World Economic Situation and Prospects 2008

Western Asia

Regional Development and Outlook 2007-2008

With oil prices up by an estimated 10 per cent and oil production slightly higher in 2007, the Western Asia region has maintained its fifth consecutive year of robust growth. After oil prices had fallen substantially in the last quarter of 2006, they rose steadily during 2007. Average GDP growth for 2007 is estimated at 5.7 per cent for the Gulf Cooperation Council (GCC) [1]; while the more diversified economies (Jordan, Lebanon, Syrian Arab Republic and Yemen) are expected to grow 3.9 per cent. For the region as a whole, average growth of real GDP in 2007 is estimated at 5.4 per cent.

Strong growth is likely to continue in 2008 as the region's six GCC member countries continue to benefit from high global demand and price for oil. The region's average growth rate is forecast to increase slightly to 5.5 percent in 2008. Based on an average price of OPEC oil of US $ 68 per barrel, real GDP in the GCC subregion is expected to expand by 5.6 percent, while the more diversified economies are forecast to average 4.1 percent growth. It is assumed that improvements in the security situation and higher oil revenues will lead growth in Iraq to accelerate to 7.5 percent. This grouping of growth rates illustrates that countries with higher income are obtaining higher growth while less resource-rich countries remain, on average, caught in low growth trajectories. Despite these differences, the challenge remains to achieve broader-based growth based on implementation of regional trade initiatives and greater investment that targets innovation and industrial integration throughout the region.

Diversification efforts for the GCC have included finance which constitutes 25 per cent of GDP in Bahrain, 13 per cent in UAE, and 8.5 per cent in Saudi Arabia. Non-oil exports remain limited, gauging by sources of public taxes— oil based revenues average about 85 per cent. In non-export activities, greater demand for construction sector output has raised steel production. Saudi Arabia, in an effort to diversify its economy has created four new economic cities and has two more are planned in 2008. These efforts raise demand for housing, education, health, water, and electricity and expand job opportunities in non-oil sectors.

However, leading sectors that generate income with higher value added activities in technologically advanced sectors, remain illusive. Although many Western Asian economies are pursuing diversification strategies, they fall short of providing dynamic sectors with increasing productivity. For the region, productivity growth is estimated at less than 1 per cent per year, and it is noteworthy that even in some of the fastest growing countries of the GCC, productivity growth has been negative.

The good news is that strong growth in oil revenues has bolstered fiscal and trade-account positions in the GCC economies in 2007. Growth has been supported by increased private investment and robust consumer expenditures mainly in the GCC with certain

[1] The GCC economies consist of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates).

positive spillover effects such as increased FDI, worker remittances and tourism receipts into the more diversified economies of Jordan, Syria, but to a lesser extent in Yemen and Lebanon. FDI has shown strong signs of growth with great variation by country. In Jordan, FDI is expected to reach 13 per cent of GDP in 2007, in Lebanon 5 per cent, but in Syria only one per cent of GDP. Tourism receipts remain important sources of income, most notably for Jordan, which is showing steady growth over the past few years. In Lebanon, a central tourist destination, tourist receipts declined 35 per cent during the first half of 2007. Worker's remittances are varied, but are up slightly, and have reached values equivalent to half of the value of exports in Jordan, and a fifth of exports in Yemen; these ratios, however, represent a decline from previous years, partly for reasons related to the changing composition of immigrant workers' nationalities. (see box). Lebanon and Syria, however, show recent growth of worker's remittances. However, despite these spillover effects there has been little impact on reducing high rates of unemployment outside of the GCC. Unemployment remains stubbornly pervasive in Iraq, Jordan, Lebanon, Yemen and Syria.

In the GCC, high growth is driven by oil prices and a recent surge of domestic demand. GCC inflation, which averaged just two percent in 2005, reached 5.5 per cent in 2006, and could approach 8 per cent in 2007. GCC and other Western Asia countries each have very diverse inflationary histories with a mix of imported and domestically-generated inflation that is coming from distributional causes and sectoral supply constraints. Yemen's 17.8[2] per cent inflation rate is in part due to elimination of the fuel subsidy and the introduction of a general sales tax. Iraq's 20.4[3] per cent inflation is due partly to turmoil and conflict, supply-side fuel shortages and the reduction of fuel subsidies impacting higher transport and household consumer costs. Qatar's 12.8[4] per cent inflation is partly driven by rising rents and greater demand for expatriate labour. In the highly open UAE where imports amount to 60 per cent of GDP, imported inflation is prevalent, yet domestically generated inflation is observed in housing.

Furthermore, with most of the region's exchange rates fixed to the dollar, Western Asia is facing higher costs of Euro-denominated and other non-dollar imports as the dollar declines. In response to these pressures there is pressure to re-examine exchange rate regimes. In the GCC countries, the combination of accelerating domestic inflation, a continuous weakening of the US dollar against other major currencies, and recent cuts in the Federal Reserve's benchmark rates has led to an intense debate on the appropriate exchange rate policies. This debate is all the more relevant at a time when the Governments of Bahrain, Kuwait, Qatar, Saudi Arabia, and the UAE have to decide whether to proceed with the plans of establishing a monetary union by 2010 or to postpone the target date, following Oman's decision in late 2006 to pull out of the single currency plan. Presently, all GCC countries, except Kuwait, peg their national currencies to the US dollar.[5] As a result, GCC monetary authorities face a serious policy dilemma: they either follow the Fed's latest moves to cut interest rates, at a time when strong economic growth and increasing inflation rates would rather call for a tightening of monetary policy, or they allow the spread between domestic and US interest rates to widen, thereby stimulating capital inflows and further increasing the upward pressure on national currencies. In light of this dilemma, there is a growing number of

[2] Review of Monetary and Banking Developments, Central Bank of Yemen, May 2007.
[3] Iraqi Ministry of Planning Website, November 2007. Iraqi inflation is difficult to gauge, diverse estimates range from 30 per cent by the IMF to as high as 55 per cent by the Economist Intelligence Unit.
[4] Qatari Central Bank Website, annualized inflation rate as of second quarter 2007.
[5] Kuwait dropped its dollar peg in May 2007, replacing it by a peg to a basket of undisclosed currencies.

analysts and policy experts that suggest a move to more flexible exchange rate regimes such as replacing the dollar peg by a peg to a basket of goods. A less radical policy option would be a revaluation of national currencies against the dollar. Given that the US dollar weakness is likely to continue, US interest rates are expected to further decline in 2008, and authorities in GCC countries are increasingly committed to fight inflation, this alternative is increasingly discussed, especially in Saudi Arabia and the UAE. However, the respective central banks are reluctant to such a move since it would not only reduce the value of oil exports and foreign reserve assets but also further complicate monetary integration. Whether further US interest rate cuts are likely be matched is not discernable from the region's current policy environments.

GCC fiscal policies remain conservative with budget surpluses of enormous magnitudes in Kuwait (32 per cent of GDP), UAE (25 per cent), Saudi Arabia (13 per cent), Oman (7 per cent) and Bahrain (5 per cent). Similarly large GCC current account surpluses and fiscal conservatism are driving high rates of financialization as oil-exporters continue to buy into instruments in the United States as well as in dollar-based hedge funds outside the United States. The region's gross official reserves are soaring and expected to reach $400 billion in 2007.

Such assets held externally in stabilization funds for future generations are currently underutilized with regard to present generations and the real economies of the region. Foreign reserves are typically held for precautionary motives such as defending floating exchange rates, servicing debt, and to secure imports. GCC's fixed exchange rates, very low debt and great wealth render the need for precautionary foreign exchange reserves negligible. A more strategic range of instruments beyond holding foreign debt can serve to link medium-term economic development with sound management of national investment portfolios.

In financial markets, renewed deepening has been observed as of mid-October 2007 with record IPO issues. Most bourses are faring well too, although the Saudi market shows only marginal gains. All other indexes, however, are up by at least 10 per cent since the beginning of 2007. Kuwait's stock market is up 45 per cent, Doha's Securities Market is up 30 per cent, the Amman Stock Exchange is up 20 per cent, and Dubai is up 15 per cent.

These markets, however, despite financial deepening remain secondary with regard to production. The capacity of "real" economies to absorb financial flows and provide enough jobs to reduce poverty and unemployment remains illusive. Employment and growth accounting reveals that reducing unemployment will require that the per capita growth rate of demand has to exceed productivity growth. One way of realizing higher levels of demand is through greater income derived from leading sectors with economies of scale and increasing returns. As these sectors grow, incomes earned from their production spill over into demand for other goods. In the absence of such sectors with rising productivity, however, demand generation would have to continue to rely on oil revenues and spillovers from the GCC to other countries.

The economic outlook therefore suggests that inflation is not to be seen as a deterrent to accelerating pursuit of development programs. "Unbalanced growth" is a normal state of development, and calls not for a "cooling" government role just because inflation is observed. Rather, a targeted role augmenting supply to offset bottlenecks can be instrumental. Conversely, fiscal expenditure to raise demand when underutilization and unemployment is prevalent might be needed despite inflation, depending on the source of inflation and specific country histories. Typically, Western Asia economies are either narrowly-based and highly "open" as in the case of the GCC or they are more diversified but exhibit higher unemployment. Under either condition, sustained increases in growth of productive base are not only needed, but necessary for these economies to serve the needs of their growing populations.

If the current oil boom subsides and intra country flows slack off before unemployment levels are reduced, then this historical moment will be remembered as a lost development opportunity. If there is a further deterioration in the US economy, or increased financial markets turmoil, then Western Asia's GCC economies could be impacted by reduced demand and prices for oil. Other more diversified economies like Jordan are also directly coupled with the US through exports. Indirectly, however, current flows from GCC economies to other Western Asia countries would decline in the event of global crisis, and the current opportunity to take advantage of these flows to reduce unemployment and poverty would fade away.

Structural change, therefore, is paramount for sustainable growth and will require a central government role to enable innovative industries in the private economies of the region. For countries with fiscal difficulties, however, such as Iraq, Jordan, Lebanon, Palestine, and Syria, and due to market convention, targeted expansionary fiscal policies may not be in the cards. In these cases, growth opportunities can be pursued by public sectors without massive expenditure by encouraging the implementation of bilateral trade agreements that aim for regional integration, industrial upgrading and dynamically growing sectors.

Western Asia's limited industrial capacity and negligible industrial integration suggests that few countries will be able to climb the productivity ladder by relying on private sectors to undertake investments that are not underscored by national development programs. Government can be instrumental to the development process through allocation of credit programs, loan and export guarantees, and other protections that help higher productivity sectors grow up to face global competition. Continued investment in education will also be a necessary step in industrial upgrading, yet without a targeted public sector role in the private economy, education expenditure is insufficient by itself to bring about growth in "leading" sectors. For the more diversified economies and countries in conflict, targeted support of some low-end manufacturing industries can get the growth cycle started.

Development based on fiscally sustainable expansionary policies is compatible with one of this year's WESP's central messages. Decoupling from the US through demand-driven expansionary fiscal policies can reduce vulnerability to global imbalances, and this might require activating idle financial resources currently tied up in foreign government debt.

Finally, in the low growth performing economies of the region, particularly Yemen, and the countries in conflict, weak economic growth during recent years has reduced progress towards achieving the Millennium Development Goals. Poor growth has limited the resources of the individual governments that are available for social programmes and policies. At the midpoint between the adoption of the MDGs and the target date for their achievement, it is clear that Yemen and the countries in conflict, Iraq and Palestine require very high and sustained economic growth rates in order to be able to reach the different goals and targets by the year 2015.

The significant disparities in living conditions between Western Asian subregions and individual countries call for intensified regional and South-South cooperation activities. Indeed, faster progress towards the achievement of the MDGs requires not only intensified policy efforts in these countries themselves, but also further strengthening of regional cooperation between the countries in Western Asia, including more generous and effective development aid. This is all the more important since current levels of intra-Arab ODA are significantly below averages for the 1980s.