

Regional Economic Outlook: Middle East and Central Asia, May 2008

Highlights

Economic activity in the Middle East and Central Asia (MCD) region continued to be strong in 2007, underpinned by robust global growth, high commodity prices, and improved policy frameworks. Real GDP grew at about 6½ percent, matching the region's performance in 2006, and marking its best five-year performance since the 1980s. In oil-producing countries, relatively flat oil production limited the direct contribution of the oil sector to growth, but the record-high oil prices continued to support vigorous non-oil economic activity by financing large public investment programs and generous wage settlements and by boosting business and consumer confidence. Despite higher fuel import costs, emerging market and low-income countries in the region have benefited indirectly from the surge in oil prices through increasing foreign direct investment (FDI), particularly from the Gulf Cooperation Council (GCC)¹ countries and worker remittances.

Growth was, however, accompanied by a pickup in inflation, reflecting rising international food and fuel prices, booming domestic demand, and increasingly binding capacity constraints, particularly in the housing sector. Strong domestic demand was driven by expansionary macroeconomic policies and a sharp increase in private investment, buoyed by optimism about the region's medium-term growth prospects. Notwithstanding the fiscal and monetary expansion and strong import growth, the further rise in oil revenues generated fiscal and current account surpluses for the region as a whole of 5 and 15 percent of GDP, respectively, strengthening public sector balance sheets and reducing external vulnerability. International reserves approached the US\$1 trillion mark, while external debt fell below 30 percent of GDP. Most equity markets in the region rebounded following the correction in 2006.

All countries in the region have been largely unscathed by the recent financial turmoil in developed countries, except Kazakhstan, where the banking sector relied heavily on foreign borrowing. As in most other emerging markets and developing countries, this resilience owes much to the region's strengthened macroeconomic position and progress with structural reforms.

The short-term outlook for the MCD region remains favorable, given the expectation that commodity prices will remain high, notwithstanding the downward revision in global growth. The surge in investment and strong productivity gains from broad-based structural reforms are expected to sustain growth at around 6 percent. However, against the background of persistently high fuel and food prices, strong domestic demand, and supply bottlenecks, inflationary pressures are unlikely to abate. With high oil prices boosting oil revenues, fiscal and current account surpluses in oil-producing countries are projected to remain large despite stronger imports and further fiscal expansion. In most non-oil-producing countries, the policy stance will likely aim to rein in fiscal and external deficits, contributing to further accumulation of international reserves and helping to reduce vulnerabilities.

Risks to the outlook are broadly neutral, with upside risks from domestic demand likely to be balanced by downside risks from the external sector. High oil prices and further cuts in U.S. interest rates could lead to a stronger-than-expected increase in domestic demand in the GCC countries.

Furthermore, the growing surplus in oil exporters, combined with concerns about asset quality in advanced economies, may well lead to increased inflows to the other countries in the region, fueling stronger credit and domestic demand. However, a protracted slowdown in advanced economies would hurt growth in most MCD countries, depressing exports and commodity prices. Tighter credit in

advanced economies and lower risk appetite, as evidenced by widening sovereign spreads, could also curtail the capital inflows that have supported growth in many countries in the region.

The key macroeconomic policy challenge in the short run for most countries in the region is to contain rising inflationary pressures, and for countries with large external debts and current account deficits to protect their external stability in the context of high oil prices and slowing world growth. The appropriate policy mix will depend on each country's particular circumstances but would most likely call for fiscal and monetary tightening and greater exchange rate flexibility when feasible. In oil-exporting countries with currencies pegged to the U.S. dollar, demand management policies will face challenges in controlling inflation, given the continuing bias toward monetary easing in the United States. The burden of the adjustment may well have to fall on fiscal policy, particularly in the GCC countries where a change in the exchange rate regime would be disruptive in the run-up to the planned monetary union. But the room for maneuver of fiscal policy is also limited in view of the need for higher investment to alleviate supply bottlenecks and political pressure for higher spending on wages and social programs. Therefore, tolerating somewhat higher inflation for a while may be necessary.

Beyond this immediate challenge, policies need to remain focused on strengthening policy frameworks, promoting sound financial deepening, and supporting the growth potential of the private sector.

In particular, countries need to continue strengthening their fiscal policy frameworks tailored to address specific issues in their fiscal outlook, most notably the efficient and sustainable use of oil revenues in oil-exporting countries, and high public debt in some low-income and emerging market economies. Phasing out fuel and food subsidies while establishing a more targeted safety net would help some countries in the region preserve long-term fiscal sustainability, enhance efficiency of spending, and improve equity. For countries where greater exchange rate flexibility is desirable over the medium term, it is important to continue to lay the foundation of an independent monetary policy. Despite the difficult challenges ahead, GCC countries should be encouraged to keep the agenda of the proposed monetary union on track, including reaching consensus on the appropriate exchange rate regime.

Continued development of banking systems will be critical for achieving high growth and for the region's successful integration into the world economy. In particular, dealing with the large stock of nonperforming loans and restructuring state banks in some countries will be crucial for enhancing the efficiency of the banking sector and lowering the cost of borrowing. Strong supervisory vigilance is also important, particularly in countries experiencing rapid credit growth.

The private sector is essential for the expansion and diversification of the production and export base of MCD economies and for the creation of jobs for the rapidly growing labor force—a pressing problem for many countries in the region. Among the key policies in this regard are those to improve the investment climate and lower the cost of doing business (including by reducing barriers to trade and removing excessive government controls and regulations), to enhance the transparency of the legal and administrative systems, and to overhaul national education systems to meet the demands of an increasingly competitive world economy. ■

¹ *GCC* countries comprise Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.