



OMAN

SELECTED ISSUES

January 2024

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SELECTED ISSUES

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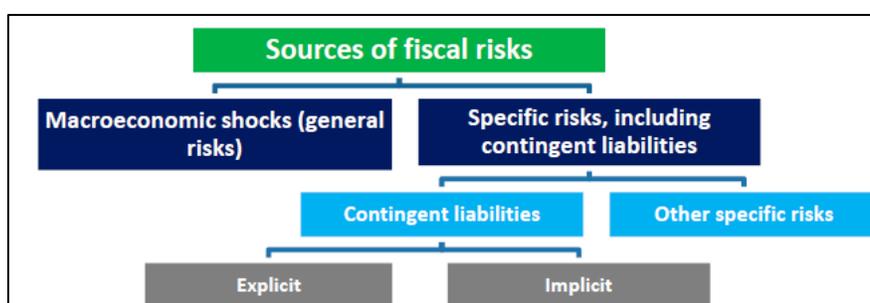
MITIGATING FISCAL RISKS IN OMAN¹

Fiscal risks are multifaceted in Oman and their potential impact on the fiscal position could be significant. Identification, monitoring, transparent reporting, and effective risk management of fiscal risks are a key component of a sound medium-term fiscal framework and paramount in underpinning fiscal credibility and the sustainability of public finances. This note revisits the exposure of Oman's fiscal position to an array of potential risks, zooming in on the impact of oil price volatility and potential risks stemming from state-owned enterprises. It documents actions taken by Omani policymakers to mitigate the impact of fiscal risks and provides further recommendations on fiscal risk disclosure and management.

A. Context

1. Fiscal risks are multifaceted in Oman. Oil and gas are the major sources of export income and fiscal revenues, and this income impacts the rest of the economy through government spending and savings. As of end of 2022, Oman's economy remains particularly dependent on hydrocarbons, which represent about 40 percent of GDP, nearly 80 percent of total fiscal revenue, and 65 percent of total export of goods.

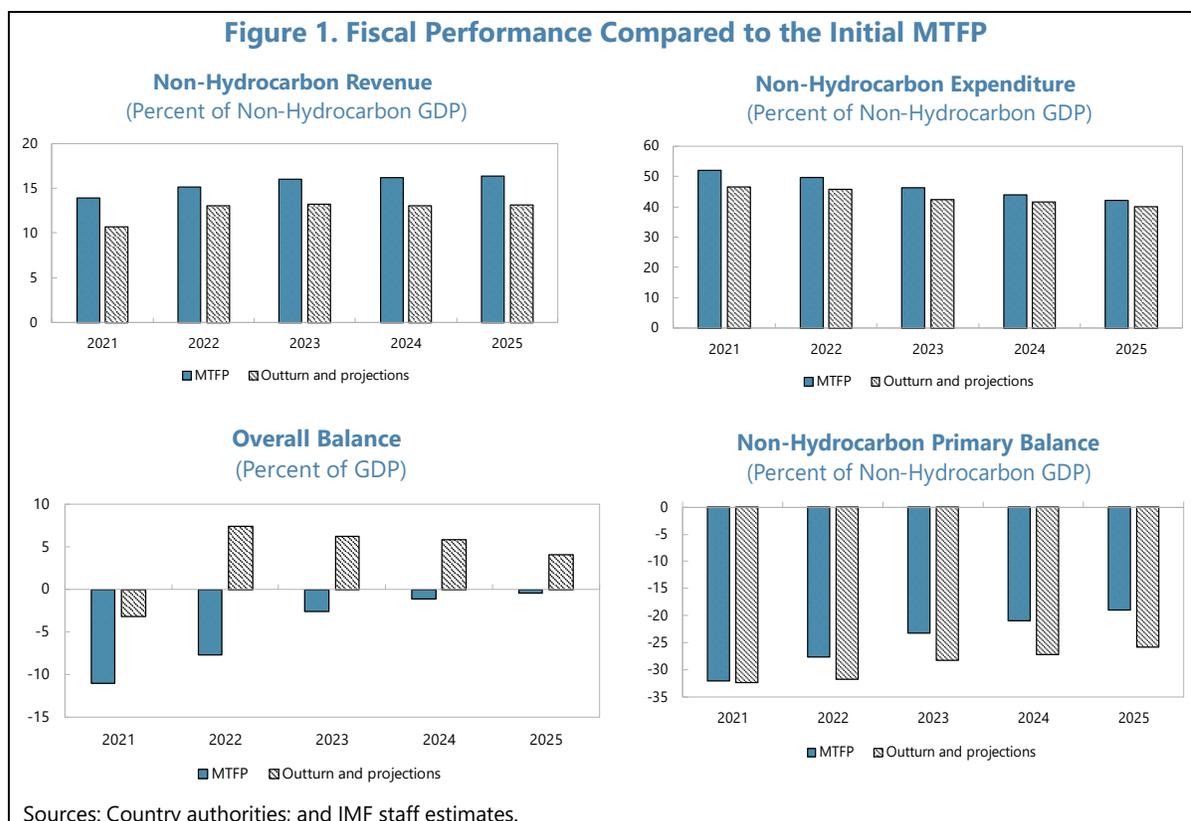
Fiscal risks comprise potential shocks to government revenues, expenditures, assets, or liabilities, which are not reflected in the government's fiscal forecasts (IMF 2014). These risks, which may arise from different sources, can be broadly classified into two main categories:²



- **Macroeconomic risks.** These could materialize when outcomes markedly deviate from baseline forecasts, as envisaged in Oman's Medium-Term Fiscal Plan (MTFP), for key variables, such as oil prices, GDP, inflation, and borrowing costs, which are themselves key determinants of fiscal performance (Figure 1). To mitigate macroeconomic risks, the authorities are developing an early warning system.

¹ Prepared by Abdullah AlHassan and Dalia Aita, with inputs from the Ministry of Finance's Macro-Fiscal Unit (Salim Ahmed Said Al-Jahwari, Salwa Abdullah Nasser Al-Jabri, Abdullah Saleh Mohamed Al-Brashdi, Hajar Hamed Hamood Al-Ghafri) and Oman Investment Authority.

² Fiscal shocks can be large, adverse, and nonlinear. Cross-country analysis shows that governments experienced on average an adverse fiscal shock of 6 percent of GDP once every 12 years (IMF 2016).



- **Specific fiscal risks.** These arise from the realization of contingent liabilities or other uncertain events, such as those related to state-owned enterprises (SOEs), public-private partnerships (PPPs), power purchase agreements (PPAs), and natural disasters. The materialization of one risk could trigger other risks, which can amplify its impact on public finances. Macroeconomic downturns also tend to trigger the realization of these risks.

2. Oman's Ministry of Finance has identified key fiscal risks. Oman's General Budget outlined key potential fiscal and economic risks for the first time in 2023. These include oil price volatility, tighter global financial conditions, global inflationary pressures, climate change and natural disasters, and geopolitical tensions.

B. Fiscal Risk Management

This section highlights the exposure of Oman's fiscal position to key risks, zooming in on the impact of oil price volatility and fiscal risks stemming from SOEs. It documents the actions taken, ongoing, and planned by Omani policymakers to mitigate the impact of the potential realization of fiscal risks.

Key Fiscal Risks

Oil Price Volatility

3. The volatility of oil prices is the major fiscal risk for Oman. Volatility and unpredictability of oil prices have increased in recent years due to a combination of supply and demand shocks, posing significant fiscal challenges. The uncertain path of oil prices ahead is particularly elevated as the energy transition unfolds with the need to balance climate change and energy security considerations. With the high degree of oil dependency, sharp declines in oil prices over the past decade resulted in sizable fiscal deficits (20 percent and 16 percent of GDP in 2016 and 2020, respectively) and surging public sector indebtedness (central government and SOEs) by close to 80 percent of GDP during 2015-2020. A stress scenario of a one-standard-deviation decline in oil prices, relative to current assumptions in the IMF's World Economic Outlook, would turn overall fiscal balances from surpluses under the baseline to persistent deficits and revert all the gains achieved so far in rebuilding fiscal buffers (Figure 2).

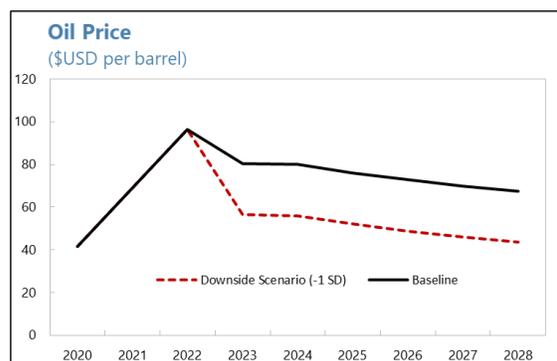
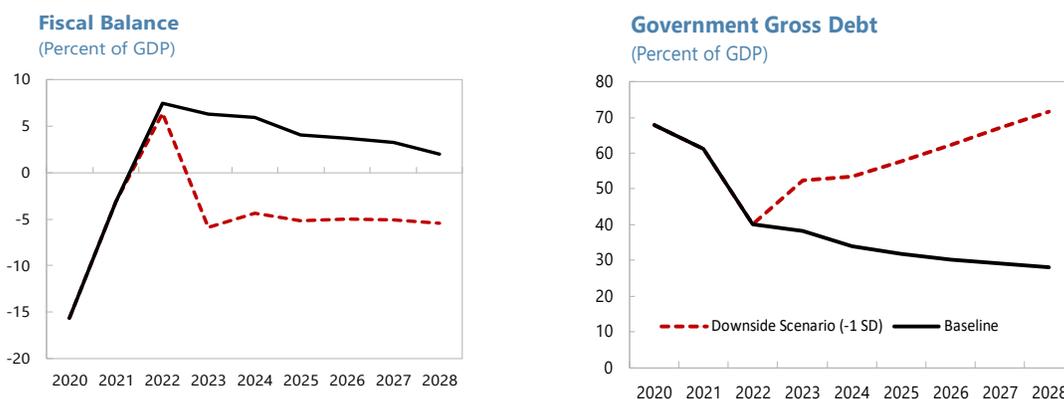


Figure 2. Downside Oil Price Scenario 1/



Sources: IMF staff calculations.

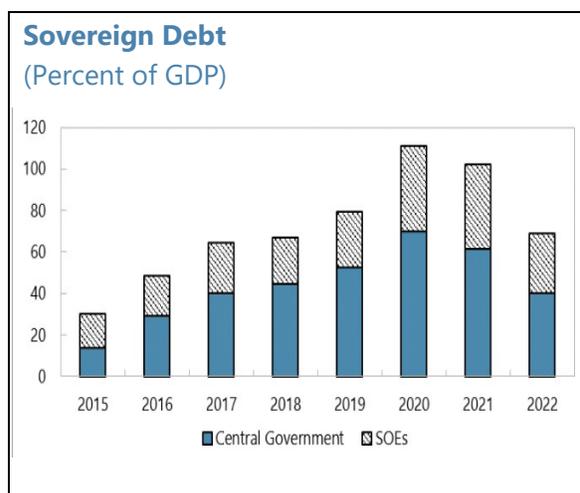
1/ The downside oil price scenario assume a one standard deviation below the WEO oil price from 2023 to 2028. The scenario assumes no change in government spending, non-hydrocarbon revenue collections, or external borrowing relative to the baseline scenario.

4. The authorities have followed different strategies to hedge against oil price shocks.

- **Fiscal adjustment.** Rationalizing expenditure and mobilizing non-hydrocarbon revenue, including the introduction of excises in 2019 and VAT in 2021, have helped mitigating the risk from volatile oil prices. Nonetheless, achieving the medium-term objectives under Oman's Medium-term Fiscal Plan would require additional revenue and expenditure measures, including a comprehensive tax administration reform, the introduction of PIT, and phasing out untargeted energy subsidies.
- **Medium-term Fiscal Framework.** Given uncertainties in oil markets, the 2023 budget continued to assume a conservative price for oil (\$55 per barrel) to contain public spending and as a precaution against oil price volatility. While such a strategy has helped contain spending pressures to an important extent in the past, it has not prevented budget overruns and has delinked the budget process from expenditure ceilings under Oman's Medium-term Fiscal Plan. Instead, the authorities, based on IMF technical assistance, are working to adopt a full-fledged and legally binding Medium-term Fiscal Framework with quantifiable fiscal targets from which near- and medium-term aggregate expenditure ceilings can be estimated. These in turn should anchor the budget preparation process to instill fiscal discipline regardless of the level of oil prices.
- **Fiscal buffers.** The authorities have continued accumulating buffers that could be mobilized at times of need. They continue transferring a portion of its fiscal revenue to the Petroleum Reserve Fund (PRF) each year.³ As of end of 2022, the central government maintains ample buffers as deposits with domestic commercial banks (14.4 percent of GDP) and the Central Bank of Oman (3.5 percent of GDP). In addition, Oman Investment Authority (OIA) holds substantial liquid assets amounting to about 10 percent of GDP.

State-Owned Enterprises

- 5. The realization of contingent liabilities from SOEs can be a significant source of fiscal risk.** Such risk can be either explicit (e.g., government loan guarantees) or implicit (e.g., support during slowdown in economic activity). SOE debt increased from 16 percent in 2015 to 41 percent of GDP in 2021, before declining to 30



³ Oil revenue equivalent to the value of 20,000 barrels per day, on average, are transferred to the PRF on an annual basis.

percent in 2022. The marked decline was driven by asset divestments, improved SOE financial performance, and deleveraging initiatives, underpinned by the ongoing SOE reform led by Oman Investment Authority (OIA) (see below). Explicit government guarantees to SOEs are limited and reached 8 percent of GDP in 2022. Guarantees are extended to the development phase of an SOE's project until the start of its operations. So far, no guarantee has been called. Nevertheless, a deterioration of the financial performance of SOEs could impose fiscal costs from direct budget subsidies (e.g., due to the impact of COVID-19 on the aviation sector, the government provided temporary support to Oman Air, amounting to 0.3 percent of GDP in 2022, while also initiating restructuring and refinancing operations for the company).

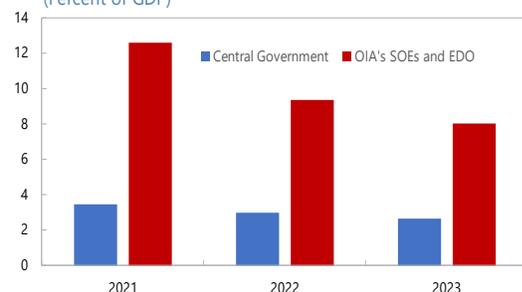
Box 1. Overview of State-Owned Enterprises

The Oman Investment Authority (OIA) was established in 2020 to manage existing sovereign financial assets and most state-owned companies (SOEs). Energy Development Oman (EDO) was also established in 2020 to manage oil and gas exploration as well as renewable energy projects in Oman. Government ownership in all non-financial SOEs, previously overseen by the Ministry of Finance, was transferred to OIA except for EDO. The OIA has embarked on a comprehensive SOE reform, guided by the Rawabet program, with the main goals of enhancing SOEs governance and efficiency, and setting the strategic priorities and the evaluation framework across OIA-affiliated entities.

SOEs operate across several sectors. Capital spending by SOEs (OIA-affiliated and EDO) amounted to 13.6 percent and 9.3 percent of GDP in 2021 and 2022, respectively. It is projected at 8.2 percent of GDP in 2023. This compares against central government's capital expenditure of 3 percent of GDP, on average, over the same period. The lower capital spending in 2023 is primarily attributed to OIA's strategy to stimulate private sector participation in the economy, where OIA's share in new projects is limited to 40 percent, as well as due to the planned divestment of a few SOEs. Capital spending is concentrated in energy and services sectors, accounting for approximately 90 percent of total capital spending during 2021-2023.

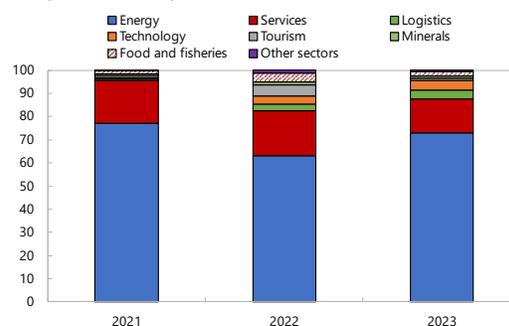
SOEs have sizable assets and liabilities. As of end of 2022, SOE assets amounted to about 31.4 percent of GDP, while liabilities accounted for 29.9 percent of GDP. SOEs debt is concentrated in few entities, largely OQ (Oman Oil Company), Energy Development Oman, NAMA (Electricity Holding Company), Oman Air, Asyad's Group (integrated logistics services provider), and Omantel (representing 90 percent of total SOEs debt in 2022). Most of the indebtedness of Oman's SOEs is project-based financing. Explicit government guarantees to SOEs amounted to 8 percent of GDP in 2022.

Public Sector Capital Spending
(Percent of GDP)



Sources: National authorities; and IMF staff estimates.

Structure of SOEs Capital Spending
(Percent of total)



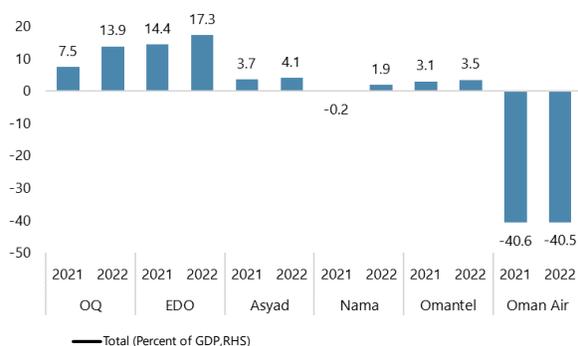
Box 1. Overview of State-Owned Enterprises (concluded)

Financial performance across the top SOEs is generally strong. For five out of the six SOEs representing 90 percent of total SOE debt in 2022, financial performance improved from 2021 to 2022, except for Oman Air. These SOEs have relatively high leverage, which declined in 2022. Profitability and interest coverage ratios, however, are strong and their liquidity ratios (represented by the ratio of current assets to current liabilities) are relatively healthy. Oman Air faced the brunt of the COVID-19 shock and is ongoing a restructuring process led by OIA, including a recently completed refinancing operation.

State-Owned Enterprises' Financial Indicators

Return on Assets

(Percent)



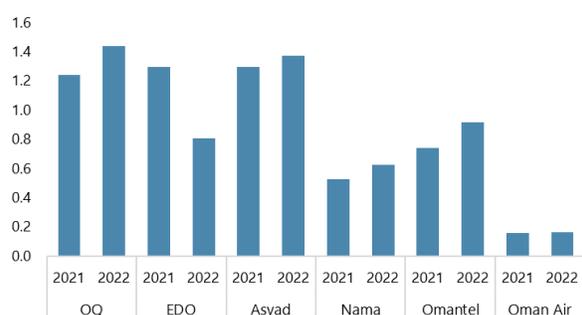
Interest Coverage Ratio

(EBITDA/interest expenses)



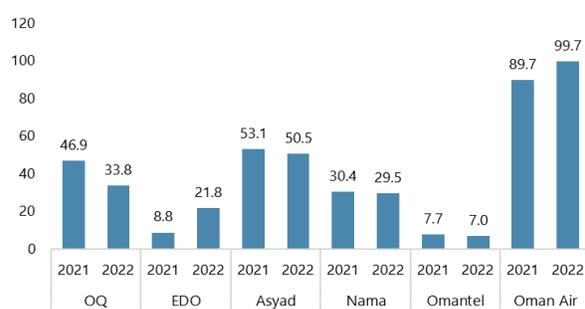
Current Ratio

(Current assets/current liabilities)



Leverage

(Total debt/total assets, percent)



Sources: National authorities; and IMF staff estimates.

6. OIA's Rawabet program has been instrumental in mitigating risks from SOEs. Upon its establishment, OIA inherited more than 160 companies from the state, with varying financial and non-financial performance. Different maturity levels, the lack of synergy among the companies, and unclear boundaries and relationships between the SOEs and the private sector complicated the task of resource allocation and strategic planning. In September 2020, OIA launched the Rawabet

program aimed at addressing these challenges and thereby strengthening SOEs performance, governance, risk management, and their strategic direction to further their contribution to the national economy and align their activities to Vision 2040 goals. Key actions that have mitigated SOE risks include:

- **Establishing robust governance**, including through the restructuring of SOEs' boards of directors and setting a cap of two terms for board membership; and issuing a Code of Governance to improve SOEs performance, raise efficiency, and organize the work and functions of SOEs to ensure alignment between the goals of sustainable development in Oman and the purpose for which these SOEs were established.
- **Instilling accountability** through boards' KPIs covering financial sustainability, governance, in-country value, divestments, and other strategic initiatives and assessed by a certified external auditor appointed by OIA and approved by the Capital Market Authority.
- **Risk management**, including quarterly risk-based monitoring of SOEs; annual risk assessments of SOEs business plans and submission of risk registries containing detailed assessments and mitigation plans of corporate risks; and annual borrowing plans submitted to the Ministry of Finance's Debt Management Office, prior to any funding activity during the year.
- **A deleveraging and divestment strategy** to improve SOEs' creditworthiness, while fostering operational efficiency and bolstering confidence in financial management and strategic planning of the SOE sector. Deleveraging initiatives reduced SOE debt by about \$10 billion during 2022-2023. OIA's divestment plans are considered as one of the levers towards empowering the private sector, securing strategic and/or financial partners, deepening the capital market, and contributing to the state budget. Since 2020, 16 SOEs have privatized and 5 partially divested. The 2023 divestment plan as approved by OIA Board consisted of divesting 8 companies through 3 IPOs and 5 trade sales.

7. Oman's healthy public sector balance sheet helps mitigates risks. Oman has sizable sovereign assets and liabilities. It has multiple pools of sovereign assets (OIA, PRF, and deposits in banks) and liabilities (central government and SOE debt). The consolidated public sector balance sheet—estimated based on publicly available information—has an estimated net assets (net financial assets) of 674 (-33) percent of GDP at end of 2022. The net present value of hydrocarbon assets represented about 500 percent of GDP and OIA's assets (SOEs under management and liquid assets) accounted for about 40 percent of GDP. Liabilities of about 88 percent of GDP are composed largely of central government and SOEs debt.

Oman: Public Sector Balance Sheet 1/
(2022 or latest available, percent of GDP)

	General Government		Public Non-Financial Corporations		Public Financial Corporations		Public Sector
	Budgetary Central Government	Social Security Funds	SOEs	Oil company	SWFs	CB	
Assets	221.0	n.a.	31.4	499.9	9.2		761.5
<i>Non-Financial Assets</i>	198.3		31.4	499.9			729.5
Fixed assets 2/ Hydrocarbon 3/ other assets	198.3			499.9			
			31.4				
<i>Financial Assets</i>	22.7				9.2	23.0	55.0
liquid assets	22.7				9.2	23.0	55.0
other assets						0.0	0.0
Liabilities	40.0	n.a.	23.6	5.1		19.1	87.8
Domestic	9.8		11.1	3.6			24.5
External	30.2		12.5	1.5			44.2
Net Assets	181.0		7.7	494.8	9.2	-19.1	673.7
Net Financial Assets	-17.3		-23.6	-5.1	9.2	4.0	-32.8
Net Liquid Financial Assets	-17.3		-23.6	-5.1	9.2	4.0	-32.8

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

1/ A simplified balance sheet.

2/ IMF staff estimate using the perpetual inventory method.

3/ Net present value of government hydrocarbon revenue.

8. The authorities have embarked on reforms to improve institutions entrusted with managing sovereign assets and liabilities. To improve public asset management, the OIA has been created to manage efficiently public enterprises and support the government in investing the fiscal surplus achieved from the hydrocarbon windfall. An integrated central system is being developed to take full account of government assets to maximize returns and enhance transparency of sovereign assets (including tangible assets, financial assets, oil and gas reserves, PPPs, real estate investments, and SOEs). On the liability side, the authorities established a Debt Management Committee to coordinate sovereign debt issuance, whose scope has been expanded with oversight of sovereign assets and liabilities. The forthcoming Medium-Term Debt Strategy will help manage risk exposures arising from the government's debt portfolio. Moreover, the recent unification of pension funds from 11 fragmented institutions into a unified entity will ensure medium- to long-term sustainability of the pension system as it will help arrest the potential fiscal burden that could have emerged in the long term had the existing fragmented pension schemes continued.

Other Fiscal Risks

Global Financial Conditions

9. While rising interest rates have had limited impact on short-term fiscal positions, tighter-for-longer financial conditions risk increasing borrowing costs over the medium-term.

Nevertheless, near-term refinancing risk (about 12.5 percent of total debt matures in the next 12 months as of end-2023) and interest rate risk exposure (with 84 percent of the total debt portfolio have a fixed rate) are low. Moreover, central government gross financing needs are projected below 1.0 percent of GDP on average over the period 2024-2028.

10. The authorities have implemented policy measures to mitigate refinancing risks. In 2022-2023, they conducted liability management operations, using some of the hydrocarbon windfall to repay, prepay, and buyback part of its external debt—amounting to 7.2 percent of GDP in 2022 and 4.6 percent of GDP in 2023—to reduce future debt service costs and gross financing needs. In addition, the authorities have created debt provisions since the 2021 budget, amounting to 0.5-0.8 percent of GDP annually to the Debt Reserve Account to meet future borrowing requirements.

Public-Private Partnerships

11. Public private partnerships (PPPs) are at an incipient stage in Oman, with the Public Private Partnership Law adopted in 2019. The authorities aim to encourage private sector to invest in infrastructure projects and public services. The Ministry of Finance undertook certain projects carried out under PPPs that are expected to solve the challenges related to investment projects such delivery on-time and on-budget, optimize life cycle costs for projects, bring in private sector knowledge, and enhance efficiency, innovation, and value of money by improving production efficiency and governance framework. These projects are in education, health, transport, and port sectors.

12. The PPP Unit, under the Ministry of Finance, is preparing detailed policy measures to mitigate potential fiscal risks, including its rights, obligation, and other exposures under PPP contracts. The role of the Unit is to steer the PPP process and procedures from the project planning stage to the tendering stage. Every new PPP initiative will have to be approved by the Ministry of Finance before tendering. As a part of the project preparation stage (i.e., detailed project feasibility studies), the fiscal exposures, obligations and guarantees will be explicitly analyzed. The Unit works closely with relevant government entities to ensure any risks has been thoroughly understood, mitigated, and approved. While the government provides a comfort letter—detailing the budgeting approval process and budget allocations to various ministries and government related entities—it does not provide any guarantees.

Climate-Related Events

13. Similar to other countries, Oman is exposed to fiscal risks from natural disasters. Climate-related events have increased in recent years, as evident by changes in the number and

intensity of tropical cyclones, with 14 events since 2002.⁴ Natural disasters have inflicted moderate fiscal costs so far. For example, the fiscal cost of cyclone Shaheen in 2021 was about 0.5 percent of GDP.

14. The authorities have put in place funding mechanisms to address climate challenges from natural disasters. The National Fund for Emergency (NFE), with an initial contribution of 0.3 percent of GDP, was established in 2022 to tackle the aftermath of tropical cyclone Shaheen and similar natural disasters that may occur in the future. The NFE is supported annually by allocating an amount from the State's General Budget, as well as donations from companies, associations, and philanthropists. The authorities have also access to a funding support from the Green Climate Fund (GCF) to tackle potential climate change impacts, covering six areas: water resources, agriculture, marine and fisheries, urban areas, health, and energy efficiency.⁵

C. Policy Implications

15. Steadfast implementation of fiscal reforms would mitigate fiscal risks. This would require pressing ahead with additional measures to mobilize non-hydrocarbon revenue and rationalize expenditure, as well as utilizing hydrocarbon windfalls to increase buffers and reduce debt burden. Developing a full-fledge medium-term fiscal framework would help entrench fiscal discipline and provide predictability of government expenditures.

16. Comprehensive analysis, management, and reporting of fiscal risks would ensure sound public finances and macroeconomic stability as well as fiscal transparency. Building on the summary of fiscal risks that was published in the 2023 budget, developing a comprehensive fiscal risk statement would help to identify possible gaps and ensure full coverage of risks. The statement should include sensitivity analysis and alternative macroeconomic and fiscal forecast scenario to assess the impact on public finances. In this context, fiscal policy settings can respond to a range of potential fiscal shocks, where specific risks are actively monitored and managed so that abrupt and disruptive changes in policies are prevented when risks materialize. Expanding the reporting of fiscal risks would promote a better understating of the state of public finances, build support for prudent fiscal policies, and strengthen accountability for risk management.

17. Comprehensive and timely fiscal data, including extending coverage beyond the central government and specific fiscal risks, are necessary in identifying, managing, and mitigating fiscal risks. The authorities' ability to respond to fiscal risks partly depends on the quality of information about the sources and size of risks, its capacity to assess the likelihood of risks materializing, and the strength of its underlying public financial management institutions. Ongoing efforts by OIA to privatize some assets are welcome to stimulate private sector participation in the economy. Disclosing key financial performance metrics of SOEs and moving ahead with OIA's divestment process should be a priority. For specific fiscal risks, coverage would need to be

⁴ [The International Disasters Database](#).

⁵ <https://www.greenclimate.fund/document/oman-country-programme>.

expanded to PPP and pension funds to raise awareness among policymakers and the public regarding the existence and nature of these risks. Given the authorities' expected recourse to PPPs in the coming years, setting ceilings on either the stock or the annual flow of PPP projects would prevent excessive exposure to fiscal risk.

18. It is important to develop appropriate strategies for the management and mitigation of key fiscal risks. Such strategies would include, among others, allocations in the budget, limits on the exposure to specific types of risk, etc. At the same time, it is essential to strike a balance between benefits from reducing exposure to risks against the probability of these risks occurring and costs of risk mitigation (e.g., using buffers and budget contingencies), as some risks are too large to provision for and too costly to mitigate. Such strategies should specify the conditions under which the government is prepared to accept specific fiscal risks, define the level of risk it is willing to bear, specify the decision-making processes to be carried out by the government, and define the instruments that can be used to manage risks. In this context, phased withdrawal of untargeted energy subsidies should be a priority, including lifting the fuel cap and resuming the reforms through the authorities' targeted National Subsidy System. Developing a multilayer strategy on the use of additional revenue as a result of high global oil prices—reducing public debt, accumulating fiscal buffers, or accelerating economic diversification—will be essential.

19. Long-term sustainability analysis should be part of fiscal risk management given a reliance on finite natural resources. Uncertainty concerning the volume and value of resource endowments can be one of the most significant fiscal risks. Estimating value of the natural resource assets can be used to identify whether public debt is on a sustainable path and provide guidance on how public debt will evolve under different price scenario. Such analysis helps to inform public deliberation over the sustainability and intergenerational equity issues involved.

20. Developing a sovereign asset and liability framework is paramount to managing fiscal risks. It would enhance policymakers and the public's understanding and awareness of the public sectors financial strengths and vulnerabilities. The framework should set out the government's overall financial objectives and procedures for managing the cost/risk trade-offs. By consolidating the entirety of what the public sector owns and owes, the framework provides the basis for improved fiscal risk management.

21. Better understanding of fiscal risks, combined with their transparent reporting and effective risk management underpin fiscal credibility and the sustainability of public finances. The annual budget can disclose guarantees, related beneficiaries, the expected duration, and the intended purpose. The budget should also disclose the government's rights, obligations, and other exposure under PPP contracts. There is a scope to enhance transparency of allocations for contingencies. This would include publishing a set of criteria that must be met before expenditure may be charged to the contingency reserve and reporting on the use of contingency appropriations for the previous fiscal year.

22. It is essential to identify and disclose the main fiscal risks from climate-related events and Oman's climate agenda, both in qualitative and quantitative terms. Direct impacts may

occur via increased public spending on, for example, repairing damaged infrastructure and social transfers to households and indirect impacts may occur via disruption of economic activity (including reduction of tax revenue) after a major disaster or the materialization of contingent liabilities affecting SOEs and private institutions. Oman is also exposed to potential fiscal costs from the implementation of adaptation and mitigation actions, committed under its National Determined Contribution (NDCs).

23. Effective fiscal policymaking and fiscal risk management require appropriate coordination of decision making between central government and other parts of the public sector. In this context, the National Committee, which advice on economic policies, has nominated representatives from MoF, MoE, NCSI, CBO, and OIA to coordinate identification, analysis, monitoring, and mitigation of fiscal risks.

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MONETARY POLICY TRANSMISSION IN OMAN¹

Amid a pegged exchange rate to the US dollar and an open capital account, Oman's policy rates move closely with US monetary policy. In this analysis, we show that transmission from policy rates into effective lending and deposit rates remains subdued in Oman, even compared to GCC peers that similarly face a high oil price environment with persistent excess liquidity in the banking system. A cap on personal loan rates and low exposure of banks to SMEs and riskier borrowers limit passthrough into effective lending rates and credit conditions. The note documents ongoing actions by Omani policymakers to strengthen transmission and provides further recommendations on liquidity management, reserve management, and relaxing the interest rate cap.

1. Since the beginning of the current Fed tightening cycle in March 2022, the CBO has followed Fed policy rate hikes closely to maintain the OMR-USD peg. Despite a 550 basis points increase in policy rates, interest rate passthrough in Oman has been weak and credit continues to grow under the impulse of strong private sector demand. This note documents the extent of monetary policy passthrough in Oman over the past 2 years, identifies reasons for weak passthrough, and provides policy recommendations to strengthen monetary policy transmission.

2. Despite rising policy rates, interest rate passthrough in Oman has been weak compared to GCC peers and financial conditions have not tightened since January 2022. Oman has closely followed the rate hikes by the Fed (Figure 1.1), like GCC peers, in order to maintain its peg. However, the passthrough from higher policy rates into deposit and lending rates has been weak in Oman compared to Saudi Arabia and the United Arab Emirates (Figures 1.4 and 1.5). While deposit and lending rates in Oman were almost flat year-on-year at the end of 2022, deposit rates rose by about 55 basis points over the past year in both Saudi Arabia and the United Arab Emirates and lending rates rose by 65 and 90 basis points, respectively.² Consequently, financial conditions in Oman have not tightened since the beginning of the Fed tightening cycle in 2022 (Figure 1.6) but have somewhat eased on the back of accelerating credit growth and lower external spreads.³ Moreover, the divergence in passthrough from policy rates into effective interest rates relative to peers cannot readily be explained by the share of unremunerated deposits (Figure 1.2) or excess liquidity (Figure 1.3) alone. Along those characteristics, Oman ranks similarly to other GCC economies.

¹ Prepared by Thomas Kroen.

² While foreign-currency lending rates have increased in Oman, FX lending only accounts for about 15 percent of all loans. In the subsequent analysis, the focus is on the overall effective lending rate including both domestic currency and foreign currency loans. The overall effective lending rate has not increased since the beginning of the Fed tightening cycle.

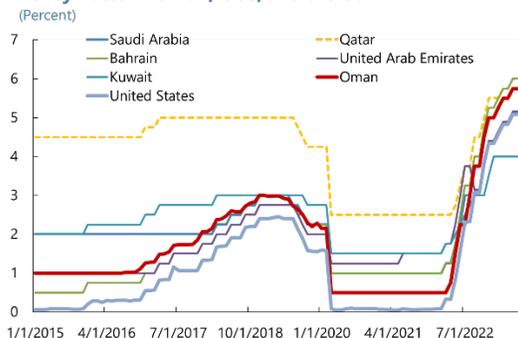
³ The financial conditions index is computed as the first principal component of several financial market time series for Oman, including deposit rates, lending rates, credit growth, sovereign spreads and the VIX. Concurrent analysis has shown that results are qualitatively similar when using the method by Koop and Korobilis (2014), which ensures that financial conditions are identified separately from broader macroeconomic conditions.

Figure 1. Interest Rates

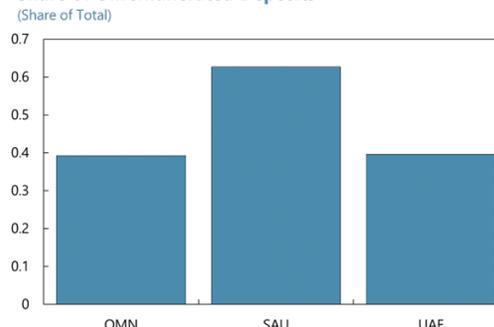
Though Oman has continued to closely follow the Fed ...

... and displays similar characteristics

Policy Rates in Oman, GCC, and the US



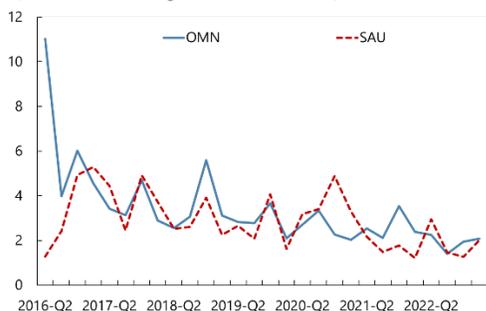
Share of Unremunerated Deposits



... as other banking systems in the region ...

Excess Liquidity

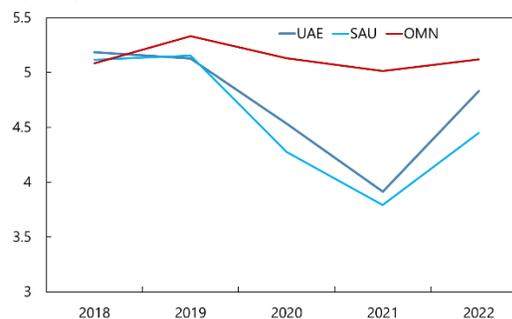
(Excess Reserves/Banking Sectors Assets in Percent)



... passthrough into lending rates

Effective Lending Rates

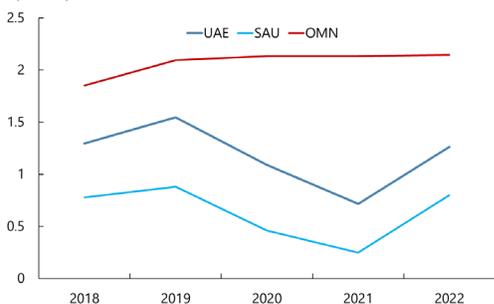
(Percent)



... and into deposit rates has been very subdued ...

Effective Deposit Rates

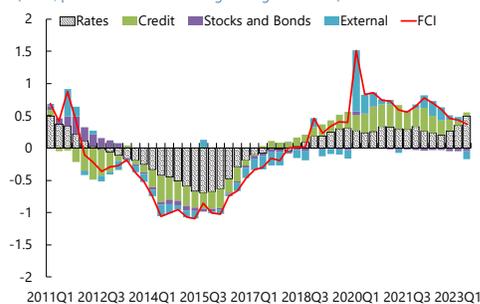
(Percent)



.... while financial conditions have eased since early 2022.

Financial Conditions in Oman

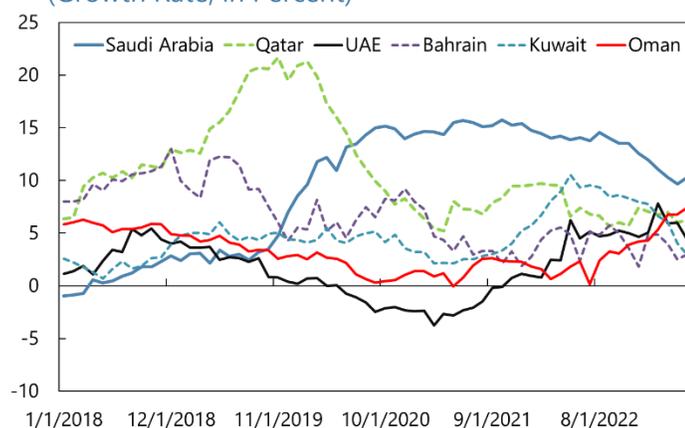
(Index, positive values indicate tightening conditions)



Sources: CEIC, Fitch Connect, CBO, Capital IQ, Haver Analytics, SAMA, and IMF staff calculations.

3. Econometric evidence confirms that passthrough into loan and deposit rates is significantly higher in other GCC countries. Using a regression model for the passthrough from US monetary policy tightening to domestic lending and deposit rates, Table 1 shows that for other GCC countries excluding Oman, a 100 bps Fed tightening correlates with a 34 bps increase in deposit rates and a 43 bps increase in lending rates after one year.⁴ In Oman, however, there is no statistically significant increase in deposit rates and the impact on lending rates is half as large as in other GCC countries despite similar monetary frameworks (peg to USD)⁵ and monetary policy transmission challenges (e.g., structural excess liquidity amidst high oil prices and a high share of unremunerated deposits).

Figure 2. Private Sector Credit Growth in the GCC
(Growth Rate, in Percent)



Sources: Haver Analytics and IMF staff calculations

Table 1. Oman: Monetary Policy Passthrough Regressions - Prices

	(1)	(2)	(3)	(4)
	Δ Effective Deposit Rate Oman	Δ Effective Deposit Rate Other GCC	Δ Effective Loan Rate Oman	Δ Effective Loan Rate Other GCC
Δ Fed Funds Rate	0.048 (.044)	0.341*** (.069)	.226** (.083)	0.431*** (.118)
Δ Oil Price	-0.004 (.003)	-0.006** (.002)	-0.011 (.006)	-0.011*** (.002)
VIX	-0.015 (.009)	0.01 (.008)	0.02 (.019)	.038 (.014)
Bank FE	x	x	x	x
Constant	.267 (.173)	-0.256* (.142)	-0.48 (.375)	-.855 (.285)
Observations	105	803	105	982
R-squared	0.098	0.272	0.18	0.06

Note: * indicates significance at the 10 percent level, ** indicates significance at the 5 percent level, *** indicates significance at the 1 percent level

⁴ This magnitude is comparable to estimates reported in IMF (2022).

⁵ The Kuwaiti Dinar is pegged to an undisclosed basket of currencies but co-movement of the Kuwaiti policy rate with the US policy rate is evident in Figure 1.

4. Amidst weak passthrough to lending rates, private sector credit displays sustained growth since early 2022 in Oman and is now the second highest in the GCC. Private sector credit growth stands at about 7 percent (y-o-y) by end of 2023H1 driven by strong growth in both personal loans and corporate loans. While credit growth has slowed to an extent in many GCC countries since the beginning of the current Fed tightening cycle (e.g., Kuwait, Saudi Arabia), private sector credit growth has accelerated in Oman over the past 18 months, mirroring the weak passthrough of higher US rates into domestic lending conditions. Econometric estimates (Table 2) confirm that passthrough from higher policy rates into credit quantities in Oman is statistically indistinguishable from zero, implying that higher policy rates are on average not affecting credit growth. While nominal credit growth in other GCC countries is also not significantly affected by higher US rates (though the sign is negative), real credit contracts by 3.7 percentage points in response to 100 bps higher US rates.

5. Amid persistent excess liquidity and limited interbank market activity, effective lending rates on OMR loans have slightly fallen since the beginning of the Fed tightening cycle. Weak monetary passthrough extends beyond the personal loans segment (40 percent of the market), which is subject to the 6 percent interest rate cap. Effectively, the entire passthrough of higher policy rates into lending rates in Oman is driven by FX lending that accounts for one-eighth of the market, as domestic currency lending rates have marginally declined. While high oil prices dampen monetary passthrough in oil-exporting countries (IMF, 2022), excess liquidity has been a pervasive feature of the Omani banking sector including during times of low oil prices (Figure 3, Panel 1).

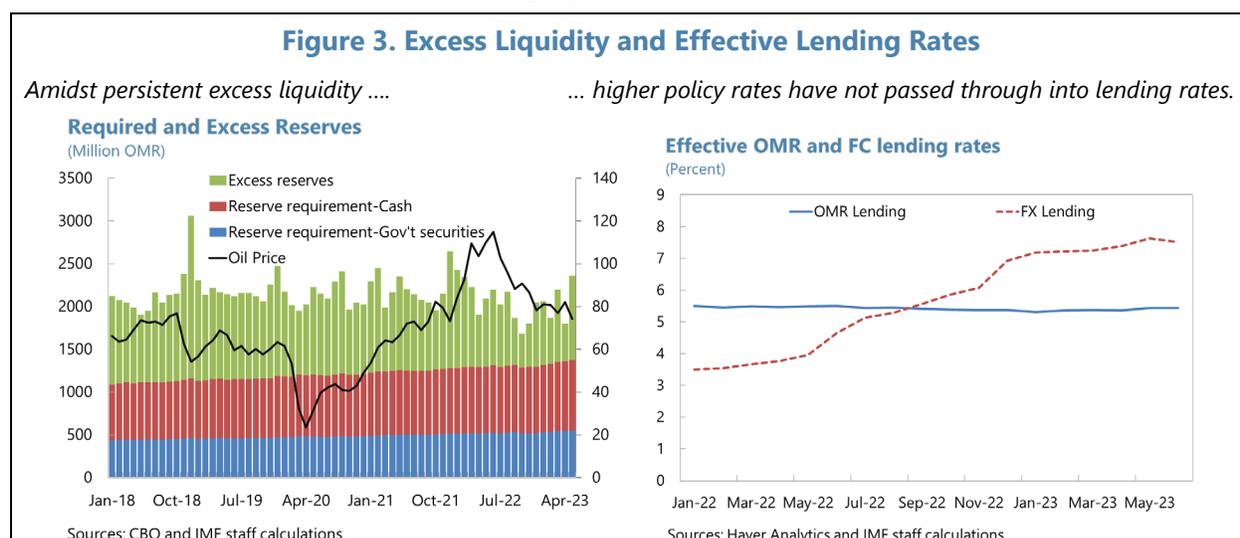
Table 2. Oman: Monetary Policy Passthrough Regressions—Credit

	(1)	(2)	(3)	(4)
	Δ Nominal Credit	Δ Nominal Credit	Δ Real Credit	Δ Real Credit
	Oman	Other GCC	Oman	Other GCC
Δ Fed Funds Rate	0.001 (0.012)	-.007 (.008)	.025 (.026)	-.037** (.013)
Δ Oil Price	-.000 (.001)	-.000 (.000)	-.001** (.000)	-.000 (.000)
VIX	-.001 (.002)	-.002 (.001)	.003 (.004)	-.005** (.002)
Bank FE	x	x	x	x
Constant	.097* (.046)	.104*** (.031)	.026 (.069)	.142*** (.036)
Observations	86	881	79	788
R-squared	.262	.317	.268	.311

Policy Recommendations

6. The authorities need to continue ongoing efforts to enhance liquidity management and improve monetary policy under the Monetary Policy Enhancement Project (MPEP).

Building on better liquidity forecasting, the CBO toolkit to absorb excess liquidity needs to be expanded, including by preparing the resumption of issuance of certificates of deposit which have not been used since 2015 and the introduction of further liquidity instruments for Islamic banks. Modifying the reserve maintenance period for required reserves to begin on a weekday will facilitate better liquidity management and pave the way towards conducting open market operations. In addition, the current regulation that the reserve requirement can partially be met with sovereign bond (up to 2 percent) should be removed. Reducing the number of reserve eligible assets would contribute towards tightening liquidity. Ongoing efforts to put in place a full liquidity management framework should be continued, starting with the planned testing of a Call Money Market and Deposit Facility. Setting the stage for the conduct of open market operations can further support effective liquidity allocation while encouraging interbank market activity.



7. Further measures to strengthen passthrough include relaxing the interest rate cap and maintaining healthy banking competition. Relaxing the interest rate cap on personal loans would ensure banks can adequately reflect related credit risk and maintain margins. Amid ongoing banking sector consolidation, it remains crucial to maintain competition in the banking sector, which will further support increased interest rate passthrough and access to credit for riskier borrowers, including SMEs.

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International Monetary Fund. 2023. Middle East and Central Asia Department. Regional Economic Outlook. Safeguarding Macroeconomic Stability amid Continued Uncertainty. April 2023.

Koop, Gary, and Dimitris Korobilis. "A new Index of Financial Conditions." *European Economic Review* 71 (2014): 101-116.

OMAN—A FINANCIAL SECTOR FOR THE ECONOMY OF THE FUTURE¹

A. Context

1. Underpinned by Vision 2040, Oman aims to reduce its economic reliance on the hydrocarbon sector by diversifying its economy. Reforms are targeted to develop a well-diversified, private-led, sustainable, and inclusive economy where innovation and knowledge play a more prominent role. This requires the existence of a well-developed, inclusive, and stable financial sector that can navigate the country's transformation and fund the new economy. As the economic transformation gains traction and entrepreneurship and innovation take center stage, Oman's financial sector will face a more complex environment where it needs to develop innovative financial and risk management solutions to cater for the emerging and expanding financial needs of the different players in the economy. Against this background, this note provides an assessment of the development of Oman's financial sector, identifies areas for potential improvement, and proposes policy actions to foster further financial development and inclusion.

B. Stylized Facts

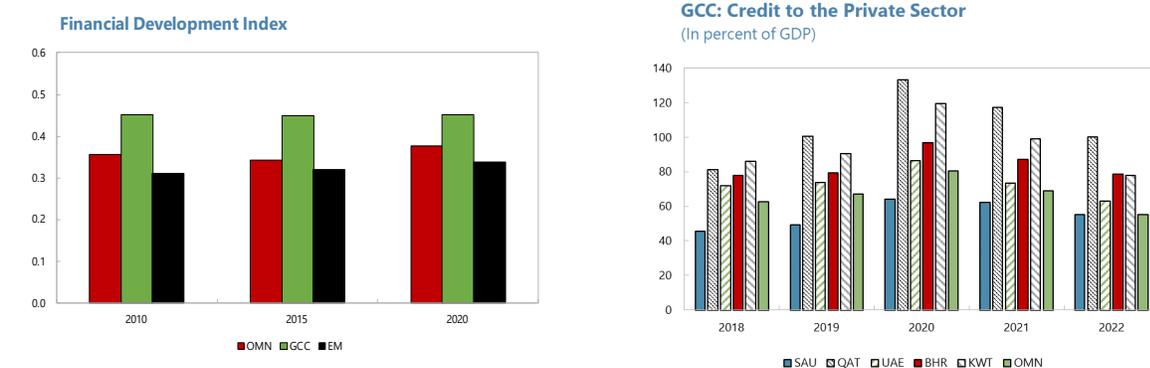
2. The Omani financial system is dominated by banks amidst a still nascent NBFi sector. Banks are the primary source of credit in the economy as debt capital markets are not widely accessible to the private sector. Credit to the private sector stood at 55.4 percent of GDP in 2022 and has persistently been among the lowest in the GCC in the past 5 years (Figure 1, Panel 2) while also lagging emerging markets (63 percent of GDP, on average). This partly reflects the still high footprint of state-owned enterprises across many sectors. The NBFi sector remains small, primarily represented by pension funds and some insurance companies. Recent consolidation of pension funds into one unified entity may contribute to scaling up NBFis and the size of their investments.

3. Omani capital markets are comparatively small and illiquid. The primary government bond market shows healthy activity but the secondary market is mostly inactive amidst persistent low market liquidity and no market-making system. Non-resident participation remains low due to the illiquidity and regulatory barriers such as the absence of OTC trading and lack of a link with Euroclear. Corporate bonds or sukuks have only been issued sporadically and the stock market significantly lags other markets in the region.

¹ Prepared by Thomas Kroen.

Figure 1. Financial Development and Private Credit Provision

Financial development has slightly progressed... ..but private credit provision is amid lowest in GCC



Sources: IMF Financial Development Indicators, Haver Analytics.

4. Oman has shown some progress on financial development since 2010 but continues to lag GCC peers, notably on the development of financial markets beyond banking. Oman's financial development index has marginally risen from 0.36 to 0.38 since the last FSAP in 2010 (Figure 1, Panel 1), driven by the strength of the local banking sector. However, it continues to lag other economies in the region. Structural challenges identified in the 2010 FSAP persist, including low capital market liquidity, the absence of a well-established yield curve, and barriers to SME funding.

C. Challenges and Avenues for Development

5. Development across all segments of the financial sector will be needed to sustain Vision 2040. Structural regulations that limit banking sector development should be removed, including, once the credit registry is fully developed to ensure adequate risk scoring, the interest rate cap on personal loans. Developing capital markets, in particular for debt and equity funding of larger corporations, will enable banks to re-allocate funding towards SMEs that do not have direct capital markets access. In a second stage, over the medium term, other capital market instruments such as exchange traded funds, derivatives, and futures contracts could also be developed.

Banking

6. The banking sector is dominated by domestic banks with an increasing share of Islamic banking. Banking activity is concentrated in 6 domestic banks² and two Islamic banks. There are also 9 foreign banks, which however typically only operate one branch. The sector is moderately

² This accounts for the recent merger of Sohar International Bank and HSBC Oman.

concentrated with the largest bank, the only domestic systemically important bank (DSIB) as of now, accounting for about 40 percent of total banking assets.³

7. Omani banks primarily lend with limited investments in securities. Since 2015, the share of loans in total assets has risen from 66 percent to 75 percent while the share of securities remains low at about 13 percent due to a cap on government bond holdings.⁴ As a result, Omani banks have the highest share of loans relative to total assets in the GCC (79 percent compared to a GCC average of 59 percent, Figure 2). Credit primarily flows towards corporate loans (46.7 percent), personal loans (32.1 percent), and SOEs (14.3 percent). While all segments have been growing in recent years, the strongest growth has been in SOE loans which have almost doubled since 2016, suggesting crowding-out of private sector credit. Across sectors, the correlation of credit growth with output growth over the past 5 years is weak, indicating that credit allocation to growing sectors can be strengthened (Figure 2 Panel 6). Utilities have seen a much larger credit growth than output growth over the past 5 years while credit provision to manufacturing, mining and quarrying, and agriculture has lagged output growth in those sectors.

8. Funding is primarily through deposits, with a sizable footprint of the state. Deposits account for two-thirds of total bank liabilities and 90 percent of non-equity funding. The domestic government, and to a lesser extent SOEs, continue to be critical funding sources accounting for 33 percent of deposits, virtually unchanged since 2015. With more than 90 percent of assets and 89 percent of liabilities owned by residents, non-resident participation remains low.

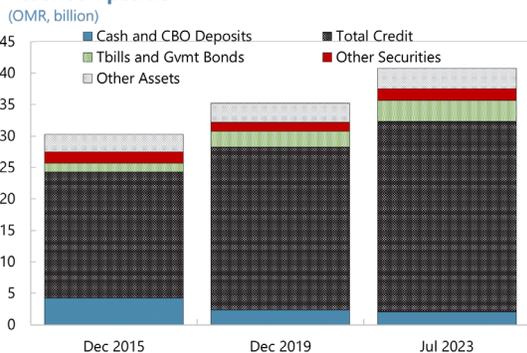
9. Banking sector concentration is moderate but projected to increase under the impact of recent merger, while net interest margins are among the highest in the GCC. The banking sector is somewhat concentrated with the third largest concentration in the GCC (Figure 3). The recent merger of Sohar International Bank and HSBC Oman and potential additional banking sector consolidation may increase concentration further against the backdrop of elevated net interest margins (Figure 4). Achieving economies of scale while preserving competition therefore remains a priority.

³ After the merger of Sohar International Bank and HSBC Oman, the newly merged bank is a potential candidate for being classified as second DSIB in the country.

⁴ Domestic government bond holdings cannot exceed 55 percent of net worth.

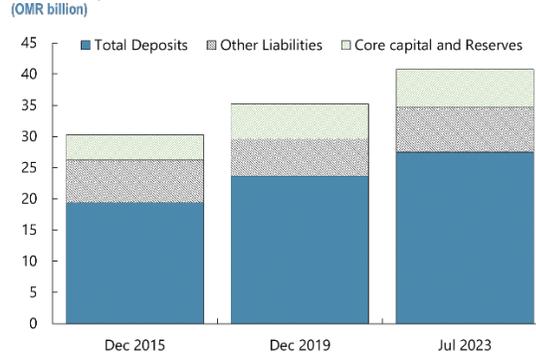
Figure 2. Banking Sector Overview

Asset Composition



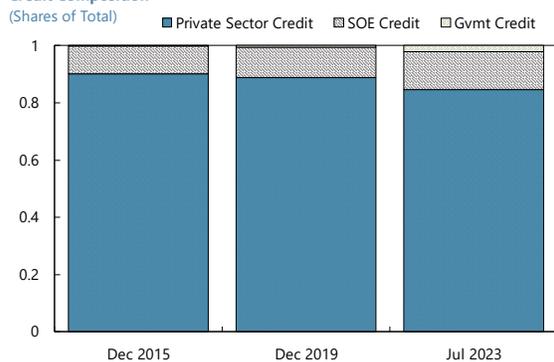
Sources: CBO and IMF staff calculations

Liabilities Composition



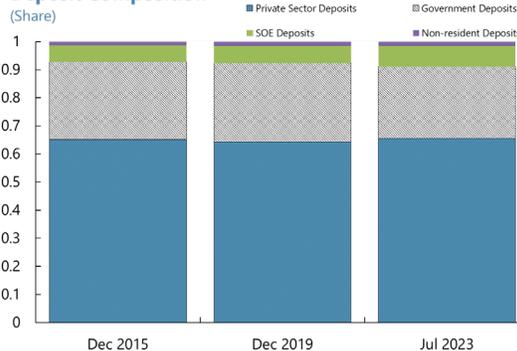
Sources: CBO and IMF staff calculations

Credit Composition



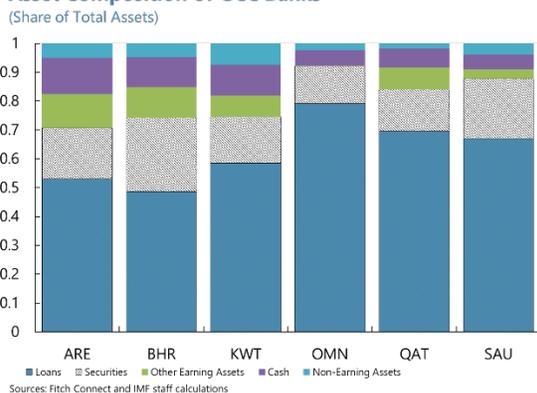
Sources: CBO and IMF staff calculations

Deposit Composition



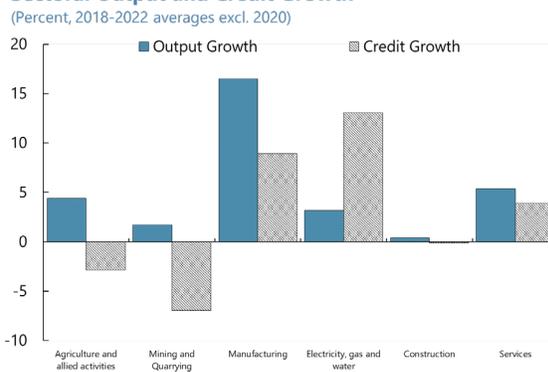
Sources: CBO and IMF staff calculations

Asset Composition of GCC Banks

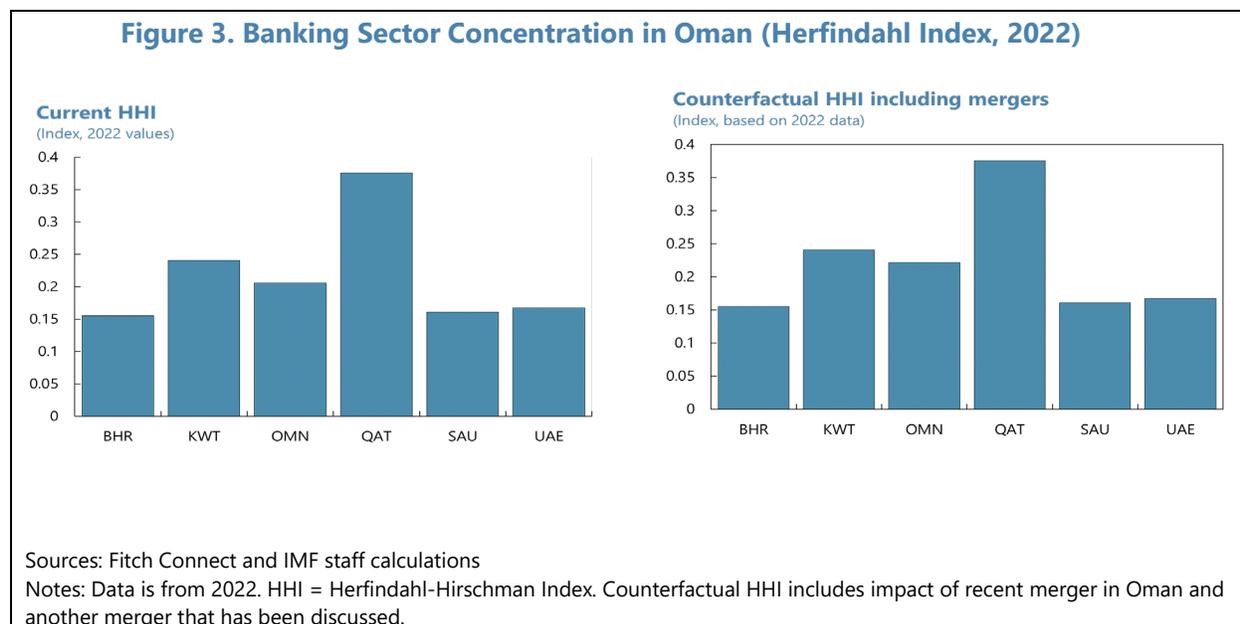


Sources: Fitch Connect and IMF staff calculations

Sectoral Output and Credit Growth



Sources: CBO, Haver Analytics, and IMF staff calculations



10. Despite some of the highest net interest margins in the region, the profitability of Omani banks is weighed down by elevated costs. Omani banks’ net interest margins of close to 3 percent are leading the GCC (Figure 4, Panel A) alongside Saudi Arabia. Profitability, measured by return on assets, however, ranks below Qatar, Saudi Arabia, and the United Arab Emirates (Figure 4, Panel B). A main driver of this difference are Oman’s comparatively elevated overhead costs and non-interest expenses (Figure 4, Panel C-D). Cost efficiencies could be achieved by exploiting economies of scale and accelerating the digitalization of the sector.

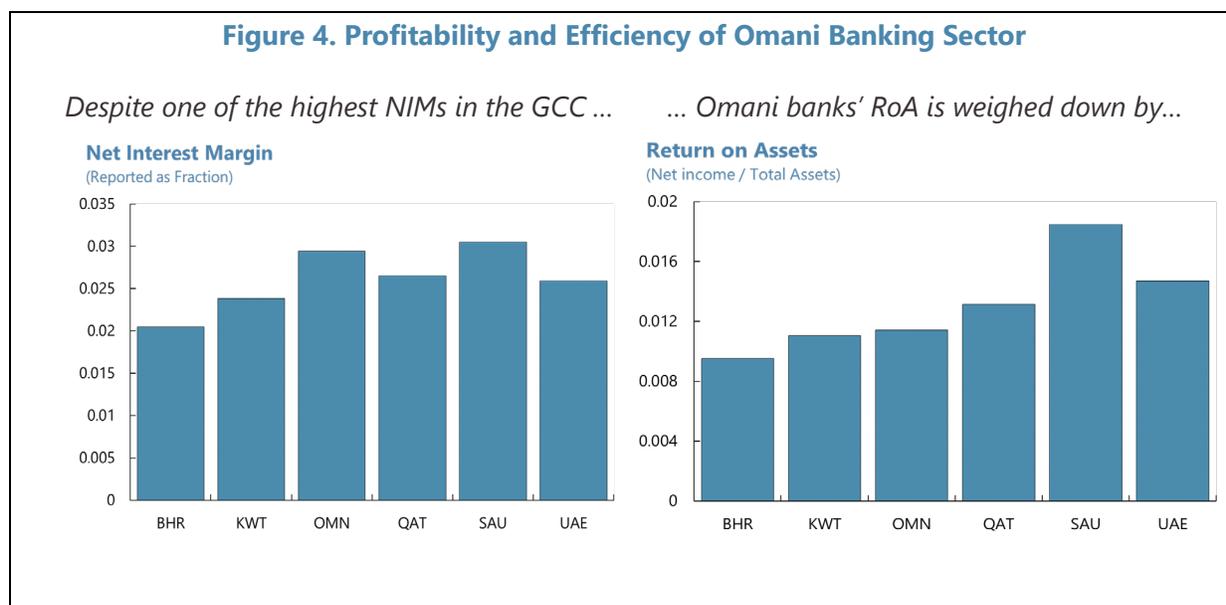
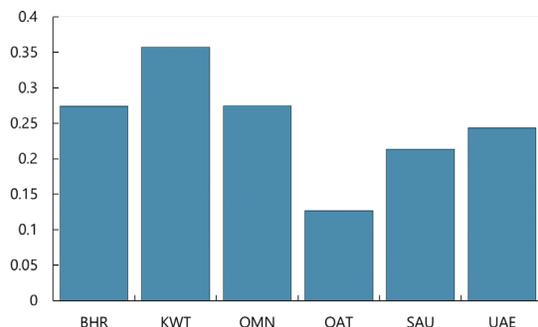


Figure 4. Profitability and Efficiency of Omani Banking Sector (concluded)

... elevated cost-to-operating income ratios.

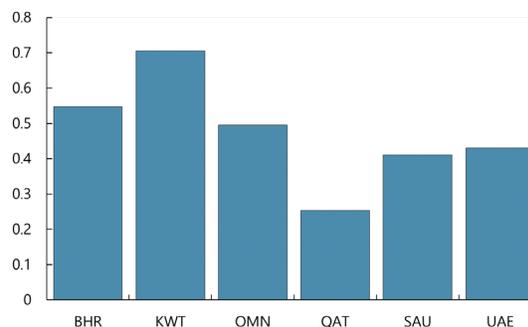
Overhead Costs/ Operating Income

(Ratio)



Non-interest Expenses/ Operating Income

(Ratio)



Sources: Fitch Connect and IMF staff calculations

Notes: Data is from 2022. Figures are reported as median across banks within each country.

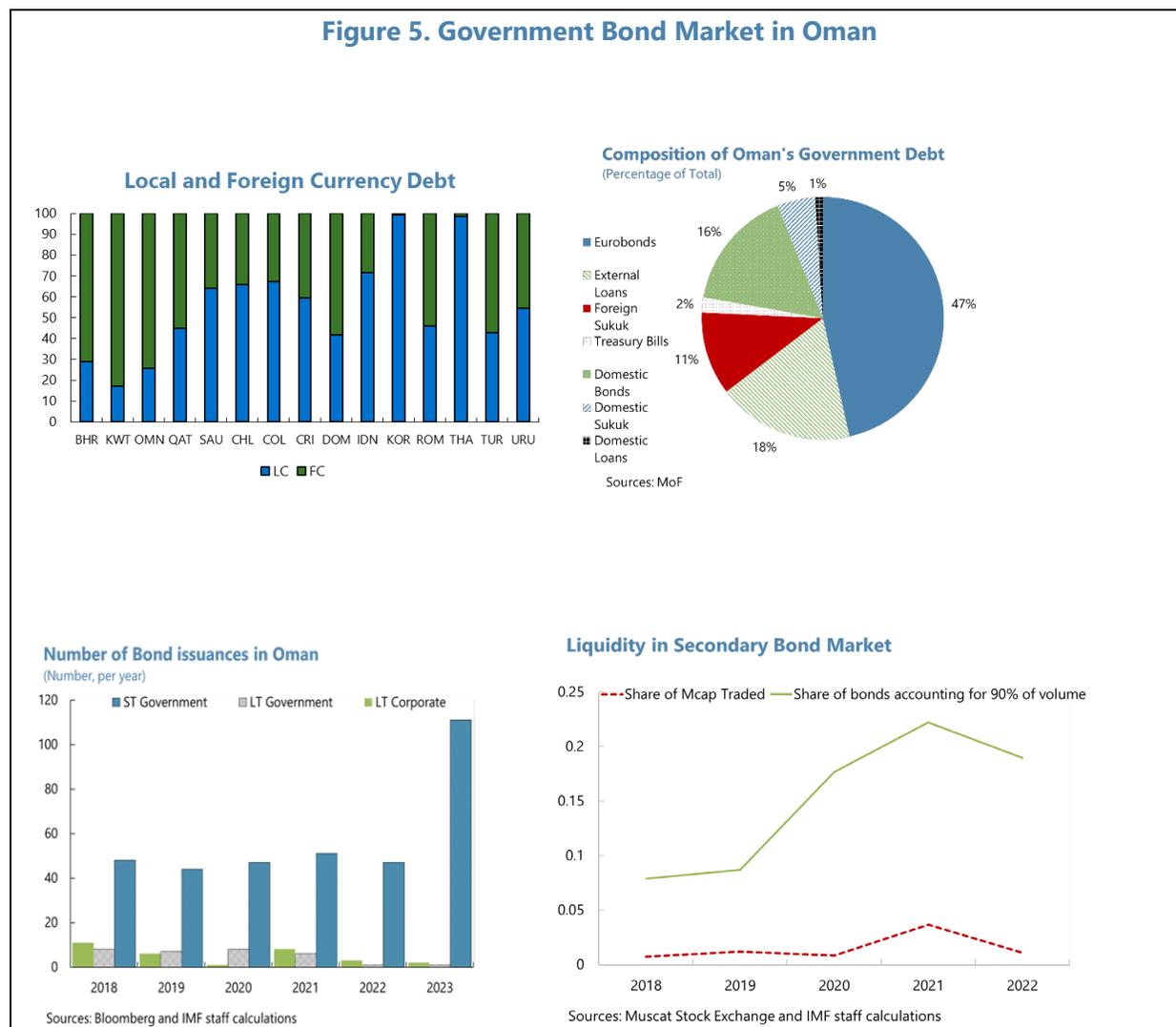
Fixed Income Markets

11. Well-functioning and liquid fixed income markets form the bedrock of a well-functioning financial system. Government bond markets with issuances of various maturities and sufficient liquidity across the yield curve establish a risk-free benchmark rate for the pricing of riskier financial assets. The Omani authorities are currently developing their local currency bond market following recommendation from a recent MCM TA, with several preliminary steps requiring completion before a primary dealer system for the secondary market can be established. This can in turn pave the way to the development of asset-backed securities and corporate bond markets.

12. Fixed income markets in Oman remain small and illiquid due to very limited secondary market trading. Relative to other countries in the region and emerging markets, Oman has a very low share of local currency government debt at 26 percent, split between conventional bonds (government development bonds), sukuks, and some Treasury bills (Figure 5, Panel A). Irregular issuances especially at longer maturities (Figure 5, Panel D), lack of benchmarks, absence of secondary market trading, and impediments to non-resident participation further hold back domestic fixed income markets (IMF 2023). As a result, secondary market activity in corporate bond markets⁵ and sukuks is also subdued. While the share of bonds traded in the secondary market has increased over the past five years, total secondary bond market trading accounted for 1.1 percent of market capitalization over the entire year of 2022 (Figure 5, Panel C). In July 2023, total secondary bond market trading on the Muscat Stock Exchange amounted to OMR 18 million relative to a market capitalization of OMR 4.4 billion. The average bond or sukuk traded 18 times in 2022, with

⁵ The vast majority of corporate bond issuances in Figure 5, Panel D are from financial sector firms.

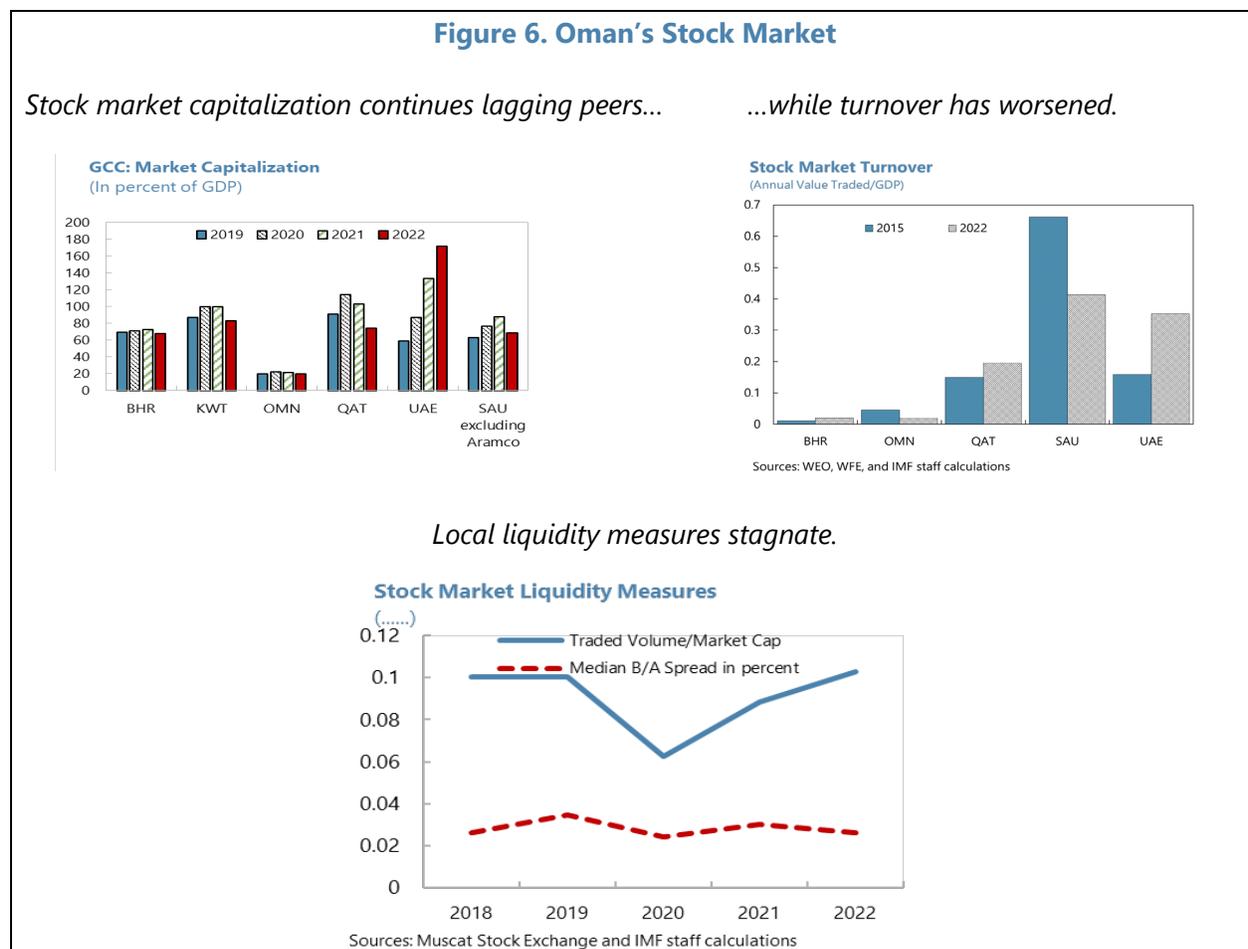
trading concentrated, however, in a few issuances: 19 percent of bonds accounted for 90 percent of transaction volume in the secondary market while 22 out of 58 bonds did not trade at all.



13. The development of the local currency government bond market is a key pillar for financial market development. Recommendations from the recent MCM TA include more regular and predictable issuances, developing money markets at the short end of the yield curve, and implementing a medium-term debt management strategy. To mitigate crowding-out of domestic bank credit, broadening the investor base in the government bond market will be critical, including insurance groups, the new consolidated pension fund, and other sources of demand. This could be achieved by incentivizing the development of life insurance products and further expand labor force participation. Eliminating barriers to non-resident participation such as the requirement that all secondary market transactions must go through a broker—rather than OTC—and facilitating the integration to Euroclear could further contribute to diversifying the investor base. In the longer run, efforts to gain eligibility to widely tracked emerging market bond indices could attract passive investors.

Stock Market

14. Stock market capitalization in Oman persists at low levels. At the end of 2022, stock market capitalization stood at \$22 billion (19.4 percent of GDP), far behind other stock markets in the region (average of 93.1 percent of GDP)⁶ and emerging markets. New listing activity over the past decade has remained subdued as most IPOs since 2010 ranged below OMR 60 million in volume. One factor limiting growth in the number of listed firms has been the large share of SOEs and of closely held companies.



15. Persistent low liquidity, exemplified by low turnover and elevated bid-ask spreads, hampers secondary stock market trading and non-resident participation. Oman’s stock market traded value as a share of GDP reached 2 percent in 2022, the lowest in the GCC, and it has declined compared to 2015. Since 2018, stock market liquidity measures have not improved (Figure 6, Panel C). Yearly traded volume continues to account for about 10 percent of market capitalization. While

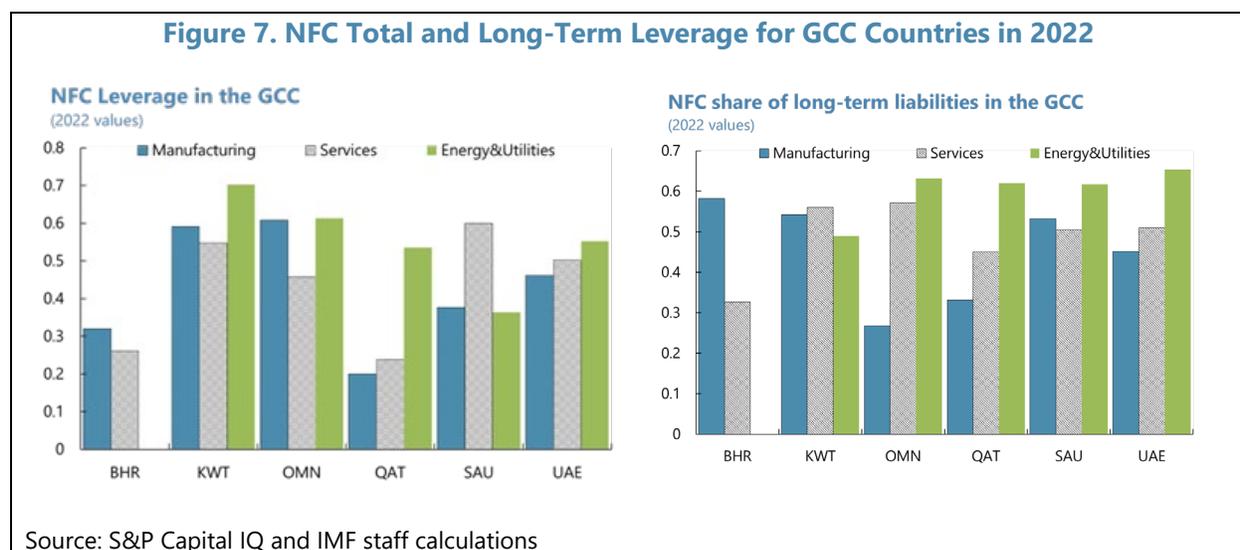
⁶ For Saudi Arabia, stock market capitalization was computed net of ARAMCO to mitigate the impact of a single company on the overall figures.

the median bid-ask spread stood at 2.6 percent in 2022, somewhat down from 3.4 percent in 2018, it remains significantly higher than bid-ask spreads for other emerging markets.⁷

16. To play a more prominent role in the future, the stock market will require more depth and increased non-resident participation while exploiting synergies with the development of other markets. The planned listing of several state-owned enterprises over the coming years could contribute to growing the size of the market while Oman's Capital Market Authority should seek to attract more non-resident participation. Satisfying the criteria for inclusion to widely used emerging market equity indices is one step to increase foreign inflows. Stock market development will also likely benefit from the development of debt capital markets as improved liquidity and depth of both markets will facilitate portfolio allocation for investors between safe and riskier securities. Jointly, these steps can pave the way towards introducing further investment vehicles, including exchange-traded funds or futures contracts, in the longer run.

Corporate Financing

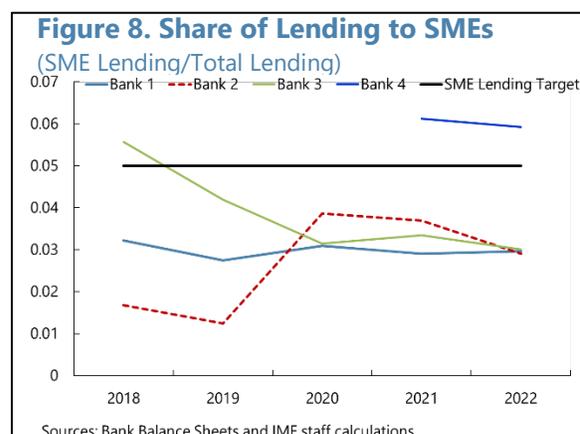
17. Oman's non-financial corporations (NFC) have among the highest leverage in the GCC, yet short-term funding dominates in some sectors. Omani firms are among the most levered in the GCC with publicly listed firms in the manufacturing and energy sectors reaching a ratio of debt to assets of 0.6, above the average for the region (Figure 7, Panel A). In the manufacturing sector, however, most funding is short-term. The share of long-term debt in total debt only stands at about 20 percent, the lowest among the entire GCC (Figure 7, Panel B), suggesting that the provision of long-term debt instruments can be further expanded.



18. While credit has continued to grow strongly in the past year, only a small share goes to SMEs. Credit growth stands at about 7 percent (y-o-y) in the first half of 2023, yet banks continue to

⁷ Corwin and Schultz (2012) estimate bid-ask spreads in India between 1 and 2 percent for the pre-GFC period.

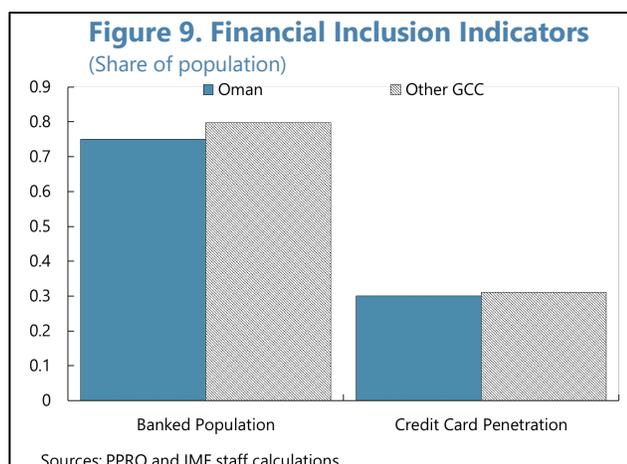
miss the target of 5 percent of lending to SMEs. Amidst time-invariant effective lending rates (see Selected Issues Paper on Monetary Policy Transmission) and low risk appetite, credit access for SMEs remains a challenge. Close to two-thirds of credit flow to either personal loans, SOEs, or listed companies. At the same time, most banks continue to miss the target for SME lending (5% of total lending) and SME lending as a fraction of total lending has declined for several institutions over the past years (Figure 8).



19. Continued development of local debt capital markets could therefore be an important avenue to provide more long-term funding to non-financial corporations while freeing up bank credit for SMEs. Development of debt capital markets in the medium term, including the corporate bond market, can provide additional sources of debt funding for large private corporations with market access. Reduced bank reliance by large corporations would enable the banking sector to strengthen its exposure to corporations without market access, in particular SMEs.

Other Aspects

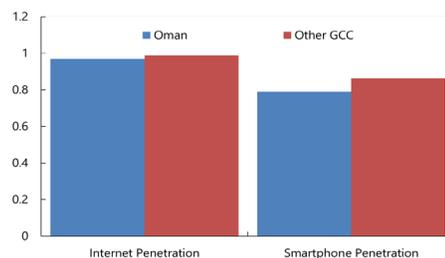
20. With 75 percent of the population banked, Oman could further progress on financial inclusion. Oman's share of banked population and credit card penetration range in the middle of the GCC (Figure 9), which as a region, however, lags countries of similar levels of development in financial inclusion (IMF, 2022a). Further progress, including on promoting access to finance for women and the rural population, could increase savings and allow financial institutions to intermediate savings to investment opportunities. With close to full Internet penetration (at 97 percent) and new e-KYC guidelines, FinTech and digital payment solutions could play a stronger role in achieving financial inclusion targets.



Box 1. Fintech in Oman

Fintech has been growing rapidly around the world and with a young and digitally savvy population, Oman may be well positioned to develop its Fintech sector. Over the past decade, increased connectivity amid rapid advances in Internet penetration and the rapidly declining cost of computing power have fueled the growth of fintech (World Bank, 2022). In the GCC, the number of fintech companies is growing rapidly after several countries launched regulatory sandboxes (IMF, 2022a). With its young population—24 percent of the population are between 15 and 29 years old—and high Internet and smartphone penetration (Figure B1), Oman satisfies important prerequisites for developing fintech.

Digital Connectivity
(Share of population)



Sources: PPRO and IMF staff calculations

The CBO's Fintech Regulatory Sandbox launched in December 2020 follows in the footsteps of several GCC peers. Three cohorts have started with a focus on digital wallets, blockchain technology for trade finance, and alternative financing methods. The next cohort in 2024 will work on open banking solutions. In the future, dedicating one cohort to SME financing solutions could foster innovation in a market segment that has been traditionally underserved by the domestic banking sector.

Facilitating access to capital, setting regulatory frameworks, and fostering human capital will create the conditions for Fintech growth and facilitate industry-led approaches. Recent education initiatives, such as the creation of a dedicated Fintech certificate in higher education, will need to continue to develop sector-specific human capital at the intersection of finance and computer science. Financial sector development can further promote industry-led approaches in fintech. More liquid equity markets with more IPOs will be important to provide exit options to fintech founders and their investors. In combination with private initiatives and increased OIA funding for venture capital, this can contribute to growing Oman's small venture capital sector.^{17F} Throughout, authorities will need to ensure that adequate regulatory and supervisory frameworks are in place to foster financial innovation while ensuring customer financial protection and safeguarding financial stability in the wake of potentially disruptive financial innovation.

^{17F} Industry figures report a total of 11 venture capital deals for a total volume of \$3.5 million for Oman in 2022 relative to \$907 million in Saudi Arabia, \$36 million in Qatar, and \$26 million in Jordan.

D. Addressing Policy and Regulatory Gaps

International Practices

21. Successful financial market development hinges on the right sequencing of reforms, while exploiting synergies. Many emerging economies aim to transition from an initially bank-dominated financial system towards a multi-pronged one. Chami et al. (2010) emphasize the foundational role of the government bond market in providing a risk-free asset and hence, a risk-free rate. Developing the yield curve of government bonds can serve as a steppingstone to develop a repo market and markets for asset-backed securities and covered bonds before developing commercial paper and corporate bond markets. Financial market development will need to exploit synergies and interdependencies to maximize success. For example, the development of the repo

market increases demand for government bonds and can foster secondary market trading (BIS 2020). Hence, the development of the latter can be accelerated by the former. Likewise, fostering venture capital and equity market trading can reinforce each other. Venture capital funding is unlikely to occur in the absence of a well-developed IPO market, which in turn relies on liquid secondary equity markets. Hence, simultaneously developing different markets is critical.

22. Financial market development requires an evolution of banks' business models. As capital markets grow and large corporations gain direct capital market access, banks' traditional lending business would shrink. To offset lost income, banks will need to expand the scope of their operations to include securities underwriting, liquidity provision through market making, or wealth management. Financial market development will only succeed if banks face the right incentives to alter their business model. Otherwise, the initial bank-based financial system is likely to prevail. A mix of direct incentives for domestic banks, potentially complemented with increased competition by foreign institutions, can achieve the evolution of the banking sector.

23. In practice, development of local bond markets coupled with increased non-resident participation has been pivotal for financial market development. Domestic bond markets are the cornerstone of the financial development agendas in many EMs (e.g., Malaysia, Mexico, Thailand–BIS 2020).⁸ More predictable and transparent issuances at benchmark maturities have proven successful in Mexico and Thailand (BIS, 2020). In several countries, such measures have been combined with repo market development (e.g., Hungary, Malaysia, Mexico, Thailand) to initiate more secondary market trading in government securities. Specific policies include adopting the standards of the General Master Repurchase Agreement and fostering repo market activity in private markets, rather than repos intermediated by the central bank. Taking steps towards inclusion in widely used emerging market indices can further increase non-resident participation as seen in Colombia or Mexico.⁹

24. The development of deeper and more diversified capital markets needs to be complemented with adequate supervision and regulation. As capital markets grow, large corporations increasingly substitute from bank borrowing towards direct issuances, while banks reallocate those funds towards SMEs. More liquid, deeper, and less concentrated capital markets with a broader investor base have multiple potential benefits ranging from lower sovereign yields (e.g., Colombia), greater total credit provision (e.g., Poland), and diversification of bank lending towards SMEs (e.g., Malaysia). Monetary policy passthrough has also strengthened in several countries that have undergone active financial market development, including Colombia, Indonesia, Korea, Mexico, and Thailand (BIS, 2020) as interest rates in more liquid financial markets become more sensitive to the policy rate. Regulators and supervisors need to update their frameworks adequately as financial

⁸ For example, growing and diversifying domestic bond markets was a core pillar of Malaysia's Financial Sector Master Plan from 2001-2010 (IMF 2014).

⁹ Similarly, non-resident participation in equity markets can benefit from the inclusion in such indices, e.g., MSCI Emerging Markets Index, as in the case of Saudi Arabia's Tadawul exchange (BIS, 2020).

markets develop to mitigate financial stability risks, including from increased non-resident participation which can increase vulnerabilities from capital outflows.

Box 2. International Best Practices for SME Financing

Several countries around the world have resorted to targeted measure to improve SME access to finance beyond capital market development. While developing financial markets and providing financing alternatives for large corporates will free resources for SME lending in the long-run, additional policies are needed to improve access to finance in the short and medium term. This ensures SMEs have access to adequate funding that enables them to grow and boost economic growth.

Credit reporting can provide critical information to evaluate SME creditworthiness. A significant impediment for SMEs' access to finance is the lack of established hard information about their financials and business prospects. Hence, they require closer relationships with potential lenders, which in turn can impose additional costs on the lender. Easily accessible credit registries can facilitate access to credit information on SME for lenders for the purpose of credit scoring. In a cross-country study, Martinez Peria and Singh (2014) show that the introduction of a credit registry raises the likelihood that a firm has access to finance by 7 percentage points, leads to a 5-percentage-point drop in interest rates, and 7 months longer maturities. Customized products for SMEs have been introduced in some countries. For example, a Chilean credit bureau developed an SME credit score based on encrypted mobile data that supplements information from the traditional credit database (World Bank, 2018).

Secured lending and alternative financing mechanisms such as leasing and factoring can further support SME lending. Given the higher opaqueness of SMEs, secured lending can alleviate information frictions between lenders and SME borrowers. Collateral registries with notice-based registration and online access provide a unified source of information for lenders. Financing and maintaining a consistent cash flow are among the largest challenges for SMEs (World Bank, 2018). Factoring—the selling of accounts receivable to receive an immediate cash flow—can alleviate those liquidity challenges. In Mexico, for example, Nacional Financiera—a development bank institution—provides factoring and reverse factoring services. SMEs can thus use accounts receivable from large clients to secure loans. Interest rates for factoring services are capped at 7 percentage points above the bank rate, a rate significantly below the average commercial bank interest rate (World Bank, 2018).

Promoting FinTech solutions for SME funding can enhance financial inclusion for firms without access to the conventional banking system. The development of Fintech as an alternative financing solution can complement steps to increase financial inclusion of SMEs into the formal banking system. Examples include equity-based crowdfunding (e.g., Eureeca in the UAE), peer-to-peer business lending, and invoice lending (IMF, 2019). While the government can provide guardrails for fostering the fintech environment, for example by setting regulatory and legal frameworks, successful FinTech development will ultimately hinge on private sector initiatives.

These steps need to be accompanied by structural policies to aid SME access to finance. Oman satisfies several of the macroeconomic criteria that are associated with facilitating SME access to finance in IMF (2019) including macroeconomic stability, financial sector soundness, and financial regulatory and supervisory capacity. Maintaining a competitive banking sector and reducing the public sector footprint in the economy (to limit crowding out of SMEs) will further support efforts to enhance credit access for SMEs (s. IMF, 2019).

Policy Recommendations to Foster Financial Development

25. Oman’s Vision 2040 requires substantial financial market development to support the funding needs of a diversified economy. The current financial system is centered around domestic banks, features a substantial government footprint, is characterized by low liquidity, and provides very limited SME funding. Authorities’ diversification plans to unlock sustained growth from non-hydrocarbon activities require a deeper, more liquid, and larger financial sector. Successfully developing financial markets will depend on structural financial sector reforms and successful coordination with other policy areas, particularly government debt management.

26. Developing local capital markets requires a proper sequencing of reforms. To that end, reform recommendations regarding fixed income markets should be phased appropriately. There should be at least two phases of reform.

27. In Phase 1, the key priorities should be continued development of local currency bond markets to improve market liquidity. The first step consists of developing local currency government bond markets, in particular secondary market trading, to establish a benchmark yield curve. Priorities include deepening the market by developing the NBFIs¹⁰ and facilitating non-resident participation, removing regulatory hurdles, such as the cap on government bond holdings, and introducing a market maker system. The repo market should be developed alongside the government bond market as it can create additional demand for government bonds and invigorate secondary market trading. The authorities may consider adopting the Global Master Repurchase Agreement (GMRA) to standardize transactions and encourage private market repo activity that is not intermediated by the central bank. Throughout, reform efforts need to be consistent with government debt management. A medium-term debt management strategy and predictable issuances at benchmark maturities facilitate participation, especially for new market participants.

28. In Phase 2, after establishing a benchmark yield curve, markets for riskier securities can be developed, including corporate bond and equity markets. Unlocking these alternative funding sources for corporations allows to reduce bank dependence of large corporations, which in turn frees up resources for SME lending in the banking sector. The development of markets for riskier debt securities can proceed with covered bonds or asset-backed securities. As riskier fixed income securities are getting priced, this will facilitate the emergence of the still nascent corporate bond market in Oman, providing more large corporates with direct debt market access and thus freeing banking sector resources for SME lending. Broadening the investor base to include domestic NBFIs and non-residents is essential to ensure that capital market development does not result in crowding out of corporate credit.

29. Under the impetus of the planned listing of several SOEs, the equity market would likewise benefit from increased secondary market activity to attract a broader investor base.

¹⁰ The insurance sector remains underdeveloped but could provide an important source of demand for longer-dated bonds as those naturally match the liabilities profile of life insurance companies.

Satisfying the criteria for inclusion to widely used emerging market equity indices will attract greater non-resident participation.¹¹ While broadening the investor base is desirable to achieve investor diversification and mitigate crowding out of bank credit, regulators need to remain mindful of financial stability implications by adapting their regulatory frameworks and increased monitoring of NBFIs and foreign investors. One example is the recently issued framework for cybersecurity and resilience.

30. The banking sector will benefit from relaxing regulatory constraints and achieving cost efficiencies while maintaining healthy competition. The development of debt capital markets will enable banks to re-allocate lending towards SMEs. Authorities should consider relaxing or removing the current cap on government bond holdings. Since it only applies to the gross stock of government bonds, the cap is unlikely to be effective at mitigating crowding-out of private credit. Instead, the cap should either target net exposures (e.g., government bond holdings and loans to the government net of government deposits) or flows rather than stocks. Relaxing the interest rate cap on personal loans would allow to adequately price risks, maintain margins, and improve access to credit for private sector employees. To be successful, a relaxation of the interest rate cap will hinge on increased usage of the credit registry (Mala'a), which is currently being developed into a full-fledged credit bureau. Against the backdrop of ongoing banking sector consolidation, efficiency and cost gains from larger bank scale need to be balanced against rising market power and systemic risks.

31. Improving SME's access to finance and promoting fintech can further contribute to deepening the financial sector and diversifying the economy. Facilitating factoring and secured lending for SMEs can bridge information asymmetries, alleviate cash flow shortfalls, and facilitate credit provision by the formal banking sector. New fintech businesses can complement the development of debt capital markets and resulting reallocation of bank funding to support growth of SMEs and the non-hydrocarbon sector. Investors can benefit from a well-designed SME credit guarantee scheme with the objective to provide third-party credit risk mitigation to lenders to stimulate debt financing to SMEs (IMF, 2022). Throughout, authorities should consider exploiting synergies between different financial market development measures.

¹¹ The MSCI Emerging Market Index already features 4 of the 6 GCC economies. Saudi Arabia reports a substantial pickup in inflows after inclusion to the index (BIS, 2020).

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LIFTING PRODUCTIVITY IN OMAN: THE ROLE OF STRUCTURAL REFORMS¹

Oman's potential nonhydrocarbon real GDP growth has trended downward since the global financial crisis, with a negative contribution from total factor productivity. This paper estimates productivity gains associated with structural reforms and identifies key binding constraints and reform priorities to boost productivity in Oman. Our results show that reforms to reduce the state's footprint and strengthen institutions, as well as product market reforms, should be prioritized and packaged together to magnify productivity gains from labor market and financial sector reforms. These findings could inform the planning and implementation of the ongoing structural reform agenda envisaged under Oman Vision 2040.

A. Context

1. **Oman has made significant strides in advancing economic development and improving living standards, but the hydrocarbon sector continues to dominate economic activity.**

Supported by large hydrocarbon production and favorable oil prices, average GDP per capita in Oman increased from \$7,700 in the 1990s to \$14,800 in the 2000s and further to \$20,700 in the 2010s. Nevertheless, the hydrocarbon sector continues to dominate economic activity, while nonhydrocarbon activities remain subject to fluctuations in oil prices and are hampered by low productivity. The share of hydrocarbon exports in total exports remains large at about 65 percent, and hydrocarbon activities constituted more than 37 percent of total output in 2022. At the same time, productivity trends have been declining, reflecting a largely segmented labor market, with negative implications for nonhydrocarbon growth.

2. Oman is striving to diversify its economy and strengthen nonhydrocarbon growth. The severe shocks in oil markets (2014–15 and 2020) and the energy transition ahead have raised the urgency of accelerating the implementation of a comprehensive reform agenda to create a more resilient economy that is less dependent on hydrocarbon windfalls. In this context, the authorities designed a broad-ranging economic strategy, Oman Vision 2040, with numerous initiatives to strengthen economic resilience and lay the foundations for diversified and sustainable private sector-led growth. Structural reforms in key areas—such as the business environment, labor markets, social protection, and the financial sector—are ongoing, with several at the implementation stage.

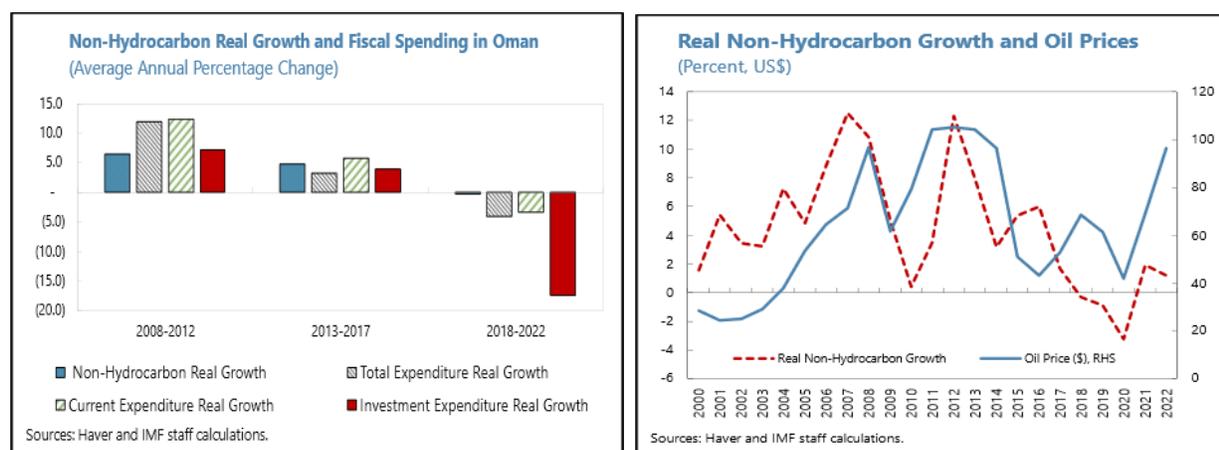
3. This paper assesses key binding productivity constraints and identifies structural reform priorities that can help boost productivity and potential nonhydrocarbon GDP growth in Oman. To do so, it estimates potential productivity gains from structural reforms over the short to medium term and examines appropriate packaging and sequencing of such reforms to magnify productivity and growth dividends. This paper is structured as follows. Section II provides selected stylized facts on the Omani nonhydrocarbon economy and productivity trends. Section III empirically

¹ Prepared by Haytem Troug and Muayad Ismail

estimates productivity gains from implementing structural reforms under different scenarios. Finally, policy recommendations are discussed in section IV.

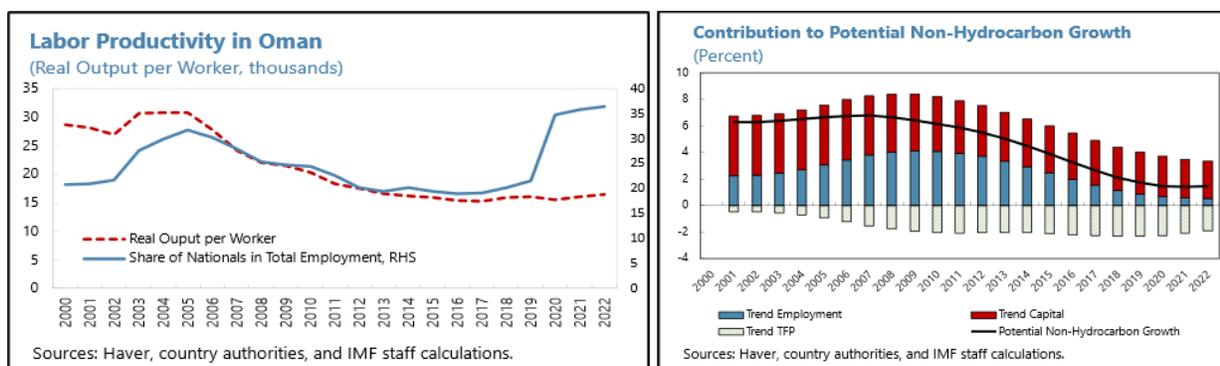
B. Stylized Facts

4. Nonhydrocarbon real GDP growth in Oman has been strongly correlated with government spending and exhibited high oil price-driven volatility. Government expenditures have been Oman's main engine of growth, with significant spillovers to nonhydrocarbon activities. Specifically, while government investment expenditure has played a more direct role in supporting nonhydrocarbon activities in Oman (mainly through construction and infrastructure projects), government spending on wages and subsidies has also contributed to stimulating aggregate demand and nonhydrocarbon output. Nonhydrocarbon growth has been exposed to high volatility in oil prices through government spending. This underscores the need to press ahead with structural reforms to boost private sector-led growth to strengthen the sustainability and resilience of nonhydrocarbon growth and mitigate any potential negative spillovers from the ongoing efforts to rationalize government spending.

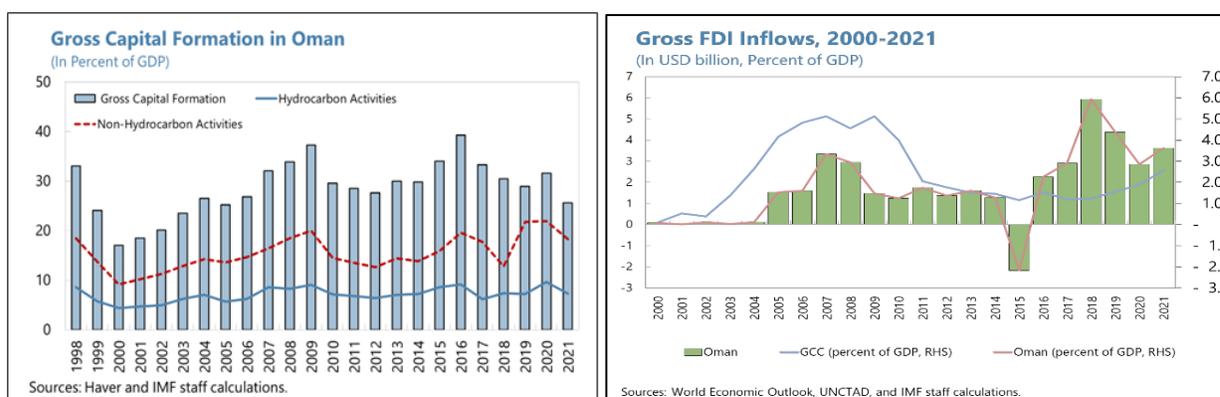


5. Potential nonhydrocarbon growth in Oman has slowed, primarily driven by declining productivity and subdued trend employment growth. Total Factor Productivity (TFP) growth has generally declined in the aftermath of the global financial crisis in many emerging markets and developing economies owing to, among other factors, a slowing pace of structural reforms (Adler and others 2017). For Oman, despite efforts to level the playing field between the public and private sectors, the labor market remains segmented, reflecting higher wages, benefits, and job security in the public sector relative to the private sector (IMF 2022). As a result, the public sector has been a desirable destination for Omanis. The wage differential between public and private sector jobs has distorted incentives and allocation of resources in the labor market, particularly in mid- to low-skill jobs, with negative implications for productivity. This has culminated in negative contributions of TFP to potential nonhydrocarbon growth and amplified the effects of the declines in trend growth of

employment and capital investment.² Relatedly, potential nonhydrocarbon growth has been driven by factor accumulation rather than productivity improvements. This suggests that there is scope for structural reforms to boost productivity and amplify the gains from the ongoing diversification agenda in Oman.



6. Gross capital investment in Oman has declined in recent years, but foreign direct investment (FDI) inflows surged in 2018 and have remained elevated since. Nonhydrocarbon investment has been relatively volatile and highly concentrated in non-tradable activities, specifically construction and services.³ This high concentration in labor-intensive activities has limited the scope for capital investment. On the other hand, ongoing efforts to attract FDI, including the removal of capital requirements and limits on foreign ownership, are bearing fruit in the form of increased FDI inflows in recent years, albeit with more than half of total FDI still directed toward the oil and gas sector in 2021 (NCSI 2022). Accelerating structural reforms can help attract and diversify domestic and foreign investment.



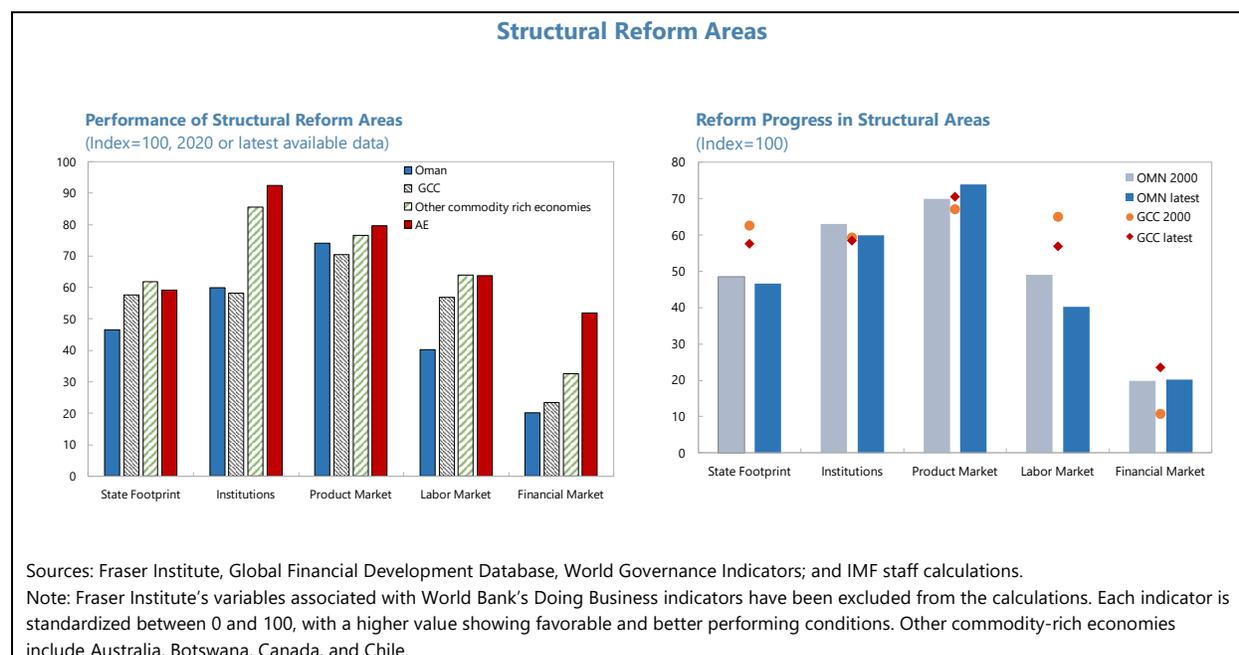
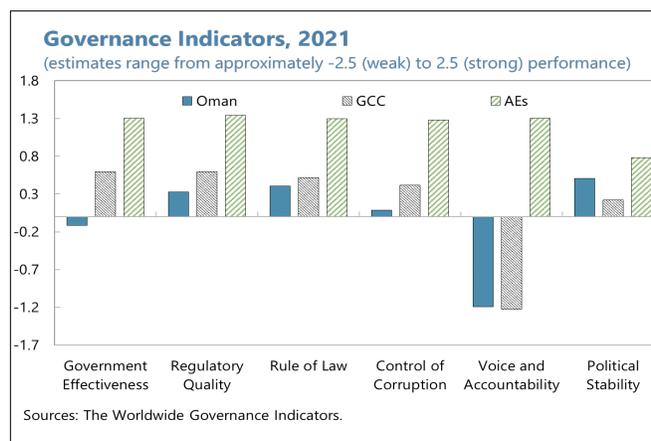
² Potential nonhydrocarbon GDP is estimated based on the Cobb-Douglas production function approach with constant labor share, where potential output is decomposed into capital, labor, and total factor productivity (TFP). Nonhydrocarbon capital is estimated based on the perpetual inventory method, where initial capital stock is assumed to increase with nonhydrocarbon capital formation while accounting for depreciation.

³ The rent-seeking nature of the labor market in Oman has contributed to the expansion of labor-intensive sectors with low productivity.

C. The Role of Structural Reforms

7. Oman has made limited progress in key structural areas over the past two decades, broadly in line with regional trends.

Staff constructed structural indicators to assess reform implementation in state footprint, institutions, product markets, labor markets, and financial sector (see Annex I for details). Although Oman has progressed in some areas, sizable reform gaps remain vis-à-vis peers and advanced economies. Notably, Oman has improved its performance in the product market area and financial sector area, owing primarily to improvements in the business environment and business deregulation and the development of the financial sector (mainly the banking sector), albeit lagging the marked improvement in regional performance. In contrast, Oman’s performance in the areas of labor markets and institutional quality has worsened, mainly reflecting declines in labor market flexibility and government effectiveness.⁴ As a result, and despite progress in some areas, substantial and widening reform gaps remain between Oman and other comparator groups in most structural areas.

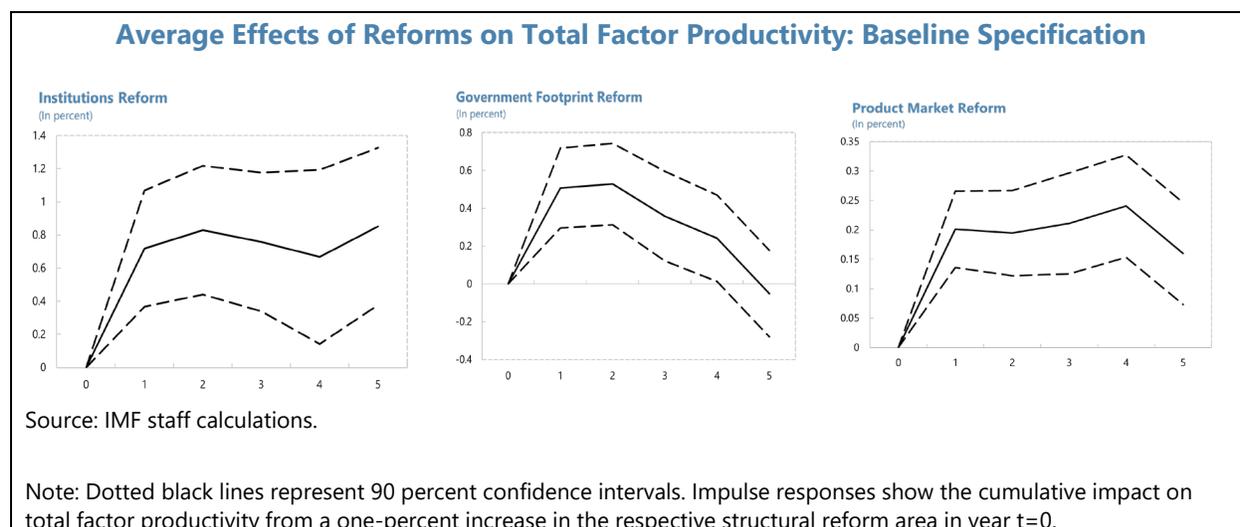


⁴ Government effectiveness measures the quality of the civil service and its independence from political pressure, the quality of public services, the credibility of the government’s commitment to its stated policies, and the quality of policy formulation and implementation, including the efficiency of revenue mobilization and budget management.

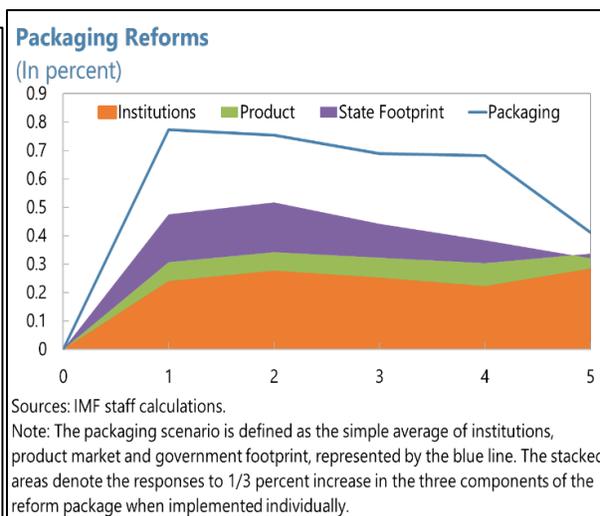
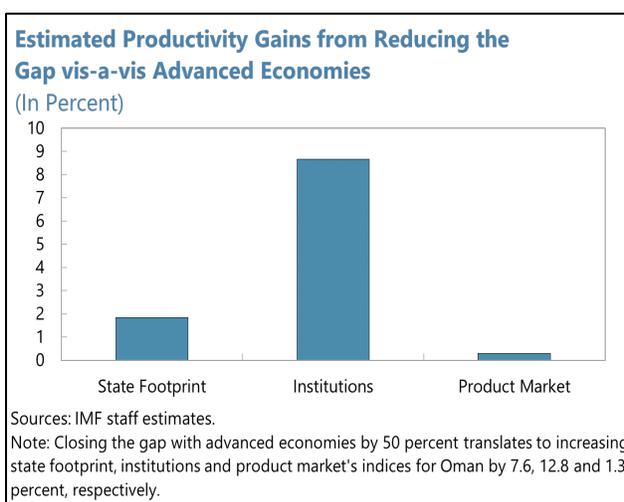
8. Institutional quality in Oman is well below the average for advanced economies, underscoring the need to scale up reform efforts to improve institutions to support investment and nonhydrocarbon growth. Specifically, Oman lags its peers in areas such as government effectiveness and control of corruption and regulatory quality. This suggests that Oman has further scope to improve the quality of its institutions, which would help attract FDI, improve productivity, and support nonhydrocarbon growth (Moers 1999; Thanh, Canh, and Schinckus 2019).

9. What could be the productivity gains of reducing structural reform gaps? We employ a local projections method to quantify these effects using panel data for 53 advanced and emerging market economies over 2000–19 in line with previous IMF work (IMF 2023a; IMF 2023b) (see Annex II for details). This methodology helps to identify reform areas that can generate the highest productivity gains in the short term while identifying those areas where productivity gains would take longer to materialize. We also conduct a similar exercise to quantify the potential productivity gains from reform packaging (the simultaneous implementation of multiple reform areas) or sequencing (the implementation of selected reform areas after sufficient progress in other areas).

10. Productivity gains from reform efforts differ across structural areas and over time. Impulse responses generally point to important productivity gains over the short term, with the short-term impact of institutional reforms being the highest among all structural reform areas. TFP is estimated to increase by 0.8 percent two years after reform efforts deliver a one-percent increase in the indicator of institutional quality. Similarly, reforms aimed at reducing the state footprint in the economy and enhancing product markets can generate productivity gains of about 0.5 percent and 0.2 percent two years after reform efforts secure a one-percent improvement in the respective structural indicators. Impulse responses also indicate that productivity gains under the baseline specification remain persistent and sizable in the case of institutional reforms and, to a lesser extent, in the case of product market reforms. Without reform packaging, productivity gains from reducing the state footprint are less persistent than institutional and product market reforms yet sizable. In contrast, baseline results indicate that productivity gains from financial sector and labor market reforms, on average, appear to be elusive both in the short and medium term, likely underscoring the need for proper reform sequencing (see below).

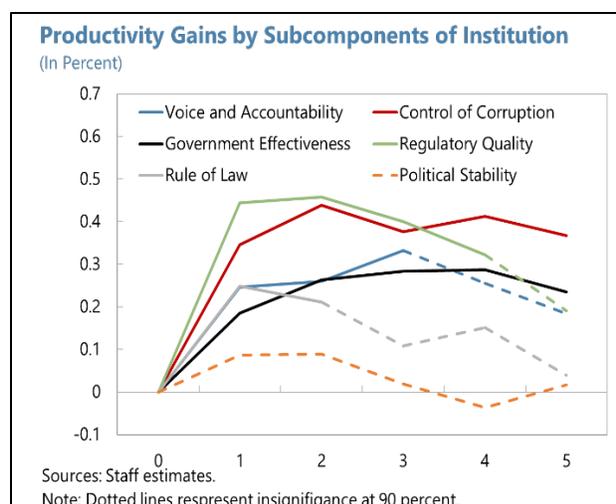


11. Reducing the institutional, state footprint, and product market gaps would yield substantial productivity gains for Oman. Staff analysis shows that if Oman were to reduce its existing institutional, state footprint, and product market gaps relative to the advanced economy average by half, TFP would increase by 3.6 percent, on average, four years after reform efforts. Implementing institutional reforms would lift productivity by more than 8.5 percent cumulatively over the medium term, primarily reflecting substantial productivity gains from strengthening regulatory quality, control of corruption, and government effectiveness. The large gaps in these areas in Oman and their strong statistical effect on productivity underscores the need to prioritize these institutional reforms. Product market reforms generate the lowest productivity gains among all three structural reforms, although still significant and increasing over the medium term. The small potential gains from product market reforms reflect the relatively smaller structural gap for Oman in this reform area.



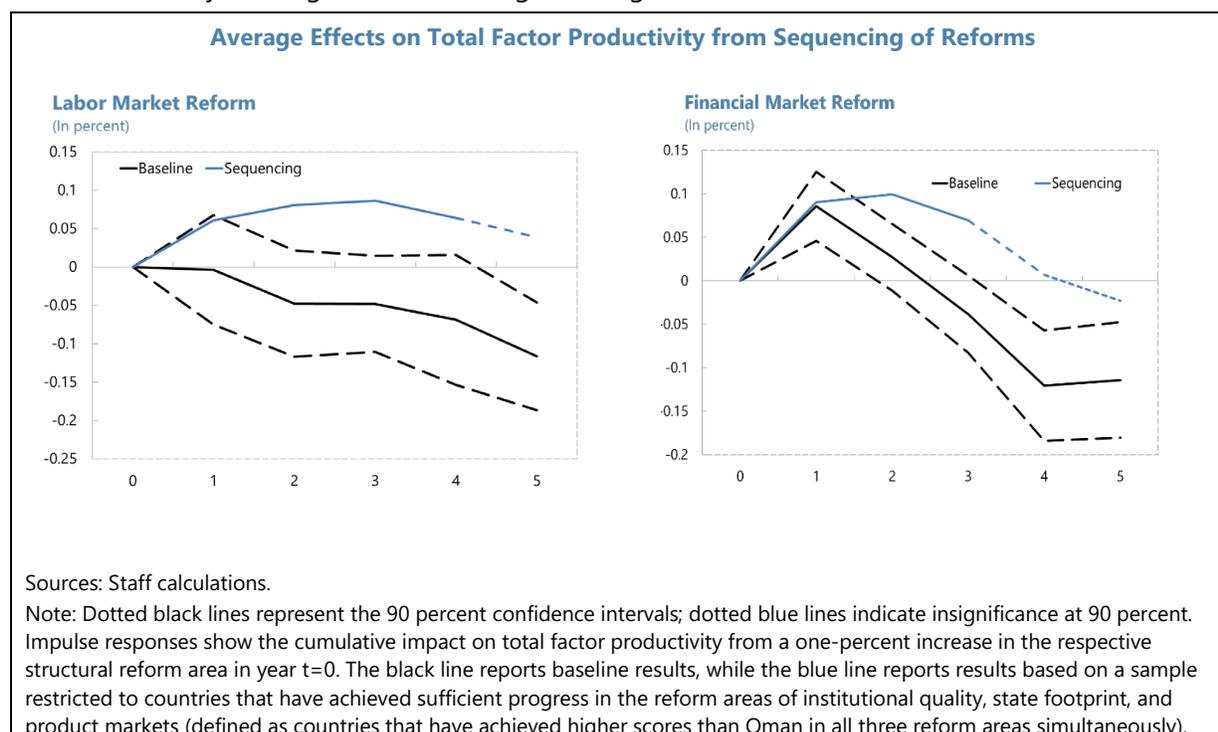
12. Implementing multiple structural reforms together can yield higher productivity gains than implementing them individually. We empirically examine the joint implementation (“packaging”) of various combinations of structural reforms to explore potential complementarities and synergies across structural reform areas.

The analysis suggests that a strategic bundling of structural reforms that jointly improves institutional quality, rationalizes the state footprint in the economy, and better regulates product markets would magnify the overall positive effect of implementing these reforms together, yielding higher productivity gains compared to the simple sum of productivity gains from implementing individual reforms. For instance, reducing the state’s footprint in the economy and leveraging digitalization would streamline government operations and improve



the efficiency of public institutions, allowing for a greater role for the private sector in the economy. For Oman, results show substantive productivity gains from packaging these three reform areas in a way that closes reform gaps vis-à-vis advanced economies by 50 percent simultaneously in each reform area. In this scenario, productivity gains would amount to about 5 percent over the medium term.

13. Proper sequencing of structural reforms also yields larger and broad-based productivity gains. For Oman, the strategic sequencing of reforms would help to build capacity, maintain reform momentum, and limit possible adverse short-term externalities. For instance, having effective institutions in place reinforces public confidence in the government’s ability to plan, conduct, and monitor reform measures. Also, rationalizing the state presence and establishing a well-functioning product market with the proper regulatory environment ensures that privatization efforts are conducted on a level playing field that enables fair competition and innovation while encouraging citizens to engage in private sector activity. To quantify the impact of sequencing, we re-estimate productivity gains from labor market and financial market reforms, conditioning the sample of countries to those that have achieved progress in institutional quality, state footprint, and product markets above what Oman has achieved in these structural areas so far. Baseline results show that gains from labor market and financial sector reforms are insignificant, reflecting the limited impact of increasing human capital and developing the financial sector on productivity when structural prerequisites are not in place. Specifically, inadequate institutional setting, dominant public sector presence, and restricted product markets would undermine positive spillovers to productivity from labor market and financial sector reforms. Thus, implementing labor market and financial sector reforms after sufficient progress has been achieved on institutional, state footprint, and product market reforms yields higher and more significant gains than under the baseline scenario.



D. Policy Recommendations

14. Strategically packaging and sequencing structural reforms would lift productivity substantially in Oman. Reducing structural reform gaps with advanced economies would help unleash Oman's growth potential. Specifically, short-term gains would be significant and could be maximized if structural reforms are packaged appropriately and implemented sequentially. Enhancing institutional quality, reducing the state's footprint in the economy, and improving the business environment are prerequisites to lay the groundwork for larger productivity gains from subsequent structural reforms.

15. Improving the quality of institutions is critical to lifting productivity in Oman. Despite commendable improvements in recent years, two indicators hamper Oman's institutional quality: regulatory quality and government effectiveness. Oman lags behind advanced economies, commodity-rich economies, and other GCC peers on these indicators. There is scope to further strengthen the regulatory environment by enhancing transparency and improving the management and implementation procedures of public procurement, which would magnify productivity gains. Enforcing more transparency and accountability in public institutions, reducing the size of the public sector, and improving the skillset of civil servants while leveraging digitalization in the provision of public services are essential for improving the quality of institutions and lifting productivity.

16. A more streamlined role for the government sector would enhance productivity. There is scope for Oman to further limit the government's involvement in the economy while supporting private sector-led growth by improving the efficiency of government spending and limiting its size (see Annex on Assessment of Oman's Government Expenditures). Ongoing divestment efforts by the Oman Investment Authority (OIA) and broader efforts to attract private sector domestic and foreign investment are expected to reduce the relative size of the public sector's footprint in the economy and enhance productivity. Allowing the private sector an expanded role in the economy would have positive externalities on Oman's product and labor markets, including by leveling the playing field between public and private sector wages and benefits to incentivize Omanis to work in the private sector, with positive implications for productivity, especially if followed by labor market reforms (see below).

17. Product market reforms help amplify the effect of other reforms. Oman's business environment has experienced steady improvements in recent years, reflecting simplified procedures to start a business, a significant relaxation of restrictions on foreign investment (including opening most economic sectors to full foreign ownership), and improved ease of dealing with various permits. The literature shows that lower initial levels of regulation are associated with higher TFP over subsequent years. Therefore, further efforts are needed to enhance product market competition, streamline administrative and regulatory requirements—including export and import procedures—and promote investment in R&D to improve the competitiveness and productivity of Oman's nonhydrocarbon tradable sector. Bundling product market with institutional and state footprint reforms would create an enabling business environment that would boost the impact of other reform measures.

18. Labor market reforms are crucial to lifting productivity and supporting Oman's development efforts. With a fragmented labor market across different dimensions, labor market reforms would unleash untapped potential in the Omani economy. Recently approved social protection and labor laws are expected to contribute to improving labor market flexibility, competition, and mobility. However, further enhancing mobility-enabling policies, particularly for expatriate workers, would also facilitate sectoral reallocation that supports economic diversification and promotes structural transformation toward a knowledge-based economy. Improving labor mobility would trigger market incentives (promotions and higher wages) across the labor market and improve competition between Omanis and expatriate workers. This incentivizes upskilling and attracts more mid to high-skilled expatriate workers, leading to higher productivity gains. Continued efforts to improve the quality of education would also help to address skills mismatches in the labor market and encourage young Omanis to pursue technology and science-related majors with positive implications for productivity. Finally, the new labor and social protection laws include provisions that support female labor force participation, such as aligning maternity leave with international standards and introducing paternity leave. More can be done to increase female labor force participation, such as by promoting more women to senior managerial positions and institutionalizing flexible work arrangements.

19. Deepening financial markets and enhancing credit options would facilitate lifting productivity, particularly if preceded by other structural reforms. A well-functioning financial sector would enhance resource allocation and improve productivity in Oman. Credit in Oman is concentrated on public sector employees and a limited number of big entities. Implementing the Estidamah reform agenda, including strengthening the role of financial institutions in the economy, developing financing products, and strengthening financial inclusion, is expected to enhance credit in the economy, particularly for small and medium enterprises. However, targeted financing schemes (such as Oman Development Bank financing) should be limited to viable small and medium enterprises. Also, fiscal consolidation efforts and state-owned enterprise divestment plans are expected to reduce the government's crowding-out effects, thereby boosting liquidity in the banking sector and enhancing lending opportunities for private firms. Moreover, ongoing efforts to develop the financial markets in Oman are expected to promote alternative financing sources (see Selected Issues Paper on financial sector development).

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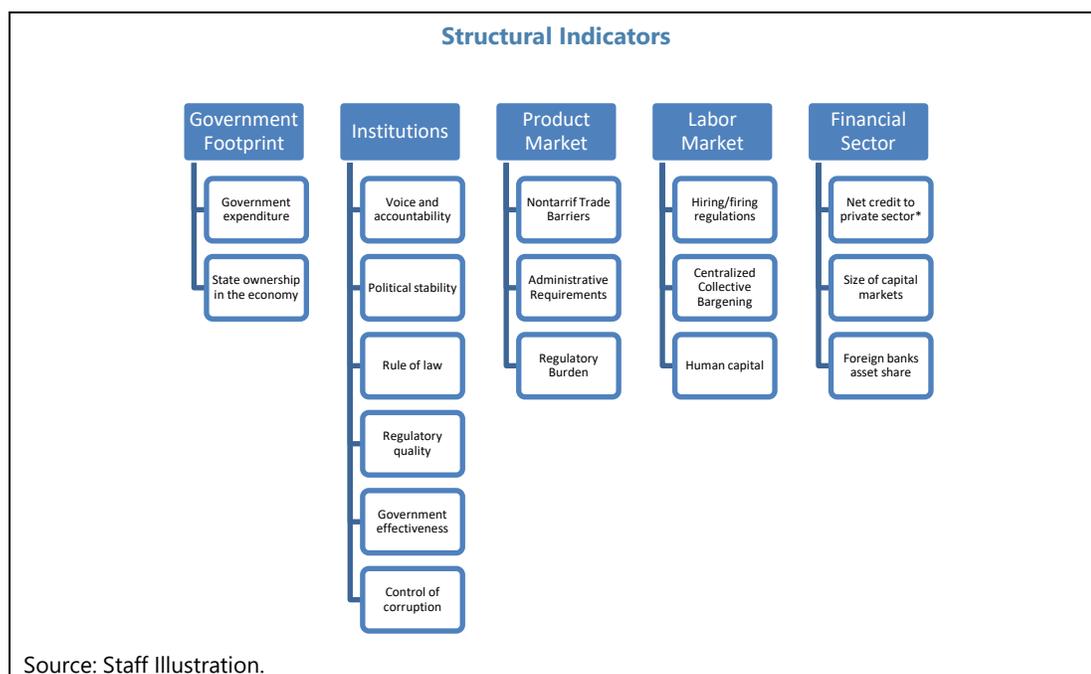
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Annex I. Measuring Structural Reform Indicators

1. **We construct five structural indices to identify main drivers of TFP and measure Oman’s position on structural reform areas versus other economies.** Following the existing literature, we group determinants of TFP into five areas: state footprint, institutions, product market, labor market and financial sector development. For each of these dimensions, we standardize each sub-indicator to vary between zero and one, take their unweighted average, and scale the score to 100, with a higher value showing favorable conditions for TFP. Our indices are constructed by utilizing data from the World Development Indicators, the UNCTAD database, and the Fraser Institute’s database covering the period 2000–20.



- **State footprint index.** This index includes three variables: (1) government consumption as percent of total consumption, (2) government investment as percent of total investment, and (3) the size of state-owned enterprises in the economy. The existing literature shows that there is a negative relationship between the share of government activities and TFP (Loko and Diouf 2009; Hansson and Henerkson 1994; Wu and others 2017). Higher government involvement translates into lower TFP levels. Thus, countries with more government involvement in the economy are assigned lower scores.
- **Institutions index.** We use UNCTAD’s institution index to measure the quality of institutions. This index includes all six of the Worldwide Governance Indicators (Voice and Accountability, Political Stability, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption). The existing literature shows that countries with higher quality of institutions have higher TFP levels and attract more investments (Balta and Mohl 2014; Kent and Simon 2007; Wu and others 2017; Zhang 2017).

- **Product market index.** This index includes three sub-indicators: (1) nontariff trade barriers, (2) administrative requirements, and (3) regulatory burden. This index reflects the ease of doing business in the economy, capturing both tariff and nontariff barriers, in addition to the costs of business operations. The existing literature suggests that a less cumbersome business environment is associated with a more dynamic product market and higher TFP (Buccirossi and others 2013; Fink 2016; Kent and Simon 2007; Van der Marel 2012).
- **Labor market index.** This index captures the degree of flexibility in the labor market, in addition to the quality of labor inputs (human capital) in the labor market. It also captures labor market restrictions and collective bargaining. The existing literature, including Bassanini (2009), Loko and Diouf (2009), Hansson and Henerkson (1994), and Kent and Simon (2007), suggests that removing labor market rigidities and improving human capital significantly increase TFP, despite some potential short-term losses.
- **Financial sector index.** This index covers the depth and development of the financial sector. It includes three variables: (1) net credit to the private sector,¹ (2) stock market capitalization, and (3) foreign bank assets among total assets. Previous studies show that financial sector development has positive spillovers to the rest of the economy (Han and Shen 2015; Naceur and others 2017). This index was constructed to capture the crowding out effect of government borrowing, the availability of alternative financing sources in the economy, and the level of competition in the banking sector.

¹ Net credit to the private sector is defined as credit to the private sector net of credit to government.

Annex II. Estimations of the Impact of Structural Reforms on Productivity using Local Projections

1. We use a Local Projections approach to accommodate for our panel structure and not constrain the shape of the impulse response functions while allowing for results to become less sensitive to misspecification, following the work of Jordà (2005).¹ Using data for 53 advanced and emerging market developing economies over the period 2000–19, the baseline specification is defined as follows:

$$TFP_{i,t+h} = \alpha_{i,h} + \delta_h SR_{i,t-1} + \beta X_{i,t-1} + \epsilon_{i,t+h} \quad (1)$$

Where $TFP_{i,t+h}$ denotes the log form of total factor productivity; SR represents structural reform indicators; and h is the time horizon considered where $h = 1, 2, \dots, 5$. $X_{i,t-1}$ denotes a vector of control lagged variables including private investment, total factor productivity, real GDP growth, and human capital index. The specification also includes country fixed effect ($\alpha_{i,h}$) to control for country-specific features and cross-country heterogeneity. The model's impulse response functions (IRFs) are based on the estimates of δ_h coefficients at each time horizon, and the robust standard errors are constructed by using the Huber-White sandwich estimator. Shock of this specification are presented in percentage terms, where the standard shock reflects a 1 percent increase in SR .

2. For the sequencing estimation, we follow the approach of (El Herradi and Leroy 2021; Ramey and Zubairy 2018) to introduce state dependency to our baseline specification above. This specification compares IRFs of labor market and financial sector reforms conditional on the state of institutions, state footprint, and product market reform indicators with their baseline levels in equation (1) above. The sequencing specification takes the form:

$$TFP_{i,t+h} = \vartheta_{i,t}^j [\alpha_{i,h}^j + \delta_h^j SR_{i,t-1} + \beta^j X_{i,t-1}] + (1 - \vartheta_{i,t}^j) [\alpha_{i,h} + \delta_h SR_{i,t-1} + \beta X_{i,t-1}] + \epsilon_{i,t+h} \quad (2)$$

3. In the above specification, $\vartheta_{i,t}^j$ is a binary variable (0,1) that captures the state of j , where ϑ is equal to 1 when the values of institutions, state footprint, and product market are above the 70th percentile of the sample to reflect how additional reforms in these areas could affect labor market and financial sector reforms in Oman compared to the baseline scenario. As such, larger impulse responses of labor market and financial sector reforms in the sequencing scenario relative to the baseline would imply improving institutional quality, rationalizing state footprint, and product market reforms should be prioritized ahead of other reforms.

¹ Panel VAR results are broadly in line with our LP baseline results.

4. On the packaging scenario, we examine whether bundling structural reforms on institutions, state footprint, and product market together would yield larger productivity gains compared to implementing these reforms in isolation of each other. This packaging specification takes the form:

$$TFP_{i,t+h} = \alpha_{i,h} + \delta_h SR_{i,t-1}^{\bar{x}_{1,2,3}} + \beta X_{i,t-1} + \epsilon_{i,t+h} \quad (2)$$

In the above specification, the reform package is calculated as the simple average of the institutions, state footprint, and product market reform indices.

List of Economies

Australia	Luxembourg
Austria	Malaysia
Belgium	Malta
Brazil	Mexico
Canada	Mongolia
Chile	Morocco
China	Netherlands
Croatia	New Zealand
Cyprus	Norway
Czech Republic	Poland
Denmark	Portugal
Estonia	Romania
Finland	Russian Federation
France	Serbia
Germany	Singapore
Greece	Slovenia
Hungary	Spain
Iceland	Sweden
India	Switzerland
Indonesia	Taiwan, Province of China
Ireland	Thailand
Israel	Trinidad and Tobago
Italy	Turkey
Japan	Ukraine
Korea, Rep.	United Kingdom
Latvia	United States
Lithuania	