Regional Economic Outlook: Middle East and Central Asia, May 2007

Highlights

The region covered by the Middle East and Central Asia Department (MCD) appears set for another year of strong growth. Real GDP should average over 6 percent in 2007, for the fifth year in a row. All country groupings within the region—oil exporters, emerging markets, and low-income countries—have been performing well, with growth especially strong in the Caucasus and Central Asia (CCA).[1] Continued high oil and non-oil commodity prices, robust global growth, a favorable international financial environment, and sound policies in many MCD countries are underpinning this performance.

But inflation is rising, fueled by rapid demand growth and strong foreign inflows. With monetary policy largely accommodative in many countries, inflation is expected to average nearly 9 percent in 2007 compared with 7½ percent last year. The uptick is particularly notable in some oil-exporting countries. In these countries, higher inflation is beginning to translate into more appreciated real exchange rates, as would be expected in response to increased oil prices.

The region's external and fiscal surpluses remain very high, but are expected to decline in 2007. For oil exporters, only one-fourth of the projected fall in the external current account surplus in 2007 is due to lower oil prices. The remainder is accounted for by the impact of higher spending, with imports rising strongly as major public and private infrastructure projects get under way and spending on social programs increases. Oil export revenues are projected to decline slightly to $570 billion in 2007, based on an average oil price of $61 a barrel, down from $64 last year. Naturally, the revenue projections are highly sensitive to oil prices, with a $5 a barrel decline estimated to reduce the region's annual exports by $45 billion, and fiscal receipts by $35 billion.

The performance of the MCD region's capital markets has been mixed. In the Gulf Cooperation Council (GCC) countries,[2] stock market corrections that started in early 2006 have continued, but outflows from these markets have benefited some other regional markets, especially those in the Maghreb countries.[3] With ample liquidity and increasing demand for investment project financing, there has been a jump in the issuance of Islamic bonds (*sukuk*), particularly in the GCC.

There are risks to the generally very positive outlook, but the region is becoming increasingly resilient to potential shocks. Potentially adverse global developments include the possibility of slower world growth, perhaps triggered by a sharper-than-expected slowdown in the United States, or a sustained rise in financial market volatility. At the regional level, escalating conflicts are a perennial threat. The International Monetary Fund (IMF) is actively engaged in several post-conflict countries in the region, including Lebanon, for which the Fund is providing financing through the recently approved Emergency Post-Conflict Assistance. Sharply lower oil prices would also hit regional growth, although the balance of risks in the oil market appears to be on the upside. Strong macroeconomic policies, increases in international reserves, and declining debt in recent years will help the region withstand all but the most severe shocks.

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[1]CCA countries comprise Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

[2]GCC countries comprise Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

[3]Maghreb countries comprise Algeria, Libya, Mauritania, Morocco, and Tunisia.

The key policy challenge for the region is to sustain or even accelerate growth, in order to make significant inroads into reducing poverty and unemployment. Strong growth has not yet generated sufficient jobs for the rapidly expanding labor force, and poverty rates have not yet declined much, even in the rapidly growing low-income countries.

Oil-exporting countries' policies are on the right track. Even with moderately lower oil prices, programs to boost social and infrastructure investment can still be financed comfortably. Investments to promote economic diversification will also be important, particularly in countries that face an imminent decline in oil production, as well as in countries benefiting from buoyant metal prices that may not be sustained. A stable macroeconomic setting and reforms to improve the business environment and strengthen the financial sector are key to attracting more private investment to the noncommodity sectors.

Fiscal consolidation remains a priority in *emerging market countries*. Fiscal deficits are still high in several of these countries, preventing debt from declining sufficiently. Further efforts to broaden tax bases, strengthen tax administration, and reduce subsidies would help limit deficits while creating room for well-targeted programs to reduce poverty.

Managing the macroeconomic impact of large-scale foreign-financed investments is an important challenge for *low-income countries*. With improved policies and declining debt, these countries are attracting substantial financing for infrastructure projects, particularly in the energy and transportation sectors. While the projects have the potential to boost growth and reduce poverty substantially, they will only be effective if accompanied by essential structural reforms and a cautious debt management strategy that prevents the buildup of excessive debt.

The *CCA countries* need to be vigilant against inflationary pressures, fueled by very strong demand growth and large inflows of capital, remittances, and, in some cases, oil revenues. Tighter monetary policy and more nominal exchange rate appreciation would help prevent these pressures from becoming entrenched, while faster structural reforms to boost productivity would help maintain international competitiveness.

All countries in the region would benefit from more developed financial institutions and deeper markets, and increased integration with neighboring countries. The need to efficiently utilize the region's large savings has made this especially important. Encouraging progress is being made in several countries, including in the GCC and the Maghreb. ■