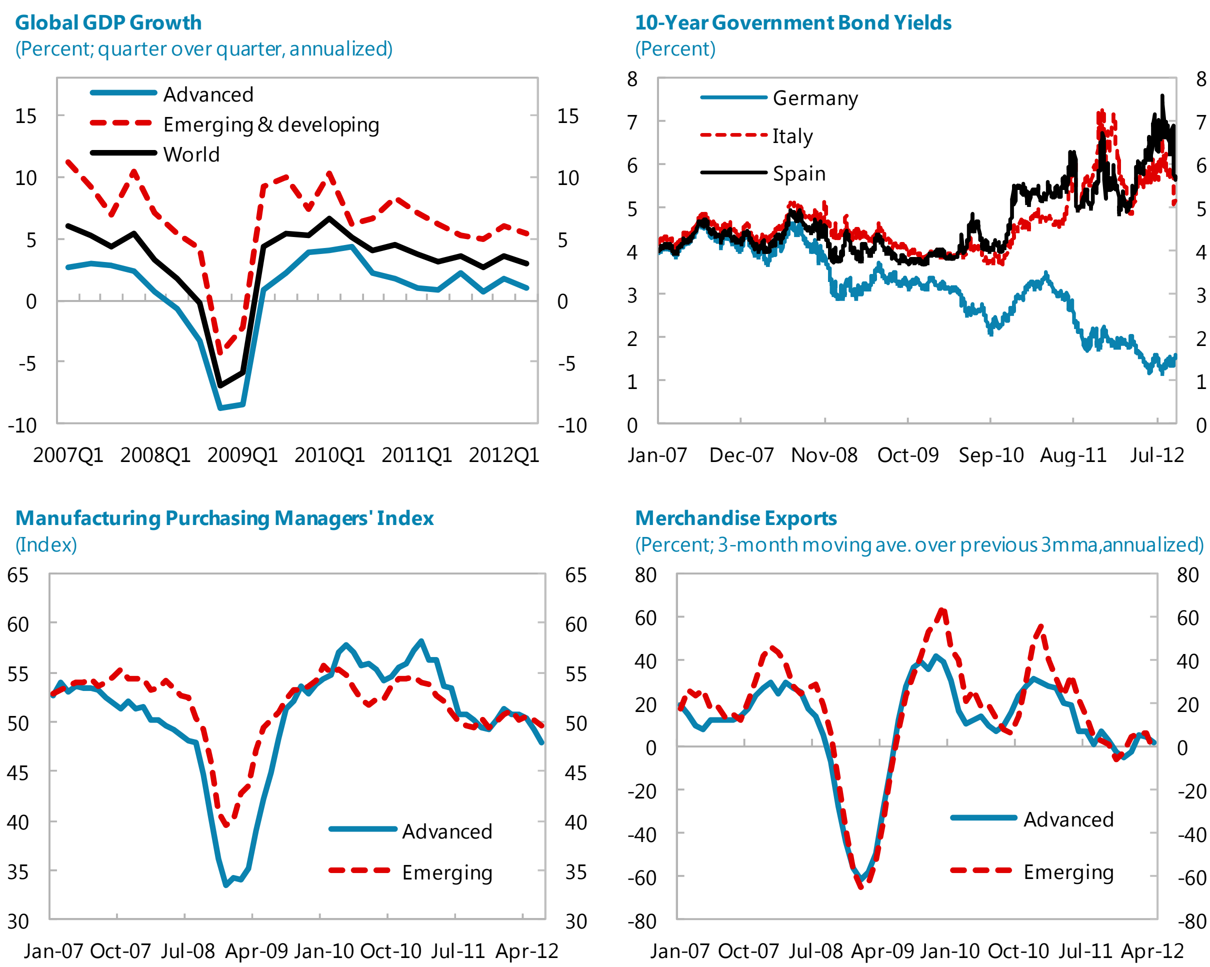
Prepared by May Khamis, Tobias Rasmussen, and Niklas Westelius.

I. International Context

The already sluggish global recovery has suffered new setbacks and uncertainty weighs heavily on prospects. The euro area crisis intensified in the first half of 2012 and growth has slowed across the globe amid deteriorating financial conditions and uncertainty about medium term prospects. Activity is forecast to remain tepid and bumpy, with a further escalation of the euro-area crisis or a failure to avoid the "fiscal cliff" in the United States entailing significant downside risk.

1. **Economic activity showed widespread weakness over the past year** (Figure 1). The downturn has been most pronounced in the euro area periphery where most countries are now in recession. The slowdown has been observed in all regions, however, reflecting financial market tensions, extensive fiscal tightening in many countries, and cross-country spillovers. As demand for durables flagged, global manufacturing was particularly hard hit and global trade stagnated.

Figure 1. Recent Economic Indicators, 2007–12



Sources: DataStream; Haver; and IMF staff estimates.

2. **The euro area crisis deepened in the first half of the year but financial tensions have recently moderated.** The euro area periphery has been at the center of several bouts of intense financial market stress, triggered by political and financial uncertainty in Greece, banking sector problems in Spain, and doubts about governments' ability to deliver on fiscal adjustment and the extent of partner countries' willingness to help. As the crisis intensified, periphery bond yields rose, stocks fell—in particular those of banks and peripheral economies—and the euro depreciated. This culminated in Spanish spreads reaching a euro-era record in late July. Since then, a new bond-buying program announced by the European Central Bank and further monetary easing by U.S. Federal Reserve have led to a marked improvement in market sentiment.

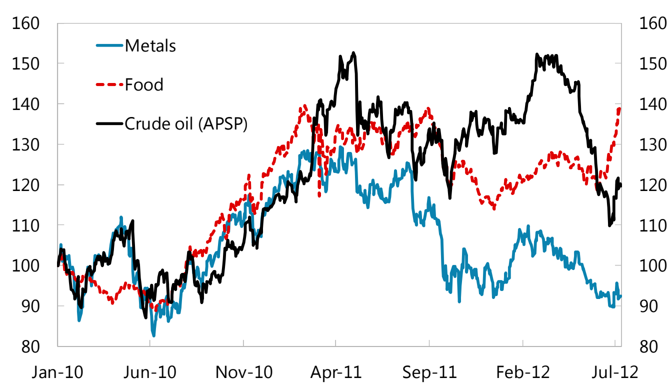
3. **Growth in advanced economies has slowed noticeably.** In Europe, as the downturn in the euro area periphery deepened, growth also slowed considerably in the core, and real GDP contracted in the United Kingdom. In the United States, employment and output growth was lower than expected even as the housing market is showing tentative signs of improvement. In Japan, growth fell sharply as the boost from reconstruction activity following last year's earthquake and tsunami started to wane.

4. **Emerging markets—especially those in Asia—continue to outperform advanced economies but they too have seen the momentum fade.** Although still strong at an annual rate of almost 8 percent in the second quarter, the pace of real GDP growth in China has continued to decline following earlier policy tightening aimed at reducing price pressures and as a result of weak external demand. A partial reversal of this earlier policy tightening has yet to gain traction, and slowing growth in China has affected activity throughout the region. The pace of expansion in India's economy has also moderated significantly, with weaker business sentiment weighing in. Along with slower growth, many emerging markets have been hit by investor risk aversion, which have led to equity price declines and in some cases capital outflows and currency depreciation.

5. **Consumer price inflation has generally eased along with slower growth.** Headline inflation has declined in both advanced and emerging and developing economies, with the combined rate slipping from 4½ percent in the last quarter of 2011 to currently around 3½ percent.

6. **Reflecting the weakness in demand, commodity prices are on average somewhat lower than a year ago, but with considerable variation across products** (Figure 2). For some goods, supply side developments have been an important factor in price movements. Oil markets have through the year been heavily influenced by anticipated or actual changes in supply,

Figure 2. Commodity Price Indices, 2010–12
(Index, Jan.1, 2010=100)



Source: IMF staff calculations.

with increased geopolitical risks relating to Iran as well as production outages in several countries driving up prices by over 20 percent since early June. Food prices have increased by a similar amount due to a rapidly deteriorating supply outlook for some crops (especially maize, wheat, and soybean) following adverse weather in key producing regions. For both oil and food, however, futures markets indicate that prices will fall back somewhat over the next year.

7. **Looking ahead, ebbing fiscal tightening and easing monetary policy will help support activity.** In advanced economies, where most countries are struggling to reduce deficits and reign in debt, cyclically adjusted fiscal balances improved by about ¾ percent of GDP in 2011 and a similar degree of adjustment is in store for both 2012 and 2013. Fiscal positions are generally on a stronger footing in emerging and developing economies, and for these countries no significant fiscal tightening is expected following their 1¼ percent of GDP adjustment in 2011. Across the world, given limited price pressures, monetary policy has mostly been easing and that process will likely continue, although interest rates already close to zero in many advanced economies are constraining the room to maneuver.

8. **Overall, the outlook is for only a slow acceleration in output with significant downside risks.** Activity is projected to gradually pick-up across both advanced and emerging economies. This projection, however, is predicated on two important assumptions: first, that European policymakers will take steps to stabilize and gradually bring down sovereign spreads; and, second, that U.S. policymakers will avoid the drastic automatic tax increases and spending cuts (the “fiscal cliff”) implied by current law.

II. Developments in the Middle East and North Africa (MENA) Region

Differences in economic performance between oil exporters and importers have widened as oil prices have remained near historical highs. Moreover, several countries in the region continue to struggle with internal conflict and commodity risks loom large.

9. **Overall real economic growth for MENA fell from 5 percent in 2010 to 3.3 percent in 2011 and is projected to pick up to 5.3 percent in 2012.** Much of this movement in region-wide growth has, however, been driven by the 2011 collapse and 2012 rebound of Libya's oil production.

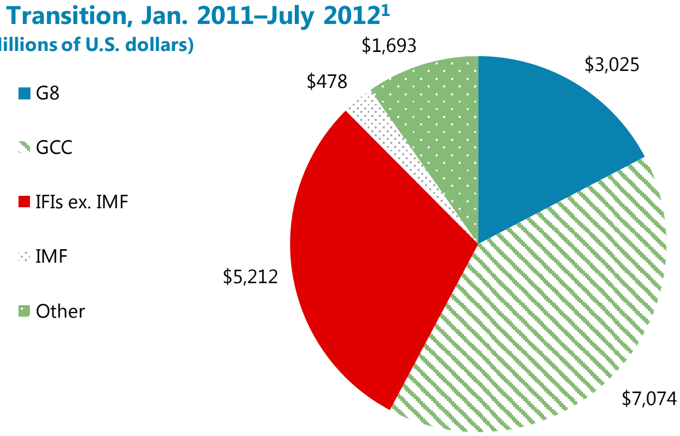
10. **Several MENA economies have been severely affected by ongoing political transitions and associated disruptions to economic activity.** Changes of governments in Egypt, Libya, Tunisia, and Yemen were accompanied by varying degrees of social unrest, and the political transition continues. Moreover, the conflict in Syria continues to intensify and is affecting its neighbors. The countries in transition have all seen interruptions to production, and unrest also led to wider declines in tourism and foreign direct investment, which have not been able to rebound strongly due to weak conditions in Europe and elsewhere in the world. Management of popular expectations will remain a challenge.

11. **Near-term growth prospects for the region's oil importers remain subdued.** Uncertainties stemming from ongoing political transitions, a weakening global economy, and the recent increase in food and fuel prices are weighing on the outlook. Growth for the oil importers (excl. Syria) is projected at just 1.4 percent this year—a rate that is far below both potential and what is required to address chronic and growing unemployment. Buffers have largely run out, yet fiscal and current account balances continue to deteriorate. With borrowing costs rising in several countries, fiscal and external deficits have also become harder to finance in the absence of external assistance.

12. **The GCC countries have contributed significant assistance to the transition countries.** Of the $17.5 billion in official financing disbursed since the start of 2011, the GCC countries have provided $7.1 billion (Figure 3). Overall, however, support to the transition countries has still fallen short of financing needs.

Figure 3. Official Financing Disbursed to Arab Countries in Transition, Jan. 2011–July 2012[1]

(Millions of U.S. dollars)



Sources: National authorities; and IMF staff calculations.

[1] Includes Egypt, Jordan, Libya, Morocco, Tunisia, and Yemen.

13. **The near-term outlook for the region's oil exporters is buoyed by accommodative fiscal and monetary policy stances.** For the group, real GDP growth is projected at 6.6 percent in 2012, up from 3.9 percent in 2011. There are significant

differences across countries, with Yemen and Iran facing negative growth in 2012—the latter reflecting sharply lower export revenue as a result of tightened U.S. sanctions and the EU oil embargo. Generally, however, high levels of government spending and accommodative monetary conditions are expected to support robust non-oil GDP growth of 4.8 percent in 2012. Many countries are expected to have relatively fast growth in the construction, infrastructure and non-tradable consumer sectors.

14. **For both importers and exporters, risks revolve around commodity prices and global growth.** Weaker global aggregate demand could lead to a prolonged large drop in oil prices, which for the oil exporters would worsen their fiscal and external balances. Conversely, geopolitical tensions could lead to a sharp increase in oil prices, although the net effect on oil revenue would depend on what happens to export volumes if this translates into supply disruptions. The oil importers' economies would be negatively affected by higher oil prices but, considering import weights, another important risk for them would be an additional increase in international food prices. Given trade ties, the Maghreb countries would be particularly vulnerable to a further downturn in Europe.

III. Developments in GCC Countries

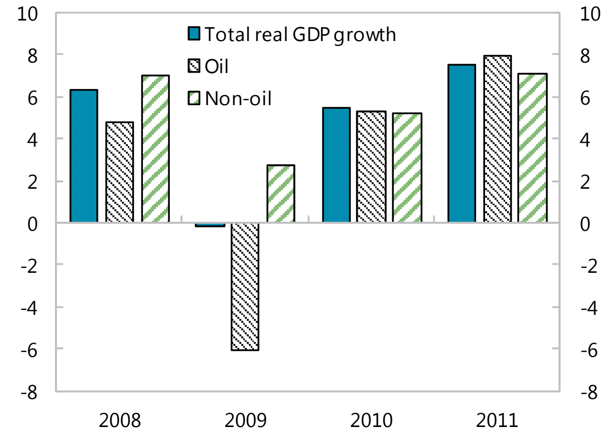
The GCC economies have benefitted from historically high oil prices and expanded oil production, with expansionary fiscal policies and low interest rates providing additional stimulus. External and fiscal surpluses are generally large, consumer price inflation is moderate, and the outlook for growth remains positive. Risks stemming from direct exposure to developments in Europe are limited, but indirect effects via oil prices could be substantial.

15. **The GCC economies are growing at a strong pace.** Output growth has in most countries been steadily increasing since hitting a low in 2009 in the wake of the global financial crisis (Figure 4). In 2011, overall real GDP growth for the GCC reached 7.5 percent—the highest since 2003. This occurred as oil production rose by over 10 percent and as non-hydrocarbon growth increased in all countries, except Bahrain where social unrest has taken a toll.

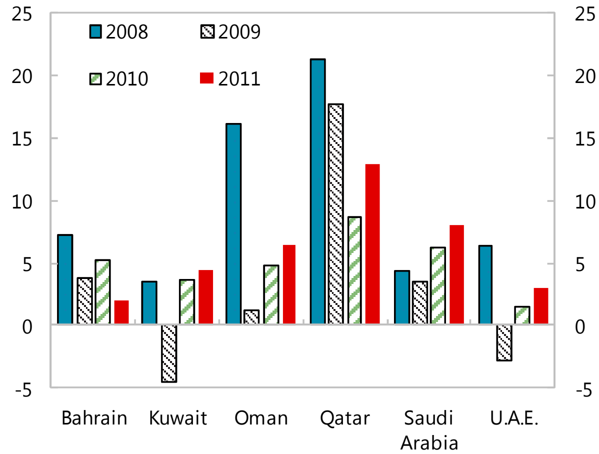
16. **Fiscal policies have provided significant stimulus.** In 2011, as governments responded to social pressures and took advantage of surging oil revenues, overall spending grew by some 20 percent in U.S. dollar terms, about double the pace of the previous two years. Much of the higher spending was in current expenditure, including from larger wage bills (all countries) and introduction of new benefits for job-seekers (Oman and Saudi Arabia). Capital expenditure also increased sharply in Saudi Arabia.

Figure 4. GCC: Recent Economic Developments

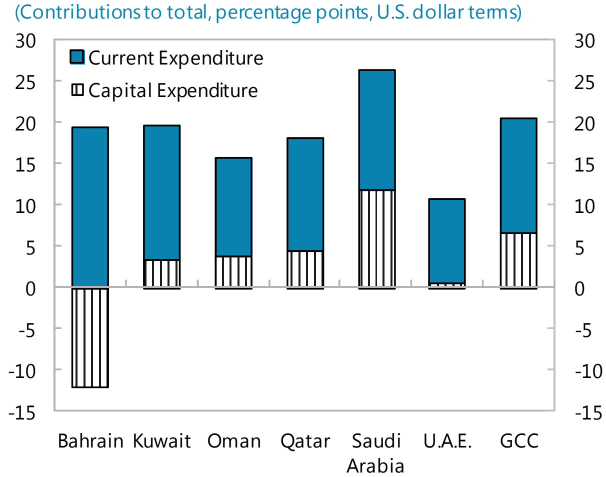
Total Real GDP Growth, 2008–11
(Percent)



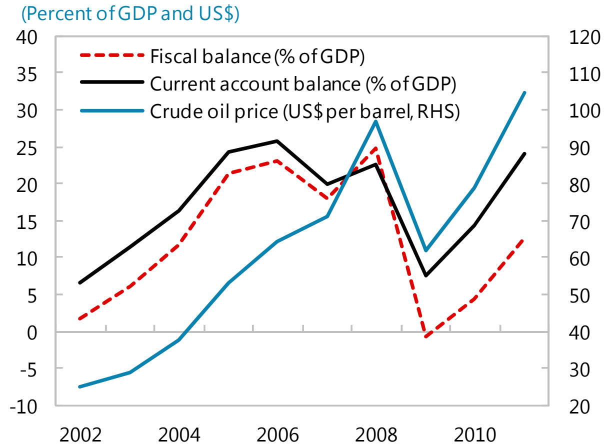
Non-oil Real GDP Growth, 2008–11
(Percent)



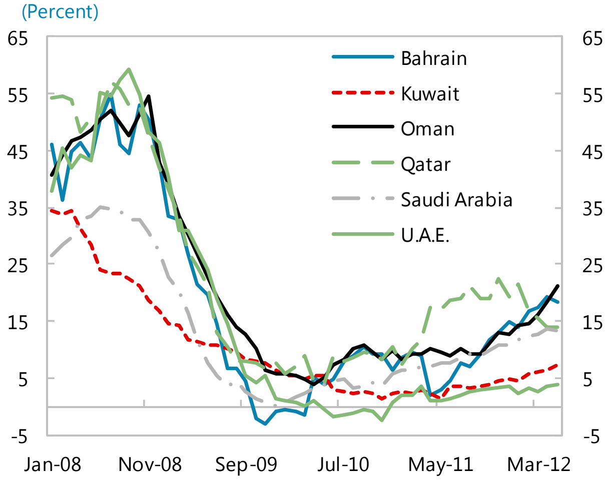
Government Expenditure Growth, 2011
(Contributions to total, percentage points, U.S. dollar terms)



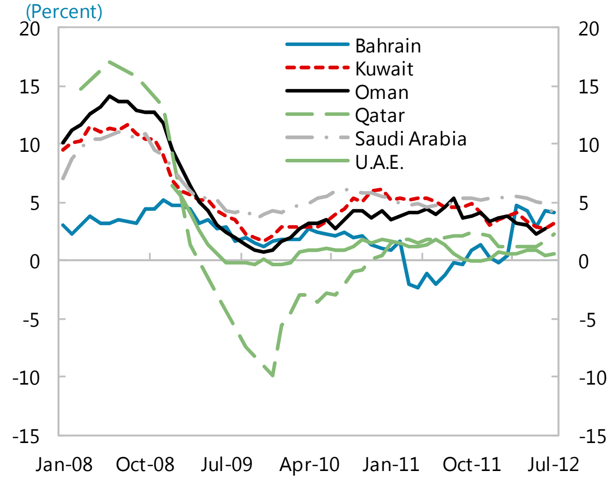
Oil Prices and Main Balances, 2002–11
(Percent of GDP and US$)



Private Sector Credit Growth, 2008-Latest
(Percent)



CPI Inflation, 2008–Latest
(Percent)



Sources: Country authorities; Bloomberg; and IMF staff calculations.

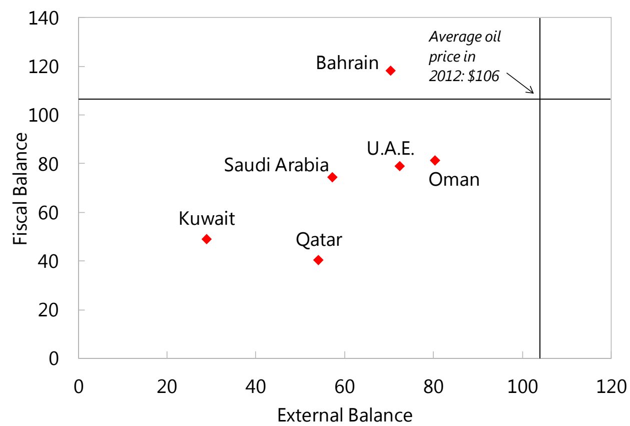
17. **Monetary conditions have remained highly accommodative, helping to offset retrenchment in international risk appetite.** Policy rates have stayed exceptionally low, in line with those applying to the anchor currencies for the region's exchange rate pegs. This has provided important support to the ongoing recovery. Indeed, all GCC countries have seen growth in local bank credit to the private sector increase over the past year, although the pace remains anemic in Kuwait and UAE where non-oil growth is also still relatively low. Conditions for external funding have tightened, however, with ongoing deleveraging by European banks and a general reduction in capital flows to emerging markets.

18. **Despite buoyant activity and expansionary policies, price pressures are well contained.** CPI inflation has mostly moderated over the past year and has in all cases been below 5 percent in the latest data. Both food and rental prices—two traditional drivers of inflation in the GCC—have generally been subdued, with food prices in many cases held down by subsidies and the real estate market in some countries still facing a supply overhang from the pre-2009 boom.

19. **Fiscal and external surpluses remain large, but higher government spending has raised breakeven oil prices.** Driven by the surge in oil revenue, the GCC's fiscal surplus is estimated to have reached about 13 percent of GDP in 2011 and the external current account about 24 percent of GDP. Both these balances are projected to remain broadly stable in 2012 as oil prices have leveled off. Along with rising government spending, however, the underlying breakeven oil prices have continued to increase. Although mostly remaining well below actual oil prices (Figure 5), breakeven oil prices are at a historical high, implying heightened vulnerabilities.

Figure 5. Break-even Oil Prices, 2012

(U.S. dollars per barrel)



Sources: Country authorities; and IMF staff estimates.

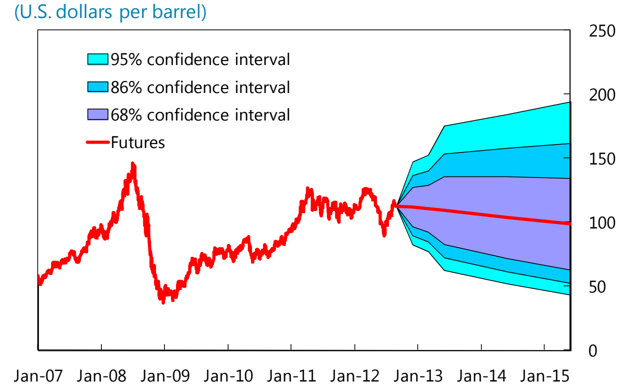
20. **Non-oil growth is expected to remain strong, albeit somewhat lower than in 2011.** Real non-oil GDP growth is projected to slow from 7 percent in 2011 to just under 6 percent in 2012 and then to 5½ percent in 2013. This slowdown reflects lower growth in government spending as well as weaker external conditions, with the effects partially offset by still accommodative monetary conditions and the positive momentum in private sector activity.

21. **Income from oil is also expected to become less buoyant, highlighting longer-term challenges.** Oil production is expected to fall slightly in the year ahead. Moreover, based on futures prices, the latest projection in the World Economic Outlook has crude prices declining gradually over the medium term, falling below $100 per barrel in 2015. Accordingly, along with continued increases in government spending, fiscal and external

surpluses are, with unchanged policies, projected to decline in 2013 and beyond, with the combined fiscal surplus turning to deficit around 2017.

22. **The outlook, however, is clouded by significant uncertainties.** The distribution of options prices for oil have widened considerably in recent months and are now skewed upwards (Figure 6), suggesting that markets are assigning greater weight to geopolitical risks and resulting supply disruptions than to a further slowdown in global oil demand. Downside risks include potential disruptions to shipping in the event of escalating conflict in the region. Moreover, as discussed in the next section, a further intensification of the European crisis would affect the GCC through a range of channels. Over the longer term, advances in energy production from shale and other unconventional sources could depress prices of hydrocarbons, as has already been seen in the U.S. market for natural gas.

Figure 6. Brent Oil Price Prospects, 2007–15[1]
(U.S. dollars per barrel)



Sources: Bloomberg; and IMF staff calculations.
[1]Derived from prices of futures options on August 28, 2012.

IV. Spillover Risks from Europe and a Global Slowdown

A worsening of the European debt crisis could impact the GCC through trade and financial linkages. Two main transmission channels are explored in this section: (i) real sector effects of a widening of the crisis resulting in lower global growth and energy demand, and (ii) financial links to global and European banks.

23. **A global growth slowdown following an intensification of the euro area debt crisis could adversely affect the GCC through lower oil export revenues.** The region's high dependence on hydrocarbon export revenues makes it vulnerable to sharp declines in oil prices and global energy demand. Given the central role of public spending in GCC economies and the low degree of diversification, a prolonged drop in oil prices caused by a slowdown in global demand would result in a weakening of external and fiscal balances and could have an adverse impact on financial and economic conditions. However, large public external asset buffers and low government debt levels should help mitigate the impact on non-oil activity in most GCC countries.

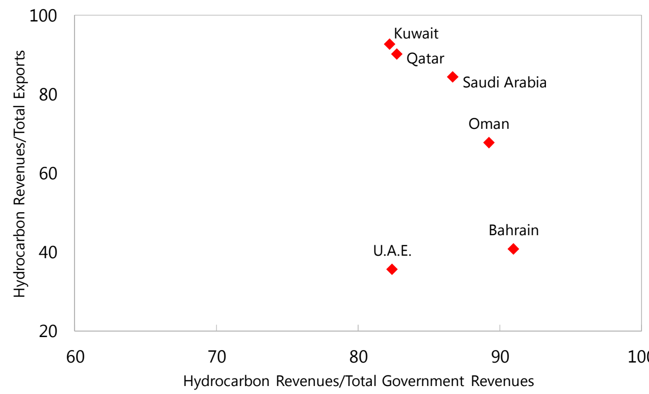
24. **A worsening of the euro area debt crisis could also lead to reduced access to foreign funding for the GCC.** As European banks seek to strengthen capital buffers and address sovereign debt exposure, lending to the GCC could fall and potentially cause a temporary shortage of liquidity. However, large domestic liquidity buffers and ample foreign reserves should help bridge such a liquidity squeeze. If the retrenchment of European banks is long lasting, alternative funding sources—both domestic and foreign—may have to fill the gap. A further deterioration of financial and economic conditions in Europe could also

negatively affect the quality of foreign assets held by bank and non-bank sectors in the GCC, reducing private sector and sovereign net worth.

A. Trade Linkages and Exposure to Europe

25. **The GCC's high dependence on hydrocarbon export revenues makes the region vulnerable to a sharp drop in oil prices.** The shares of hydrocarbon export revenues in total exports exceeded 80 percent for Saudi Arabia, Kuwait and Qatar in 2011 (Figure 7). In contrast, Bahrain and the UAE's shares only amounted to 36 and 41 percent, respectively, reflecting a higher degree of economic diversification with large financial service and tourism sectors.[1] However, hydrocarbon export receipts are the dominant source of revenue for all GCC governments, with shares exceeding 80 percent of total receipts.[2] Consequently, a sharp fall in oil prices would imply a substantial worsening of external and fiscal balances and could potentially also have an impact on government spending and economic activity.

Figure 7. Reliance on Hydrocarbon Export Revenues, 2011
(Percent)



Source: Country authorities.

26. **Reflecting their exposure to oil price uncertainties, most GCC countries have therefore built up significant precautionary buffers.** The GCC governments have used the oil windfall to build up public external asset buffers and attain relatively low sovereign debt-to-GDP ratios. Total public external assets in the GCC are estimated at about $1.6 trillion or over 110 percent of GDP in 2011.[3] Government debt is generally much smaller, with Bahrain and Qatar having the highest debt-to-GDP ratios at 36 and 37 percent, respectively. However, unlike Bahrain, Qatar's rising debt level is part of a strategy to develop a sovereign yield curve to support debt market development.

27. **Simulations involving a sharp and prolonged decline in oil prices illustrate the marked sensitivity of fiscal and external balances to oil prices, but also highlight the adequacy of public external asset buffers**. To assess the impact of a sharp and prolonged decline in oil prices, a downside scenario was constructed for each GCC country. The scenario assumes a $30 drop in oil prices that starts in 2013 and lasts through the medium term. Such a drop in oil prices is similar to the one experienced over the two years after 2008

[1] Bahrain's oil export share is net of oil imports which are significant. Without netting out imports, oil export revenues amount to 79 percent of total exports.

[2] Qatar's share of hydrocarbon revenues in total government revenues includes transfers of oil profits from public enterprises.

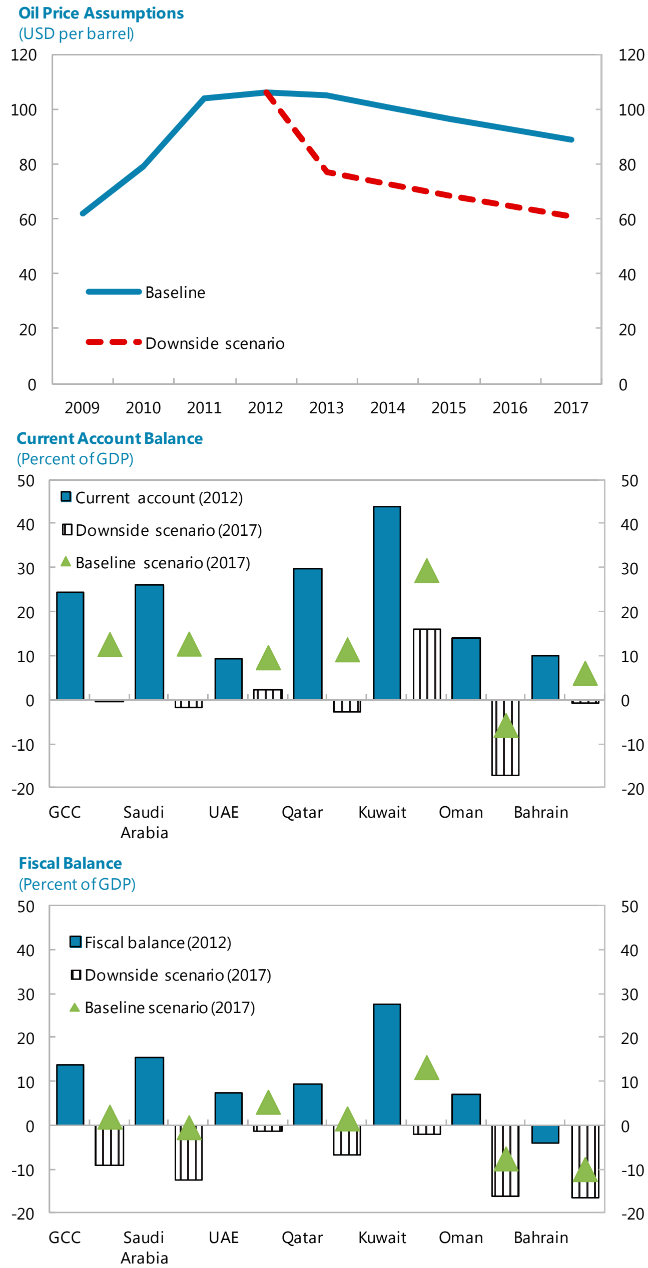
[3] Estimated as sum of sovereign wealth fund holdings and central bank reserves, but excluding foreign assets of public enterprises.

(and equal to about one standard deviation based on historical oil price volatility) but, unlike then, prices are not assumed to recover. Figure 8 shows the impact on the fiscal and external balances for each country and the GCC as a whole. The baseline scenario is based on IMF's WEO oil price projection.

- **Current account.** In the downside scenario, four of the countries are projected to experience current account deficits by 2017 (Bahrain, Oman Qatar, and Saudi Arabia) with Oman recording the largest projected deficit at over 17 percent of GDP. Comparing the baseline projection for 2017 with the downside scenario for the same year, the UAE and Bahrain are the least affected, with declines of 8 and 7 percent of GDP, respectively, reflecting the more diversified nature of these economies.

- **Fiscal balance.** The GCC in aggregate would under the downside scenario go into deficit by 2014, and all GCC economies would run fiscal deficits by 2017. Bahrain and Oman stand out with deficits of 16 percent of GDP each, but Saudi Arabia is also projected to reach a double digit deficit.

Figure 8. Projections and Downside Oil Price Scenario



Sources: Country authorities; and IMF calculations.
Note: The fiscal numbers reflect the fiscal year balances, and are labeled according to the year in which the fiscal year starts.

- **Public external assets.** The impact on public external assets is primarily driven by the accumulation of current account balances over the medium term. Since the majority of the GCC countries either remain in surplus or only record a deficit beyond 2015 (Oman being the exception), the GCC's total public external assets increase even in the downside scenario. The accumulation of assets would, however, slow down significantly and fall in some countries. Under the baseline scenario, the GCC's total public external assets are projected to reach over

$3 trillion by 2017 while in the downside scenario they reach $2.2 trillion (up from a projected 1.9 trillion at end-2012).

- **Economic activity.** The simulations assume that oil production remains unaffected. In reality however, a fall in global energy demand is likely to reduce hydrocarbon exports and negatively affect overall GDP growth. The impact on non-oil GDP is more uncertain and would depend on how well the government can cushion the fall in budget revenues. The simulations assume that government spending remains unaffected, which for those countries where public external assets are projected to decline could test the available fiscal space. A sharp drop in oil prices could also have an indirect impact on non-oil activity through reduced consumer and business confidence as well as through declining assets prices.

In sum, the simulations confirm the sensitivity of fiscal and external balances to oil price declines, but also show that the accumulated buffers generally provide a significant cushion.

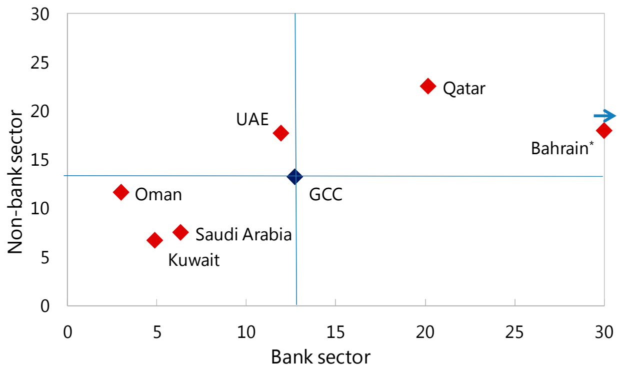
B. Financial Links and Exposure to Global and European Banks[4]

28. **Linkages with global banks vary across the GCC both in terms of size and by sector** (Figures 9 and 10). Total foreign bank claims on the GCC amounted to $328 billion in the first quarter of 2012, while funds provided to global banks by the GCC amounted to $462 billion. These aggregate numbers, however, mask significant variation within the GCC economies. The UAE is the main destination for foreign bank lending (40 percent of total foreign bank claims) while Saudi Arabia is the largest creditor to global banks (47 percent of total foreign bank liabilities). Relative to its size and reflecting its position as an international financial center, Bahrain has the highest exposure to foreign banks with claims and liabilities exceeding well over 100 percent of GDP. However, only about 10 percent of Bahrain's borrowing from foreign banks is directed to the non-bank sector, reflecting the dominant size of its off-shore banking industry. In comparison, foreign bank lending to Qatar and the UAE's amount to about 40 and 30 percent of GDP, respectively, with over half of the inflows going to the non-bank sector in each country.[5] Saudi Arabia and Kuwait are considerably less dependent on foreign bank financing, but have sizable outward exposure to foreign banks.

[4] The data used in this section are taken from the BIS's consolidated and locational banking data reflecting claims and liabilities of BIS reporting banks. Consolidated bank data includes exposure of foreign offices net of inter-office accounts.

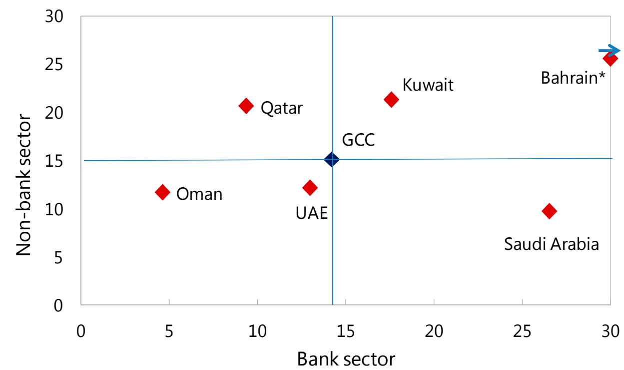
[5] According to the BIS data, both bank and non-bank sectors in Qatar have negative net foreign assets positions while in the UAE this is true only for the non-bank sector. Bahrain's non-bank sector has a positive net foreign asset position while the opposite is true for its bank sector. All other countries have a positive net assets position in both sectors.

Figure 9. Foreign Bank Claims on GCC Countries, 2012:Q1
(Percent of 2011 GDP)



Sources: BIS locational bank data; and IMF staff calculations.
* Foreign bank claims on Bahrain's bank sector amount to 162 percent of GDP.

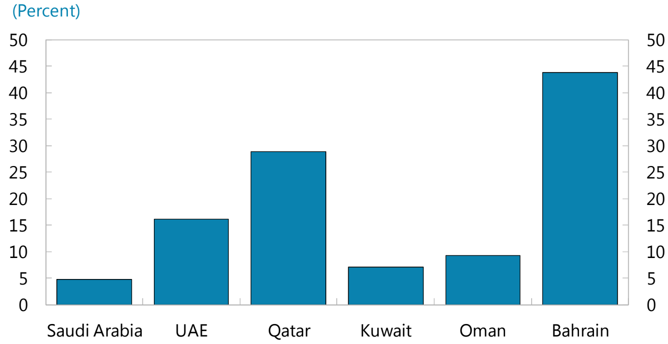
Figure 10. Foreign Bank Liabilities to GCC Countries, 2012: Q1
(Percent of 2011 GDP)



Sources: BIS locational bank data; and IMF staff calculations.
* Foreign bank liabilities to Bahrain's bank sector amount to 107 percent of GDP.

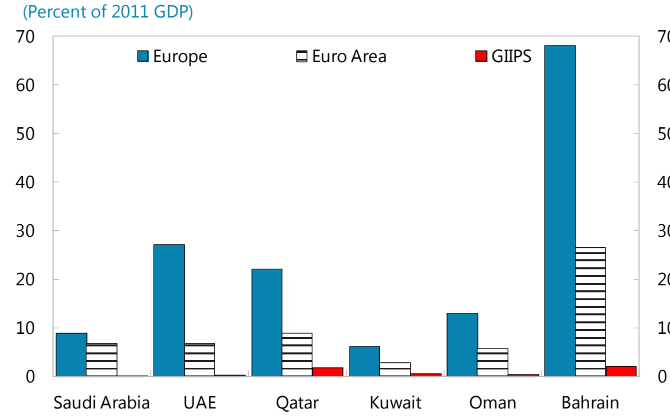
29. The share of foreign liabilities in total liabilities of commercial banks is another measure of foreign financing exposure (Figure 11). Bahrain is again an outlier at over 40 percent followed by Qatar (29 percent) and the UAE (17 percent). On aggregate, commercial banks in Oman, Kuwait and Saudi Arabia are less dependent on foreign financing with foreign liability shares below 10 percent.

Figure 11. Commercial Banks' Foreign Liabilities as a Share of Total Liabilities, 2012[1]
(Percent)



Source: Haver Analytics.
[1] The data for Saudi Arabia, Qatar, Kuwait and Oman are from June 2012, while the data the UAE are dated March 2012. The data on Bahrain covers both retail and whole sale and is dated May 2012.

Figure 12. Funding from European Banks, 2012: Q1
(Percent of 2011 GDP)



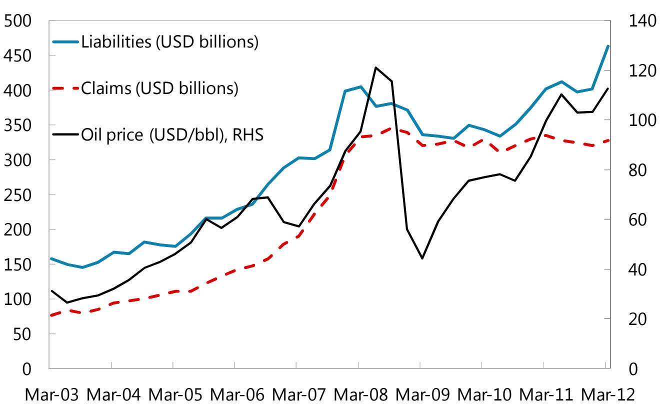
Sources: BIS consolidated bank data; country authorities; and IMF staff calculations.

30. **European banks account for the majority of outstanding claims on the GCC, but reliance on bank finance from European periphery countries is marginal** (Figure 12). European bank claims on GCC economies amounted to $220 billion in the first quarter of 2012 (65 percent of total claims), with UK banks having a large presence in the UAE and Qatar, and French bank lending dominating in Saudi Arabia. Financing from euro area banks is relatively small across the GCC—at less than 10 percent of GDP—except for Bahrain. The exposure to GIIPS banks (Greece, Ireland, Italy, Portugal and Spain) is significantly less, at less than 2 percent of GDP in all GCC countries.

31. **In the wake of the global financial crisis, foreign bank lending to the region has remained weak while the GCC's financing of global banks have recently regained momentum, reflecting higher oil revenues.** (Figure 13). Leading up to the global financial

crisis, financial claims between foreign banks and GCC countries grew significantly as the GCC economies expanded along with higher oil prices. The UAE accounted for the largest increase in borrowings from foreign banks while Saudi Arabia accounted for the largest increase in lending to foreign banks. As the global financial crisis spread to the GCC, however, flows to and from global banks came to a standstill or reversed. Despite the recovery in oil prices in 2010–11 and the strengthening of GCC economic indicators, foreign bank lending to the GCC has on aggregate declined by 5 percent since September 2008 (Qatar being the notable exception to the declining trend). In particular, foreign claims on Kuwait and Bahrain have fallen by over 55 and 25 percent, respectively, reflecting deleveraging of Bahrain's off-shore banks and restructuring of troubled investment companies in Kuwait. In contrast, foreign bank liabilities to the GCC have recently regained momentum (with the exception of Bahrain) as higher oil prices have strengthened external balances. Again, Qatar stands out with a tripling of claims on foreign banks since September 2008. Nevertheless, as nominal GDP levels have grown with higher oil prices and foreign bank claims on and liabilities to GCC countries have been slow to recover, most GCC economies have seen their exposure to global banking, both on the asset and funding side, fall as a share of GDP.

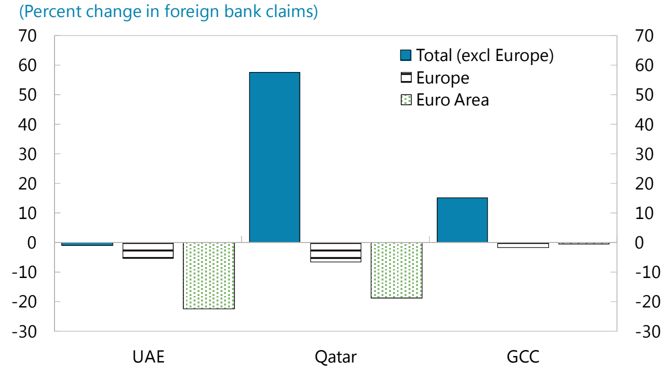
Figure 13. Foreign Bank Liabilities and Claims, 2003–12



Sources: BIS locational bank data; and IMF calculations.

Figure 14. Retrenchment of European Banks from the GCC, 2011:Q1–2012:Q1

(Percent change in foreign bank claims)



Sources: BIS consolidated bank data; and IMF staff calculations.

32. **As the debt crisis in the euro area has worsened, signs of regional retrenchment by European Banks have emerged.** Between 2011:Q1 and 2012:Q1, European bank claims on the GCC fell by about 2 percent (Figure 14). In Bahrain, the UAE and Qatar—the three GCC countries with the highest dependence on European financing —bank lending from European banks fell significantly, although this was in Qatar offset by increases in claims of other foreign banks.[6] The UAE and Qatar saw a 23 and 19 percent drop, respectively, in lending from euro area banks.

33. **Further deleveraging and retrenchment of European banks could lead to liquidity pressures.** A sharper scaling back of European banks from the GCC is likely to

[6] Total foreign bank claims on Bahrain fell by 11.4 percent between 2011:Q1 and 2012:Q1 and euro area bank claims declined by 9.7 percent over the same time period.

affect long maturity syndicated loans since they require more expensive long-term funding sources. Given the recent increase in infrastructure spending in the region and high demand for project financing, such funding pressure would come at an inopportune moment for some GCC economies. To fill funding gaps, new sources of funds could be needed. In the short-term, governments could help bridge the gaps, but if the retrenchment becomes long lasting, alternative external or domestic sources may need to be explored. The notable increase in issuance of domestic sukuks in the GCC in 2012 is encouraging in this respect and has indeed partially been attributed to the pull-back in European bank lending. Further development of regional debt markets could help channel large pools of domestic liquidity to finance large-scale infrastructure project.

34. **The soundness of GCC banking systems has strengthened over the past couple of years, putting them in a stronger position to withstand external financial pressures.** (Table 1). Capital adequacy ratios have increased for most countries in the GCC since 2009 and are currently above recommended minimum international standards. Non-performing loan ratios have fallen or remained stable in all GCC countries since 2009 with the exception of the UAE where the banking system's loan concentration to the troubled real estate sector remains high. Provisioning rates are also relatively high, with the banking systems in Saudi Arabia and Oman provisioning in excess of their current non-performing loans.[7] Notable exceptions are the UAE and Kuwait where provisioning rates have declined, reflecting rising non-performing loans in the UAE and lower specific provisioning due to write-off of bad loans in Kuwait.[8]

Table 1. GCC Financial Soundness Indicators

	Capital Adequacy Ratio		Non-performing Loans (share of gross loans)		Provisioning Rate (percent of non-performing loans)	
	2009	2011	2009	2011	2009	2011
Saudi Arabia	16.5	17.3	3.3	2.3	89.8	132.8
UAE	19.9	21.2	4.3	6.2	94.4	67.8
Qatar	16.1	20.6	1.7	1.7	84.5	86.3
Kuwait	16.7	18.5	11.5	7.3	38.3	33.9
Oman	15.5	15.9	2.7	2.4	104.0	120.6
Bahrain	19.6	20.3	4.3	4.5	63.9	65.9

Source: Country authorities.

[7] Provisioning coverage in Saudi Arabia, Oman and Qatar includes general as well as specific provisioning.

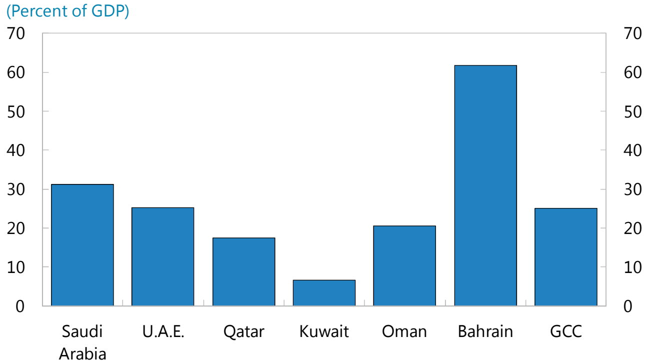
[8] Since the onset of the global crisis Kuwait has required banks to set aside additional "precautionary" provisions, which are not reported in the table.

C. Other Potential Spillover Channels

35. **As major creditors in global financial markets, GCC countries are subject to external credit risk.** A large share of the region's oil revenue is saved abroad, by sovereign entities as well as by private corporations and individuals. Unfortunately, limited availability of information with respect to the geographical composition as well the risk profile of the GCC's public external asset portfolios makes it hard to assess their exposure to European assets. Nevertheless, under the assumption that a significant share of their investment is in sovereign debt securities—reflecting high risk aversion—some exposure to European sovereigns is likely. Information on the geographical distribution of private portfolio investments is available for Kuwait and Bahrain. These data show that most of the portfolio investments are within the GCC and that there is only limited exposure to Europe and GIIPS.

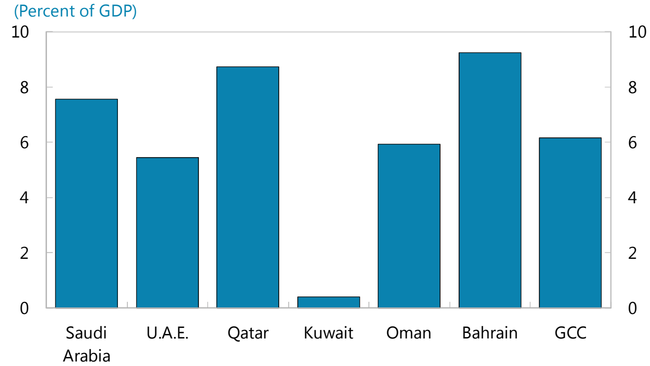
36. **The stock of inward foreign direct investment (FDI) is sizable and could constitute a spillover channel.** According to UNCTAD data (Figures 15 and 16), FDI inflows to the GCC has averaged 6 percent of GDP per annum between 2005 and 2011, resulting in a significant increase in the total stock of outstanding foreign direct investment. Bahrain has the largest stock of inward FDI relative to its GDP at almost 62 percent followed by Saudi Arabia and the UAE at 31 and 25 percent, respectively. Bahrain, Qatar and Saudi Arabia have seen the largest inflows over the past six years, averaging between 7–10 percent of GDP per year. Although information on the geographical distribution of inward FDI is limited, available data for Kuwait and Saudi Arabia suggest that a large share of FDI has originated from within the GCC. That said, a significant share of FDI in Saudi Arabia has come from Europe (over 23 percent of the total stock in 2010) with France as the largest European investor (9 percent).

Figure 15. Stock of Foreign Direct Investment in GCC Countries, 2011
(Percent of GDP)



Sources: UNCTAD; and country authorities.

Figure 16. Average Inflows of Foreign Direct Investment in GCC Countries, 2005–11
(Percent of GDP)



Sources: UNCTAD; and country authorities.

V. POLICY CHALLENGES

The strong growth outlook for the GCC economies implies diminishing need for near-term policy stimulus. Given risks to the outlook, however, continued emphasis on reducing vulnerabilities will be important alongside greater focus on strengthening the foundations for economic diversification and longer-term growth.

37. **Against the backdrop of weakening global growth, the GCC economies have held up well.** Spillovers from slowdowns elsewhere in the world have been limited, oil prices remain at historically high levels, and the economic recoveries underway in the GCC since 2009 have become more entrenched. Absent further deterioration in external conditions, near-term prospects for continued high growth remain good. Policymakers are therefore in a strong position to focus on the foundations for robust and sustainable private sector-led growth and economic diversification.

38. **In terms of fiscal policy, the strong state of the GCC economies means that the pace of government spending growth can be scaled down from recent highs.** While expansionary fiscal policies helped the region weather the global financial crisis, given the healthy economic expansion currently underway, the need for continued fiscal stimulus is diminishing. Most GCC countries should therefore plan to reduce the growth rate in government expenditure in the period ahead, with a view to gradually lowering the ratio of their non-oil deficits to non-oil GDP. This would help ensure long-term sustainability given the prospective of budgets moving into deficit over the medium term. It would also help prevent the possibility of overheating in the region's fastest-growing economies.

39. **The accommodative monetary stance is appropriate, but it will be important to be on the lookout for buildup of risk in the financial sector or wider price pressures.** Current levels of credit growth and inflation are not excessive in any GCC country. But credit growth is in some cases on a strong upward trajectory and U.S. interest rates—imported via the pegged exchange rate regimes—are now likely to stay low through at least 2015 given the latest Federal Open Market Committee statement. If credit expansion leads to domestic price pressures or if other indicators start to signal overheating, the region's exchange rate pegs mean that fiscal policy tightening would have to be the first line of defense. However, macroprudential tools—such as ceilings on loan-to-deposit and debt service-to-income ratios; loan provisioning and capital requirements; and minimum liquidity ratios—can be actively used to help ensure macroeconomic as well as financial sector stability.

40. **The positive outlook for near-term GCC growth notwithstanding, policymakers should stand ready to respond to a possible global downside scenario.** A rapid deterioration in the global economy could bring about developments similar to what the region experienced in 2008 and 2009, including a sharp fall in oil prices and disruptions to capital flows. In such an event, the GCC should aim to insulate its economies by proactively using available buffers from large fiscal surpluses and past savings to keep up government spending and provide any needed liquidity to the financial sector. A sustained decrease in oil

prices could, however, be difficult to manage, highlighting the risks associated with continued dependence on hydrocarbon revenues.

41. **Addressing underlying vulnerabilities and longer-term challenges is important.** Steps that can be taken to enhance the resilience of the GCC economies while at the same time addressing the overarching challenge of ensuring progress on economic diversification and raising the growth potential include:

- *Reducing fiscal risks and strengthening the fiscal outlook.* Containing increases in spending on entitlements that are hard to reverse and instead prioritizing growth-enhancing investments in infrastructure would help improve the budgetary outlook and reduce vulnerabilities to a prolonged drop in oil prices. Reforming costly energy subsidies by bringing domestic fuel prices closer in line with those in international markets would also strengthen government finances while helping raise economic efficiency and encouraging a transition to less energy-intensive modes of production.

- *Strengthening fiscal frameworks and institutions.* The introduction of multi-year budgeting, supported by macro-fiscal units and possibly a formal fiscal rule, would help delink-spending from volatility in revenue. This would enhance macroeconomic stability, facilitate long-term planning, and boost private sector investment.

- *Bolstering the financial sector*. Policies that would help enhance financial sector preparedness for tail risks include intensive surveillance of systemic and weak banks, early intervention in weak banks, establishing early warning systems, strengthening bank resolution frameworks, and the use of macroprudential tools to manage the buildup of risks to financial stability. Enhancing preparedness also encompasses testing of monetary instruments and of emergency liquidity arrangements. Crisis simulation exercises should also be considered. Upgrading regulatory and supervisory frameworks for banks in line with ongoing global initiatives and strengthening disclosure requirements would help reduce risks.

- *Deepening domestic debt markets.* Putting in place the necessary legal and financial infrastructure, along with regular placement of government debt in a range of maturities to establish a yield curve, could help develop a corporate debt market. This would enhance options for domestic financing of productive activity and reduce reliance on foreign funding.

42. **Ensuring sufficient job creation for nationals has become a crucial issue for several GCC countries.** Social unrest in the rest of the MENA region has highlighted the importance of employment for social cohesion. For the GCC, rapid increases in the working age population coupled with private sectors that rely mainly on foreign labor mean that economic growth alone will not be sufficient to provide the needed number of jobs. Enhancing education and training systems, improving job placement services, and, potentially, providing targeted subsidies for hiring of new labor market entrants could help boost job creation. At the same time, it will also be necessary to address differences in wages

and benefits that are causing nationals to prefer to work in the public rather than in the private sector.

43. **Finally, enhancing statistical systems should remain a high priority.** Improving the timeliness, quality, and periodicity of macroeconomic statistics would assist decision making and contribute importantly to macroeconomic management. Regional initiatives, including Gulfstat and Arabstat, would help harmonize statistical measures and could help anchor improvement plans.

Table 2. GCC Countries: Selected Economic Indicators, 2007–13[1]

	2007	2008	2009	2010	2011	Proj. 2012	Proj. 2013
	(Percent change)						
National accounts and prices							
Real GDP							
Bahrain	8.4	6.3	3.2	4.7	2.1	2.0	2.8
Kuwait	6.5	4.2	-7.8	2.5	8.2	6.3	1.9
Oman	6.7	13.1	3.9	5.0	5.4	5.0	3.9
Qatar	18.0	17.7	12.0	16.7	14.1	6.3	4.9
Saudi Arabia	2.0	4.2	0.1	5.1	7.1	6.0	4.2
United Arab Emirates	6.5	5.3	-4.8	1.3	5.2	4.0	2.6
GCC countries	5.3	6.3	-0.2	5.5	7.5	5.6	3.7
Real Oil GDP							
Bahrain	1.1	0.4	-0.8	1.8	3.4	2.6	9.3
Kuwait	-4.7	5.4	-12.9	0.7	14.9	8.4	-3.4
Oman	-3.5	7.7	9.3	5.4	3.8	3.2	0.9
Qatar	13.8	13.2	4.5	28.8	15.7	2.9	-0.3
Saudi Arabia	-3.6	4.2	-7.8	2.4	4.6	4.5	0.0
United Arab Emirates	-2.7	1.6	-8.9	0.9	9.4	5.3	1.0
GCC countries	-2.0	4.8	-6.0	5.2	7.9	4.8	0.0
Real Nonoil GDP							
Bahrain	9.6	7.2	3.8	5.2	1.9	1.9	1.9
Kuwait	14.7	3.4	-4.6	3.5	4.4	5.1	5.3
Oman	13.2	16.0	1.2	4.7	6.3	5.9	5.5
Qatar	21.6	21.3	17.6	8.6	12.9	9.0	9.0
Saudi Arabia	4.6	4.3	3.5	6.2	7.9	6.5	5.6
United Arab Emirates	9.1	6.3	-2.9	1.4	3.0	3.3	3.5
GCC countries	8.9	7.0	2.7	5.2	7.0	5.9	5.5
CPI inflation (average)							
Bahrain	3.3	3.5	2.8	2.0	-0.4	0.6	2.0
Kuwait	5.5	10.6	4.0	4.0	4.7	4.3	4.1
Oman	5.9	12.6	3.5	3.3	4.0	3.2	3.0
Qatar	13.8	15.0	-4.9	-2.4	1.9	2.0	3.0
Saudi Arabia	4.1	9.9	5.1	5.4	5.0	4.9	4.6
United Arab Emirates	11.1	12.3	1.6	0.9	0.9	0.7	1.6
GCC countries	6.6	11.0	3.0	3.2	3.6	3.5	3.6
	(Percent of GDP)						
Government sector							
Fiscal balance							
Bahrain	1.9	4.9	-6.6	-7.0	-2.4	-3.9	-3.6
Kuwait	39.0	19.8	26.8	25.2	29.1	30.2	26.4
Oman	11.1	13.7	-2.1	4.0	8.1	7.1	5.8
Qatar	10.9	9.8	13.4	2.6	12.3	9.6	8.5
Saudi Arabia	16.3	34.4	-4.7	3.4	14.0	16.6	11.2
United Arab Emirates	16.0	16.8	-12.8	-2.2	3.1	7.5	7.5
GCC countries	17.9	24.8	-0.7	4.5	12.7	14.6	11.2
External sector							
Current account balance							
Bahrain	15.7	10.2	2.9	3.6	12.6	9.9	10.5
Kuwait	36.8	40.9	26.7	31.9	44.0	44.1	39.2
Oman	5.9	8.3	-1.2	8.6	16.7	14.0	10.0
Qatar	25.4	28.7	10.2	26.7	30.2	29.6	26.8
Saudi Arabia	24.3	27.8	5.6	14.6	26.5	26.1	22.7
United Arab Emirates	6.9	7.9	3.5	3.2	9.7	9.3	10.1
GCC countries	19.9	22.7	7.5	14.4	24.1	23.6	21.1
	(US$ billions, unless otherwise indicated)						
Memorandum items							
Nominal GDP, GCC countries	897.5	1,136.0	907.5	1,067.8	1,372.1	1,484.6	1,534.3
Current account balance, GCC countries	197.9	294.3	109.0	178.5	362.6	382.9	342.3
Oil price (US$ per barrel) [2]	71.1	97.0	61.8	79.0	104.0	106.2	105.1
Oil production (million of barrels per day)	15.7	16.2	14.8	14.9	16.6	17.5	17.4

Sources: Country authorities; and IMF staff estimates.

[1]GCC aggregates in the form of growth rates or shares of GDP are weighted by GDP valued at purchasing power parities. GCC nominal GDP and current account correspond to the sum of the values for each country.

[2]Crude Oil (petroleum), simple average of three spot prices; Dated Brent, West Texas Intermediate, and the Dubai Fateh.