Middle East and Central Asia
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Economic prospects for the countries of the Middle East and Central Asia are improving along with the global recovery, although the latter remains fragile. Growth in the region—comprising the (1) Middle East, North Africa, Afghanistan, and Pakistan (MENAP) oil exporters; (2) MENAP oil importers; and (3) Caucasus and Central Asia (CCA)—will gather momentum in 2010, but stay below precrisis levels. While the impact on the region of the Dubai crisis and the unfolding events in Greece has been limited so far, a repricing of sovereign debt cannot be ruled out, adding an element of uncertainty to the outlook.

Dealing with the legacy of the global economic crisis will be the priority in 2010. In some MENAP oil exporters, bank balance-sheet strains emerged during the crisis, and country-specific solutions to address these strains will need to be found. As unemployment continues to rise in the MENAP oil importers, the need to raise growth and competitiveness will take center stage, against the backdrop of a weak pickup in external demand and tight competition from other emerging markets. In the CCA, the priority is to repair bank balance sheets as a prerequisite for a recovery in credit.

MENAP Oil Exporters: Emerging from the Crisis

The MENAP oil exporters were hit hard in 2009. In the first part of the year, crude oil prices plummeted to US$40 per barrel, real estate and asset prices plunged, and external financing dried up. The oil exporters' combined current account surplus fell to US$53 billion in 2009, after having risen more than tenfold in the previous decade to US$362 billion in 2008. Oil GDP contracted by 4.7 percent in 2009, but a massive step-up in government spending along with central bank liquidity support and capital injections into the banking sector helped mitigate the impact of the crisis on the non-oil sector, which grew by 3.6 percent. Overall, these economies grew by 1.5 percent in 2009.

A resumption of capital inflows and the rebound in crude oil prices, to more than US$80 per barrel by the end of last year, have aided the recovery in these countries. International reserve positions are improving again—by an estimated US$46 billion in 2010. Higher oil prices and output are projected to boost oil exports by 31 percent, to US$682 billion, more than double the current account surplus, to US$140 billion, and boost oil-GDP growth to 4.3 percent in 2010. Moreover, many governments—most notably in Saudi Arabia—are planning to expand spending. This stimulus will continue to buoy domestic non-oil-sector activity, projected to grow by 4.1 percent in 2010, and sustain positive spillovers to the global economy as well as neighboring countries through trade and remittances.

Strong oil demand underpins a promising outlook for the medium term. In 2011, the recovery is expected to strengthen further, with overall GDP growth reaching 4.5 percent. Although growth is slated to remain well below precrisis levels, it is more likely to be sustainable in the long run.

For many MENAP oil exporters, an important impediment to a stronger recovery is sluggishness in private-sector credit. In previous years, vigorous credit growth was driven by high leverage, expanding external funding, rapid deposit growth, and surging asset prices, all of which reversed during the crisis, leading to considerable strains on bank balance sheets. To revive credit, banks will need to repair their balance sheets by recognizing losses and, in some cases, governments will need to support this by requiring greater transparency and enhancing regulatory clarity. Over the medium term, local debt and equity markets will need to be developed in order to provide alternatives to bank finance.

MENAP Oil Importers: Slowly Gaining Traction

MENAP oil importers have limited financial and trade ties, and positive spillovers from fiscal expansions in the MENAP oil exporters have offset the impact of the global slowdown. Thus, overall growth fell only modestly to 3.8 percent in 2009, from 5 percent in 2008. With trade rebounding since mid-2009 and investment and bank credit beginning to pick up, growth is estimated to increase marginally to 4.1 percent in 2010 and 4.8 percent in 2011. These growth rates, however, are below the average for emerging and developing countries, and, more importantly, insufficient to create the jobs needed in a region where the working-age population is projected to increase by a quarter in the next decade.

Credit growth—which fell to a weighted average of 2 percent in the year to October 2009 from almost 20 percent before the crisis—remains low. And the resurgence of capital inflows witnessed in other emerging markets is not yet evident in most MENAP oil importers. Continued weakness in European demand, appreciated exchange rates, and competition from other emerging markets, especially Asia, constrain the potential for export-led growth. Consequently, enhancing competitiveness to raise growth rates and generate employment will be key challenges in this region. Additional efforts to create a more business-friendly environment for foreign and local investments, liberalize the financial sector, and develop local capital markets will help meet this goal.

High debt levels in several countries limit the scope for fiscal stimulus. And for the most part, little space remains for additional monetary stimulus, given relatively high inflation in much of the region and international interest rates having begun to rise.

The CCA: Incipient Recovery

The global economic downturn took a toll on the CCA, though countercyclical fiscal and monetary policies and donor support provided some offset. With exports and remittances falling sharply, energy importers were hit hardest—Armenia suffered the largest drop in growth, from 6.8 percent in 2008 to –14 percent in 2009, as a construction boom faltered. In Georgia, the contraction of 4 percent was less severe, partly because the slowdown had already started in 2008. In the Kyrgyz Republic and Tajikistan, growth also fell in 2009, but stayed positive at 2 to 3 percent. The CCA energy exporters fared better, and their growth declined only moderately—from 6.6 percent in 2008 to 4.7 percent in 2009—but was substantially lower than the 12.6 percent rate recorded in 2007. Kazakhstan was affected markedly by international financial market turbulence, evidenced by a net outflow of private portfolio capital of US$5 billion since the beginning of the crisis.

Across the CCA, there are signs of recovery. Exports have begun to pick up, the decline in remittances appears to be slowing or reversing, and capital inflows have turned positive. In light of these developments, growth for the CCA is projected to rise to 4.3 percent in 2010. Growth remains weaker in the energy importers, where it is projected at about 2 to 4 percent. In all four energy importers, fiscal constraints loom large, and additional donor support would be needed to help create the fiscal room needed if the recoveries were to falter. Growth is expected to be strongest in the energy exporters, with projections ranging from 2 to 3 percent for Azerbaijan and Kazakhstan to 8 percent in Uzbekistan and 12 percent in Turkmenistan.

A common challenge across most CCA countries is to revive private-sector credit growth. CCA banking systems were adversely affected by the global crisis, and credit growth has slowed sharply and even turned negative in real terms in a number of countries, compared with the meteoric increases, ranging from 40 to 80 percent, in the period immediately prior to the crisis. Policies to restore credit growth should aid banks to repair balance sheets and, under particular circumstances, provide liquidity and capital injections. In the medium term, macroeconomic and macroprudential policies should promote dedollarization—high levels of dollarization of 40 to 80 percent were a key transmission channel of the global crisis to the region—and develop local debt markets to provide a more diversified funding base for banks.