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The Middle East and Central Asia *Regional Economic Outlook* (REO) is prepared annually by the IMF's Middle East and Central Asia Department (MCD). The analysis and projections contained in the MCD REO are integral elements of the department's surveillance of economic developments and policies in member countries. It draws primarily on information gathered by MCD staff through their consultations with member countries.

The analysis in this report was coordinated under the general supervision of Jihad Azour (Director of MCD). The project was directed by Taline Koranchelian (Deputy Director in MCD), Bikas Joshi (Chief of MCD's Regional Studies Division), and Ali Al-Eyd (Deputy Chief of MCD's Regional Studies Division). The primary contributors to this report were Olumuyiwa Adedeji, Philip Barrett, Dalmacio F. Benicio, Qiaoe Chen, Lawrence Dwight, Matthew Gaertner, Divya Kirti, Sergejs Saksonovs, Moussé Sow, Iulia R. Teodoru, and Ling Zhu.

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Assumptions and Conventions

A number of assumptions have been adopted for the projections presented in the *Regional Economic Outlook: Middle East and Central Asia*. It has been assumed that established policies of national authorities will be maintained, that the price of oil¹ will average US\$61.80 a barrel in 2019 and US\$57.90 a barrel in 2020, and that the six-month London interbank offered rate (LIBOR) on US-dollar deposits will average 2.3 percent in 2019 and 2.0 percent in 2020. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The 2019 and 2020 data in the figures and tables are projections. These projections are based on statistical information available through late September 2019.

The following conventions are used in this publication:

- In tables, ellipsis points (. . .) indicate “not available,” and 0 or 0.0 indicates “zero” or “negligible.” Minor discrepancies between sums of constituent figures and totals are due to rounding.
- An en dash (–) between years or months (for example, 2011–12 or January–June) indicates the years or months covered, including the beginning and ending years or months; a slash or virgule (/) between years or months (for example, 2011/12) indicates a fiscal or financial year, as does the abbreviation FY (for example, FY 2012).
- “Billion” means a thousand million; “trillion” means a thousand billion.
- “Basis points (bps)” refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

As used in this publication, the term “country” does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

The boundaries, colors, denominations, and any other information shown on the maps do not imply, on the part of the International Monetary Fund, any judgment on the legal status of any territory or any endorsement or acceptance of such boundaries.

¹Simple average of prices of UK Brent, Dubai Fateh, and West Texas Intermediate crude oil.

Country Groupings

The October 2019 *Regional Economic Outlook (REO): Middle East and Central Asia* covers countries in the Middle East and Central Asia Department (MCD) of the International Monetary Fund (IMF). It provides a broad overview of recent economic developments and of prospects and policy issues for the medium term. To facilitate the analysis, the 31 MCD countries covered in this report are divided into two groups: (1) countries of the Middle East, North Africa, Afghanistan, and Pakistan (MENAP)—which are further divided into oil exporters and oil importers; and (2) countries of the Caucasus and Central Asia (CCA). The country acronyms and abbreviations used in some tables and figures are included in parentheses.

MENAP oil exporters comprise Algeria (ALG), Bahrain (BHR), Iran (IRN), Iraq (IRQ), Kuwait (KWT), Libya (LBY), Oman (OMN), Qatar (QAT), Saudi Arabia (SAU), the United Arab Emirates (UAE), and Yemen (YMN).

MENAP oil importers¹ comprise Afghanistan (AFG), Djibouti (DJI), Egypt (EGY), Jordan (JOR), Lebanon (LBN), Mauritania (MRT), Morocco (MAR), Pakistan (PAK), Somalia (SOM), Sudan (SDN), Syria (SYR), and Tunisia (TUN).

MENA comprises Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, the United Arab Emirates, and Yemen.

MENA oil importers comprise Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Somalia, Sudan, Syria, and Tunisia.

The **GCC** (Gulf Cooperation Council) comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

The **Non-GCC** oil-exporting countries are Algeria, Iran, Iraq, Libya, and Yemen.

CCA countries comprise Armenia (ARM), Azerbaijan (AZE), Georgia (GEO), Kazakhstan (KAZ), the Kyrgyz Republic (KGZ), Tajikistan (TJK), Turkmenistan (TKM), and Uzbekistan (UZB).

CCA oil exporters comprise Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.

CCA oil importers comprise Armenia, Georgia, the Kyrgyz Republic, and Tajikistan.

¹Somalia is included in all regional aggregates starting with the October 2017 publication of the *Regional Economic Outlook*. For Sudan, data for 2012 onward exclude South Sudan. Because of the uncertain economic situation, Syria is excluded from the projection years of REO aggregates.

Global Developments: Implications for the Middle East and Central Asia Region

Global developments continue to impact the Middle East and Central Asia (MCD) region. Average growth worldwide has once more been revised down and is anticipated to reach 3 percent in 2019, and 3.4 percent in 2020 versus projections one year ago of 3.7 percent for both of these years (see October 2019 *World Economic Outlook*). Although the reduction in global demand may be partly offset by the recent loosening of global monetary policy, concentration of the slowdown among key trading partners (especially Europe and China) has amplified the impact on the MCD region. Despite rising geopolitical tensions, including those related to Iran, recent disruptions to Saudi Arabia's oil production, and ongoing conflicts in the region (Libya, Yemen), global oil prices have remained low and financial conditions relatively loose.

The outlook for the MCD region is driven by a large contraction in Iran in the short term (see Chapter 1) followed by a rebound in 2020. The risks around the forecast are skewed to the downside and are highly dependent on global factors.

- Ongoing *trade tensions* represent a substantial risk to the region. In September, the United States introduced additional tariffs on Chinese goods, with more scheduled for December. Regional trade links to China are concentrated in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) oil exporters and Central Asia. Yet the spillovers from a China-focused slowdown may not be solely concentrated in these countries. Export shares capture only the direct effects of an external slowdown, so can underestimate exposure to a given country through indirect channels. For example, even countries with few direct sales to China may be impacted considerably by increased competition from redirected trade, as countries with large exports to China seek new markets. Figure 1 addresses this, comparing two measures of export elasticity to a reduction in Chinese demand: one assuming the effect of displaced competition is zero, and one that it is spread equally across all exporters to China. When these competitive spillovers are considered, the likely impact of a China-focused slowdown is more uniform across MCD countries.¹
- *Oil price volatility* has risen, while remaining below the highs of 2018. The overall level, however, remains similar to that expected in the spring (Figure 2). This is likely a function of both increasingly elastic global oil supply—due to expanded US shale production—and shocks to geopolitical tensions

Real GDP Growth, 2018–24

	2018	2019	2020	2021–24
World	3.6	3.0	3.4	3.6
Euro area	1.9	1.2	1.4	1.4
United States	2.9	2.4	2.1	1.6
China	6.6	6.1	5.8	5.7
Russia	2.3	1.1	1.9	2.0
MENAP	1.6	0.5	2.7	3.1
MENAP oil exporters	0.2	-1.3	2.1	2.1
of which: non-oil GDP growth	0.4	1.1	2.6	2.5
MENAP oil importers	4.3	3.6	3.7	4.8
CCA	4.2	4.4	4.4	4.5
CCA oil and gas exporters	4.1	4.3	4.4	4.5
of which: non-oil GDP growth	3.0	5.1	4.6	4.2
CCA oil and gas importers	5.2	4.9	4.5	4.5

Sources: National authorities; and IMF staff calculations.

Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, Pakistan.

¹The goods-weighted export share to China for country i is $\sum_m w_m^i \omega_m$, in which w_m^i is the share of good m in country i 's exports, and ω_m is China's share of all imports of good m . This measure captures at least some of the spillovers as other exporters adjust. For example, one of Georgia's main exports is metal ore, particularly copper. China is a very large purchaser in this market, constituting nearly half of global demand. A reduction in Chinese demand will likely increase competition for Georgian copper exports as other producers seek to find new markets. Although direct exports to China are very small (about 6 percent of total in 2018), the impact through competitive spillovers may be larger, and is captured at least in part by the goods-weighted exposure.

Figure 1. MCD Exposure of Exports to China, 2017
(Share of exports)

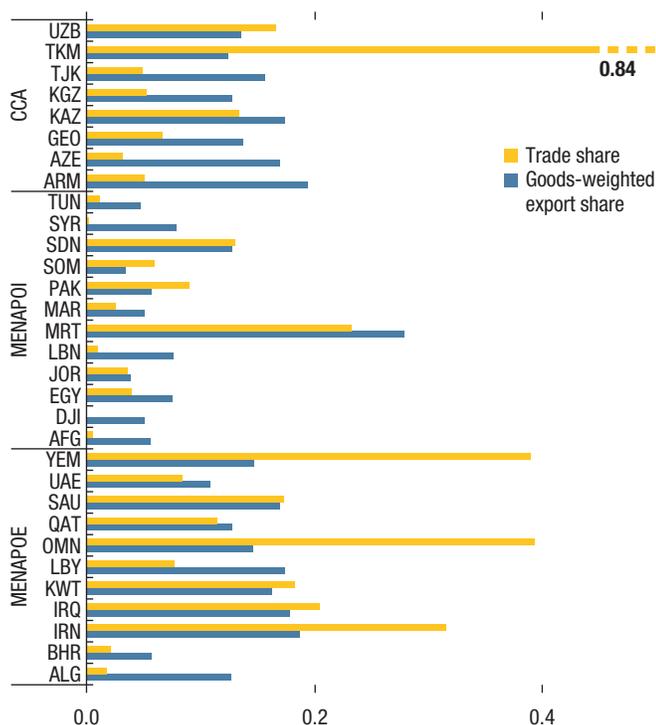
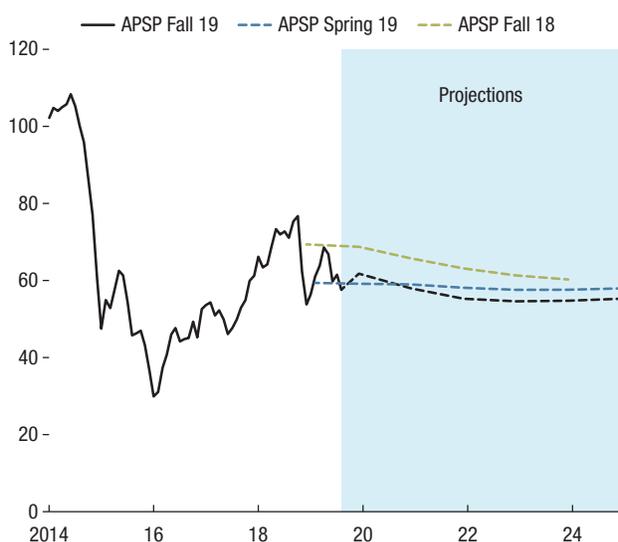


Figure 2. Evolution of Oil Prices
(APSP, US dollars a barrel)



Sources: National authorities; and IMF staff calculations.
Note: APSP = average petroleum spot price. APSP is the average of UK Brent, Dubai Fateh, and West Texas Intermediate crude oil prices.

Sources: BACI International Trade database; Centre d'Etudes Prospectives et d'Informations Internationales; and IMF staff calculations.
Note: The goods-weighted export share for each country is the sum of the product of exports in 4-digit harmonized system goods categories with Chinese import shares of each good. It thus measures the elasticity of exports to a goods-neutral reduction in Chinese demand assuming that exporters' shares of global goods markets remain fixed. CCA = Caucasus and Central Asia; MENAPOE = Middle East, North Africa, Afghanistan, and Pakistan oil-exporting countries; and MENAPOI = Middle East, North Africa, Afghanistan, and Pakistan oil-importing countries. Country abbreviations are International Organization for Standardization (ISO) country codes.

and global demand (Box 1). Yet recent events in the Gulf have highlighted the sensitivity of the global oil market to disruptions in oil shipments and facilities.

- A *disorderly Brexit* could also significantly impact the region. A general slowdown across Europe from Brexit will reduce external demand in countries with tight trade links to the continent, such as Morocco and Tunisia. Yet the direct spillovers from a sharp contraction in the UK economy are likely to be much more acute and more unpredictable. Financial channels could be particularly important, as the UK is the largest banking counterparty for the MCD region, and several countries have considerable exposure to the pound sterling (Kuwait, Oman, Pakistan).
- Finally, *social tensions* across the region remain elevated. Protests earlier this year in Algeria and Sudan have been accompanied by those in Georgia and Kazakhstan (Box 2). The evolution of these events highlights the urgent need for reforms to deliver higher and more inclusive growth, and will shape policymakers' options for addressing the economic challenges faced by the region.

In the longer term, even larger risks loom. Foremost among these are *demographic changes*, which are already straining labor markets and demand for public services, and *climate change*, which will most likely impact the region through more adverse weather events, oil price uncertainty, and tension over scarce resources, particularly water.

Given this environment, regional governments' *policy objectives* should, in the near term, stabilize macroeconomic conditions and build resilience by addressing unsustainable fiscal policies while protecting the most vulnerable, and in the medium term, promote inclusion and raise growth by tackling impediments to jobs and investment. More accommodative policies should be considered if there is further slowdown in countries where growth is already too low and when there is policy space.

To achieve these objectives, country authorities will face *three key policy challenges*, highlighted in this report. First, fundamental reforms to the *conduct and institutions of fiscal policy* are essential to tackle high public debt and inefficient government services. This will include the adoption of policies to promote fiscal transparency *and* predictability, such as credible medium-term fiscal frameworks. Second, the composition of *capital flows* to the region has changed, becoming less conducive to growth. Foreign direct investment (FDI) has been replaced by portfolio flows, especially in MENAP countries; policies to promote deeper markets, reduce restrictions on investment, and improve macroeconomic stability can help attract FDI. Third, *structural reforms* are essential for boosting growth and employment throughout the region. A failure to deliver higher and more inclusive growth may fuel already-elevated social tensions, threatening regional stability.

Box 1. Decoupling of Regional Geopolitical Tensions and Oil Prices

Although global oil prices used to rise sharply and remain elevated for long periods in response to major geopolitical tensions in the MENAP region, more recent episodes of heightened geopolitical tensions have had a much less severe impact. For example, oil prices rose by nearly 60 percent, from \$22 a barrel in November 2002 to \$35 a barrel in March, in the lead-up to the 2003 Iraq war. However, they only rose by 8 percent from \$71 in August to \$77 in October following the reimpositions of US sanctions on Iran, which was much milder than expected given the fact that Iran is a large oil producer.

This subdued response of oil prices to geopolitical tensions can be explained by a combination of key factors. First, increased risks of an adverse demand shock, most recently owing to the rising uncertainties in global trade, have been a major dampening force on oil prices. Second, supply-side considerations matter. The oil market structure has changed with US shale oil producers playing an increasingly important role. US shale oil production increased from slightly less than 7 percent of the total US crude oil production in the early 2000s to more than 60 percent in 2018.

A regression analysis using monthly data confirms these relations (Table 1). There is a positive and significant relationship between political risks in the MENAP region and real oil prices. However, this effect is dampened by the rise of shale oil since 2010, when US shale oil production started to accelerate (Box Figure 1.1).¹ The increased shale oil production has also contributed to crude oil inventory in the United States, which has remained at historically high levels since 2015, exerting further downward pressure on oil prices. Trade uncertainty, captured by recent spikes in the Chicago Board Options Exchange Volatility Index (VIX), is associated with a further negative impact on oil prices.

Table 1. Selected Determinants of Oil Price

Variables	Δ Real oil price
Δ Political risk in MENAP	0.96** (0.59)
Δ Political risk in MENAP * Shale dummy	-0.87* (0.63)
Δ VIX	-0.12*** (0.03)
Δ US crude inventory	-0.31*** (0.16)

Sources: Haver, International Energy Agency (IEA); PRS Group; IMF Research Department; and IMF staff calculations.

Note: Sample period is from January 1999 to June 2019. Real oil price is calculated by deflating the monthly average petroleum spot prices using the US consumer price index. Political risk in MENAP is proxied using median political risk ratings of all MENAP countries by Political Risk Service Group—transformed so a higher number indicates increased risks. Shale dummy is set to 0 before year 2010, and 1 from year 2010 onward. All time-series variables are in percentage changes from previous month to ensure stationarity.

11-(month) lagged dependent variables are included as additional controls to alleviate omitted variable bias and reduce serial correlations (Durbin-Watson test confirms no serial correlation). Constant term and coefficients of shale dummy and lagged dependent variables are omitted in the table to save space. Robust standard errors in parentheses. *** $p < 0.05$, ** $p < 0.1$, * $p < 0.2$.

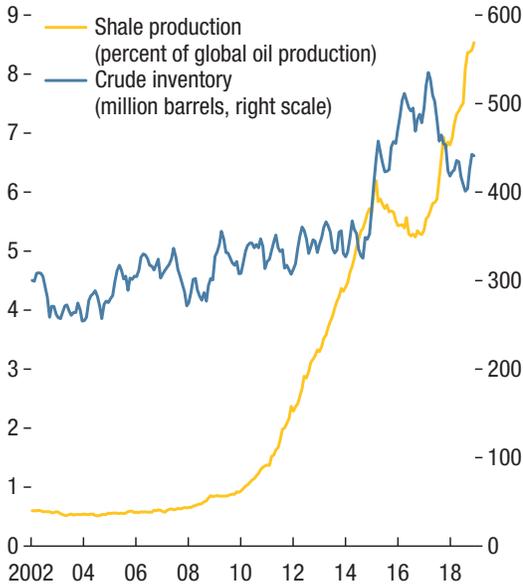
VIX = Chicago Board Options Exchange Volatility Index.

Prepared by Ling Zhu.

¹Political risks in the MENAP region are proxied using MENAP countries' median political risk ratings, as calculated by the Political Risk Service Group. This measure accounts for political stability of a country on a comparable basis with other countries by assessing risk points for each of the component factors of government stability, socioeconomic conditions, investment profile, internal conflict, external conflict, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability, and bureaucracy quality. Original ratings range from a high of 100 (least risk) to a low of 0 (highest risk); data for this analysis were transformed—subtracting the index from 100—to imply a higher number indicating increased risks.

Box 1 (continued)

Box Figure 1.1. US Shale Oil Production
(Percent of global oil production; million barrels)



Sources: US Energy Information Administration; Haver Analytics; and IMF staff calculations.

The muted response of oil prices to changes in perceptions of political risk seems driven by two factors: First, the increasing importance of the US shale oil, especially its role as a major swing producer, has weakened the link between oil prices and geopolitical tensions in the MENAP region. Given the secular nature of the rise in US shale oil, the link between geopolitical tensions and oil prices is likely to remain subdued. Second, trade uncertainty appears to play a large role in keeping oil prices from rising. A protracted trade dispute, increasing the risk of a further global slowdown on top of an already slowing world economy, is expected to keep oil prices low despite geopolitical tensions in the region.

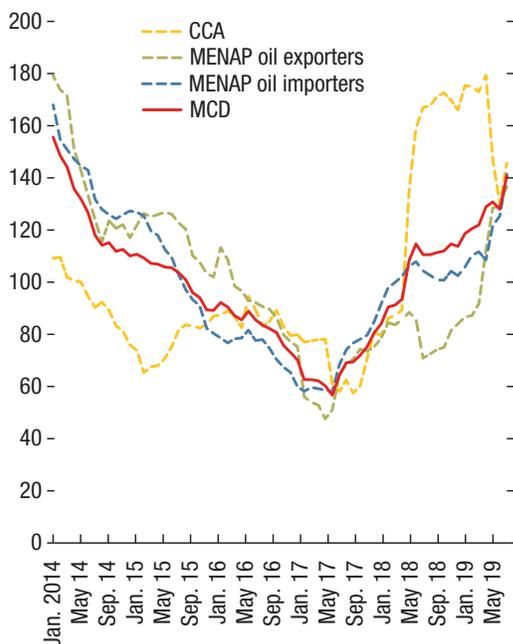
Box 2. Monitoring Social Unrest in the Middle East and Central Asia

Social unrest is growing throughout the Middle East and Central Asia. The Reported Social Unrest Index (RSUI), which counts media reports of social unrest in member countries, shows that reported social unrest has risen to highs not seen since 2014 (Box Figure 2.1).¹

This recent trend is widespread. Unrest earlier this year had been concentrated in Algeria and Sudan. More recently, though, protests have flared in Georgia and Kazakhstan—albeit in a very different social and political context to that in North Africa (Box Figure 2.2). Still, this contrasts with previous bouts of unrest; prior to 2017 social unrest was relatively more prevalent in countries in the Middle East, North Africa, Afghanistan, and Pakistan region (Box Figure 2.1).

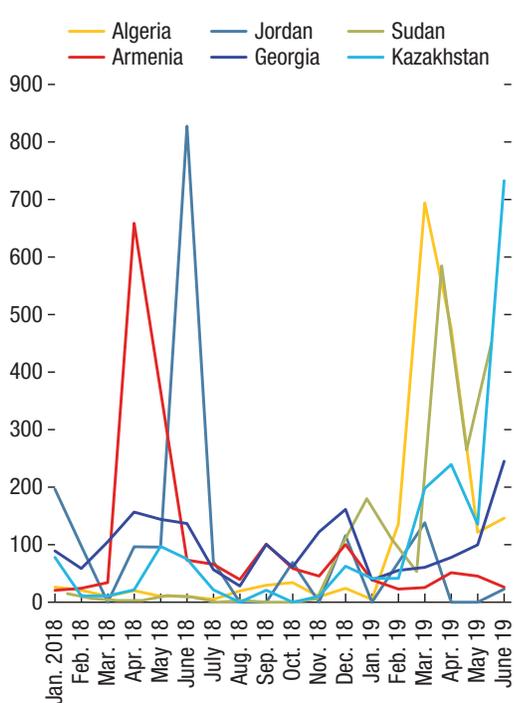
Social unrest constrains policymakers’ choices. For example, urgent reforms to Tunisia’s public sector wage bill were postponed earlier this year due to fear of widespread protests. And major demonstrations last year led to policy changes in both Armenia and Jordan (Box Figure 2.2). Yet policymakers cannot shy away from reform. Authorities are faced with persistent structural shortcomings, which are limiting jobs and opportunities for their citizens, likely risking further instability.

Box Figure 2.1. Reported Social Unrest Index
(12-month rolling average, 2014–present = 100)



Sources: Factiva; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MCD = Middle East and Central Asia Department; MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

Box Figure 2.2. Reported Social Unrest Index
(Average, 2018–present = 100)



Sources: Factiva; and IMF staff calculations.

Prepared by Philip Barrett.

¹See Box 1 in the April 2019 *Regional Economic Outlook: Middle East and Central Asia* and associated online annex for further discussion about the construction of this index. Previously computed only for 7 MENA countries, this index is now calculated for the 27 MCD countries for which there are sufficient data.

1. MENAP Oil-Exporting Countries: Transitioning to a Sustainable Fiscal Position and Higher Growth

Growth in the near term remains subdued for oil exporters in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region, amid volatile oil prices, precarious global growth, elevated fiscal vulnerabilities, and heightened geopolitical tensions. In addition, declining productivity is dampening medium-term growth prospects. To reduce dependence on oil prices and pave the way for more sustainable growth, fiscal consolidation needs to resume, underpinned by improved medium-term fiscal frameworks. In parallel, structural reforms and further financial sector development would boost foreign direct investment (FDI) and domestic private investment and foster diversification, thus contributing to improved productivity and potential growth.

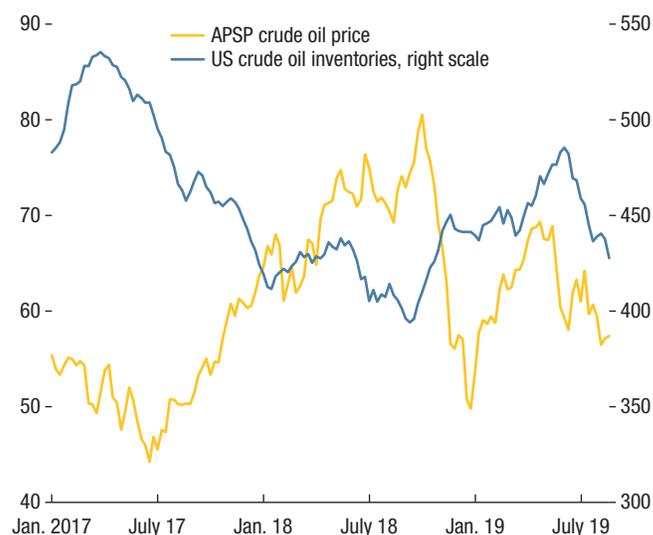
Managing External and Domestic Policy Challenges

Against a backdrop of slowing global growth, ongoing trade tensions, and renewed geopolitical risks, including developments in Iran and recent attacks on Saudi Arabia's oil facilities, oil prices remain volatile, swinging from \$55 to \$75 a barrel since the start of the year (see Global Developments). Uncertainties related to future Organization of the Petroleum Exporting Countries and other major oil producers (OPEC+) production decisions and the pace of US oil output expansion add to bouts of oil price volatility (Figure 1.1). At the same time, ongoing conflicts in Libya and Yemen limit scope for effective macroeconomic policies in these countries and further intensify ongoing regional uncertainties.

In this context, growth in MENAP oil exporters (excluding countries affected by conflict and Iran) is expected to be 1.3 percent in 2019 (a downward revision of 0.9 percentage point since April 2019)

Prepared by Olumuyiwa Adedeji (lead author), Divya Kirti, Jorge de León Miranda, and Moussé Sow.

Figure 1.1. APSP Crude Oil Prices and US Crude Oil Inventories
(US\$ a barrel and thousands of barrels, right scale)



Sources: Bloomberg Finance L.P.; US Energy Information Administration; and IMF staff calculations.

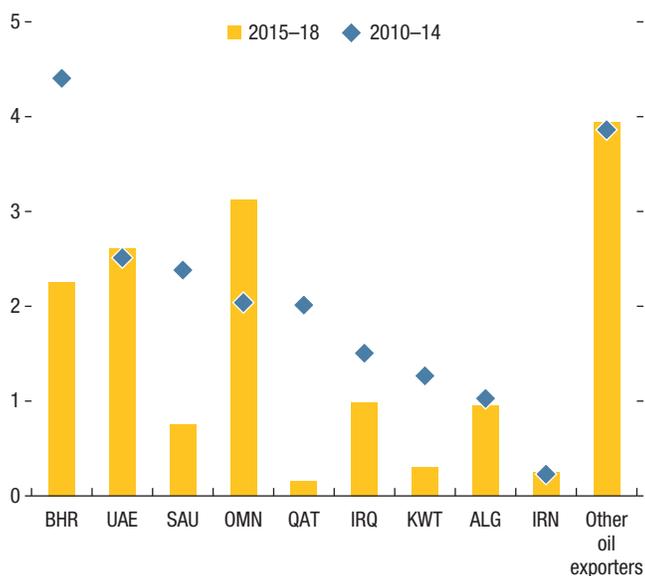
Note: APSP = average petroleum spot price.

compared to 1.6 percent in 2018. Increased activity in the oil and gas sectors is expected to support a moderate pickup in growth in these countries to 2.8 percent in 2020. However, this too reflects a downward revision relative to April of 0.7 percentage point, while considerable downside risks underscore prospects for much lower growth outcomes.

Downside risks are significant. Lower global demand and oil production could potentially weaken oil prices, business confidence, and investment decisions, with adverse implications for growth and fiscal and external positions.

Meanwhile, increased fiscal vulnerabilities in some countries—in the context of higher public spending to support growth—reinforce risks from lower projected medium-term oil prices. Finally, while increased bond and equity inflows can finance investment, and potentially stimulate

Figure 1.2. FDI Inflows, 2010–18
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.

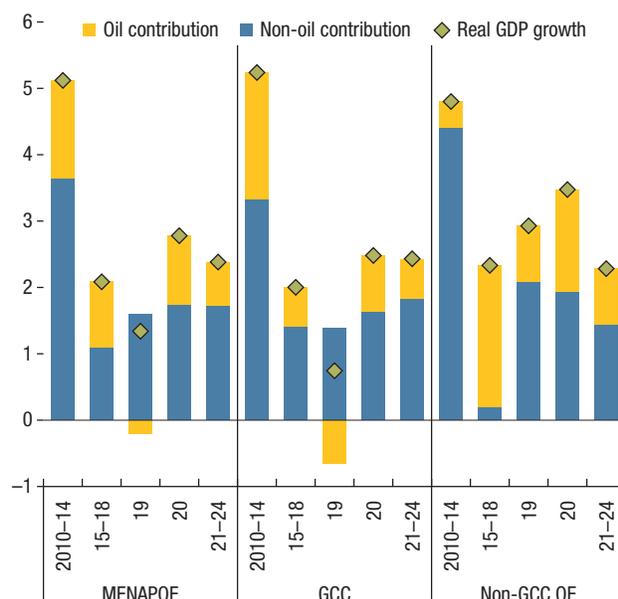
Note: FDI = foreign direct investment. Other oil exporters comprise: Albania, Angola, Bolivia, Brunei Darussalam, Cameroon, Chad, Republic of Congo, Côte d'Ivoire, Democratic Republic of the Congo, Ecuador, Equatorial Guinea, Gabon, Indonesia, Mexico, Nigeria, Norway, Papua New Guinea, Russia, Timor-Leste, Trinidad and Tobago, Venezuela, and Vietnam. Country abbreviations are International Organization for Standardization (ISO) country codes.

growth, they can also make the region more susceptible to developments in international financial markets (see Chapter 4).

Looking ahead, growth is constrained by a slowdown in productivity, amid reduced FDI flows (Figure 1.2) and scope to improve the allocation of fiscal resources. In this environment, further boosting demand through expansionary fiscal policy would heighten fiscal vulnerabilities and have only a modest impact on growth.

Against this outlook, a mix of macroeconomic and financial policies that would strengthen resilience and promote private-sector-led, job-rich growth is required. Reducing fiscal vulnerabilities is a priority, combined with enhanced emphasis on structural reforms to spur growth. The pace of fiscal consolidation in individual countries should take into consideration the growth impact. Fiscal adjustment needs to be embedded in a medium-term fiscal framework and focused on improving the collection of non-oil revenue,

Figure 1.3. Real GDP Growth: Non-Oil and Oil Contributions
(Percent)



Sources: National authorities; and IMF staff calculations.

Note: Iran and Libya are excluded from MENAPOE and non-GCC OE. GCC = Gulf Cooperation Council; MENAPOE = Middle East, North Africa, Afghanistan, and Pakistan oil-exporting countries; OE = oil exporters. Country-specific weights correspond to purchasing-power-parity-adjusted GDP.

containing wage bills, raising energy prices, and improving the quality of public expenditure (see Chapter 5). Structural and financial sector reforms would boost FDI and investment, and foster private sector activity, thus helping to lift productivity and potential growth.

Improving but Subdued Growth

The implementation of ongoing infrastructure projects and improved credit conditions will reinforce the projected near-term recovery in growth of MENAP oil exporters (Figure 1.3). But the growth outlook is fragile given the projected downward trend in oil prices, elevated oil price volatility, and emerging fiscal vulnerabilities.

- Growth in Gulf Cooperation Council (GCC) countries is projected to be 0.7 percent in 2019, down notably from 2 percent in 2018. This decline mainly reflects oil production cuts in line with OPEC+ agreements. Growth

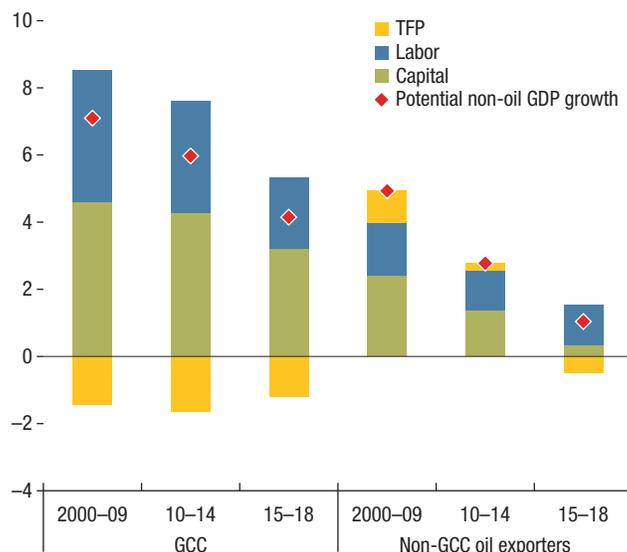
1. MENAP OIL-EXPORTING COUNTRIES: TRANSITIONING TO A SUSTAINABLE FISCAL POSITION AND HIGHER GROWTH

in 2020 is expected to rebound to 2.5 percent, driven by a recovery in real oil GDP growth of 1.9 percent (compared to –1.4 percent in 2019 and 2.5 percent in 2018). This reflects a mix of rising oil production in Kuwait and Saudi Arabia, the Jizan refinery becoming fully operational (Saudi Arabia), and a pickup in gas output in Oman and Qatar. However, it is uncertain whether the OPEC+ agreement in place will expire by March 2020. Non-oil GDP growth (increasing to 2.8 percent in 2020 from 2.4 percent in 2019) will be supported by infrastructure spending (Kuwait and UAE seeing a boost to tourism from Expo 2020, and Qatar, given its preparations toward hosting the 2022 World Cup).

- Iran's economy has entered a steep recession. Output in 2019 is expected to shrink by 9.5 percent as US sanctions have continued to tighten. Iran's main export, oil, is severely restricted, and imports have collapsed. Some stability in the level of output is expected in 2020, culminating in near-zero growth.¹
- Other non-GCC oil exporters show a mixed growth outlook. Growth in Iraq is projected to be 3.4 percent in 2019, improving from –0.6 percent in 2018 on rising public spending and a modest increase in oil production. Similar trends, alongside better rainfall and sustained improvement in electricity production, will see growth increase to 4.7 percent in 2020. In Algeria, growth is expected to reach 2.6 percent in 2019, up from 1.4 percent in 2018, on rising oil production, before moderating to 2.4 percent in 2020 reflecting ongoing uncertainty. Security and political conditions have deteriorated since April 2019 in Libya, adversely impacting economic performance. Growth is expected to decline slightly in Yemen. The projected growth in non-GCC oil exporters assumes some easing of regional tensions. Growth could be lower if this critical expectation fails to materialize.

¹See Box 1.1 on the regional spillovers of the re-imposition of economic sanctions on Iran.

Figure 1.4. Potential Real Non-Oil GDP Growth: Contributions of Capital, Labor, and Productivity (Percent)



Sources: National authorities; and IMF staff calculations.

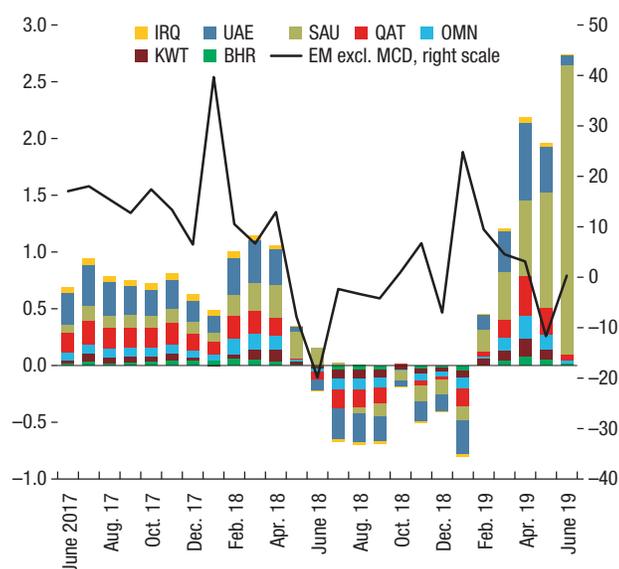
Note: Libya is excluded from non-GCC oil exporters. GCC = Gulf Cooperation Council; TFP = total factor productivity. Simple averages are used to compute regional aggregates.

Potential non-oil GDP growth has slowed, reflecting diminishing productivity growth in non-GCC oil exporters, persistently negative productivity growth in GCC oil exporters, and declining capital accumulation across MENAP oil exporters (Figure 1.4).² Dominant public sectors in GCC countries continue to skew incentives for investment toward nontradables, weighing on diversification and productivity growth (Callen and others 2014; Cherif and Hasanov 2016).

Against this background, activity is expected to remain subdued over the medium term. Real GDP growth is expected to average about 2.4 percent for GCC countries and 2.3 percent for non-GCC oil exporters (excluding Iran and Libya) during 2021–24. These growth levels are too low to create the approximately 1 million new jobs a year needed to absorb new entrants into labor markets.

²Oil prices may also significantly impact confidence and the pace of government investments, with impacts on potential output.

Figure 1.5. EPFR Bonds and Equity Net Flows
(US\$ billions, rolling 3-month cumulative flow)



Sources: Haver Analytics; and IMF staff calculations.

Note: EM = emerging market economies; EPFR = Emerging Portfolio Fund Research; MCD = Middle East and Central Asia Department. Country abbreviations are International Organization for Standardization (ISO) country codes.

Improving Financial Conditions Supporting Growth

MENAP oil-exporting countries are benefiting from supportive global financial conditions. Interest rate cuts by major central banks (matched in most GCC countries), and the inclusion of GCC countries in global equity and bond indices, boosted debt and equity flows to many countries in the region in 2019, outperforming other emerging market economies (Figure 1.5).

There has been a modest recovery in private credit growth in GCC countries, partly supported by lower domestic interest rates in response to recent easing by the US Federal Reserve. Nonetheless, pressures in real estate markets persist, impacting financial and monetary conditions (see the April 2019 *Regional Economic Outlook Update: Middle East and Central Asia* for the computation of financial conditions indices).

The banking sector in GCC countries is adjusting to the decline in real estate prices by reducing credit allocation to construction and real estate sectors (Qatar), while mortgage

lending is increasing in Saudi Arabia from a low base. Although the banking sector remains healthy, safeguarding the stability of the financial system will require continued effective monitoring of emerging trends in the real estate sector and exploring the scope for continued use of macroprudential measures to contain risks as needed.

In other countries (Algeria, Iran, Yemen), monetary financing of fiscal deficits and inflation driven by exchange rate pressures have lowered real credit growth to the private sector. In conjunction with containing fiscal deficits, these countries need to redouble efforts to mop up liquidity already injected through monetary financing operations to contain inflationary and exchange rate pressures and the associated adverse impacts on economic activity. In Iraq, bank balance sheets remain weak. The public banking system requires restructuring to safeguard financial stability.

Comovements between Oil Prices and Expenditures, and Fiscal Risks

With concerns about weak growth, the challenge of the strong association between oil prices and government expenditures remains (Figure 1.6). Fiscal consolidation is slowing in some countries and reversing in others (Figure 1.7) due largely to increased spending (Figure 1.8). Nonetheless, the spending effect on growth has been modest so far, partly because of the composition of spending (Figure 1.9).³ As a result, fiscal vulnerabilities have increased, especially compared to the pre-2014 period. Gross financing needs and public debt have moved up, while governments' net financial positions have deteriorated (Figure 1.10).⁴ Thus, countries are now more vulnerable to a decline in oil prices, particularly those with limited fiscal buffers (Bahrain, Iran, Iraq, Oman, Yemen). The estimated gap between the non-hydrocarbon primary balance needed to ensure

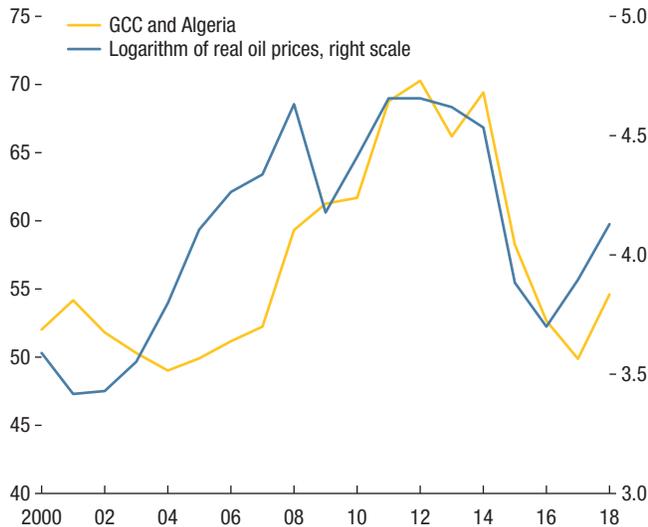
³See Fouejieu, Rodriquez, and Shahid 2018.

⁴This measure excludes sovereign wealth funds due to lack of information on the size of their liquid components.

1. MENAP OIL-EXPORTING COUNTRIES: TRANSITIONING TO A SUSTAINABLE FISCAL POSITION AND HIGHER GROWTH

Figure 1.6. Real Oil Prices and General Government Expenditure

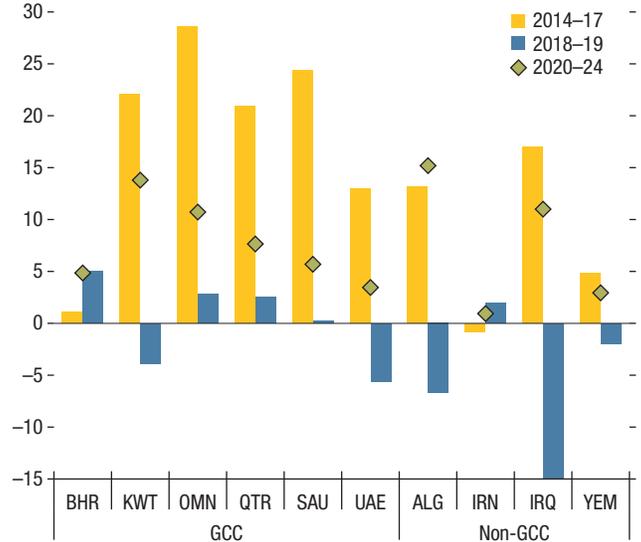
(Logarithm of oil prices and percent of non-oil GDP, weighted averages)



Sources: National authorities; and IMF staff calculations.
 Note: The real oil prices are calculated using the US GDP deflator.
 Country-specific weights correspond to nominal GDP in US dollars. GCC = Gulf Cooperation Council.

Figure 1.7. MENAPOE: Changes in Non-Oil Primary Fiscal Balances

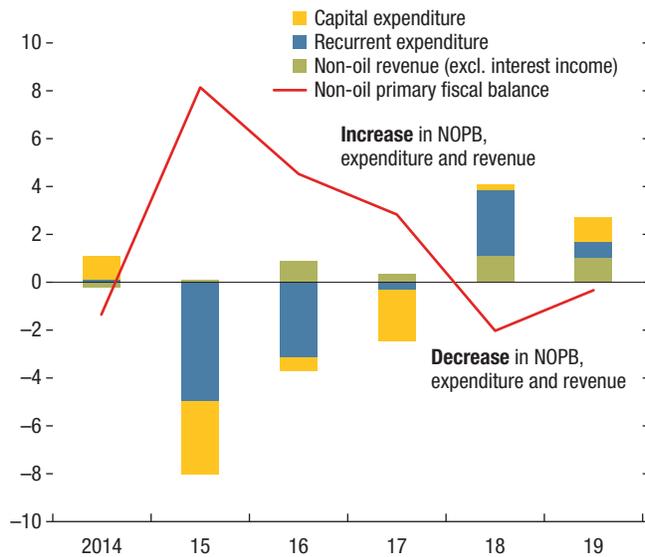
(Percent of non-oil GDP)



Sources: National authorities; and IMF staff calculations.
 Note: Country-specific weights correspond to GDP in US dollars. GCC = Gulf Cooperation Council; MENAPOE = Middle East, North Africa, Afghanistan, and Pakistan oil-exporting countries. Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 1.8. MENAPOE: Changes in the Non-Oil Primary Balance, Expenditure, and Non-Oil Revenue

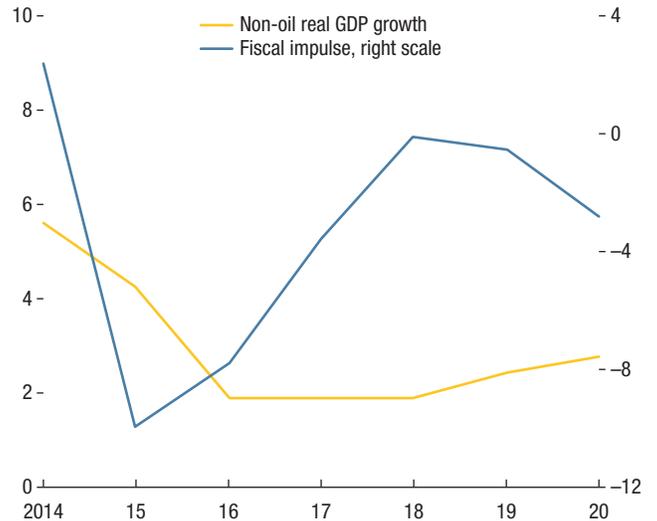
(Percent of non-oil GDP, weighted averages)



Sources: National authorities; and IMF staff calculations.
 Note: MENAPOE = Middle East and North Africa, Afghanistan, and Pakistan oil-exporting countries; NOPB = non-oil primary fiscal balance. Country-specific weights correspond to GDP in US dollars.

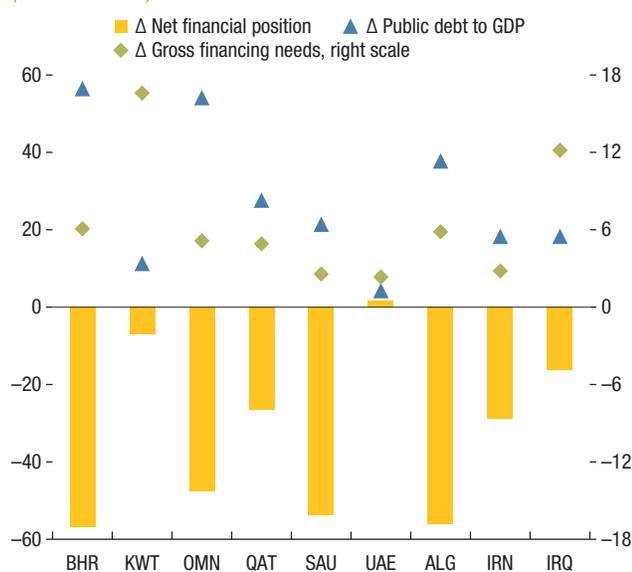
Figure 1.9. GCC: Non-Oil Real GDP Growth and Fiscal Impulses

(Percent and percent of non-oil GDP, weighted averages)



Sources: National authorities; and IMF staff calculations.
 Note: Fiscal impulse is calculated using the change in non-oil primary deficit to non-oil GDP ratio. Country-specific weights correspond to purchasing-power-parity-adjusted GDP. GCC = Gulf Cooperation Council.

Figure 1.10. MENAPOE: Changes in the Gross Public Debt, Gross Financing Needs, and the Net Financial Positions, 2014–19
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.

Note: The net financial position is the difference between domestic and external debt, and government deposits. Gross financing needs for Kuwait include mandatory transfers to the sovereign wealth fund. Sovereign wealth funds are not included in the definition of the net financial position due to lack of information. Country abbreviations are International Organization for Standardization (ISO) country codes.

intergenerational equity and the projected primary balance in 2019 ranges between 5 and 23 percentage points of nonhydrocarbon GDP.

Addressing Fiscal Vulnerabilities and Intergenerational Equity

Resumption of fiscal consolidation would help rebuild policy buffers and complement efforts to achieve private-sector-led growth. Individual countries' fiscal space, economic conditions, and financing needs should determine the magnitude and pace of the adjustment. However, in the event of adverse shocks or if cyclical conditions warrant, countries with significant fiscal space (Kuwait, Qatar, United Arab Emirates) could undertake slower fiscal consolidation. Overall, an effective fiscal consolidation would depend on several important elements:

Enhancing non-oil revenue collection. MENAP oil exporters have taken significant steps to improve non-oil revenue mobilization.⁵ However, there is scope to further augment tax revenues by undertaking comprehensive tax reforms. The strategy could be to prioritize measures to broaden the base by gradually reducing exemptions, eliminating loopholes in tax legislations, and strengthening tax administration. Some countries (Kuwait, Oman, Qatar) would benefit from introducing a value-added tax to enhance domestic revenue mobilization. Consumption taxes could be expanded and enhanced in Iraq. In addition, consideration could be given to introducing other measures, including income and property taxes.

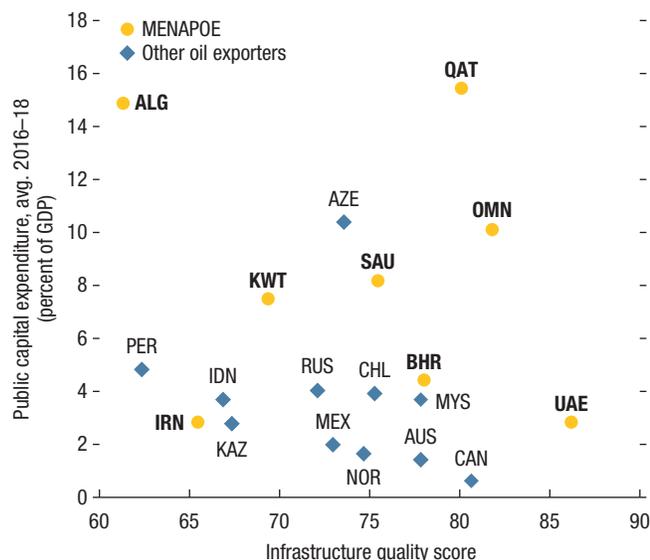
Contain wage bills and energy subsidies and improve the quality and efficiency of spending. Efforts to contain and streamline wage bills (see Tamirisa and others 2018) and energy subsidies⁶ (with emphasis on cost-recovery and incentives to reduce energy intensity and inefficiencies) together with strengthening social protection would contribute to a more effective and efficient allocation of resources, crucial for improved productivity. While infrastructure quality in MENAP oil exporters varies, such quality has been achieved at high levels of capital expenditures as ratios of GDP (Figure 1.11), indicating room for improving the efficiency of public investment. Key areas for improvement are procurement, transparency, and appraisal and selection processes.

Strengthening fiscal frameworks. The uncertainty about oil price prospects underscores the need to decouple the evolution of public expenditures from volatile oil receipts. Medium-term fiscal frameworks could prove useful. Strengthening fiscal institutions, including improving transparency and adopting credible medium-term fiscal frameworks, could help improve the

⁵Saudi Arabia introduced a set of measures, including a 5 percent value-added tax rate in January 2018, excises, and an expatriate levy to improve non-oil revenue collection. The United Arab Emirates introduced excises in late 2017, and a value-added tax in January 2018. Bahrain introduced a value-added tax at a 5 percent rate in January 2019. Qatar introduced excise taxes in 2019 (100 percent on tobacco, 50 percent on all carbonated drinks, and 100 percent on all energy drinks).

⁶In some countries lower subsidies going forward will raise revenues rather than lower expenditures (Saudi Arabia).

Figure 1.11. MENAPOE and Comparators: Infrastructure Quality Score and Public Capital Expenditure
(Score and percent of GDP)



Sources: WEF *Global Competitiveness Report 2018–2019*; and IMF staff calculations.

Note: The World Economic Forum's Global Competitiveness indicators combine both official data and survey responses from business executives. These indicators should be interpreted with caution due to a limited number of respondents, limited geographic coverage, standardized assumptions on business constraints, and information availability. They may also not reflect more recent important structural transformations. MENAPOE = Middle East and North Africa, Afghanistan, and Pakistan oil-exporting countries. Country abbreviations are International Organization for Standardization (ISO) country codes.

macroeconomic performance of MENAP oil exporters (see Chapter 5, Adedeji and Zhang 2019).

Structural Reforms to Achieve Higher and Inclusive Growth

Even as continued fiscal consolidation remains a priority, there is a pressing need to generate jobs across the region. To this end, further financial development and structural reforms would help raise economies' supply potential (see Chapter 4 and the October 2019 *World Economic Outlook*). This is important as growth must come from the private sector to ease the burden of much-needed fiscal adjustment.

A recent analysis of GCC countries indicated that increased financial development could raise annual

per capita income growth by 0.4–0.7 percentage point and increased financial inclusion in this region could be associated with higher growth of some 0.3–0.7 percentage point (Ben Ltaifa and others 2018).

Strategies to improve financial development and inclusion should focus on the following:

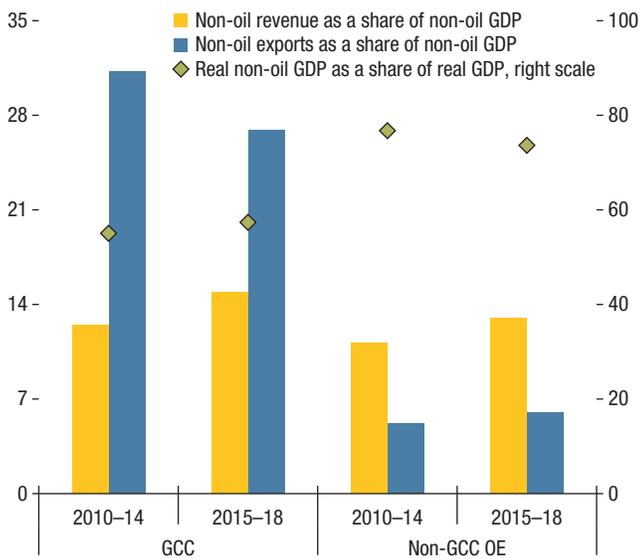
- *Reforms to strengthen access to finance for young and growing companies.* Promoting financial sector competition would help enhance access to finance. Financial literacy and insolvency frameworks could also be improved.
- *Debt and securities markets.* Developing debt markets, making stock markets more accessible to a larger pool of companies and investors, and further improving corporate governance and investor protection would support improved productivity and higher growth.

Although non-oil revenues have been strengthened, considerable scope exists for increasing the non-oil share of economic activity and exports (Figure 1.12).

Structural reforms to support private-sector-led non-oil growth and raise productivity are therefore important. Emphasis could be placed on four key objectives:

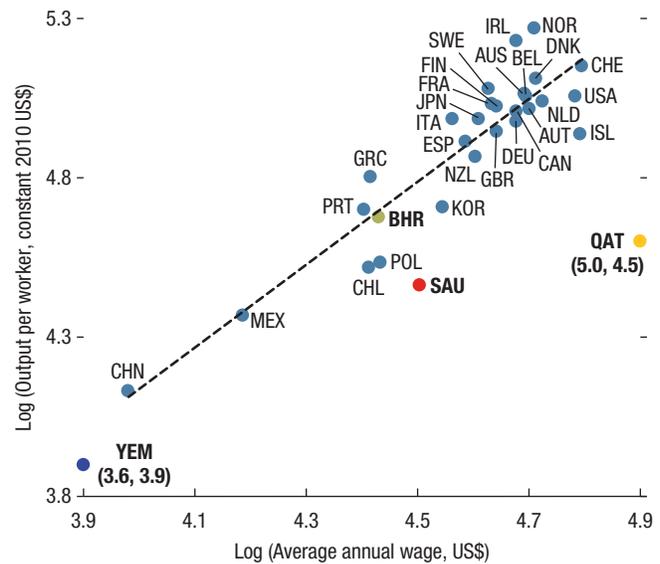
- *Further improving an environment in which the private sector can flourish.* Continued initiatives in GCC countries and concerted efforts in non-GCC oil exporters to improve business environments will help catalyze domestic and foreign direct investment. FDI can lift productivity and growth through technology spillovers and knowledge creation (OECD 2002, WEF 2013). Closing FDI gaps in GCC countries could raise real non-oil GDP per capita growth by as much as 1 percentage point (Stepanyan and others 2018). Relaxing restrictions on foreign ownership would help attract FDI (Algeria).
- *Improving competition and discipline.* A more focused role for the public sector through

Figure 1.12. Diversification from Oil: Real Non-Oil GDP, Non-Oil Revenues, and Non-Oil Exports
(Percent of real GDP and non-oil GDP)



Sources: National authorities; and IMF staff calculations.
Note: Libya was excluded due to data availability. GCC = Gulf Cooperation Council; OE = oil-exporting country. Country-specific weights correspond to purchasing-power-parity-adjusted GDP.

Figure 1.13. Average Annual Wage and Productivity
(Logarithm of output per worker and logarithm of average annual wage)



Sources: Haver Analytics; International Labour Organization; national authorities; World Bank; and IMF staff calculations.
Note: Productivity for Gulf Cooperation Council (GCC) countries is estimated using the relationship between the quality of human capital—based on the World Bank’s Human Capital Index—and productivity in the sample of countries shown, as direct data on productivity of nationals in GCC countries are not available. Values for Qatar and Yemen are not within the range of the scale and are shown in parentheses. The remaining MENAP oil-exporting countries are excluded due to data availability. Country abbreviations are International Organization for Standardization (ISO) country codes.

privatization and effective public–private partnerships (in GCC countries), broader and better enforced competition laws (Algeria and GCC countries), and a level playing field between the private sector and state enterprises and foundations (Algeria, Iran) would support competition. All six GCC countries have adopted national visions with significant industrial policy components. Although such policies could encourage the development of new sectors, it is important for these policies to be approached with caution and that any support targets sectors rather than individual companies and is time-bound with specific performance criteria.

- *Incentivizing private sector employment and improving competitiveness.* Wages seem higher than would be suggested by productivity levels in some countries (Figure 1.13; see Kirti 2019). As high public wages and employment contribute to wage-productivity gaps, public-private wage gaps need to be contained (Kuwait, Oman, Saudi Arabia,

United Arab Emirates) by more closely linking compensation to performance and improving control over bonuses and allowances (see Tamirisa and others 2018), and expectations of limited growth in public sector jobs communicated (Kuwait, Oman, Saudi Arabia). Improved education and training are essential to improving human capital and raising productivity for all MENAP oil exporters.

- *Improving governance.* Legal frameworks require strengthening to protect contractual, ownership, and creditor rights. Reinforcing the rule of law would require increasing the transparency of corporate beneficial ownership. Many countries would benefit from enhancing asset declaration systems for senior public officials, criminalizing bribery and embezzlement, and reducing the scope for corruption and rent seeking.

Box 1.1. Iran: Regional Spillovers

A lack of integration in global trade means that the sharp recession in Iran will probably have limited spillovers to the rest of the region. The largest impact will likely be in the international oil market, although geopolitical tensions, as well as responses of other oil producers and weakening global oil demand, make the resultant price impact highly uncertain. Other specific markets—including tourism, agriculture, and electricity—in particular countries may also be moderately impacted.

Iran's trade links are limited. In 2017, Iran's gross trade (imports plus exports) was 47 percent of GDP, about half that of other MENA oil exporters (84 percent). Few countries were dependent on Iranian demand for their exports prior to the latest round of sanctions (Table 1.1.1) and even those partners for which Iran's share of exports is large are insulated either through their role as reexporters (United Arab Emirates) or their small export sector (Afghanistan, Tajikistan).

Despite limited overall exposure, trade in specific markets may be severely impacted. For example, Iraq relies on Iran for about one-third of its electricity, both as direct supplies and gas for power stations. Excess demand for US dollars in Iran has spilled over to Afghan currency markets, amplifying depreciation of the Afghani. Agricultural producers in the Caucasus may also be exposed to lower Iranian demand.

Loss of Iranian oil supply contributed to global oil price volatility. Iran's share of global oil production dropped from 5.5 percent in 2017 to only 4 percent at the end of 2018. While increased OPEC and US shale production has cushioned the loss of Iranian supply, uncertainty over the timing of these adjustments and the extent of sanction exemptions granted to importers of Iran's oil contributed to higher oil price volatility since the first half of 2018.

Financial linkages are limited. Foreign residents have relatively few claims on Iranian assets. The Bank for International Settlements reports Iranian financial liabilities to foreign residents of only \$1.9 billion in the third quarter of 2018. However, Iranian assets held overseas rose above \$25 billion—more than double 2017 levels—with much of the increase in Germany and Korea (Figure 3). US sanctions triggered a decline in correspondent banking relationships, from about 350 relationships in 2017 to fewer than 60 in 2018.

Table 1.1.1. Countries with Significant Exports to Iran

	Goods exports to Iran, 2017			Iranian import share (percent)	Major products
	US\$ (millions)	Export share (percent)	GDP share (percent)		
Tajikistan	67.42	0.06	0.01	0.00	
UAE	7,716.94	0.04	0.02	0.28	Motor vehicles
Armenia	84.12	0.04	0.01	0.00	Live animals
Georgia	76.35	0.03	0.01	0.00	Live animals
Uzbekistan	258.30	0.02	0.01	0.00	
Afghanistan	32.36	0.02	0.00	0.00	
Turkey	3,259.27	0.02	0.00	0.05	Metals
Oman	597.40	0.02	0.01	0.00	Tobacco
Sri Lanka	177.00	0.02	0.00	0.00	Tea, Coffee
Brazil	2,559.77	0.01	0.00	0.01	Corn seed

Sources: National authorities; and IMF staff calculations.

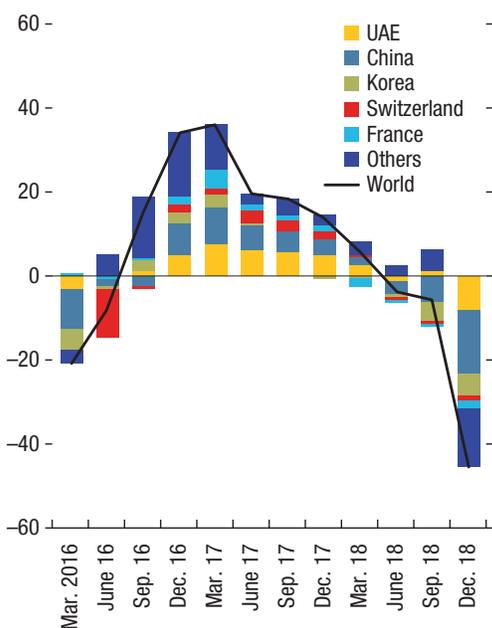
Note: This table lists the 10 countries for which exports to Iran account for the largest fraction of total exports.

Box 1.1 (continued)

Tourism and migration flows may compound trade and financial spillovers from Iran. Lower incomes and a weaker rial are likely to reduce tourism from Iran. According to the UN World Tourism Organization, Iranian residents made more than 10.5 million international trips in 2017, a rise of 60 percent since 2015. Turkey was the most popular destination, with more than 2.5 million visits. Iran hosts nearly 1 million refugees, who may be more likely to return home. The UN International Office of Migration reports that more than 500,000 undocumented Afghans returned from Iran in the first nine months of 2018, more than double the same period in 2017.

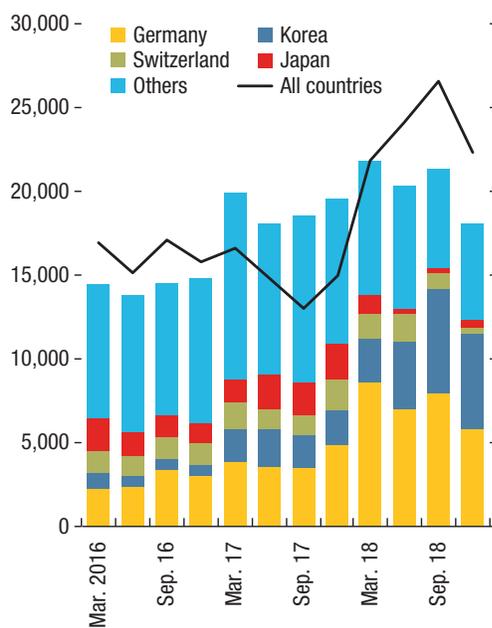
Geopolitical tensions may directly impact international trade. The Persian Gulf is a critical global shipping lane for oil; according to the US Energy Information Administration, oil shipments through the Strait of Hormuz were equivalent to more than 20 percent of global consumption in 2018. Recent tensions, including explosions aboard two oil tankers in June and the detention of a UK-registered ship in July, highlight the risk that increased geopolitical tensions could impact global trade, especially in oil.

Figure 1.1.1. Imports Growth
(Percent, year-over-year growth rate)



Sources: Bloomberg Finance L.P.; Haver Analytics; Iranian authorities; and IMF staff calculations.

Figure 1.1.2. Iranian Overseas Claims
(US\$, millions)



Sources: Bloomberg Finance L.P.; Haver Analytics; Iranian authorities; and IMF staff calculations.

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2. MENAP Oil-Importing Countries: Addressing Fiscal Challenges amid Social Pressures

Growth in oil-importing countries in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region is expected to be muted in coming years, and lower than comparators. High public debt levels and associated financing costs are not only holding back growth in the region, but also pose a source of acute fiscal stress. Yet a mix of sustained social tensions, unemployment, and global headwinds leave policymakers facing a difficult trade-off between rebuilding fiscal buffers and addressing growth challenges. For now, supportive global financial conditions and lower oil prices are helping to ease this trade-off. But managing high levels of public indebtedness will require fiscal consolidation and policies to deliver higher, more inclusive growth.

A Tepid Recovery Expected to Continue

Real GDP growth in MENAP oil importers is expected to fall slightly in 2019 to 3.6 percent, down from 4.3 percent in 2018, driven mostly by Pakistan and Sudan. Excluding these two countries, the rest of the region's real GDP growth in 2019 is projected to be 4.4 percent. In Egypt, growth is expected to remain strong, supported by gas production and a return of tourism. Overall, though, growth in most countries is projected to be below its 2000–15 average in 2019.

In 2020, real GDP growth in the region is expected to remain about 3.7 percent but recover to 5 percent over the medium term. This is largely driven by Pakistan, where ongoing reforms are expected to boost growth. However, this outlook implies that the region is set to fall behind other countries with similar income levels (Table 2.1).

Inflationary pressures have been largely kept at bay by weak domestic and external demand.

Prepared by Philip Barrett with research assistance by Gohar Abajyan.

Table 2.1. Real GDP Growth
(Median by group)

	2018	2019	2020
Emerging market economies			
MENAP oil importers	2.7	2.4	2.4
Rest of world	3.0	2.8	3.1
Low-income countries			
MENAP oil importers	2.8	3.0	3.5
Rest of world	4.6	5.0	5.0

Sources: National authorities; and IMF staff calculations.

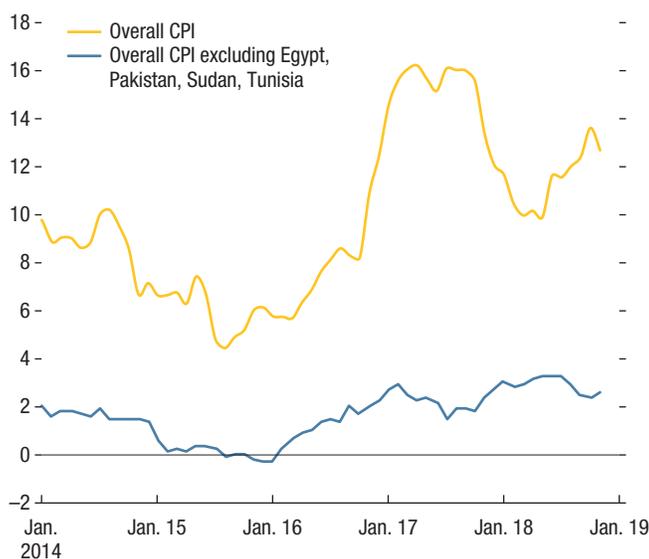
Note: MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

Egypt, Pakistan, Sudan, and Tunisia are notable exceptions where, at different times in the last three years, exchange rate depreciations, while helping reduce external imbalances, have contributed to increased inflation (Figure 2.1).

Despite lower global oil prices (relative to the April 2019 *Regional Economic Update: Middle East and Central Asia*), external imbalances remain large for nearly all oil importers, held back by the slowdown in world trade (particularly in China and other key trading partners in the European Union and the Gulf Cooperation Council), and in some cases overvalued exchange rates. Although partly mitigated by a rebound in remittances—often from oil-exporting Middle Eastern countries and thus tending to track oil prices—such deficits leave countries vulnerable to changing sentiments in international capital markets. Overall, immediate short-term external financing needs (amortization of external debt plus current account deficits) are expected to total some \$238 billion in 2019, or more than 160 percent of reserve assets.

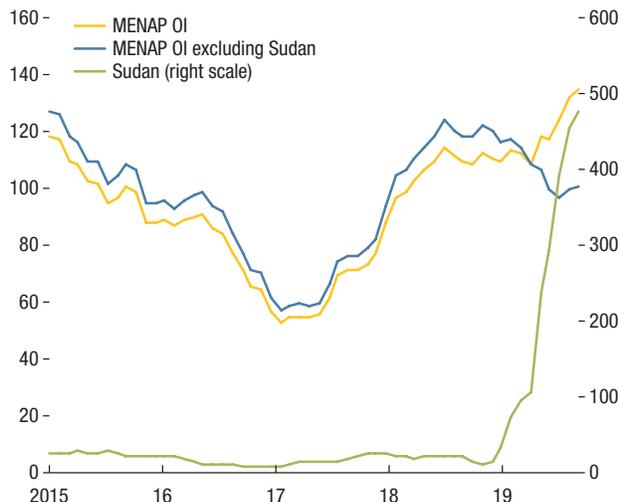
Current account deficits in oil importers are financed principally by bank flows (see Chapter 4) and reserve losses. For example, Lebanon's current account deficit has exceeded one-fifth of GDP every year since 2015. In previous years, short-term deposits from nonresidents represented a substantial share of financing. But as nonresident deposit growth declined in 2018, reserves fell by 7 percent. In Jordan, a large current account deficit of 7 percent of GDP, together with private

Figure 2.1. Inflation
(Consumer prices; period average, annual percentage change)



Sources: Haver Analytics; national authorities; and IMF staff calculations.
Note: CPI = consumer price index. Overall CPI excludes Djibouti and Syria due to lack of recent data.

Figure 2.2. Reported Social Unrest
(Index, average 2014–present = 100, 12-month rolling average)



Sources: Factiva; and IMF staff calculations.
Note: Index measures monthly mentions of unrest and related topics in major English-language newspapers and broadcast networks. See April 2019 *Regional Economic Outlook: Middle East and Central Asia* for further details.
MENAP OI = Middle East and North Africa, Afghanistan, and Pakistan oil importers.

sector capital outflows and falling foreign direct investment (FDI) inflows, resulted in reserve losses. And in Tunisia, donor support continues to play an important role in financing the current account deficit.

Although there has been some progress on the structural reforms necessary to address twin social and economic challenges (Egypt—see Box 2.1—Mauritania), the business climate across the region lags behind comparators such as East Asia. This is reflected in weak FDI, which underperformed relative to other emerging market economies since the global financial crisis (see Chapter 4).

Looking forward, current account deficits in individual countries are likely to stay broadly constant. Inflation is forecast to stabilize over the medium term as level effects (particularly those from exchange rate depreciation) fade.

Tense Social Conditions

Social and political tensions remain prominent throughout the region (Figure 2.2): uncertainties

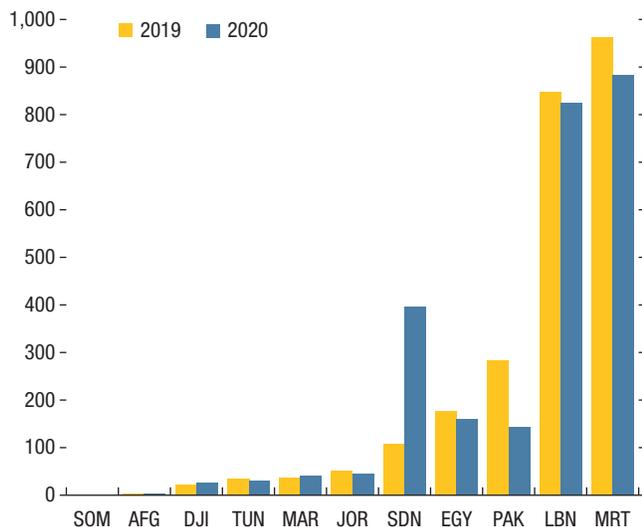
over political control have left Sudan’s spiraling economic problems unaddressed; internal and international political disputes are bringing the West Bank and Gaza economy to a halt; the runup to elections in Tunisia is hampering implementation of policies and reforms; and violent conflict is interfering with everyday life in Afghanistan, Somalia, and Syria.

At the same time, unemployment has remained high in many countries, furthering social tensions. Unemployment averages 11 percent throughout the region versus 7 percent across other emerging market and developing economies. Women and young people are particularly likely to be out of work, with more than 18 percent of women and nearly 23 percent of young people without jobs in 2018.

Fiscal Constraints Become More Pressing

Recent positive developments, including lower global oil prices and interest rates (see Global

Figure 2.3. Gross Financing Needs in Percent of Government Revenues
(Percent of revenues)



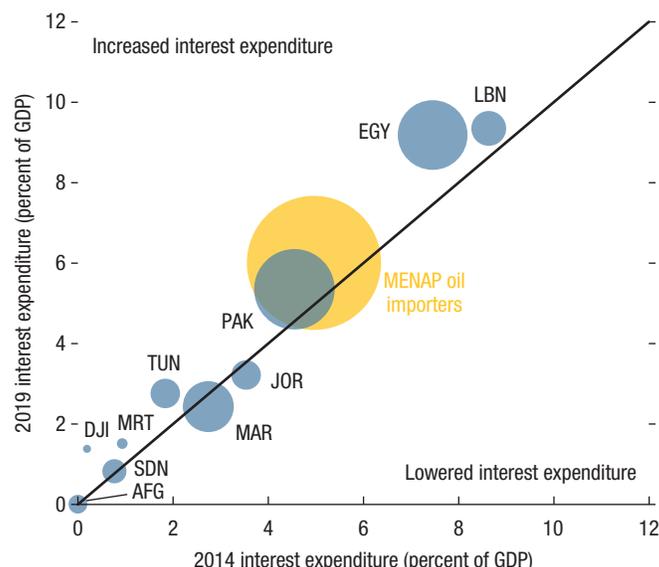
Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

Developments), have had little benefit for the central concern in the region: mounting public debt, which has been a main drag on inclusive growth. Public debt levels are very high in many countries—exceeding 85 percent of GDP on average, and more than 150 percent in Lebanon and Sudan.

Having built over many years, the cost of public debt burdens has become sizeable, preventing investments critical to the region's long-term economic future. For several governments in the region, the immediate budgetary pressure is acute; gross financing needs—which account for the impact of debt maturity—are particularly high in Egypt, Lebanon, Mauritania, and Pakistan at several multiples of public revenues (Figure 2.3). As a result, many governments are vulnerable to sudden changes in market sentiment. High debt levels are also coincident with low FDI, consistent with public debt crowding out productive private investment (see Chapter 4).

In many countries (Egypt, Lebanon, Pakistan) the largest component of short-term budgetary

Figure 2.4. Government Interest Expenditure, 2014 and 2019
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: Size of bubbles denotes weight in regional GDP. MENAP = Middle East, North Africa, Afghanistan, and Pakistan. Country abbreviations are International Organization for Standardization (ISO) country codes.

pressure is mounting interest payments. Despite temporary relief from looser global financial conditions since June, this has grown to absorb large shares of total GDP (Figure 2.4) in many countries, crowding out growth-enhancing investment and social spending. For instance, interest expenditures in MENAP oil importers average 50 percent of capital investment, or more than triple social spending.

Current fiscal positions are stressed further by weak domestic demand (Jordan, Lebanon, Sudan, Tunisia), which would usually provide a motive for countercyclical fiscal expansion. Yet with large outstanding debts, governments are forced to confront a difficult trade-off between debt stabilization and fiscal sustainability (Fournier 2019). At the same time, limited revenue capacity (Jordan, Pakistan), a narrow tax base and relatively inefficient tax administrations (Sudan), and large current expenditures (Jordan, Lebanon) constrain the ability of governments to raise surpluses quickly. Despite medium-term consolidation plans, primary fiscal balances

will likely remain negative in all but one of 11 oil-importing countries during 2019.

High Debts Driven by Lack of Fiscal Adjustment and Lower Growth

The acute cost of such large debt burdens raises two questions. What has caused debt to be so high? And what can be done to reduce debt?

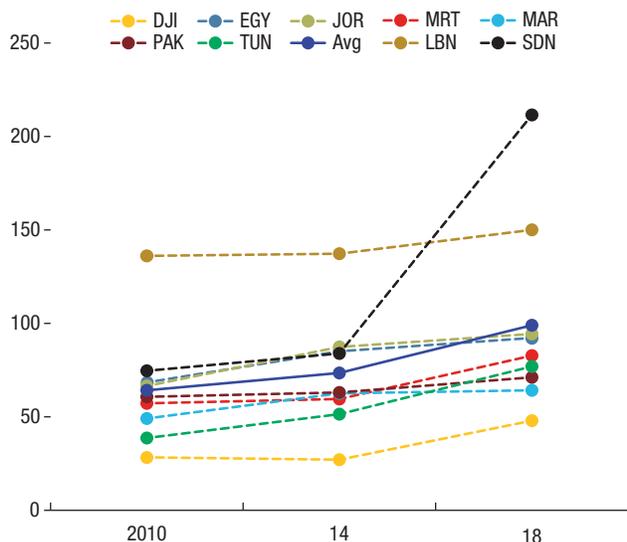
Figure 2.5 speaks to the first of these questions. It shows that MENAP oil importers' high public debt levels are not the result of a sudden runup in debt (except perhaps Sudan). Instead, most countries have experienced increases over many years, primarily driven by a combination of sustained declines in growth and a rise in primary deficits, particularly in the wake of the Arab uprisings in 2011 (Egypt, Jordan, Morocco, Tunisia).

Figure 2.6 shows the important role of growth (in red; notably in Jordan and Lebanon).¹ Indeed, during periods of relatively strong growth, including prior to and in the early stages of the global financial crisis, debt ratios declined throughout most of the region, even in countries where primary deficits increased (in yellow; Djibouti and Jordan). However, in more recent years debt has amassed amid persistent growth-weakness and increased spending on public wages and subsidies in many countries.

This vicious cycle of low growth and rising debt has limited space for growth-enhancing capital investments. As a result, many countries have found it difficult to reduce debt levels, even those tightening their fiscal stance (Egypt, Morocco, Pakistan, Tunisia). The current level of primary deficits would have been sustainable if growth were at precrisis levels. However, the growth being persistently weaker, debt under current fiscal policy is no longer sustainable. In combination

¹In Figure 2.6, country-specific factors are a residual, which can include factors such as debt forgiveness and interest spreads over US rates.

Figure 2.5. Government Debt Has Been Increasing Steadily (Percent of GDP)



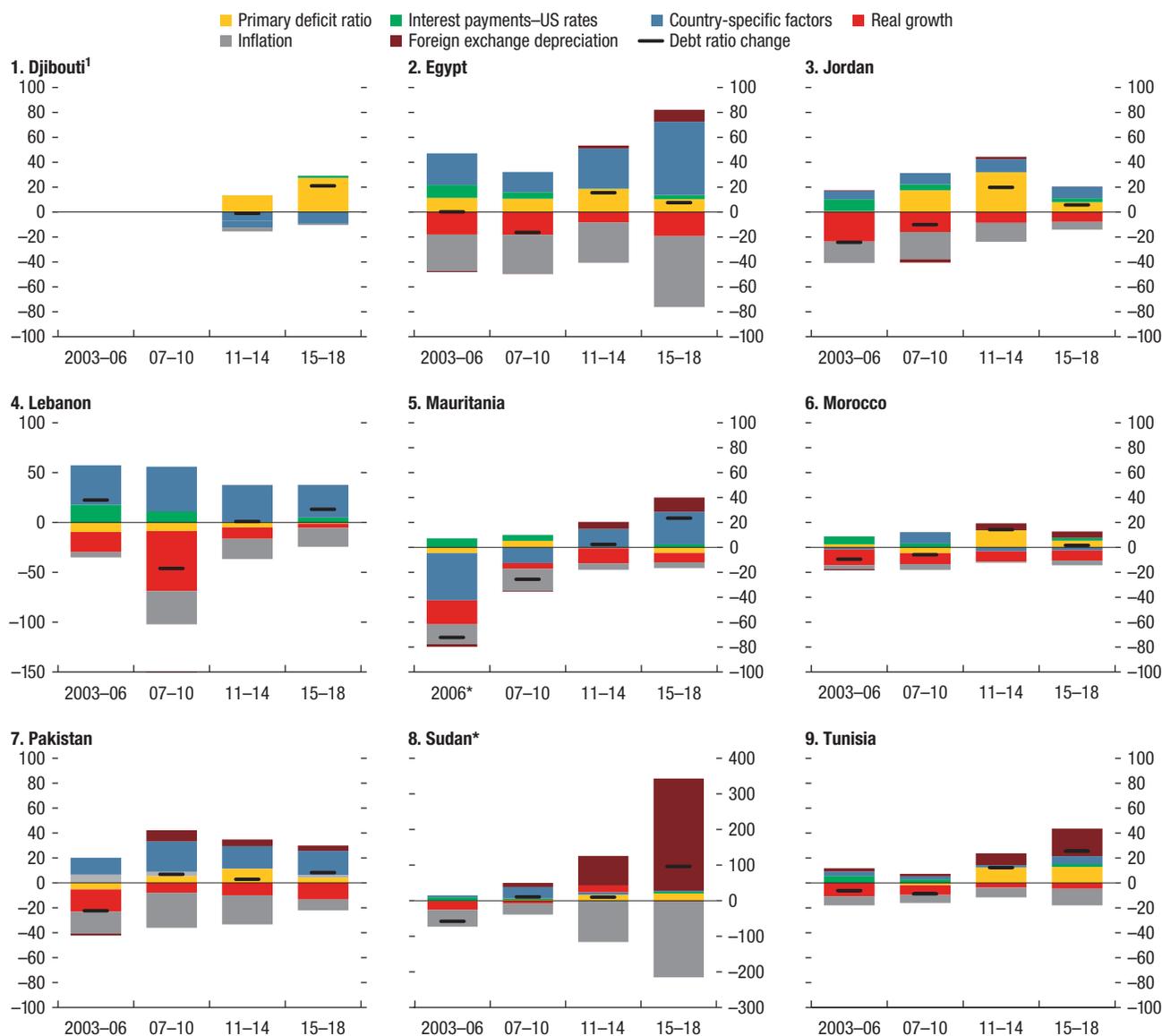
Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

with already-elevated debt, this has resulted in higher country-specific interest rate spreads (blue bars), further accelerating the rate of debt increase.

Figure 2.6 shows that changes in global interest rates (green bars) have contributed relatively little to debt dynamics, pointing to only modest benefits from the recent easing of global financial conditions. This is because risk-free interest rates have been relatively low since early 2009, and because debt levels need to be very high for this impact to be large.² However, pressures in the external and monetary sectors can have a significant impact on debt dynamics. For example, in Tunisia, threats to external sustainability were mitigated by a sizable exchange rate depreciation during 2015–18, which contributed to a higher debt ratio. Similarly, the debt ratio in Egypt increased in 2017 following the exchange rate depreciation, which was needed to reduce external imbalances. In Pakistan, tighter

²Even at a debt ratio of 100 percent of GDP, a 50 basis point interest rate rise will increase annual debt service costs by only 0.5 percent of GDP. And with long-maturity debt, this impact will be much delayed.

Figure 2.6. Changes in Government Debt Ratios
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.

Note: *Sudan appears on a different scale.

¹Includes central government and debt related to the railway and the water pipeline.

monetary policy was required to stem ongoing reserve losses, at the expense of higher interest payments.

In Sudan, the relationship between the monetary and fiscal sectors is particularly apparent. While the inflation generated by monetizing deficits has eroded the debt ratio, this has been offset by the corresponding devaluation of the Sudanese pound,

increasing the domestic value of foreign currency debts (see purple and gray bars in Figure 2.6). Nor is higher inflation a viable long-term strategy for debt sustainability in countries with large domestic currency debts. In these countries, nominal interest rates would rise in expectation of higher inflation, offsetting the reduction in nominal debt from higher inflation (reflected in opposing gray and blue bars for many countries in Figure 2.6).

Table 2.2. Annualized Contributions to Changes in Debt Ratios for MENAPOs, Cross-Country Average
(Percentage of GDP, per year)

	2003–10	2011–18
Change in debt ratio	-2.8	4.0
Primary deficit	0.5	2.5
Growth	-3.8	-1.6
Other factors (inc. spreads)	0.5	3.1

Source: IMF staff calculations.

Note: Afghanistan omitted 2003–06.

In summary, increases in primary deficits after the Arab uprisings have not been the only driver of high debt levels. A persistent decline in growth has also played a critical role. Once debt started to rise, spreads increased, generating adverse debt dynamics and accelerating the growth of debt ratios (see Table 2.2, which summarizes Figure 2.6).

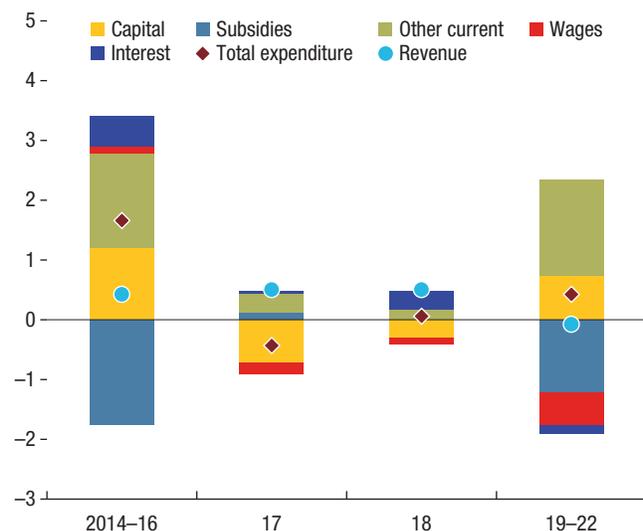
Ensuring Debt Sustainability

There are two key policy approaches that can be used to reduce debt ratios: lowering primary deficits and raising growth.

Policies that boost growth directly are discussed in the next section. Yet growth cannot be ignored when pursuing fiscal consolidation. While deficit reduction may dampen growth, via higher taxes or reduced government spending, there is considerable scope for governments in oil-importing countries to minimize the cost of consolidation by focusing on the composition of fiscal adjustments.

On the expenditure side, this means rebalancing the composition of spending away from inefficient current spending and toward investments that will enhance growth in the long term. Performance on this front has varied (Figure 2.7). Cuts in capital spending have helped contribute to debt stabilization but come at the price of lower future growth. Large public sector wage bills continue to be a significant component of non-capital expenditure (Morocco, Tunisia). Indeed, over the last decade public wage bills in MENAP oil importers have averaged about 8 percent of GDP, a level comparable to oil exporters worldwide (see Tamirisa and others 2018). Efforts to reduce

Figure 2.7. Changes in Government Spending and Revenues¹
(Percent of GDP, change vs. start of period, simple averages)



Sources: National authorities; and IMF staff calculations.

¹Excludes Jordan, Pakistan, Sudan, and Tunisia due to limited data availability.

or even eliminate regressive energy subsidies have resulted in considerable gains (Egypt, Jordan, Morocco, Tunisia). Although progress slowed somewhat in 2018—as the deteriorating economy and higher oil prices increased both political pressures for subsidies and their cost—ongoing reforms are expected to reverse this trend.

On the revenue side, the picture is similarly mixed. In Tunisia, an ambitious package of new measures and improved administration led to a revenue increase of more than 2 percent of GDP. In other countries, considerable scope remains for increased revenues through broadening the tax base and removing exemptions (Jordan, Pakistan).

The ways in which fiscal consolidation balances expenditure and revenue measures also have growth implications. Although Tunisia's tax package helped reduce the deficit, forgoing civil service wage hikes and cutting subsidies could have achieved the same consolidation with smaller growth costs.

Alongside changes in the fiscal stance, reforms to the systematic conduct of policy are essential. More robust fiscal institutions, particularly those

that can establish transparency and credible medium-term frameworks, are crucial in rebuilding fiscal buffers (see Chapter 5). Moreover, enhancing debt management frameworks, including by developing a medium-term debt management strategy, would help governments navigate market risks and take advantage of opportunities, such as lower global interest rates.

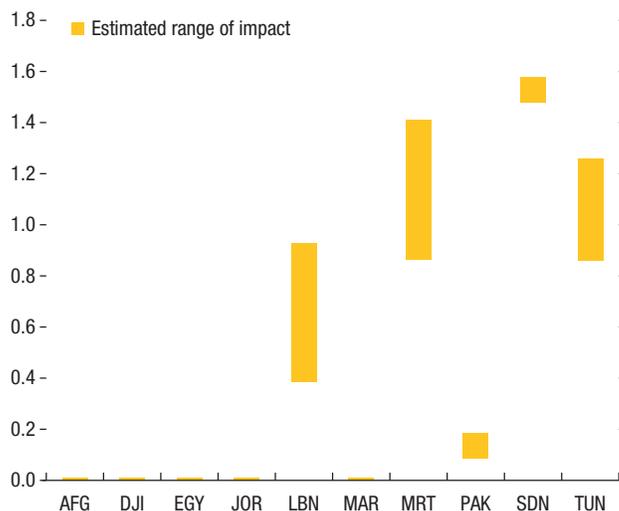
Fiscal sustainability can also be jeopardized by external shocks. Governments could thus take care to minimize their exposure to such risks. For example, those countries with ongoing energy subsidies or fixed domestic prices may be particularly vulnerable to fluctuations in global oil prices (Figure 2.8; Lebanon, Mauritania, Sudan, Tunisia). And in the case of Sudan, monetization of deficits due to inability to access international debt markets puts downward pressure on the exchange rate, further raising the cost of energy subsidies. In contrast, fiscal positions in countries with near-complete cost recovery are much less vulnerable to global oil price increases (Egypt, Jordan, Morocco).

Delivering Higher and More Inclusive Growth

Across the region, continued scope for structural reforms to boost growth in the long term remains (see October 2018 *Regional Economic Outlook: Middle East and Central Asia*). For example, privatizing state-owned enterprises (SOEs)—which have outsized influence in the market and crowd out private sector investment, including FDI—would reduce the stock of public debt, while improving their governance would create space for private sector activity and is a priority in Egypt (Box 2.1) and Tunisia.

Governance in the public sector more broadly also lags comparator countries. One way in which this is evident is via a lack of adequate recording and monitoring of off-balance-sheet contingent liabilities, particularly in the case of SOE debt in the region. Likewise, collateralization of debt may constrain policy options in the future (for

Figure 2.8. Estimated Impact of \$10 Increase in Oil Prices on Subsidy Expenditures
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: Range shows estimated impact of a \$10 oil price increase on total subsidy expenditures given current policies. Country abbreviations are International Organization for Standardization (ISO) country codes.

example, Egypt). A second important aspect of governance is corruption, which can limit growth and undermine social cohesion, and often has roots in poor governance. Reforms that make governments more transparent and accountable, as well as those that strengthen fiscal institutions, can help tackle this problem. (Chapter 5, Jarvis and others forthcoming, provides more details)

Limited access to finance (Jordan, Mauritania; see Blancher and others 2019) and poor infrastructure (Lebanon, Tunisia) continue to hinder growth. Low female labor force participation represents a huge untapped resource; remedying this will require continued public investments in high-quality education and health services (especially in Egypt, Mauritania, Morocco, and Tunisia).

In some cases, tackling domestic issues will require external support, particularly in countries where large refugee programs increase public burdens (Jordan, Lebanon, Tunisia). The international community can support these countries by providing concessional financing (for example,

Jordan and Mauritania), direct budgetary support (for example, IMF programs in Egypt, Jordan, and Tunisia), and technical assistance to improve economic management.³

To be sustainable, growth must also be inclusive (see Purfield and others 2018). Social unrest has risen in recent years, most notably in Sudan. This too represents a risk for countries in the region; social unrest may directly disrupt economic development or lead to short-term policy fixes that do not tackle underlying problems. Yet it is also an opportunity for governments to show that they

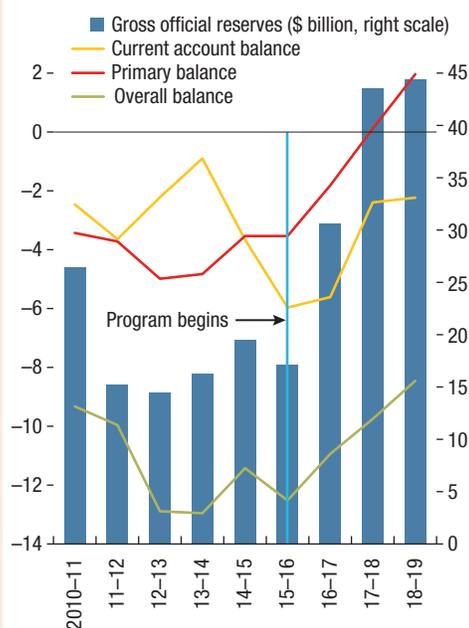
can respond to the society's demands for improved governance and better opportunities. To this end, governments could further examine efforts to raise social spending—which remains low—to protect the most vulnerable in society.

In conclusion, oil-importing MENAP countries are facing twin threats of slow growth and fiscal unsustainability. Governments across the region cannot afford to delay implementing the mix of growth-friendly consolidation and structural reforms necessary to meet these challenges.

³In 2020, planned IMF technical assistance to the region will include advice on managing the fiscal risks of SOEs and public-private partnerships, expenditure rationalization, tax administration, deepening and strengthening bank supervision, and laws and institutions to combat money laundering and terrorist financing.

Box 2.1. Egypt: From Stabilization to Inclusive Growth

Figure 2.1.1. External and Internal Imbalances
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.

By mid-2016, an unsustainable macroeconomic policy mix had left Egypt facing low growth, elevated and rising public debt, and a mounting balance of payments problem with severe shortages of foreign exchange and an overvalued exchange rate. Egypt's reform program, supported by an IMF arrangement under its Extended Fund Facility, implemented a significant policy adjustment anchored by the liberalization of the foreign exchange market and fiscal consolidation to ensure public debt sustainability. This included the phasing out of costly and poorly targeted fuel subsidies, which were a significant drain on budget resources and crowded out spending on health and education. Fiscal savings were used in part to ease the burden of adjustment on the most vulnerable through the expansion of cash transfer programs from 200,000 to 2.3 million households, covering about 10 million people. The authorities' strong ownership and decisive up-front policy actions were critical in stabilizing the economy: growth has accelerated to among the highest in the region; current account and fiscal deficits have narrowed; international reserves have risen; and public debt, inflation, and unemployment have declined.

Achieving macroeconomic stabilization is an essential precondition to long-term growth and job creation. Egypt needs to generate at least 700,000 jobs a year to absorb new entrants to the labor market expected from its fast-growing population. The recent acceleration in growth has been driven, in part, by the rebound in tourism and

natural gas production. To sustain the growth momentum, Egypt is focusing increasingly on long-standing structural impediments to growth in other sectors. Reforms to industrial land allocation, competition, and public procurement, and improved governance are important first steps, but the transition to a transparent, market-driven economy will require broadening and deepening reforms to create an enabling environment for private sector development. Continued efforts will be needed to improve the business climate, tackle corruption, and reduce the role of the state.

Prepared by Matthew Gaertner.

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2. MENAP OIL-IMPORTING COUNTRIES: ADDRESSING FISCAL CHALLENGES AMID SOCIAL PRESSURES

MENAP Region: Selected Economic Indicators, 2000–20

(Percent of GDP, unless otherwise indicated)

	Average 2000–15	2016	2017	2018	Projections	
					2019	2020
MENAP¹						
Real GDP (annual growth)	4.6	5.3	2.1	1.6	0.5	2.7
<i>of which non-oil growth</i>	5.7	2.7	2.9	1.8	2.0	3.0
Current Account Balance	8.2	-3.9	-0.5	2.9	-0.3	-1.4
Overall Fiscal Balance	2.9	-9.5	-5.6	-3.2	-4.7	-5.1
Inflation (year average; percent)	6.5	5.4	7.0	9.3	7.9	9.1
MENAP oil exporters						
Real GDP (annual growth)	4.7	6.1	1.2	0.2	-1.3	2.1
<i>of which non-oil growth</i>	6.2	2.1	2.3	0.4	1.1	2.6
Current Account Balance	11.6	-3.2	1.8	6.2	1.7	0.1
Overall Fiscal Balance	5.7	-10.4	-5.2	-1.9	-3.9	-4.5
Inflation (year average; percent)	6.9	4.4	3.6	8.7	7.0	8.2
MENAP oil exporters excl. conflict countries and Iran						
Real GDP (annual growth)	5.3	4.3	-0.4	1.6	1.3	2.8
<i>of which non-oil growth</i>	7.1	1.8	1.6	1.9	2.7	3.0
Current Account Balance	13.7	-4.7	1.3	6.8	2.8	1.0
Overall Fiscal Balance	7.0	-11.3	-5.4	-1.2	-3.3	-3.9
Inflation (year average; percent)	3.5	2.4	0.9	2.2	-0.3	2.1
Of which: Gulf Cooperation Council (GCC)						
Real GDP (annual growth)	4.8	2.3	-0.3	2.0	0.7	2.5
<i>of which non-oil growth</i>	6.7	1.9	1.9	1.9	2.4	2.8
Current Account Balance	15.3	-2.8	2.8	8.5	5.3	3.1
Overall Fiscal Balance	8.6	-10.7	-5.6	-1.8	-2.4	-3.3
Inflation (year average; percent)	2.7	2.1	0.2	2.1	-0.7	2.0
MENAP oil importers						
Real GDP (annual growth)	4.3	3.7	4.0	4.3	3.6	3.7
Current Account Balance	-2.2	-5.6	-6.7	-6.5	-5.9	-5.2
Overall Fiscal Balance	-5.7	-7.3	-6.8	-6.9	-7.0	-6.5
Inflation (year average; percent)	6.0	7.5	14.4	10.4	9.7	10.7
MENA¹						
Real GDP (annual growth)	4.6	5.4	1.8	1.1	0.1	2.7
<i>of which non-oil growth</i>	5.8	2.4	2.6	1.3	1.9	3.1
Current Account Balance	8.8	-4.2	-0.2	3.8	0.1	-1.3
Overall Fiscal Balance	3.5	-10.1	-5.6	-2.9	-4.4	-4.9
Inflation (year average; percent)	6.3	5.7	7.4	10.1	8.1	8.6
Arab World						
Real GDP (annual growth)	4.9	3.8	1.3	2.4	1.9	3.3
<i>of which non-oil growth</i>	6.2	2.2	2.2	2.5	3.1	3.4
Current Account Balance	9.8	-5.6	-0.9	3.7	0.6	-0.9
Overall Fiscal Balance	4.0	-11.4	-6.4	-2.9	-4.4	-4.9
Inflation (year average; percent)	3.9	4.9	6.9	6.0	3.3	4.8

Sources: National authorities; and IMF staff calculations and projections.

¹2011–20 data exclude Syrian Arab Republic.

Notes: Data refer to the fiscal year for the following countries: Afghanistan (March 21/March 20) until 2011, and December 21/December 20 thereafter, Iran (March 21/March 20), and Egypt and Pakistan (July/June).

MENAP oil exporters: Algeria, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, the United Arab Emirates, and Yemen.

GCC countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.

MENAP oil importers: Afghanistan, Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Pakistan, Somalia, Sudan, Syria, and Tunisia.

Arab World: Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, United Arab Emirates, and Yemen.

5. Fiscal Institutions and Fiscal Outcomes

Countries in the Middle East and Central Asia are facing significant fiscal challenges, amid volatile oil prices, subdued growth, and conflicts. Weak fiscal institutions have contributed to spending inefficiencies, rising debt and deficits, and procyclical fiscal policy, especially in countries in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region. Improving fiscal transparency, establishing credible medium-term fiscal frameworks (MTFFs), strengthening public financial management (PFM), enhancing procurement, and moving toward fiscal rules would help mitigate these vulnerabilities over time.

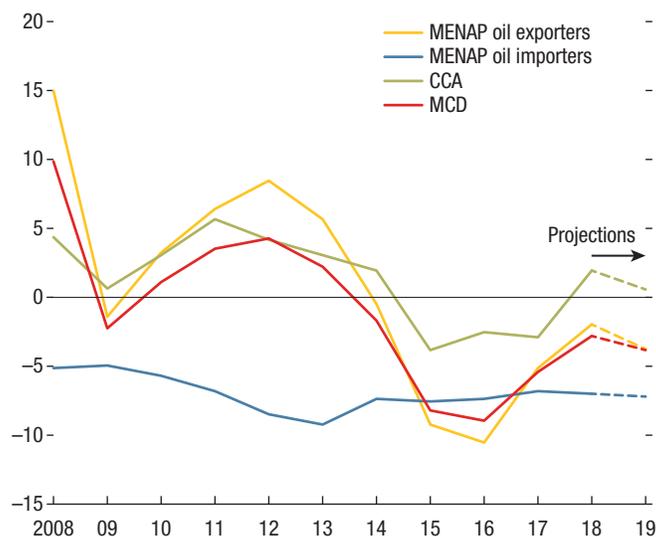
A Challenge with Limited Fiscal Policy Options

Fiscal balances have deteriorated sharply in most countries in the Middle East and Central Asia since the onset of the global financial crisis in 2008 (Figure 5.1). The combined negative effects of low growth, shocks to oil prices, and rising spending needs, particularly in countries affected by the Arab uprisings, have resulted in diminished fiscal buffers and rising public debt burdens.

Fiscal vulnerabilities have emerged despite recent consolidation efforts across the region. This has left many countries exposed to external uncertainties, including those related to the global slowdown and trade tensions and to domestic pressures from stalled growth prospects, the need to preserve intergenerational equity, and rising social tensions in some countries (see Global Developments).

In particular, MENAP oil importers face elevated public debt levels, and their financing costs are now a source of acute fiscal stress (see Chapter 2). Fiscal policies in MENAP oil exporters have

Figure 5.1. Overall Fiscal Balances 2008–19
(Percent of GDP, weighted averages)



Sources: National authorities; and IMF staff calculations.

Note: CCA = Caucasus and Central Asia; MCD = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan. Country-specific weights correspond to GDP in US dollars.

remained largely procyclical,¹ including in response to volatile international oil prices (see Chapter 1), while countries in the Caucasus and Central Asia (CCA), particularly oil exporters, are running down fiscal buffers to stave off challenges to growth (see Chapter 3).

Going forward, MENAP and CCA countries face the difficult challenge of reducing fiscal vulnerabilities to strengthen economic resilience while fostering higher and more inclusive growth through structural reforms. Elevated global growth and trade uncertainties only make this challenge more difficult, and prospects for lower and more volatile oil prices will weigh on MENAP oil exporters in particular.

¹Manasse (2006), and Alesina, Campante, and Tabellini (2008) have emphasized the suboptimal nature of procyclical fiscal policy, which can exacerbate business cycle fluctuations and amplify macroeconomic instability.

Ensuring well-developed and credible fiscal institutions can not only help ease the burden of adjustment, but also reduce fiscal vulnerabilities on a lasting basis.² For instance, the procyclicality of fiscal policy in developing countries is associated with lower-quality fiscal institutions (Frankel, Vegh, and Vuletin 2013). A lack of well-designed fiscal frameworks makes it difficult for countries to adhere to prudent debt targets over the economic cycle (OECD 2015), while low fiscal transparency and poor quality of procurement lead to inefficiencies and worse fiscal outcomes (Jarvis and others, forthcoming). In contrast, by increasing the credibility of fiscal policy and the difficulty of deviating from appropriate policies, credible MTFs are associated with successful fiscal consolidation (IMF 2010).³

Against this backdrop, this chapter examines gaps in the Middle East and Central Asia region's fiscal institutions and estimates the impact of fiscal institutions on fiscal outcomes. The analysis emphasizes the role of fiscal institutions in (1) strengthening fiscal discipline and ensuring long-term sustainability, (2) building resilience by enhancing the ability of fiscal policy to stabilize the economy, and (3) improving the predictability of fiscal policy by lowering its volatility.

Weak Fiscal Institutions in the Middle East and Central Asia

Measures of key fiscal institutions in MENAP and CCA countries tend to be weaker compared with peers, though regional variations illustrate important differences (Figure 5.2).

In particular, MENAP oil exporters have much lower *budget transparency* compared to other oil-exporting countries, with measures for Algeria, Iraq, Qatar, and Saudi Arabia not improving

between 2012 and 2017 (Figure 5.3).⁴ In contrast, despite relatively low levels, there have been notable improvements in budget transparency in some MENAP and CCA oil importers in recent years. Improvements in budget transparency seem to be positively associated with revenue mobilization (Figure 5.4).

Most MENAP oil exporters register very low nonresource tax revenues mainly because of large resource revenues. In MENAP oil importers, tax systems suffer low progressivity and complexity, with multiple tax exemptions and rates, making tax administration more difficult (Jewell and others 2015).⁵

MENAP oil exporters score higher than other oil exporters on the *MTFF indicator*, which includes the presence of a multiyear perspective in fiscal planning, expenditure policy, and budgeting.⁶ However, this stronger performance does not necessarily reflect stronger MTFs, as it is largely driven by favorable elements of frameworks in Algeria (where there is high predictability of funds available for commitments of expenditure) and Kuwait (where there is parliamentary scrutiny of the annual budget law). Similarly, MENAP oil importers score high on the MTFF indicator due to better frameworks in just two countries, Jordan and Morocco. In contrast, most CCA countries fare well in terms of MTFF.

Countries in the Middle East and Central Asia, in particular those in the CCA region, perform poorly on *public procurement* but score relatively well compared to emerging market economies on measures of *public financial management*. However, fragile states and conflict-affected countries face significant challenges in developing

⁴Transparency is measured using the Open Budget Index, which is available for 2012 and 2017, and covers only Algeria, Iraq, Qatar, and Saudi Arabia among MENAP oil exporters.

⁵An alternative revenue institutions indicator is used, but due to limited data availability, only five countries in the region (Azerbaijan, Armenia, Georgia, Mauritania, and Morocco) are assessed with slightly weaker performance than their peers.

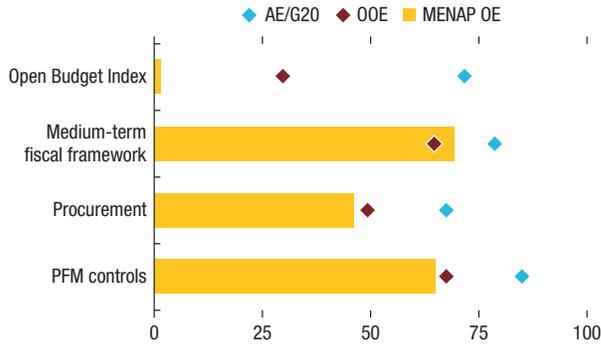
⁶The MTFF indicator is based on Public Expenditure and Financial Accountability (PEFA) assessments. These cover 115 countries, mostly emerging market economies and low-income countries. Out of 31 countries in the Middle East and Central Asia, data are available for only 23 countries.

²Fiscal institutions refer to the organizational and procedural arrangements through which decisions on fiscal matters are taken, or that provide input into such decision making.

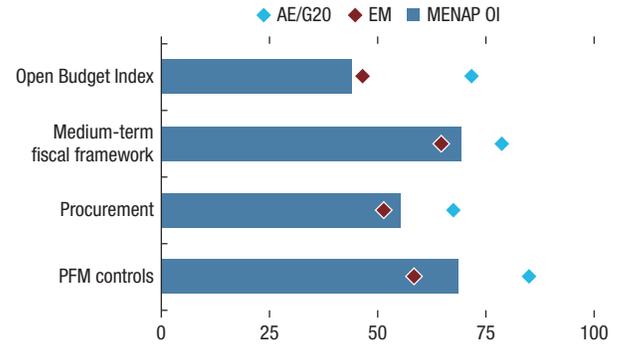
³Medium-term fiscal frameworks (MTFFs) include mechanisms to formulate multiyear fiscal objectives and ensure effective implementation.

Figure 5.2. Fiscal Institutions Indicators
(Index, 100 is best)

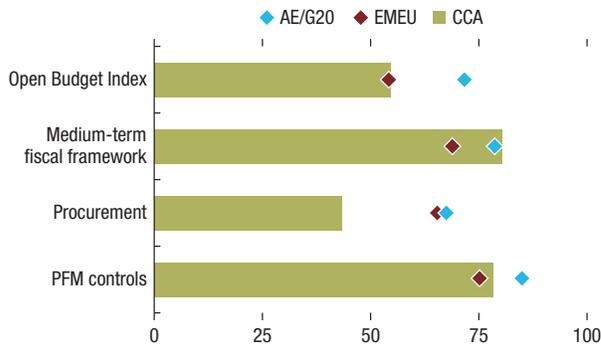
1. MENAP Oil Exporters



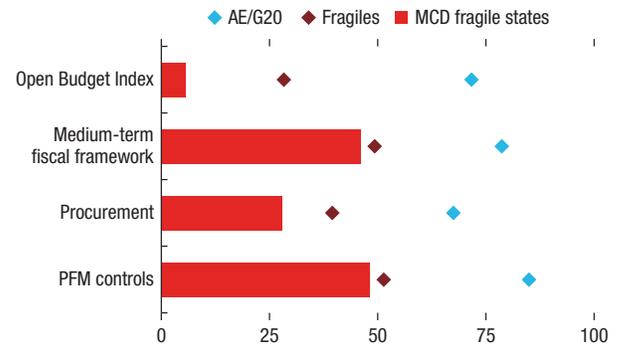
2. MENAP Oil Importers



3. CCA



4. MCD Fragile States



Sources: Public Expenditure and Financial Accountability; Open Budget Initiative; and IMF staff calculations.

Note: The Open Budget Initiative medium-term fiscal framework and PFM controls indicators, where 4 is best score, have been indexed to 100. For the procurement indicator, where 1 is best, the indicator has been indexed to 100. MENAP oil exporters and oil importers aggregates exclude fragile states. Fragile states in MCD include Afghanistan, Djibouti, Iraq, Lebanon, Libya, Somalia, Sudan, Syria, Tajikistan and Yemen. AE = advanced economies; CCA = Caucasus and Central Asia; EM = emerging Market economies; EMEU = emerging Europe countries; Fragiles = other fragile states; G20 = G20 countries; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; MENAPOE = MENAP oil-exporting countries; MENAPOI = MENAP oil-importing countries; OOE = other oil-exporting countries; PFM = Public Financial Management.

strong fiscal institutions across the board. Apart from the difficulty of conducting fiscal policy in conflict economies, this reflects their limited administrative capacity (IMF 2017).

IMF staff assessments of improvements in fiscal institutions, which supplement the results in Figure 5.2, indicate that more than 80 percent of CCA countries and half of MENAP oil exporters have MTFs (Table 5.1). A majority of MENAP oil importers do not have a formal MTF. While most countries have IMF-supported programs, these may not prove sufficient in anchoring fiscal policy in a medium-term perspective.

The quality of frameworks varies across countries.⁷ Deficiencies in MTFs reflect either incompleteness or weak implementation, with frequent breaches of fiscal targets in a few MENAP and CCA countries (Algeria, Iran, Jordan, Pakistan, Tajikistan). Such weaknesses in MTFs are also associated with higher volatility of fiscal policy and rising public debt burdens (Egypt, Pakistan).

In addition, while *fiscal rules* are prominent in peer countries, including in other oil exporters, only one-quarter of MENAP and CCA countries

⁷For example, based on the MTF indicator, Georgia has the highest scores in all four aspects, while Egypt has no formal MTF, and fares poorly in all aspects. In the IMF staff survey, the assessment of MTF has a broader scope than the MTF indicator.

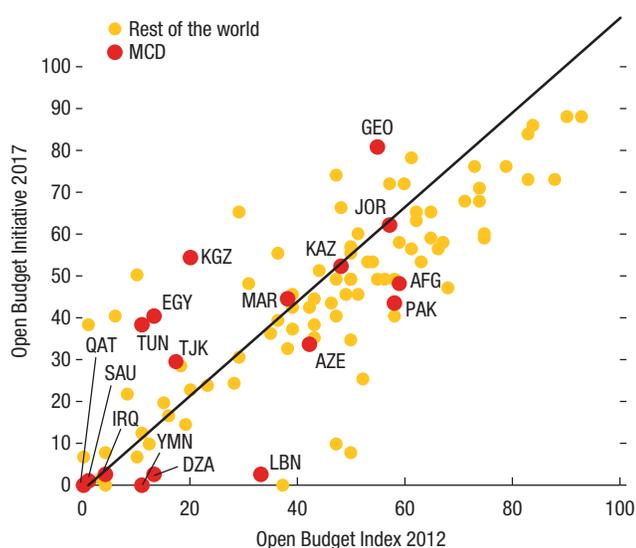
Table 5.1. Survey: MTFF and Fiscal Rules in MCD Countries

	Number of countries	MTFF in place (% of the group)	Government/independent monitoring entity (% of the group)	Fiscal rules (number of)
Oil exporters	8	50.0	50.0	2
Oil importers	6	33.3	33.3	1
Caucasus and central Asian countries	6	83.3	50.0	4
Fragile states	7	28.6	28.6	2
Total	27	48.1	40.7	9

Source: IMF staff calculations.

Note: MCD = Middle East and Central Asia; MTFF = medium-term fiscal framework.

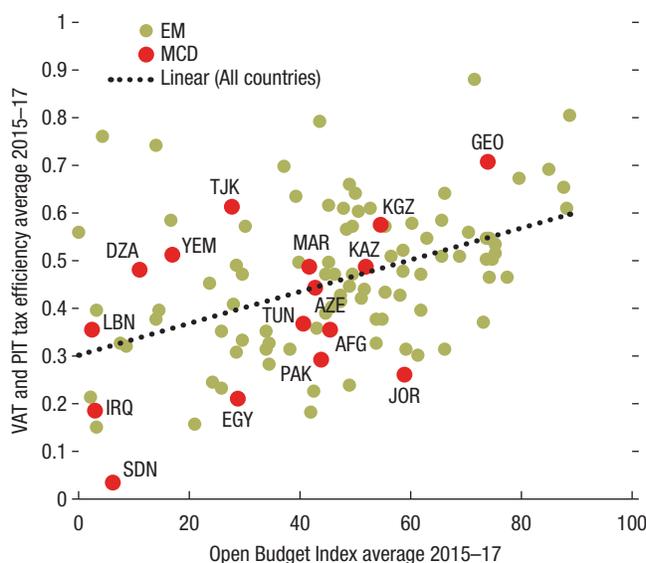
Figure 5.3. Change in the Open Budget Index, 2012–17 (Index)



Sources: Open Budget Initiative; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

(Algeria, Armenia, Azerbaijan, Georgia, Iran, Kazakhstan, Pakistan) have adopted fiscal rules, particularly budget balance or debt rules (Figure 5.5). Spending increases and low revenue mobilization efforts have weakened compliance with fiscal rules. Armenia and Georgia have amended their fiscal rules, in collaboration with IMF capacity development, to reduce the procyclical bias and avoid abrupt fiscal adjustments, while increasing flexibility (Box 5.1). Somalia plans to introduce a debt rule.

Figure 5.4. Open Budget Index and Tax Efficiency, 2015–17 (Index)

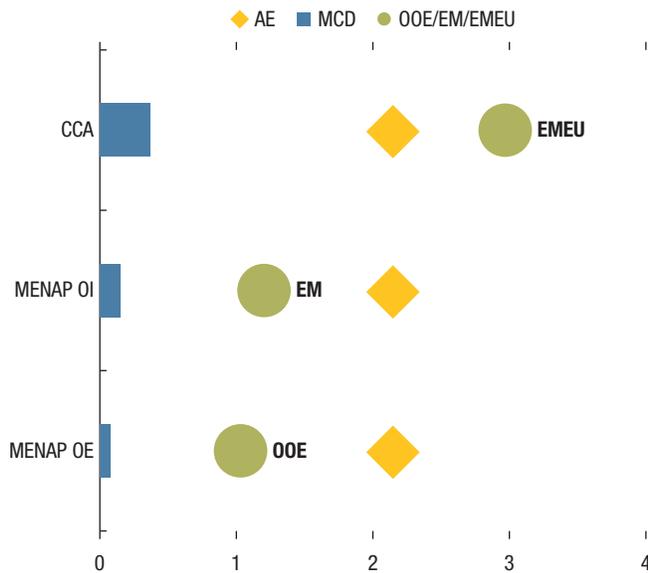


Sources: International Budget Partnership; national authorities; and IMF staff calculations.
Note: EM = emerging market economies; MCD = Middle East and Central Asia; PIT = personal income tax; VAT = value-added tax. Country abbreviations are International Organization for Standardization (ISO) country codes.

How Could Fiscal Institutions Influence Fiscal Outcomes?

How much could MENAP and CCA countries benefit from strengthening fiscal institutions? Overall, estimates indicate that fiscal outcomes in the Middle East and Central Asia could improve notably with stronger fiscal institutions (Figure 5.6; see Box 5.2 for a discussion on the

Figure 5.5. Average Number of Numerical Fiscal Rules
(Number of fiscal rules per country in the subregion)



Sources: National authorities; and IMF staff calculations.
 Note: The emerging market comparator for each MCD subregion varies.
 AE = advanced economies; CCA = Caucasus and Central Asia; EM = emerging market economies; EMEU = emerging Europe; MCD = Middle East and Central Asia; MENAP = Middle East and North Africa, Afghanistan, and Pakistan; OE = oil-exporting countries; OI = oil-importing countries; OOE = other oil-exporting countries.

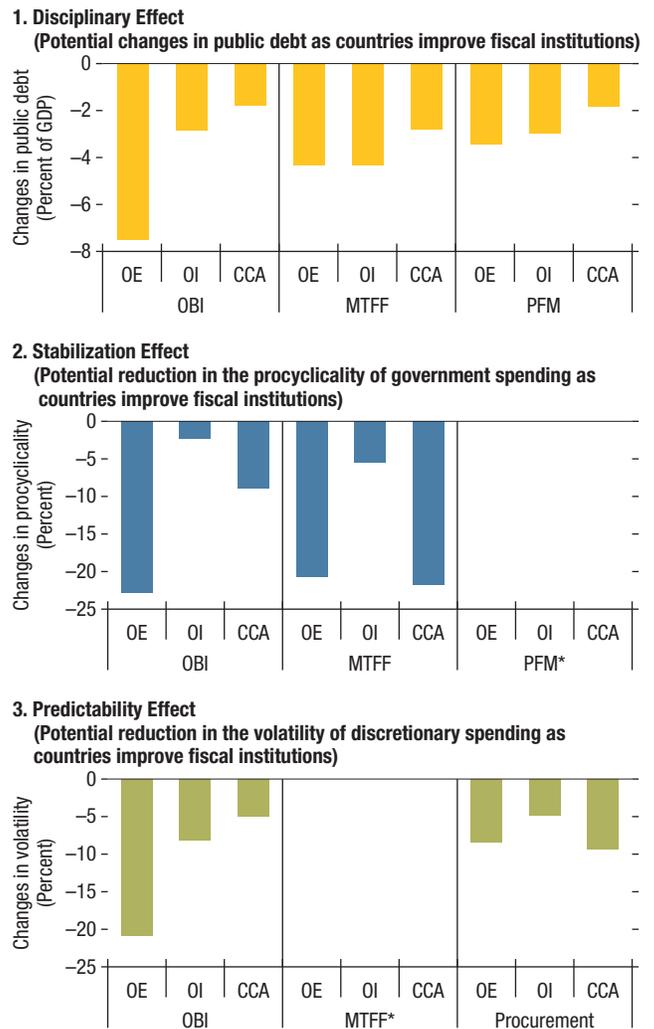
empirical methodology employed).⁸ Specifically, adopting best practices⁹ for fiscal transparency, MTFE, PFM, and procurement could improve fiscal outcomes by increasing accountability and limiting discretionary and politically motivated changes in fiscal policy.

- A slower pace of public debt accumulation over the medium term—by more than 4 percent of GDP and close to 5 percent of GDP in the Gulf Cooperation Council (GCC) and non-GCC oil-exporting countries, respectively, compared to the current level of debt.

⁸Given the small sample and multicollinearity concerns, regressions are run separately for individual fiscal institutions and are not additive. The results are counterfactual with other conditions unchanged.

⁹Adoption of a best practice would mean improving a country's fiscal institution to the level seen in an economy operating at the frontier of that institution.

Figure 5.6. Effects of Quality of Fiscal Institutions on Fiscal Outcomes



Source: IMF staff calculations.
 Note: The reported coefficients are significant at 90–99 percent confidence bands.
 *The effect for these indicators is not statistically significant. Disciplinary effect corresponds to a decline in gross public debt. The stabilizing effect corresponds to the reduction of the procyclicality of government spending. The predictability effect corresponds to the reduction in the volatility of discretionary spending.
 CCA = Caucasus and Central Asia; MTFE = medium-term fiscal framework; OBI = Open Budget Index; OE = oil-exporting countries; OI = oil-importing countries; PFM = public financial management.

- Across all MENAP oil exporters, procyclicality of fiscal policy could be reduced by 30 percent, and the volatility of government spending could be lowered by as much as 19 percent, improving the overall predictability of fiscal policy.

- In MENAP oil importers, a slower pace of debt accumulation—by about 3½ percent of GDP—and a 14 percent lower volatility of fiscal policy.
- In the CCA, a slower pace of debt accumulation—by 2 percent of GDP—while the procyclicality of fiscal policy would be strongly reduced by more than 20 percent, and the volatility of fiscal policy lowered by about 8 percent.

Improvements in fiscal institutions take time and may be hindered by administrative capacity and political constraints. MENAP and CCA countries improved their MTFFs by 10 percent over four years, whereas improvements took more than five years in other countries. Therefore, the sizable benefits associated with enhancing fiscal institutions would be reaped only over the medium or long term.

Findings for a broader sample of countries suggest that adoption of numerical fiscal rules, if accompanied by procedural rules and monitoring and enforcement mechanisms, is associated with less procyclical fiscal policy. Similarly, greater transparency and credible MTFFs are associated with enhanced domestic nonresource revenue mobilization (see Box 5.2).

Enhancing Fiscal Discipline

Improving fiscal transparency (by closing the gap with the best-performing economies), adopting credible MTFFs, and strengthening PFM systems could help reduce the pace of public debt accumulation, helping MENAP oil importers to contain large debt burdens and MENAP oil exporters to continue to gradually consolidate their fiscal positions. Specifically, in Algeria and Oman, debt accumulation could be lower by 4.5 and 6 percent of GDP, respectively, compared to their current levels of debt, while in Qatar and Saudi Arabia it could be lower by 5 percent of GDP. Egypt, Lebanon, and Pakistan, which have rising debt burdens, could slow public debt buildup by about 4 percent of GDP.

Improving transparency and strengthening PFM, combined with a credible MTFF, could slow debt accumulation, on average, in Armenia, the Kyrgyz Republic, and Tajikistan by 2 percent of GDP.

Stronger fiscal discipline could also benefit fragile countries, notwithstanding limited capacity. In Iraq, Lebanon, Sudan, and Yemen, debt accumulation could be slower by about 6 percent of GDP.

Limiting the Procyclicality of Fiscal Policy

Improving the transparency of the budget cycle and adopting a credible MTFF also reduces procyclical fiscal policy, helping to stabilize the economy.¹⁰ This is particularly the case for MENAP oil exporters and CCA countries. Procyclicality of fiscal policy can be reduced by more than 30 percent compared to the degree observed in recent years in Algeria, Qatar, and Saudi Arabia. Indeed, by reducing pressures to increase spending or cut taxes during upswings, a credible MTFF enables policymakers to implement countercyclical fiscal policy and reduce the bias toward deficits. MTFFs also raise awareness about policy actions that are destabilizing in the medium term and highlight the need for sustainable actions. Similarly, Azerbaijan and Uzbekistan could lower the procyclicality of fiscal policy by more than 20 percent.

Improving the Predictability of Fiscal Policy

Improving fiscal institutions, in particular the transparency of the budget cycle and procurement systems, can enhance the predictability of fiscal policy by lowering the volatility of discretionary government spending. In Bahrain and Oman,

¹⁰In this chapter, procyclicality is measured as a change in discretionary government spending vis-à-vis the output gap. Procyclicality measured alternatively as a change in government spending induced by the changes in oil prices—relevant particularly for MENAP oil exporters and highlighted in Chapter 1—yields similar outcomes.

volatility of fiscal policy could be reduced by about 10 percent. The potential benefits of improved transparency and procurement systems is even higher in MENAP oil importers (Egypt, Mauritania, Pakistan) and CCA countries (Azerbaijan, Tajikistan, Uzbekistan), where fiscal policy volatility could be lowered by 11 percent and 13 percent, respectively.

Strengthening the PFM and Procurement Systems

Effective PFM controls, combined with compliance with rules governing internal budget procedures and high quality and comprehensive audits of rules and procedures, would contribute to mitigating the overall rise in public debt. In particular, strengthening PFM controls—such as limiting the unreported extra-budgetary expenditure, improving tax payment efficiency, and boosting oversight of fiscal risks from public enterprises—in line with best practice standards for MENAP oil exporters and importers could lower public debt by about 3–3½ percent of GDP.

Moving toward Well-Designed Fiscal Rules

Empirical evidence shows that well-designed fiscal rules can strengthen fiscal discipline and reinforce the stabilizing capacity of fiscal policy. For MENAP oil exporters facing volatile oil prices and declining fiscal buffers, budget balance rules and expenditure rules may seem more appropriate to reduce procyclicality while ensuring intergenerational equity. For MENAP oil importers, budget balance rules and debt rules may help contain the rapid rise of public debt while allowing fiscal policy to respond to shocks (see Box 5.1).

However, the mere adoption of fiscal rules, without strong fiscal institutions to ensure compliance, is unlikely to improve fiscal outcomes. In this regard, procedural rules and enforcement and monitoring mechanisms could facilitate the implementation of fiscal rules.

Additionally, independent bodies that provide key macroeconomic assumptions and monitor compliance with rules are crucial. Moreover, comprehensive and robust PFM systems are preconditions for the adoption of fiscal rules (IMF 2018c, 2019b).

A Call for Stronger Institutions for Improved Policy Outcomes

MENAP and CCA countries are facing significant challenges with narrowing policy options to contain pressures. Fiscal consolidation efforts need to regain momentum to rebuild buffers and ensure long-term macroeconomic sustainability. MENAP oil exporters should avoid procyclical fiscal policies to strengthen the effectiveness of fiscal policy and insulate economies from global oil price volatility. MENAP oil importers should reduce precariously high levels of public debt to create space to address growth weaknesses. CCA countries should rebuild fiscal buffers to enhance macroeconomic stability and reduce vulnerabilities to external shocks. Despite recent progress, further strengthening fiscal institutions would help address these challenges.

- Countries with low transparency scores (Algeria, Iraq, Qatar, Saudi Arabia) would benefit from transparency initiatives, which would help reinforce fiscal discipline and reduce the procyclicality and volatility of fiscal policy, including by improving accountability and reducing the discretionary power to raise spending. In this regard, Saudi Arabia has taken important steps to improve transparency in recent years, including publishing more comprehensive budget statements and quarterly budget performance reports and audited financial statements for the first time (including for the state oil company). Further gains could be made by providing more detailed data on budget projections, outturns, and fiscal risks and by broadening the institutional coverage of fiscal reporting. Tunisia and Uzbekistan have recently undertaken fiscal transparency

evaluations, in collaboration with IMF capacity development, with recommendations aimed at improving fiscal reporting. To further improve transparency, Uzbekistan intends to participate to the 2021 Open Budget Index assessment for the first time.

- Adopting a comprehensive approach to analyze assets and liabilities of the public sector would enhance transparency. Better balance sheet management would enable countries to increase revenues, reduce risks, and improve fiscal policymaking, especially in MENAP and CCA countries with large sovereign wealth funds and state-owned enterprises. In this regard, the IMF encourages countries to undertake Fiscal Transparency Evaluations to help compile public sector balance sheets and assess the main risks to the fiscal outlook.
- Building a credible MTFE, with a clear understanding of fiscal challenges, would enhance fiscal discipline and reduce the pace of debt accumulation. It would also mitigate procyclicality, particularly in MENAP oil exporters. Algeria and Pakistan would benefit from ensuring compliance with existing MTFEs, and efforts to bolster fiscal policy frameworks (for example, in Qatar and the United Arab Emirates) via explicit fiscal anchors would also help to reduce procyclical fiscal policies.
- Stronger PFM systems and effective procurement processes and controls, which limit unreported extrabudgetary expenditures and reinforce oversight of fiscal risks, would help slow debt accumulation and limit unplanned changes in government spending. In this regard, Mauritania's and Algeria's recently adopted Organic Budget Laws are welcome steps toward improving PFM systems and enhancing the formulation of multiyear budgets. Kuwait passed a new procurement law to promote competition and transparency as well as participation of small- and medium-sized enterprises. It establishes dedicated procurement bodies and introduces modern approaches to evaluating bids, life-cycle costing, and complaints. The new tendering and procurement law in Saudi Arabia should improve the efficiency of public investment and transparency of tenders. In line with IMF recommendations, Azerbaijan and Uzbekistan recently passed legislation and regulations to establish e-procurement and increased transparency of bidding and contracting. Armenia plans to strengthen its public investment management framework to facilitate prioritization of investment projects.
- Fiscal rules reinforce fiscal discipline and build resilience. Moving toward flexible yet effective fiscal rules could help preserve fiscal discipline. Well-defined escape clauses, as well as monitoring and enforcement mechanisms, could assist in ensuring intergenerational equity, particularly important in MENAP oil exporters, and alleviate debt burdens, of concern in MENAP oil importers. Algeria, Azerbaijan, and Pakistan could reap further gains by fostering compliance with existing rules, while the Kyrgyz Republic should consider a lower cap for public debt when calibrating its fiscal rule.
- Revenue institutions can strengthen overall tax administration and foster domestic nonresource revenue mobilization, especially important for MENAP and CCA oil exporters. Revenue institutions can be strengthened by aligning them with good practices for internal management, improving procedures that regulate tax officials' discretionary powers, developing core tax procedures and capabilities. Easing filing and payment procedures via electronic filing, and implementing modern organizational structures and compliance risk management approaches. Having a credible medium-term fiscal framework, for example by implementing a medium-term revenue strategy focused on tax system reform, can also boost nonresource revenue mobilization (IMF, OECD, UN, and World Bank 2016).

Box 5.1. Lessons from Fiscal Reforms in Georgia

Georgia has undertaken major reforms to enhance the effectiveness of fiscal policy by strengthening fiscal institutions, reducing corruption, and improving the business climate. These reforms led to significant improvements in fiscal outcomes.

Since 2003, Georgia has enacted significant reforms of the public sector and fiscal institutions. The government undertook measures to fight corruption, including by improving fiscal institutions.¹ These consisted of (1) adopting a new budget law, which strengthened the medium-term fiscal framework by consolidating budget legislation, unifying central and local budgets, accelerating the budget approval and execution processes, and introducing program budgeting; (2) adopting numerical fiscal rules (debt, budget balance, and expenditure rules) in 2011 and enhancing them in 2018;² (3) streamlining tax policy and strengthening tax administration with the introduction of e-government taxpayer services and procurement; and (4) improving the coverage, analysis, and reporting of fiscal risks.

Stronger fiscal institutions have helped deliver better fiscal outcomes. Fiscal transparency, measured by the Open Budget Index, has improved markedly. Tax revenues rose and the efficiency of revenue collection has been higher than among peers. The government streamlined the types of taxes from 21 to 6, vastly improved taxpayer services, and restructured Georgia's Revenue Service. The adoption of flexible fiscal rules helped foster fiscal discipline, limited the rise in public debt, and reduced the volatility of government expenditure. The IMF supported Georgia in these reforms through financing arrangements and intensive capacity development.

Going forward, there is still scope for further reforms of fiscal institutions. Efficiency of spending could be enhanced, and a more binding medium-term budget framework would help enforce medium-term spending priorities. The government could improve the oversight and management of public investment and state-owned enterprises in line with the Public Investment Management Assessment recommendations. Further modernization of tax policy and revenue administration would help ensure sustainable revenues and could be achieved by a medium-term revenue strategy for comprehensive tax system reform.

This box was prepared by Iulia R. Teoduro.

¹The October 2019 *Fiscal Monitor* discusses in depth other key reforms that have reduced and contained corruption in Georgia.

²Fiscal rules limit public debt to 60 percent of GDP, the budget balance to 3 percent of GDP, and expenditures to 30 percent of GDP. The revisions entailed eliminating the expenditure ceiling, which had a procyclical bias, clarifying the scope of the deficit and the public debt under the rule, and defining escape clauses.

Box 5.2. Fiscal Institutions and Fiscal Performance: Empirical Setting

This box discusses the models developed to investigate links between fiscal institutions and fiscal performance. Fiscal institutions are measured using the transparency of the budget cycle, the adoption of a credible medium-term fiscal framework, and the introduction of fiscal rules. We focus on the role of these institutions in limiting increases in public debt (*disciplinary effect*), reducing the procyclicality of fiscal policy (*stabilizing effect, building resilience*), and lowering volatility of fiscal policy (*improving predictability*).

To explore the disciplinary effect of fiscal institutions, we posit the following empirical specification:

$$\Delta D_{it} = \alpha + \beta_1 FI_{it} + \beta_2 FI_{it} \times I_{\{=1ifMCD\}} + \sum_{k=1}^K \delta_k Z_{k,it} + \varepsilon_{it}. \quad (1)$$

Following Dabla-Norris and others (2010), the left hand-side variable is the change in gross public debt (ΔD_{it}) in percent of GDP, with i and t indicating panel and time dimensions. Our primary explanatory variable is an indicator of fiscal institutions (FI_{it}), mainly an indicator of transparency and the existence of a medium-term fiscal framework, and also the quality of the procurement process and public financial management system. Equation 1 is supplemented with additional control variables influencing changes in the public debt (that is, non-oil primary balance, real GDP growth, and inflation) to address possible omitted variable bias, and to isolate country-specific and time-invariant characteristics. We focus on β_1 and β_2 , which measure the effect of financial institutions on the changes in public debt.

The stabilizing capacity of fiscal institutions is empirically tested using a two-step approach. We first estimate the cyclicity of fiscal policy (Equation 2).

$$\Delta \text{Log}G_{it} = \alpha_{it} + \beta \Delta Y_{it} + \sum_{j=1}^J \delta_j X_{j,it} + \varepsilon_{it}. \quad (2)$$

Subscripts i and t refer to the country and time dimensions. $\Delta \text{Log}G_{it}$ represents the first differences of the logarithm of real public spending, and ΔY_{it} is the real GDP growth rate. Equation 2 describes the fiscal reaction function, which captures changes in government spending in reaction to the business cycle. The business cycle comoves with the oil price cycle (see Chapter 1). Equation 2 includes a set of controls ($X_{j,it}$: real GDP per capita, financial development, terms of trade, inflation) influencing government spending. Following Aghion and Marinescu (2007), we compute the time-varying and country-specific coefficients of procyclical ($\hat{\beta} > 0$) or countercyclical fiscal policy ($\hat{\beta} < 0$). After estimating the cyclical reaction of fiscal policy ($\hat{\beta}_{it}$), we assess the impact of FIs on the pro- or countercyclical nature of fiscal policy (Equation 3).

$$\hat{\beta}_{it} = \alpha_i + \delta_1 FI_{it} + \delta_2 FI_{it} \times I_{\{=1ifMCD\}} + \sum_{k=1}^K \lambda_k Z_{k,it} + \varepsilon_{it}. \quad (3)$$

We focus on coefficients δ_1 and δ_2 , which measure the effect of FIs on the cyclical nature of fiscal policy. Negative δ_1 and δ_2 imply that FIs are associated with lower procyclicality of fiscal policy.

Once again, we develop a two-stage approach in exploring the effectiveness of fiscal institutions in reducing the volatility of fiscal policy. First, we isolate changes in nonessential government spending using the following specification.

$$\Delta \text{Log}G_{it} = \alpha_{it} + \beta \Delta Y_{it} + \sum_{j=1}^J \delta_j X_{j,it} + \omega_{it}. \quad (4)$$

$\Delta \text{Log}G_{it}$ is the first difference of the logarithm of real government spending and ΔY_{it} , real GDP growth, captures the impact of the state of the economy on changes in spending. Equation 4 includes a set of controls ($X_{j,it}$: oil price volatility, real GDP growth volatility, inflation) influencing government spending. In this empirical setup, the residuals ($\widehat{\omega}_{it}$) play an important role as they capture the discretionary changes in government spending, driven neither by the business cycle nor by automatic stabilizers. The volatility of fiscal policy is calculated as a standard deviation of the residuals in country i , using periods of five years (σ_i^f), since we want to isolate the noise that might exist in the short term.

Box 5.2 (continued)

In the second stage, we estimate the impact of fiscal institutions on the volatility of fiscal policy using Equation 5.

$$\sigma_i^t = \alpha_i + \delta_1 FI_{it} + \delta_2 FI_{it} \times I_{\{=1ifMCD\}} + \lambda_k Z_{k,it} + \varepsilon_{it}. \quad (5)$$

δ_1 and δ_2 are our coefficients of interest. They are expected to be negative, predicting that fiscal institutions reduce the volatility of fiscal policy.

This role of fiscal rules in limiting the rise in public debt and reducing procyclicality is tested using Equation (6).

$$\Delta Y_{it} = \alpha + \beta_1 FI_{it} + \beta_2 (FR_{it} \times PR_{it}) + \sum_{k=1}^K \delta_k Z_{k,it} + \varepsilon_{it}. \quad (6)$$

The dependent variable ΔY_{it} is the change in public debt (ΔD_{it}), or the cyclical coefficients of fiscal policy ($\widehat{\beta}_{it}$) derived from Equation 3. Subscripts i and t are the panel and time dimensions. Our main explanatory variable is a dummy variable capturing the presence of a fiscal rule (FR_{it}). An interaction term ($FR_{it} \times PR_{it}$) captures the presence of a procedural rule, monitoring and enforcement bodies, the existence of escape clauses, or rules excluding investment spending in the calculation of the fiscal balance.

Equation 7 describes the econometric model used to estimate the role of fiscal institutions in influencing domestic revenue mobilization. The dependent variable is the ratio of total revenue to GDP, or nonresource revenue to GDP (Rev_{it}), with i and t the panel and time dimensions. Explanatory variables include GDP per capita, openness to trade, and political and institutional variables.

$$Rev_{it} = \alpha_i + \delta_1 FI_{it} + \delta_2 FI_{it} \times I_{\{=1ifMCD\}} + \lambda_k Z_{k,it} + \mu_k Pol_{k,it} + \varepsilon_{it}. \quad (7)$$

The sample covers 114 countries across all income groups and regions, including 31 Middle East and Central Asia countries. The panel is unbalanced due to significant data limitations, in particular regarding the indicators of fiscal institutions (Open Budget Index, medium-term fiscal framework, procurement, Public Financial Management). Given that fiscal institutions change slowly, we use five-year averages of all variables. Equations 1, 3, 5, and 6 are estimated using the Driscoll and Kraay (1998) method, which produces heteroscedastic-consistent standard errors robust to very general forms of spatial and temporal dependence. Equation 7 is estimated using the fixed effects method with robust standard errors. All specifications include control variables to reduce potential omitted variable bias. These include macroeconomic and structural (*GDP per capita, inflation, financial development, openness to trade, terms of trade, real GDP growth volatility, oil price volatility, non-oil primary balance*) and political and institutional variables (*strength of democracy, rule of law, government effectiveness, etc.*). Country fixed effects are introduced to alleviate concerns about cross-sectional dependence. Following Alesina and Perotti (1999), fiscal institutions are assumed to be costly to change and stable at least over the short to medium term. Therefore, the causality runs from fiscal institutions to fiscal outcomes, mitigating the endogeneity bias induced by reverse causality.

This box was prepared by Moussé Sow.

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