MENAP Oil-Exporting Countries: Time to Accelerate Reforms

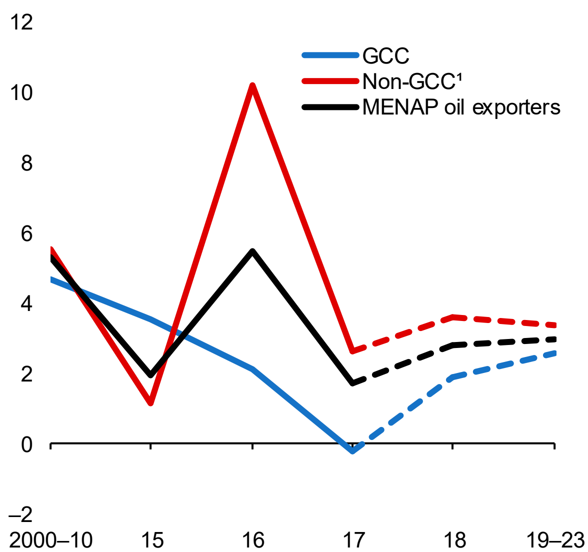
Economic growth in oil exporters in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) bottomed out in 2017 and is expected to accelerate in 2018–19. This largely reflects the continued recovery in non-oil activity as many countries are slowing the pace of fiscal consolidation in support of domestic demand. Risks to the outlook are skewed to the downside. These include the possibility of a sharp tightening of global financial conditions, growing trade tensions, and geopolitical strains—while the outlook for oil prices remains subdued and highly uncertain. If these risks materialize, they could trigger potentially significant fiscal and financing pressures for many countries in the region, affecting prospects for continued fiscal consolidation and economic recovery. Weak growth prospects over the medium term underscore the importance of accelerating planned structural reforms.

A Sharp Slowdown in 2017

In 2017, at 1.7 percent, growth in MENAP oil exporters was much weaker than the 5.4 percent outcome in 2016 (Figure 1.1). This significant slowing of economic activity reflects a deeper-than-expected slowdown in the Gulf Cooperation Council (GCC) countries relative to the forecast in the October 2017 *Regional Economic Outlook*. That slowdown was offset by stronger-than-anticipated outcomes in non-GCC countries (Figure 1.2). Specifically,

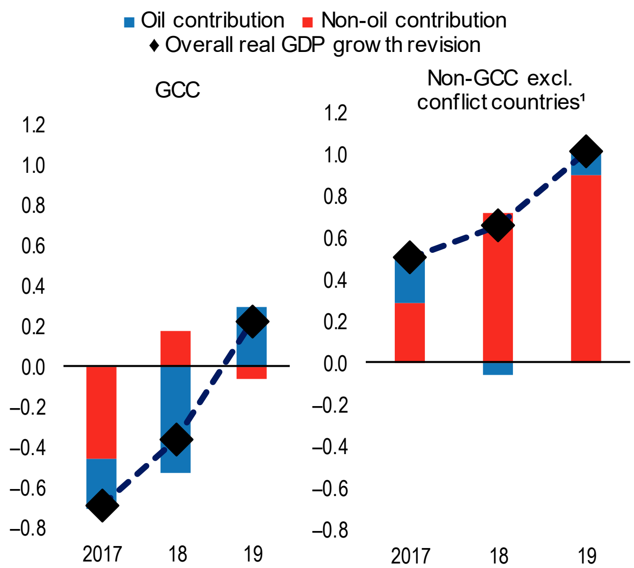
- In the ***GCC***, overall GDP fell by 0.2 percent last year, with Saudi Arabia seeing its first economic contraction since 2009. This mostly reflected the effect of the OPEC+ oil production cuts, which more than offset the continued recovery in non-oil growth in most countries. In the United Arab Emirates

Figure 1.1
Real GDP Growth
(Percent, simple average across years)



Source: IMF staff calculations.
Note: GCC = Gulf Cooperation Council.
¹ Excludes Libya and Yemen.

Figure 1.2
Real GDP Growth Revisions since October 2017
(Percentage points)



Source: IMF staff calculations.
Note: GCC = Gulf Cooperation Council.
¹ Excludes Libya and Yemen.

and Qatar, where weak consumer and investor confidence dampened domestic demand, non-oil GDP growth in 2017 was softer than that of the previous year. In Bahrain, stronger non-oil growth—supported by GCC-funded projects and robust financial and hospitality sectors—more than offset weaker oil output.

- In ***non-GCC*** oil exporters (excluding Libya and Yemen), overall growth amounted to 2.6 percent in 2017. In Iran, growth decelerated significantly relative to 2016. Oil GDP growth in that country was much slower than in the previous year, more than offsetting the continued recovery in non-oil activity, which was supported by public investment. In Algeria and Iraq, weaker growth in oil GDP in the context of the OPEC+ agreement (and weaker-than-expected demand from Europe for Algerian-produced gas) was more than offset by a pickup in non-oil activity.

- In oil-exporting countries affected by ***conflict***, growth outcomes were mixed. In Libya, stronger-than-expected growth was supported by increased oil production, which more than offset lower public spending. In Yemen, the economic contraction was much more pronounced than anticipated in October as the effects from the conflict continued.

Recovery in 2018–19 Driven by Opposing Forces

With growth estimated to have bottomed out in 2017, the overall outlook is little changed relative to October. Economic activity is projected to accelerate in 2018–19, but to remain low relative to pre-2014 levels over the medium term (Figure 1.1). Specifically, overall growth is projected at 2.8 percent this year and 3.3 percent in 2019 (versus 3.0 and 2.7 projected in October). Non-oil GDP growth is expected to be 3.2 percent this year and 3.4 percent next, 0.7 and 0.4 percentage point higher, respectively, relative to October. These changes reflect two opposing forces (Figure 1.2):

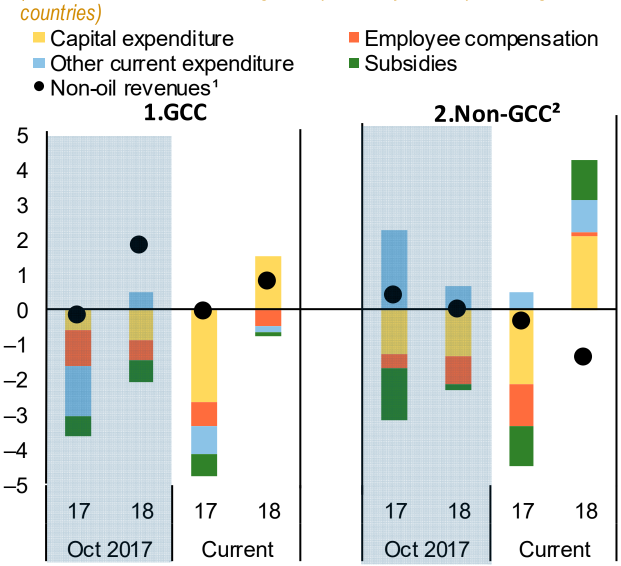
- ***Upward revisions to non-oil GDP growth for 2018 and 2019*** relative to October forecasts in several countries: The deceleration in Bahrain is now projected to be more gradual (expected completion of investment projects). Meanwhile, the pickup is now anticipated to be faster in Saudi Arabia (partly from a slower pace of fiscal consolidation as described later in this update), Algeria (mostly increased public capital spending), and Iraq (reconstruction).

- ***Downward revisions to oil GDP growth in 2018*** in most GCC countries and Iraq relative to October: This revision is driven by lower oil production consistent with the extension of the OPEC+ agreement. For 2019, the deferred expiration of the agreement means that oil GDP growth will pick up faster than anticipated in October, especially in GCC countries.

Adjusting the Pace of Fiscal Consolidation

There has been some adjustment in the ***pace of fiscal consolidation*** among MENAP oil exporters (Figure 1.3). In 2017, fiscal adjustment in Saudi Arabia was less than initially indicated in the budget—higher expenditures were supported by higher-than-expected non-oil revenues. In Qatar, the availability of fiscal buffers allowed for more gradual fiscal consolidation than expected. Outside the GCC, fiscal consolidation efforts continued in 2017, especially in Iran and Iraq (in the context of the IMF-supported program).

Figure 1.3
Change in Expenditure and Non-Oil Revenues
(Percent of non-oil GDP, change from previous year, simple average across countries)



Source: IMF staff calculations.
[1] Gulf Cooperation Council (GCC) non-oil revenue series excludes Kuwait because of discontinuities in its series related to United Nations compensation payments.
[2] Includes Algeria, Iran, and Iraq.

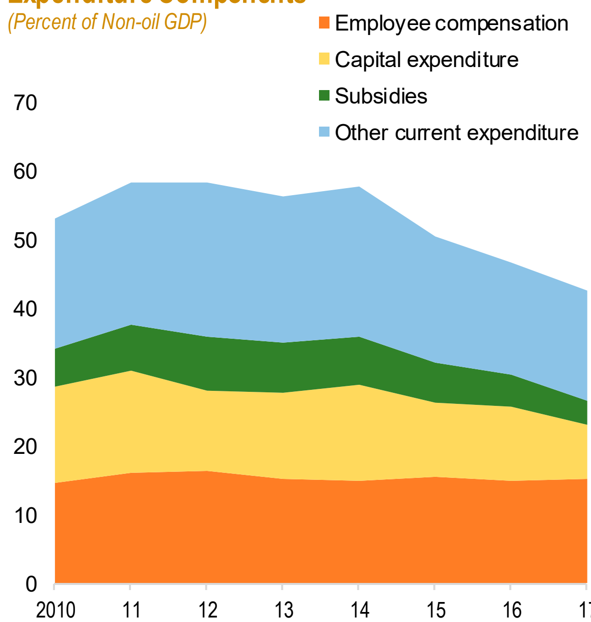
Overall, MENAP oil exporters are expected to continue their fiscal consolidation efforts, although at a slower pace. However, large increases in expenditures are expected to generate significantly larger fiscal deficits in Algeria, where consolidation is expected to resume in 2019, and in Iran.

Fiscal consolidation efforts have targeted both revenue and expenditures. Recent revenue measures include the introduction (January 2018) of a value-added tax (VAT) in Saudi Arabia and the United Arab Emirates, with other GCC countries expected to introduce a VAT this year. Similarly, Iraq is expected to introduce sales and excise taxes on some goods and services in 2018. But countries could do more to mobilize non-oil revenues, with the implementation of the VAT in the remaining GCC countries a key priority.

On the expenditure side, improving the efficiency of public spending is also a priority. Public investment efficiency indicators suggest that MENAP oil exporters perform better than emerging markets on average, but there is a substantial gap relative to advanced economies.

More efficient spending could be achieved by containing the large public wage bills that crowd out other critical components of public expenditure (Figure 1.4; Box 1.1). Measures taken so far (including temporary hiring freezes) may be difficult to sustain over time without additional structural reforms.

Figure 1.4
Expenditure Components
(Percent of Non-oil GDP)



Source: IMF staff calculations.

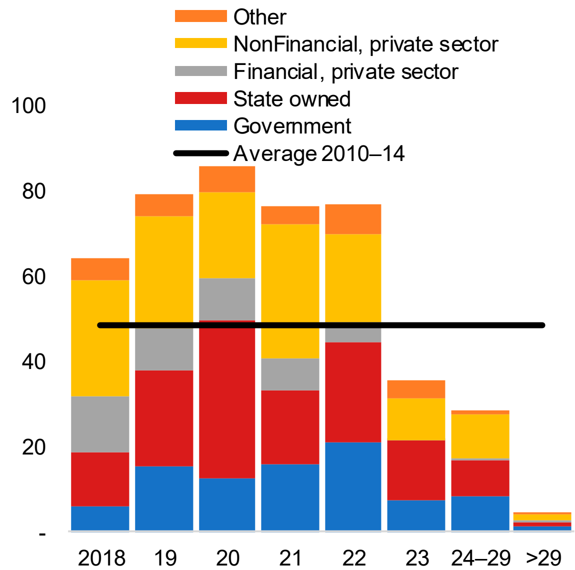
Other required reforms include further steps toward full elimination of energy subsidies, and changes to pension and social security systems—including revisions to retirement age and benefits. However, to mitigate the impact on the most vulnerable and to make such reforms equitable, they need to be accompanied by enhanced targeted social protection mechanisms and improvements in the delivery of and access to public services.

Potentially Large Fiscal and Financing Risks Could Emerge

Although public debt remains manageable for most MENAP oil exporters, the ***rapid buildup of debt*** in many of them is a cause for concern. Debt has increased by an average of 10 percentage points of GDP each year since 2013, with countries financing large fiscal deficits through a combination of drawdowns of buffers (where available) and increased domestic and foreign borrowing (see Chapter 1 of the October 2017 *Regional Economic Outlook: Middle East and Central Asia)*. Looking ahead, several factors are likely to continue to drive debt upward in MENAP oil exporters. These include the slower pace of fiscal consolidation, weak growth prospects, and the possibility of higher financing costs given the expected monetary policy tightening in advanced economies.

Given anticipated financing needs—cumulative overall fiscal deficits are projected to be $294 billion in 2018–22, while cumulative government debt amortizations amount to $71 billion for the same horizon—countries are increasingly vulnerable to a sudden tightening of global financial conditions. For example, taking account of the gross financing needs for 2018, a 200 basis point increase in interest rates would add between 0.1 and 0.6 percent of GDP a year to interest payments in MENAP oil exporters, increasing existing fiscal challenges. An additional amount of $312 billion of non-government-issued international debt (of which almost 40 percent corresponds to state-owned enterprises) is coming due over the next five years. Therefore, the fiscal impact could be larger if countries also experience a sudden stop in international market access that leads to a materialization of fiscal contingent liabilities (Figure 1.5).

Figure 1.5
Amortization Profile of International Debt[1]
(Billions of US dollars, annual average)

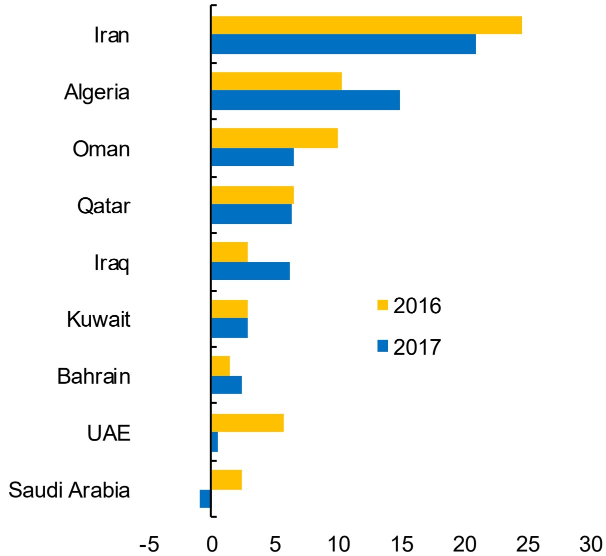


Sources: Dealogic; and IMF staff calculations.
[1]Includes bonds and syndicated loans.

Strong Banks yet Subdued Credit Growth

Despite the slowdown in economic activity in 2016–17, financial sectors have remained broadly resilient. However, ***credit growth remains subdued in most countries***, partly reflecting weak consumer, government, and government-related enterprise spending, as well as reduced confidence (Figure 1.6). This has led to some policy measures to ease access to financing. In the United Arab Emirates, for example, the introduction of a credit registry has helped banks better manage credit risks. Other reforms have also been implemented. For example, in Saudi Arabia, capital market restrictions on foreign investors have been eased, and the loan-to-value ratio for first-time home buyers has been increased. While these reforms are not a direct consequence of weak credit growth, they may support a faster recovery. To improve confidence

Figure 1.6
Credit to the Private Sector
(Percent, end-of-period annual growth)



Sources: Country authorities through Haver Analytics; IMF, International Financial Statistics database; and IMF staff calculations.

and promote credit, countries should also strengthen the legal rights of borrowers and lenders, and increase the availability of credit-related information. In Iran, the effect of rapid credit growth on non-oil activity has weakened as nonperforming loans (NPLs) continue to increase.

Interbank rates have continued to rise as monetary policy tightens in tandem with the United States, but sovereign spreads have narrowed as government cash constraints have eased with the higher oil price. Deposit growth remains slow, but has been broadly stable across the GCC. Although bank profitability has edged down due to compressed margins in several countries, NPLs do not appear to be a significant concern in many countries. While a large accumulation of government arrears has led to higher NPLs in Algeria, these are expected to decrease as arrears are cleared. However, in Iran and Iraq, banking systems continue to face numerous challenges, which will be the focus of reforms expected to be implemented this year. ***Financial markets*** across the region were moderately affected by the recent wave of volatility in global asset markets. These movements suggest that the region is not insulated from global financial developments, and underscore the importance of improving prudential regulation and oversight.

Accelerating the Structural Reform Agenda

With growth prospects low relative to historical standards, it is ***paramount to accelerate the structural reform agenda*** and move to a new growth model that promotes diversification and private sector development. Labor market and education reforms that boost productivity and create opportunities for everyone will be critical. Some important steps have been taken, but more needs to be done. For instance, the United Arab Emirates continues to invest in education and innovation, while the recent introduction of a new corporate bankruptcy law will further improve the business environment. Meanwhile, Iran is developing programs to foster job creation for young individuals and women. Also, Bahrain has introduced a wage protection system and significant measures to increase job flexibility for expatriates. In Qatar, a visa-free entry program to stimulate tourism was recently announced, along with a new law that seeks to expand the protection of expatriate labor. But these reforms should also be underpinned by efforts to increase transparency and accountability, and by stronger institutions and governance. As recognized by policymakers in Marrakesh (Box 1.2), a commitment to the completion of these reforms will be instrumental in achieving higher and more inclusive growth.

Risks Remain Skewed to the Downside

Overall, the balance of risks remains skewed to the downside. There is high uncertainty surrounding the ***outlook for oil prices*** (see the *Global Developments* section). With each $10 reduction in the price of oil leading to an instantaneous deterioration of 3 percentage points of GDP in the fiscal balance of MENAP oil exporters (excluding Libya and Yemen).
In addition to the direct fiscal impact discussed, a ***faster-than-expected tightening of financial conditions*** could also trigger abrupt financial market and asset price corrections that put pressure on the asset quality of banks. This could affect credit growth and slow economic activity in the region. Lower economic activity would also result if escalating import tariffs or a shift toward ***inward-looking policies*** disrupted global trade and investment, and resulted in lower oil prices. At the regional level, ***conflicts and geopolitical risks*** persist, and commitment to the implementation of key fiscal measures and structural reforms could weaken, considering the observed increase in oil prices. The continued commitment to fiscal consolidation, although at a slower pace, could, in contrast, boost investor confidence and result in stronger growth.

Box 1.1. Creating Fiscal Space: The Case for Reforming Public Sector Wage Bills in the Middle East, North Africa, Afghanistan, and Pakistan Region[1]

Countries in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region need to promote higher and more inclusive growth, and create jobs for their young and rapidly growing populations (see Box 1.2). Yet many countries have seen dramatic reductions in the fiscal space available for public investment in infrastructure and human capital.

Historically, most countries in the region have used public employment and compensation policies to achieve multiple socioeconomic objectives, including employment and redistribution of wealth. As a result, public sector wage bills have grown large and public employment is high relative to global peers (Figure 1.1.1). Also, public sector compensation is above that in the private sector in many cases. For example, the gap between average public and private sector wages is about 200 percent in the Gulf Cooperation Council countries.

Figure 1.1.1

Wage Bills and Public Sector Employment, 2005-16

(In percent, average)

Sources: IMF, World Economic Outlook database; country authorities; national labor force surveys; International Labour Organization data; and IMF staff model estimates.
Note: Data labels in this figure use International Organization for Standardization (ISO) country codes. Coverage (120 countries across the world) varies across periods. Red lines represent emerging market and developing economy weighted averages.

Despite high public wage bills, socioeconomic outcomes in the region remain below par. Unemployment has remained high, and overly generous public sector compensation has distorted labor markets. Government efficiency is lower than in peers, and the business and regulatory environment has stifled private sector activity; internationally comparable tests show education quality is weak, and access to and quality of public health care are mixed.

By complementing other reforms, such as energy subsidy reforms and fair taxation, public wage bill reforms can enable higher investment in infrastructure and social protection. This, together with improving the efficiency and quality of public service delivery and removing labor market distortions, can boost private sector growth and job creation—a more sustainable source of employment for the millions of youth entering the labor market each year.

Policymakers have already started to evaluate their public sector wage bills in the context of fiscal reforms. Some countries, including Algeria, Egypt, Iraq, Morocco, and Tunisia, have taken measures, such as wage and hiring freezes, to adjust public employment and compensation. International experience suggests, however, that the gains from such measures are difficult to maintain over the medium term.

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[1] This box was prepared by Gaëlle Pierre, based on Tamirisa, Duenwald, and others (2018).

Box 1.1 *(continued)*

To achieve lasting effects, countries need to implement deeper reforms. These reforms could (1) ensure that public employment and compensation policies are fiscally sustainable by identifying drivers of public wage bills and anchoring their growth in medium-term fiscal plans; (2) focus compensation and employment policies on providing public services effectively, efficiently, and equitably, by undertaking expenditure reviews and strengthening mechanisms for public service delivery; and (3) strengthen institutions and data, including control over bonuses and allowances, and linking compensation to performance.

The sequencing of public wage bill reforms should reflect country-specific circumstances and aim at building synergies with other policies. Particular attention should be paid to smoothing the transition through early social impact analyses and stronger social protection, and the private sector should be strengthened by taking steps to diversify the economy, bolster governance, and improve the business environment and the functioning of the labor market.

Box 1.2. An Action Plan for Inclusive Growth in the Middle East, North Africa, Afghanistan, and Pakistan Region [1]

The Middle East, North Africa, Afghanistan, and Pakistan region holds enormous promise, yet protracted regional conflicts, low commodity prices, weak productivity, and poor governance impede the region's performance. Since 2011, regional growth has been three-fourths the previous decade's average, a rate insufficient to significantly reduce unemployment. A staggering 25 percent of young people are jobless, and women are three times less likely than men to seek work. To take advantage of the global upswing, the region must accelerate reforms to spur growth and job creation, and harness the talent of its youth and women.

The "Opportunity for All" Conference in Morocco in January 2018 discussed how to identify new sources of growth and policy measures to make growth more inclusive and job-rich. Cohosted by the government of Morocco, the Arab Fund for Economic and Social Development, the Arab Monetary Fund, and the IMF, the conference brought together more than 400 representatives from the official and private sectors, youth, and civil society. Conference attendees agreed to a set of reform priorities, summarized as the *Marrakesh Call for Action.* This agreement calls on governments to "**ACT NOW**" to pursue actions that promote the following:

- **A**ccountability: Increase transparency and strengthen institutions to improve governance, tackle corruption, and ensure responsibility for inclusive policies.
- **C**ompetition: Foster a more vibrant private sector through improved access to finance and a better business environment with fewer barriers and less red tape.
- **T**echnology and Trade: Leverage technology and nurture trade to generate new sources of growth, create jobs, and foster prosperity.
- **N**o one left behind: Build strong safety nets and strengthen legal rights to empower disadvantaged groups, including youth, women, rural populations, and refugees.
- **O**pportunity: Increase and improve the quality of social and investment spending and pursue fairer taxation to support growth, lift up citizens, and share the burden of reform more equitably.
- **W**orkers: Invest in people and reform education to equip workers for the new economy.

The importance of the international financial community in this process was also recognized. More robust and inclusive growth is a shared responsibility and vitally important not only for the region, but also for the rest of the world. More external financing, preferably as grants, will be needed to support the region, particularly to help post-conflict countries and people displaced by war.

Looking ahead, meaningful reforms will be needed to operationalize the *Marrakesh Call for Action* and will require strong ownership of reforms and engagement by all parties. Conference participants recognized that, while some progress had been made in the past several years, much more remains to be done. The *Marrakesh Call for Action* will guide the IMF's engagement with policymakers and other stakeholders in the region, as well as its analytical work. The IMF will work closely with its member countries, private sector civil society, and international financial institutions to help implement reforms in the region to raise growth and living standards, and generate a more prosperous future.

[1] This box was prepared by Peter Kunzel.