Gulf Cooperation Council

Economic Prospects and Policy Challenges for the GCC Countries - 2022

Prepared by Staff of the International Monetary Fund

I N T E R N A T I O N A L   M O N E T A R Y   F U N D

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EXECUTIVE SUMMARY[1,2]

GCC policymakers have managed to quickly mitigate the economic impact of the twin COVID-19 and oil price shock. Commodity prices have surged, and the outlook is more positive for GCC countries, with new challenges linked to Russia's invasion of Ukraine and tighter global financial conditions expected to have a limited impact on GCC economies. While GCC countries have overall benefited from higher, albeit volatile hydrocarbon prices, numerous risks still cloud the outlook—notably a slowdown in the global economy. In this context, the reform momentum established during the low oil price years should be maintained—irrespective of the level of hydrocarbon prices.

Overall fiscal balances have improved strongly, in line with higher oil prices and receding effects of the pandemic. The cumulative primary balances are expected to average 25 percent of GDP during 2022-2026, with the rise in expenditures—particularly on wages—contained so far.

A comprehensive package of policies should be implemented to respond to near-term shocks and firmly address medium-and long-term challenges:

- **Fiscal policy in the near term** should avoid procyclical spending, with the windfall from higher oil prices used to rebuild buffers and strengthen policy space. Given the available fiscal space, targeted support to deal with shocks that affect the most vulnerable should be privileged while leveraging on the progress achieved in the provision of targeted social benefits.
- **Medium-term fiscal policy** should remain geared towards achieving growth friendly consolidation to ensure fiscal sustainability and increase savings for intergenerational equity through a credible rules-based medium-term fiscal framework. while preparing a smooth energy transition. This should be supported through non-oil revenue mobilization, energy subsidy phase-out, containment of public sector wages, and increasing spending efficiency. Proper assessment of the fiscal stance would require full incorporation of the operations of the sovereign wealth funds, which are increasingly involved in national development.
- **Maintaining financial sector stability** is essential to sustain strong economic growth. Overall, financial sectors appear sound, with GCC bank balance sheets shielded from tighter global financial conditions by a concomitant period of high oil prices and abundant liquidity, which are facilitating credit expansion. But bank soundness should continue to be carefully monitored.
- **Policies for a sustained private sector-led economic growth and diversification** will be as key as ever. Ongoing structural reforms should be accelerated and distortions reduced, including by raising female labor force participation, increasing flexibility for expatriate workers, improving education quality, further leveraging technology and digitalization, enhancing regulatory frameworks, strengthening institutions and governance, deepening regional integration, and addressing climate change.

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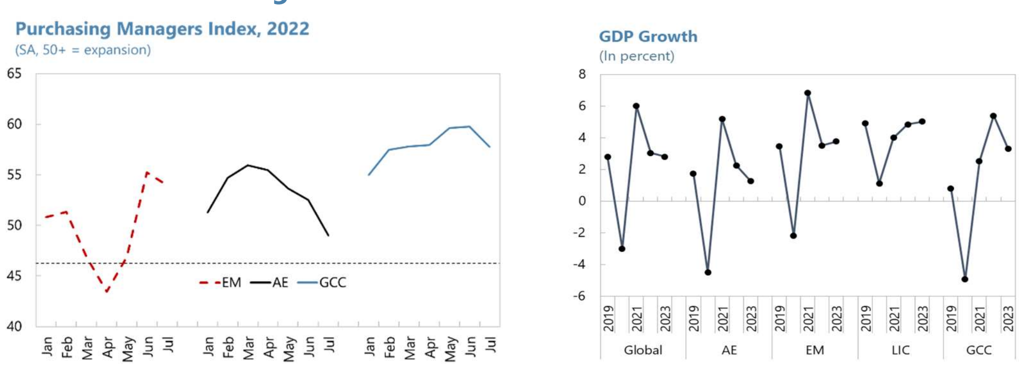
[1] Prepared by Jerome Vacher (Lead), Abdullah AlHassan, Yevgeniya Korniyenko, Charlotte Sandoz, Fei Liu, Aidyn Bibolov, Fozan Fareed, Weining Xin, and Dalia Aita under the guidance of Amine Mati. Editorial support was provided by Esther George.

[2] This paper was prepared for the GCC Ministerial Meeting that took place on October 3, 2022, in Riyadh. It reflects the information available to IMF staff at this date.

A. Global Developments and Outlook

1. The global economy is under pressure with new shocks and growth stalling (Figure 1). Global growth contracted in 2022 Q2 by 2 percent, although the Euro area's growth was positive, driven by resurgent tourism demand in southern Europe. Although vaccination has significantly progressed and the latest Covid-19 variants have inflicted less damage on public health, the pandemic continues to affect economies in various parts of the world, and in some cases with significant scarring. Lockdowns in China to contain outbreaks of the Covid-19 pandemic have negatively affected growth and put further pressures on global supply chains. In the U.S., rapid monetary policy tightening, in response to persistently high inflation, was associated with slowing domestic demand and cooling housing prices. The combined U.S. dollar appreciation and higher interest rates has negatively affected capital flows to emerging and developing economies, which led to increasing spreads on their debt and additional pressures for countries with significant dollar denominated liabilities. Global growth is projected to slow from 6 percent in 2021 to 3 percent in 2022 and 2.8 percent in 2023.

Figure 1. GCC: Global PMIs and GDP Growth

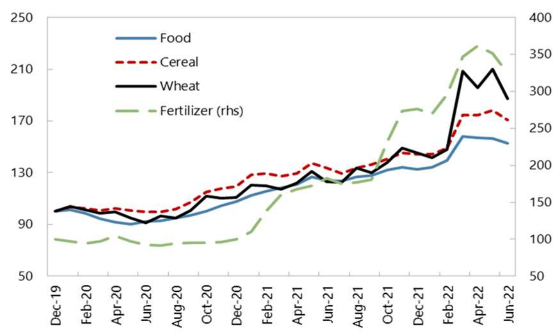


Sources: Haver Analytics, and IMF Staff Calculations.
Note: GCC PMI reflects unweighted averages for Qatar, Saudi Arabia, and UAE PMIs. AE= Advanced Economies; EM= Emerging Markets; LIC=Low-income Countries.

2. The war in Ukraine has negatively shocked growth and contributed to higher inflation globally. The war in Ukraine has exacerbated some developing vulnerabilities and added significant pressure on oil and gas markets already affected by supply constraints as economies recovered (Box 1). As the war has significantly raised global geopolitical risks, European economies have been particularly hard hit by falling growth prospects. It has also put additional pressures on energy and food supplies resulting in a temporary decrease in global food supplies and increase in the price of staple foods, in particular in countries dependent on food imports.

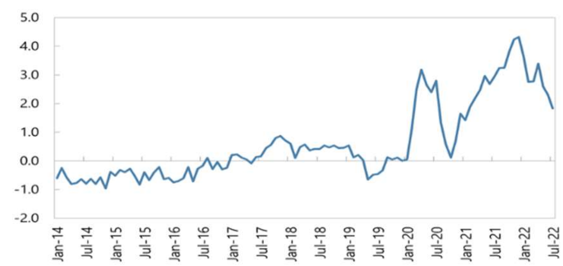
3. Inflation has proven to be higher and more persistent than expected. Inflation in advanced economies—which reached 8.3 percent in August in the US and 9.1 percent in the Euro area—rose to a new 40-year high. Core inflation has also been elevated, reflecting pass through from energy prices, supply chain pressures, and labor cost increases. The economic and social impact of the higher inflation is more pronounced in emerging and low-income economies where food prices comprise a larger share of the consumer basket as food supply constraints are also further exacerbated by the war in Ukraine (e.g., for wheat, sunflower oil). Export restrictions that were implemented in several countries further contributed to the global food price increases. While they have softened somewhat since their peaks in March, the price of wheat remains 30 percent higher in June 2022 than in December 2021 and fertilizer prices 17 percent higher than in December 2021 (Figure 2), and are not immune to further shocks (e.g., climate related - like drought - or energy related for the production of fertilizer). There are also indications that supply chain pressures have been easing somewhat (Figure 3).

Figure 2. GCC: Fertilizer and Food Price Indices
(Dec 2019=100)



Sources: Bloomberg L.P., and IMF staff estimates.

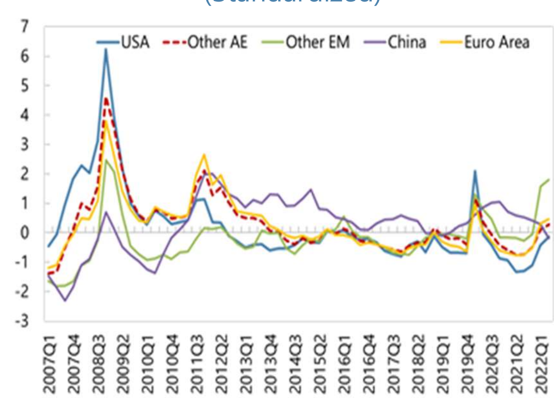
Figure 3. GCC: Global Supply Chain Pressure Index (GSCPI)
(Standard deviations from the average value)



Sources: Federal Reserve Bank of New York, Global Supply Chain Pressure Index http://www.newyorkfed.org/research/gscpi.html.

4. Global financial conditions have tightened (Figure 4).[3] As central banks around the world increased policy rates to respond to inflation, the monetary policy cycle has synchronized globally. However, financial conditions have tightened more strongly in emerging markets where increases in policy rates combined with weaker currencies have led to higher borrowing costs. Asset prices have become volatile given the uncertainty around growth and inflation outlooks and the future path of monetary policy.

Figure 4. GCC: Global Financial Conditions Indices
(Standardized)



Sources: Bloomberg L.P, Haver Analytics; and National Authorities.
Note: The Financial Conditions Indices capture the price of risk based on a range of variables (see Online Annex 1.1 of the October 2018 GFSR). An increase (decline) in the index denotes tighter (looser) financial conditions.

[3] Global Financial Stability Report, October 2022 (imf.org)

5. Risks to the global outlook are firmly on the downside.[4] The Covid-19 virus is still active and spreading, while potential variants would pose a threat to the recovery, in particular in countries where vaccination rates are low. Inflation is high and central banks will have to play a delicate balancing act of fighting inflation while not overtightening and risk abruptly slowing down growth. Increases in interest rates would further tighten financial conditions and exert pressures on countries with high debt, in particular emerging and developing economies already hit by the energy and food price shocks. A complete halt to Russian gas supplies to Europe in 2022 would lead to severe economic disruptions in European countries heavily dependent on gas imports from Russia. The war in Ukraine has already increased geopolitical risks and further fragmented the world economy and energy markets, with potentially further negative spillover effects on growth.

Box 1. Oil and Gas Market Developments

The global flow of oil and gas has been significantly affected by the Russian invasion of Ukraine. The global oil market experienced a strong rebound in 2021 as global oil demand recovered and OPEC+ continued to gradually ease production curbs that were put in place in 2020, with Average Petroleum Spot Prices (APSPs) prices reaching an average of $69.4 per barrel in 2021. However, global oil prices— which had already increased significantly as a result of lack of upstream and downstream investment and a steady depletion of existing inventories— spiked up to highs of $117 per barrel in the first quarter of 2022 spurred by the war in Ukraine– a level not seen in the last 8 years. More recently, in July and August, oil prices have declined due to fears of an economic slowdown in advanced economies, lockdowns in China and a strong dollar, but remain at elevated levels. Oil futures curves show that oil is projected to peak in 2022 and then decrease gradually reaching $71 per barrel in 2027, close to 2021 levels.

Global oil demand is expected to hit its pre-pandemic level and then jump higher in 2023. However, there is substantial uncertainty regarding future growth of oil demand considering the uncertain global economic prospects and possible shifting demand patterns. According to IEA estimates, global crude oil demand has increased from 94.3 mb/d in Q2 2021 to 98.49 mb/d in Q2 2022 and is estimated to reach 99.7 mb/d by end-2022 and further increase to 101.8 mb/d in 2023. OPEC foresees a surplus in the oil market in 2022 as it revised down its outlook for demand and increased estimates for non-OPEC production (mainly from Russia) in August. Recent developments have also put to the fore the issue of energy security as supply constraints have become more evident (e.g., with the modest cut in OPEC+ agreed oil production and the ongoing discussion about a price cap on Russian oil), but also underlined the need for a fine balance of energy security with climate mitigation objectives.

Gas markets have also been severely impacted. With Russia being the largest gas exporter, global gas supplies have experienced major disruptions with regional supply deficits, especially in Europe and the Asia-Pacific region, also as the gas market tends to be dominated by long term contracts rather than spot transactions, making adjustments to supply or demand slower (e.g., around 80 percent of Qatar LNG sales are through long term contracts mainly with Asia). According to recent IMF staff estimates, flows from Russia's pipeline have declined by about 80 percent and volume is expected to decline further to even lower levels, by mid-2024, in line with major European economies' energy independence goals. The benchmark Dutch TTF gas price has jumped to an all-time high of $70 per MMBtu in August 2022 due to continued supply shortage from Russia, Europe's main gas provider.

[4] World Economic Outlook, October 2022: Countering the Cost-of-Living Crisis (imf.org).

Box 1. Oil and Gas Market Developments (concluded)

The impact of the high oil prices and a jump in demand for non-Russian gas is likely to expand the role of GCC producers in global energy flows. Qatar Energy announced joint-venture agreements with 5 of the biggest oil companies to develop a $29 billion project known as the North Field East, which aims to increase Qatar's annual LNG output from the current 78 mn tons per annum (mtpa) to 110 mtpa by end-2027, and further to 126 mtpa by 2028. Since the war in Ukraine, Qatar has also signed partnership agreements with several European countries to increase gas supply to these countries over the medium term. Similarly, the Saudi authorities had already announced medium-term plans to lift oil production capacity by more than 1 mbpd to reach over 13 mbpd by 2027 (as well as to develop gas production). According to IEA estimates, with an eye on energy security Middle East National Oil Companies (NOCs) are the only ones among all regions that are planning to invest more in oil and gas activities in 2022 as compared to 2019.

Figure 1: Spot Benchmark Oil Prices
(US Dollars per barrel)

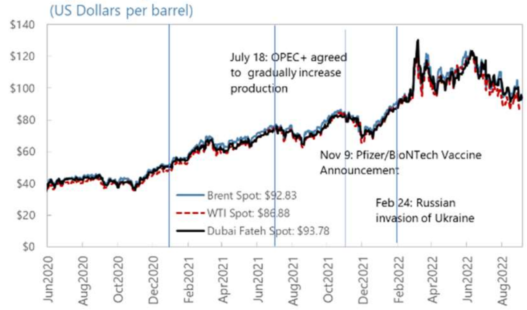


Figure 2. EIA US Department of Energy Total Change in Crude Inventories

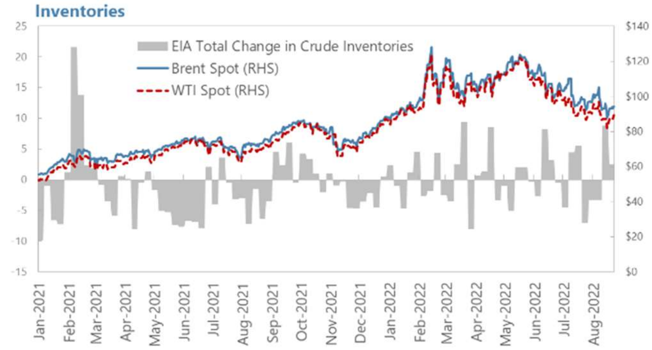


Figure 3: Brent and Natural Gas Futures
($USD per barrel, $USD per MMBtu)

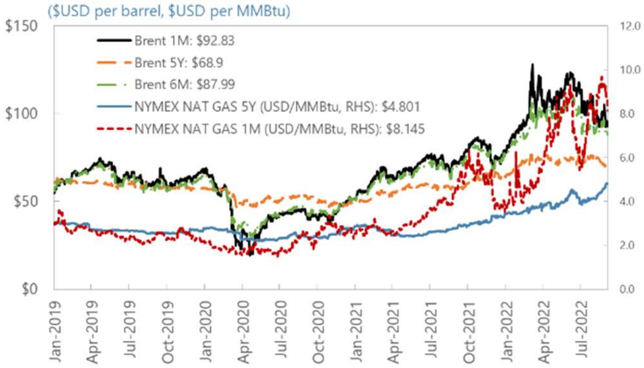
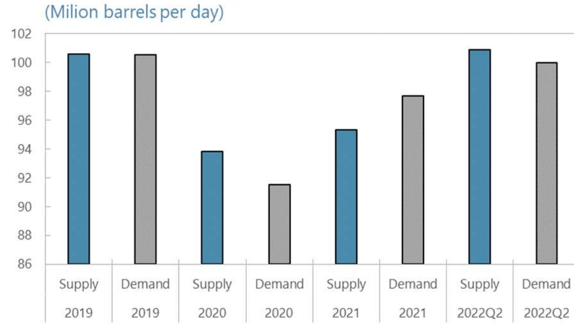


Figure 4: Global Oil Supply and Demand
(Milion barrels per day)



Sources: Bloomberg L.P, International Energy Agency (IEA); and IMF staff calculations.

B. The Economic and Financial Outlook in the GCC Countries

6. **With hydrocarbon prices picking up, relaxation of social distancing measures and increased spending in some countries in 2021, GCC economies experienced a broad-based recovery.** Liquidity and fiscal support above or comparable to what was provided by most emerging economies, successful vaccination campaigns, reform momentum and recovery in oil prices and production – in line with OPEC+ production agreements - have helped GCC countries recover swiftly and move to a more sustained growth (Table 1 and Figure 5). In 2021 GCC countries grew by 3.1 percent, with the strongest recoveries in the UAE and Saudi Arabia (Table 2). In addition to the positive shock from the hydrocarbon sector, non-oil GDP benefited in most countries from a rebound in the retail, trade and hospitality sectors (e.g., in the UAE with the tourism related to Expo 2020, in Qatar in preparation of the FIFA World Cup, but also in Saudi Arabia even though Hajj for international pilgrims only resumed in mid-2022). In Bahrain, the retail trade and hospitality sectors performed well but remained below pre-crisis levels despite the reopening to non-commercial traffic of the Causeway to Saudi Arabia in May 2021.

Table 1. GCC: Population Fully Vaccinated for Covid-19*

(As of September 2022)

	Fully Vaccinated (Million)	People Fully Vaccinated (in percent of total)
SAU	25.3	72.6
UAE	9.79	99
OMN	3.04	59.6
QAT	2.78	96.4
KWT	3.33	78.1
BHR	1.23	81.6

Sources: Our World in Data; and John Hopkins Understanding Vaccination Progress by Country - Johns Hopkins Coronavirus Resource Center (jhu.edu); and national authorities (Bahrain).

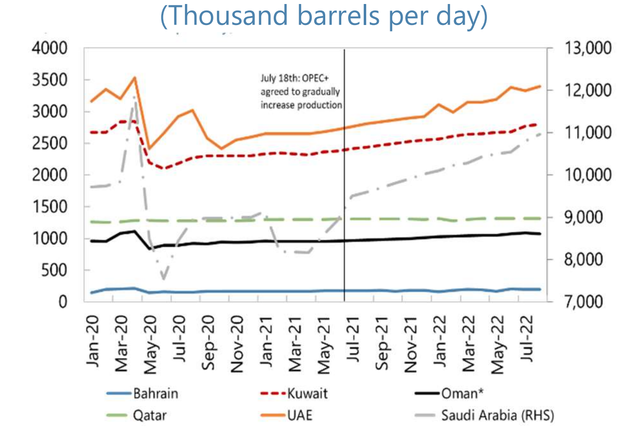
*The definition of full vaccinations varies by location and vaccine type and is subject to change over time. Some locations may reach vaccination rates close to or over 100 percent, due to population estimates that are lower than the number of people who have now been vaccinated in that place.

Economic Activity and Outlook

7. **The recovery continues with cyclical momentum going into 2022 and with the pace and strength of the recovery varying slightly across GCC countries**. In the first half of 2022, strong hydrocarbon production has continued to support rapid economic growth in the region. GCC economies are expected to grow by a strong 6½ percent in 2022, with the highest growth rates

Figure 5. GCC: Crude Oil Production

(Thousand barrels per day)

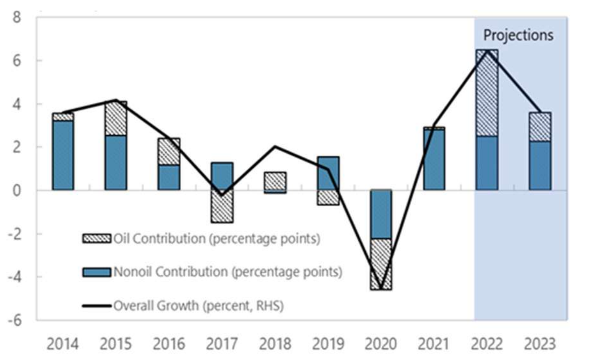


Sources: IEA; and IMF staff calculations

*IEA numbers are somewhat higher than the numbers reported by the authorities.

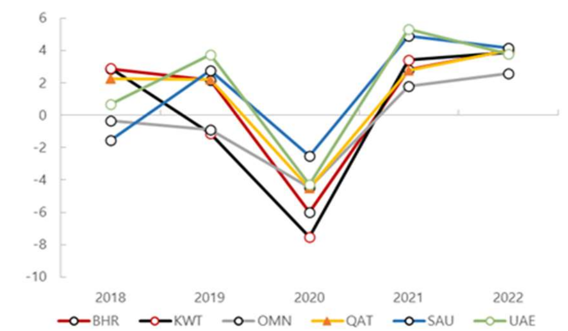
expected in Kuwait and Saudi Arabia, on the back of increased hydrocarbon production but also dynamic non-oil GDP growth (Figures 6, 7, and 8). In the UAE, the rebound in tourism activities in the wake of the hosting of the Dubai World Expo and potential spillover from the coming FIFA World Cup in Qatar should also contribute to a strong non-oil GDP growth for 2022. In Bahrain, growth is projected to accelerate to 3.4 percent in 2022, with non-oil GDP increasing by 4 percent mainly driven by strong manufacturing and the full opening of the economy. Qatar's non-hydrocarbon growth is expected to reach 4 percent in 2022, supported by favorable hydrocarbon prices and the start of the North Field expansion project, as well as the World Cup-induced buoyancy. Its hydrocarbon growth, however, is projected to be modest in 2022 as Qatar is already producing at capacity.[5]

Figure 6. GCC: Real GDP Growth, 2014-2023
(Percent)



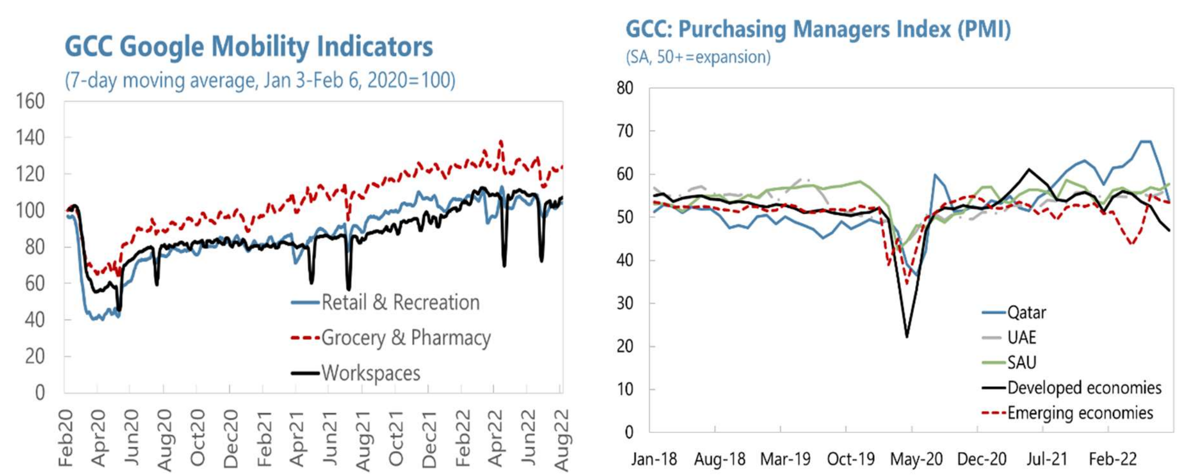
Sources: National authorities; and IMF staff calculations.

Figure 7. GCC: Real Non-Oil GDP Growth, 2018-2022
(Percent)



Sources: National authorities; and IMF staff calculations.

Figure 8. GCC: High-Frequency Indicators

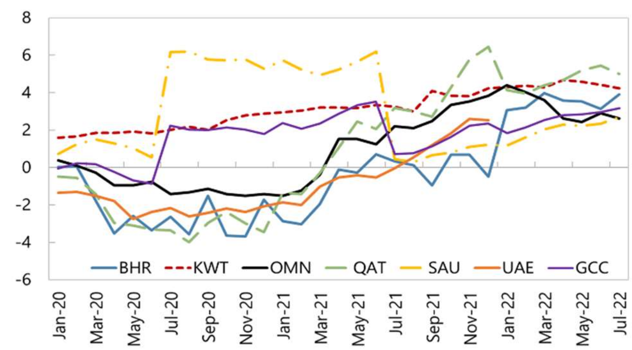


Source: Haver Analytics; and national authorities.

[5] Qatar: 2022 Article IV Consultation-Press Release; and Staff Report (imf.org)

Figure 9. GCC: Monthly Inflation[1/]

(YoY, Percent)



Sources: Haver, National Authorities; and IMF Staff Calculations.

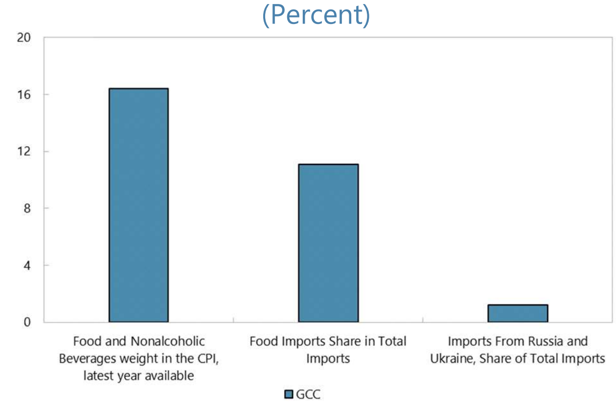
1/ UAE as of December 2021.

8. Inflation is rising but remains broadly contained (Appendix II). Inflation in GCC has picked up from 0.7 percent (y/y) in July 2021 to 3.2 percent (y/y) in July 2022, mainly driven by higher food prices (Figure 9). Inflation is expected to reach 3.6 percent on average this year (ranging from Saudi Arabia at 2.7 percent to Qatar and Kuwait at 4 ½ percent and the UAE above 5 percent). Subsidies and price caps on certain products (e.g., some food products, gasoline, electricity and water), a strong dollar that helps reduce import costs, subdued rent prices amidst higher supply in particular for some segments (e.g., villas), a limited share of food in the CPI basket, and continued labor market slack (e.g., in Saudi Arabia) have helped contain pressures from supply-side shocks and higher inflation in trading partners. Over the medium term, inflation is expected to moderate to about 2 percent as global inflationary pressures abate.

9. Direct spillovers on the GCC economies from the war in Ukraine have been small. With negligible direct trade or financial links to Russia and Ukraine, except potential limited losses from few sovereign wealth funds' investments in Russia, the initial direct impact of the war in Ukraine has been supportive thus far, mostly via higher oil prices that helped improve fiscal and external positions (Box 2). Only 2 percent of GCC food imports are from Russia and Ukraine (Figure 10), and the region has stockpiled food items and begun to tap new markets to ensure food security (Box 3), while providing financial support to vulnerable countries. Nevertheless, the war in Ukraine could potentially imply further adverse spillovers to the region, including through slower global economic activity affecting demand for oil in the short term and inflation increasing as a result of rising and volatile international prices for food and energy, and additional supply chain disruptions.

Figure 10. GCC: Food CPI Weight, Food Imports Share of Total Imports and Dependency on Russia-Ukraine Imports

(Percent)



Sources: UN Comtrade; and IMF staff calculations.

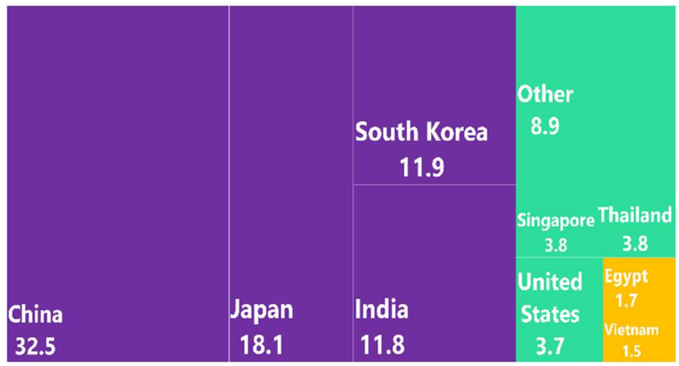
Box 2. Impact of the Russian Invasion of Ukraine on the GCC

The main impact for most of the GGC of the war in Ukraine is a spillover through higher hydrocarbon prices. For instance, preliminary estimates for Saudi Arabia-using past patterns of government spending—suggest that a $10 per barrel increase in international oil prices could also increase non-oil GDP by about ½ percentage points, though this impact could be lower going forward if fiscal expenditures respond less than in the past to shifts in oil prices.[1] Second round effects in the near term can adversely affect demand for crude (and to a lesser extent gas) through a deeper and wider slowdown in major economies, though the link would mostly be through a price impact and not production as GGC countries mostly export to Asia. Prices on fuel products are regulated, limiting the fallout of higher hydrocarbon prices on consumers (see Appendix II). However, the fiscal position is still expected to improve significantly, even if accompanied by higher energy subsidies.

GCC: Crude Petroleum Export Destination, 2020

(Percent of total)

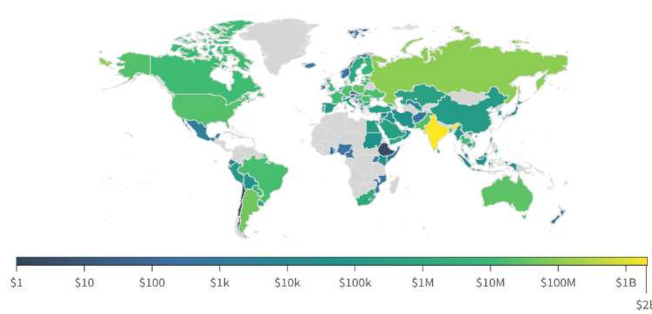
Total: $188.7B



Sources: The Observatory of Economic Complexity (OEC), Harvard University; and IMF staff calculations.

Imports of grain and similar commodities from Ukraine and Russia – both countries not major trade partners of the GCC - are relatively limited. Russia and Ukraine each accounted for about 2 and 1.4 percent respectively of total GCC agricultural and food imports in 2020 (but a combined 44 percent of imports of wheat, 66 percent of barley). In Bahrain for instance, Russia and Ukraine represented less than 1 percent of food imports. In Qatar though, Russia and Ukraine reportedly represented half of the grain imports before the war (vs. 0.1 percent in Kuwait for instance), and in Oman 60 percent of wheat imports. On the other hand, there could also be a positive impact on non-oil exports, through the local phosphate production and fertilizer industry (e.g., in Saudi Arabia).

GCC: Imports of Cereals (2020) 1/



Sources: OEC, Atlas of Economic Capacity, Harvard University; and IMF.

1/ Excluding Qatar.

Though the GCC is not insulated from global price developments, food price inflation (at 6 percent in June) has been contained so far. Food and beverages account for about 16.4 percent of the CPI with price regulation for food items in some countries, for example in Saudi Arabia covering several items: wheat flour, barley, some types of bread and infant milk (the latter recently replaced by targeted programs) and in Bahrain covering meat (lamb and beef) and flour, amounting to about 0.3 percent of GDP in 2020. Saudi Arabia has also subsidy mechanisms to support domestic producers of wheat, with overall food and agricultural subsidies at 0.4 percent of GDP. Several countries in the region also had a prudent stockpile policy, which provided for sufficient stocks of wheat at the beginning of the year.

[1] Saudi Arabia: 2022 Article IV Consultation-Press Release; and Staff Report (imf.org)

Box 2. Impact of the Russian Invasion of Ukraine on the GCC (concluded)

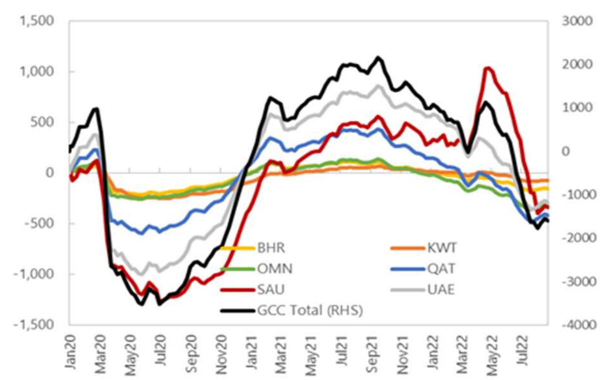
Financial links mostly through Sovereign Wealth Funds (SWFs) are small, though other risks (including reputational) could affect local financial and service sectors:

- The Saudi SWF Public Investment Fund (PIF) had developed investment relations with Russia since 2015 (mostly initially with Russia's Direct Investment Fund (RDIF)) which remained at an incipient stage, with an exposure at less than ½ percent of its assets under management. Bahrain's Mumtalakat fund has Russian exposure of 1½ percent of assets (mainly through RDIF), the Kuwait Investment Authority (KIA) 0.1 percent, UAE's Mudabala less than 1 percent. Qatar reportedly has investments representing the equivalent of 9 percent of its GDP in Russian companies (mostly Rosneft and VTB). The UAE GREs' have direct stakes in Russian and Ukrainian companies and were working on several PPPs, co-development projects, and strategic investments.

- Links through foreign direct investment appear also small overall (though the Coordinated Direct Investment Survey offers limited information).

- Most GCC countries do not have Russian or Ukrainian banks presence. However, since the beginning of the war in Ukraine some GCC countries (in particular the UAE) experienced increased financial inflows, including into real estate and digital assets. These developments should be continuously monitored and assessed against potential risks. The UAE is developing a comprehensive legislative framework to regulate Fintech and related financial services, and is advancing on regulations for crypto assets, while all GCC countries remain committed to AML/CFT in line with international standards.

Cumulative Capital Flows
(Since Jan 2020, in million USD)



Sources: Haver Analytics; and IMF staff estimates.

- Local financial markets were not affected in a major way by the start of the war (on the contrary, inflows and stocks initially surged on the back of higher oil prices).

- With regard to tourism and retail trade, anecdotal evidence suggests that only the UAE has a large share of tourists from Russia and Ukraine.

Box 3. Food Security and the GCC

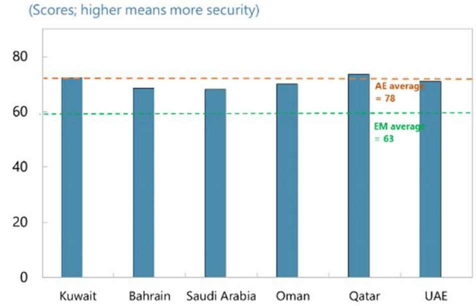
Soaring food and fertilizer prices, combined with supply bottlenecks, have posed threats to food security globally. Millions of people globally are at risk of food insecurity, with the World Food Program (WFP) estimating that up to 345 million people across 82 countries are acutely food insecure or at high risk, compared to an estimated 145 million in 2019.[1]

While GCC countries are considered more food-secure per the Global Food Security Index than many other countries, the region has a relatively high reliance on imported food. In the GCC, about 12 percent of all imported goods are food products, with Kuwait and Saudi Arabia having higher shares of food imports. GCC countries import about 85 percent of their food consumption, with cereal imports accounting for over 90 percent and almost all rice consumption imported.

To preserve food security and ease the pressure on households, governments in the GCC have launched policy measures, including financial exemptions and credits to farmers and agri-businesses, and subsidies or regulated prices for selected food items, such as wheat and other cereals. This was also supported by a food supply strategy - whereby GCC governments have announced the establishment of a common food supply network among its member states in April 2020 to address the challenges posed by the COVID-19 pandemic- and prudent policies of advance stocking in individual countries (e.g., for wheat). These steps have helped preserve short-term food security and avoided some of the more extreme situations that other parts of the world faced. Preoccupations with food security are not new in GCC countries, as they reflect the longstanding support to local producers and food supply security. For instance, following tensions on food prices globally in 2008, Saudi Arabia established the following year the Saudi Agricultural and Livestock Investment Company (SALIC, majority owned by the PIF) which aims at achieving food security by providing food products and stabilizing their prices, including through investments in production facilities abroad.

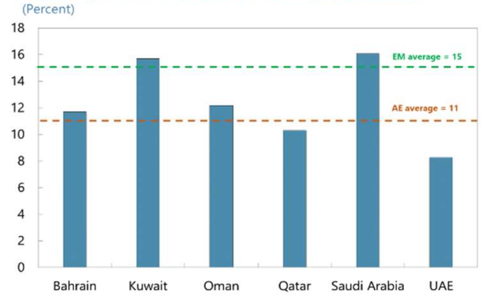
Nonetheless, ensuring food security goes beyond tackling the immediate challenges and beyond one nation. The GCC region is playing its role in achieving regional and global food security. In the near term, providing targeted national and international humanitarian support to vulnerable households is a global immediate policy priority. In this regard, the Arab Coordination Group (ACG)[2] recently announced financial support of US$10 billion to overcome regional and international food security challenges. Over the medium term, lifting agricultural productivity and accelerating climate-resilient agriculture would be key. That includes helping increase the productivity of local farmers, facilitating imports, reinforcing supply chains, and encouraging private sector involvement in climate-smart investments in agriculture, food production systems and technologies.

Global Food Security Index
(Scores; higher means more security)



Sources: Economist Impact data; and IMF staff calculations. Global Food Security Index (GFSI) considers the issues of food affordability, availability, quality and safety, and natural resources and resilience across a set of 113 countries.

Food Imports as Shares of Total Imported Goods
(Percent)



Sources: Atlas of Economic Complexity (OEC); IMF staff calculations.

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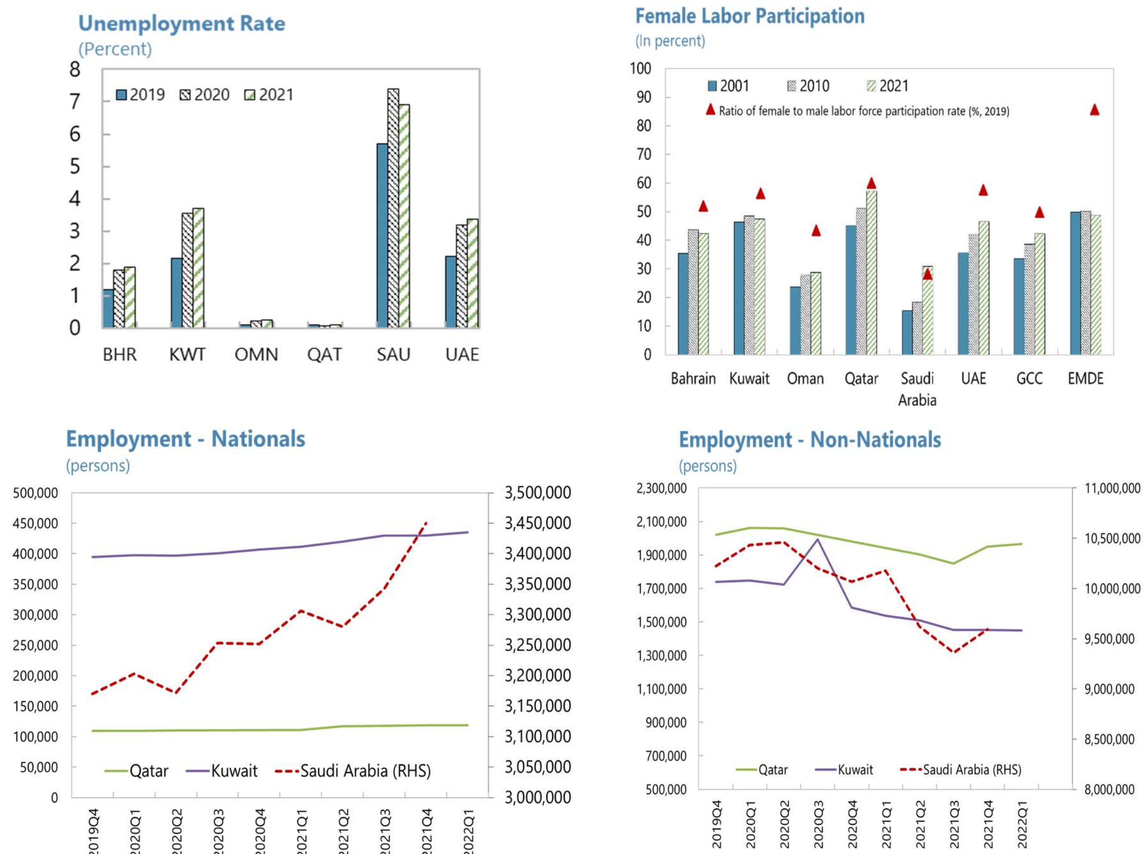
[1] Hunger Hotspots FAO-WFP early warnings on acute food insecurity June to September 2022 Outlook | World Food Programme

[2] The ACG currently consists of eleven institutions, five of which are national institutions including the Abu Dhabi Fund for Development, the Kuwait Fund for Arab Economic Development, the Qatar Fund for Development, the Saudi Fund for Development and the Iraqi Fund for External Development, and six regional organizations.

10. Despite increases in unemployment rates during Covid-19, GCC labor markets have weathered the pandemic relatively well, though structural challenges remain. For countries where more recent data is available, employment of non-nationals seems to be rebounding somewhat, while employment of nationals has held up better or even increased (Figure 11). Nevertheless, GCC labor markets still suffer from long-standing structural issues. For instance, labor markets in the region continue to be fragmented, with large public sectors used as an employment vehicle for nationals, and a private sector dominated by expatriate workers.[6] However, recent increases in participation rates among nationals are welcome and underscore the need for continued efforts to modernize labor markets to absorb new entrants. Moreover, despite recent improvements in female labor market participation in the GCC, significant gaps remain as female

Figure 11. GCC: Labor Statistics



Sources: ILOSTAT, World Bank, National Authorities; and IMF Staff Calculations.

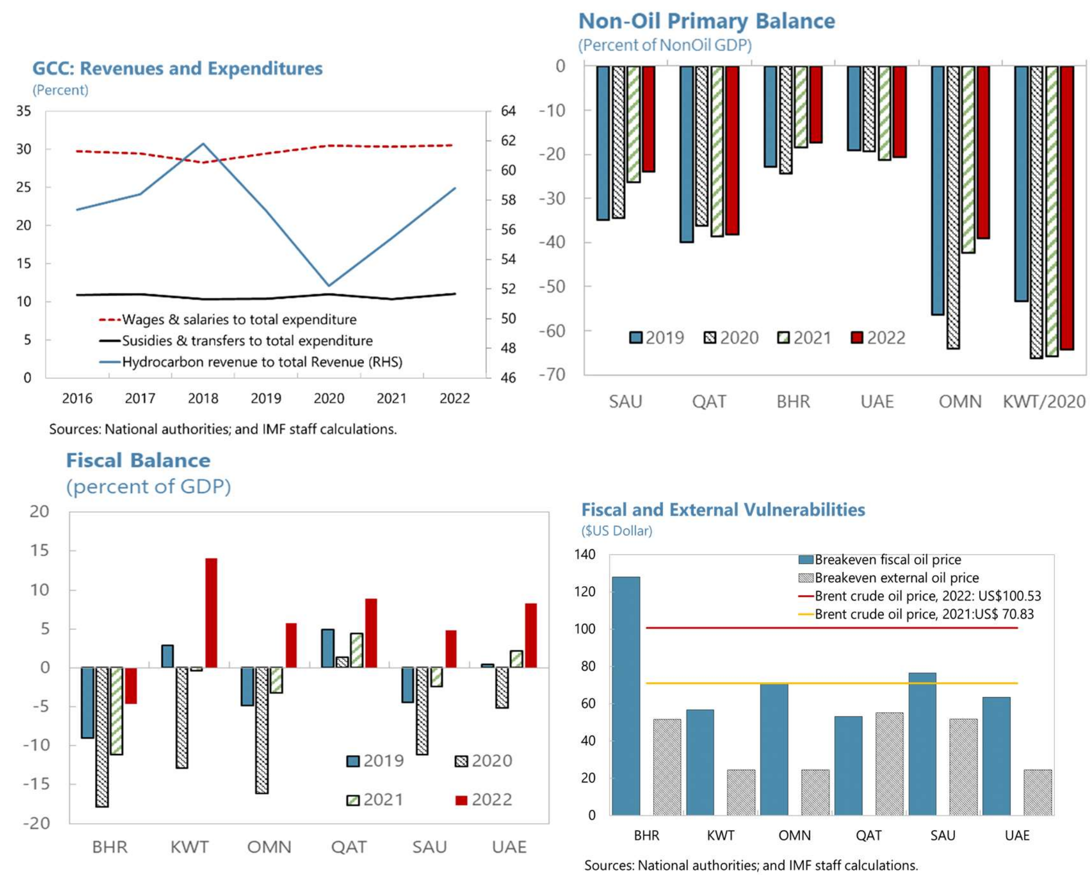
[6] Though for most GCC countries there is no publicly available and comprehensive data on the respective level of wages in the public and private sector, anecdotal evidence suggests that wages in the public sector may have spillover effects on the wage premium offered to nationals in the private sector. Policies have also been implemented recently in a number of GCC countries to increase the share of nationals in the private sector and increase their demand.

participation remains less than half of male participation, and even less in managerial positions, and is well below the average of emerging markets.[7]

Fiscal Developments and Outlook

11. Overall fiscal balances have improved strongly, in line with higher oil prices and the receding effects of the pandemic (Figure 12). The combination of higher oil prices, the benefits of earlier expenditure and tax policy reforms (e.g., with the introduction of VAT), and continued non-oil growth will improve the GCC overall fiscal balances to 7.3 percent of GDP in 2022, which are expected to remain positive over the medium term. Non-oil primary fiscal balances to non-oil GDP are projected to improve in 2022 and then decrease in 2023 in line with medium-term consolidation plans, notwithstanding commitments by GCC countries for supporting increasing costs of living with additional subsidies and incentives.

Figure 12. GCC: Fiscal Developments



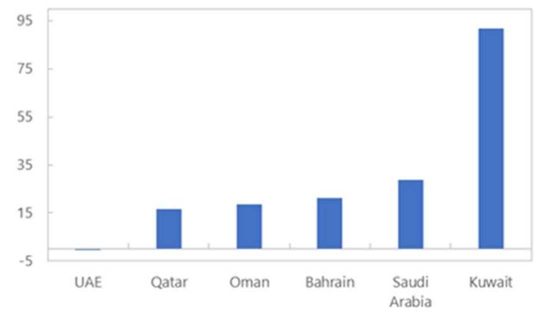
Sources: National Authorities; and IMF Staff Estimates.

[7] The share of women in managerial positions reached an average of 16 percent in the GCC but 27 percent in EMDEs, while only 10 percent of ministerial positions were occupied by women in 2020 against an average of 20 percent in EMDEs, according to ILO data.

12. GCC commitment to growth-friendly fiscal consolidation, notwithstanding oil revenue windfalls, is welcome. The cumulative primary balances have sharply increased and are expected to average 25 percent of GDP during 2022-2026 (Figure 13). In response to higher energy and food prices, governments have utilized the hydrocarbon windfalls to increase social outlays to mitigate inflationary pressures, support the economic recovery, and maintain social cohesion. While some of the fiscal support measures lacked targeting, the rise in expenditure was so far contained. In a break from the past, public sector wages – despite still high wage bills [8]- and government capital expenditure increases have remained prudent, with a caveat that potential additional capital expenditure may be undertaken by the rest of the public sector (i.e., SWFs and SOEs) and not captured in a general government fiscal stance. Energy subsidies are also often recorded off budget (for example through national oil companies) and this could further distort the assessment of the fiscal stance and the extent of the support provided.

Figure 13. GCC: Difference of Primary Balance Between 2021 April and 2022 April WEO Projections for 2022-26

(Percent of GDP, Cumulative)



Sources: National authorities; and IMF staff calculations.

13. Primary fiscal balances and oil revenue projections suggest that most countries are expected to save the increase in oil revenues between 2021 and 2022. This is reflected in the near one-to-one or even greater improvement in the projected overall primary fiscal balance for GCC countries. Over the medium term, governments in the GCC are expected, on average, to save about 40 percent of their windfall oil revenues despite the projected decline in oil prices, contrasting their stance to the procyclical fiscal policies of the past.[9] However, these results which indicate significant progress in the management of hydrocarbon windfalls with respect to the past also mask some heterogeneity in the conduct of fiscal reforms across the region (Appendix I). Fiscal breakeven prices[10] for all GCC countries (with the exception of Bahrain) are expected to remain well below observed oil prices in 2022. As these have gone down, this confirms that progress in fiscal reforms undertaken in the past few years have helped reduce fiscal vulnerabilities to oil price volatility in the region. Nevertheless, expenditure increases in response to spending pressures after the recent increase in hydrocarbon prices could limit the gains of those fiscal reforms and return the breakeven prices to higher levels.

[8] In 2021, IMF staff estimates that central government wage bills hovered around 9-10 percent of GDP for Bahrain, Oman and Qatar, with the highest levels for Kuwait (19 ½ percent of GDP) and Saudi Arabia (close to 16 percent of GDP). In the UAE (general government), it is estimated at a relatively low 7 ½ percent of GDP.

[9] Regional Economic Outlook for the Middle East and Central Asia, October 2022 (imf.org).

[10] Breakeven prices are prices that would achieve a zero fiscal balance given the level of hydrocarbon production, government expenditure and non-oil revenue.

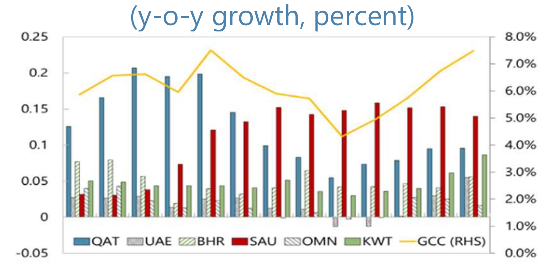
14. The pick-up in hydrocarbon prices has improved somewhat debt sustainability prospects but continued commitment to fiscal discipline remains key. The GCC average public debt ratio as a share of GDP should decrease in 2022 to pre-pandemic levels of about 46 percent of GCC GDP while average debt service burdens (amortization and interest payments) remained elevated as a result of tighter domestic and external borrowing conditions. Some countries (e.g., Bahrain and Oman) are implementing fiscal reforms to address an initially less favorable fiscal situation, while others (e.g., Saudi Arabia and UAE) continue to pursue prudent fiscal policies in the short term, while keeping an eye on their medium and long-term fiscal objectives. Overall, high hydrocarbon prices support healthy fiscal buffers in most GCC countries, though staff estimates suggest that they could deteriorate over the medium term if fiscal reforms are delayed, particularly given the challenges of adjusting to a low-carbon global economy.[11] Fiscal policies will have to play a key role in addressing mitigation costs (e.g., by at least eliminating energy subsidies in the next few years) and support a smooth transition, while energy transition risks are high for the region, and GCC countries are also particularly affected by adaptation needs.

Financial and Monetary Developments

15. The banking system continues to weather shocks relatively well, though limited pockets of vulnerabilities may yet emerge. Private sector credit continues its strong recovery at a pre-pandemic level on average, while GCC asset markets have been performing strongly (Figure 14 and 15). Financial soundness indicators (Figure 16) appear healthy, benefiting from strong buffers before entering the crisis and pandemic support measures, with banks' capital adequacy ratios well above regulatory requirements. NPL ratios remain around 4 percent on average, with provisioning near or exceeding 100 percent while profitability has improved slightly. The loan deferrals, initially rolled out as a blanket moratorium on total debt service, have been phased out in all GCC countries and in some cases (e.g., Qatar), replaced by more targeted support. Despite little evidence so far, potential asset quality deteriorations that could have been masked by pandemic support measures may yet emerge. In this context, the strong recovery in the non-oil

Figure 14. GCC: Credit to the Private Sector

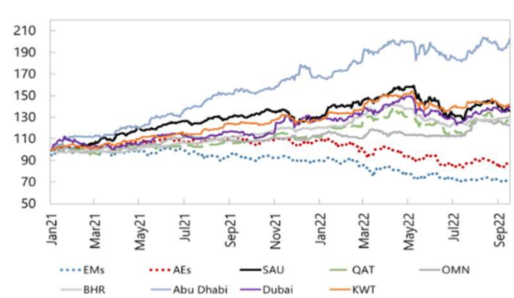
(y-o-y growth, percent)



Sources: Haver Analytics; and IMF Staff Calculations.

Figure 15. GCC: Stock Market Indices

(January 1st, 2021= 100)

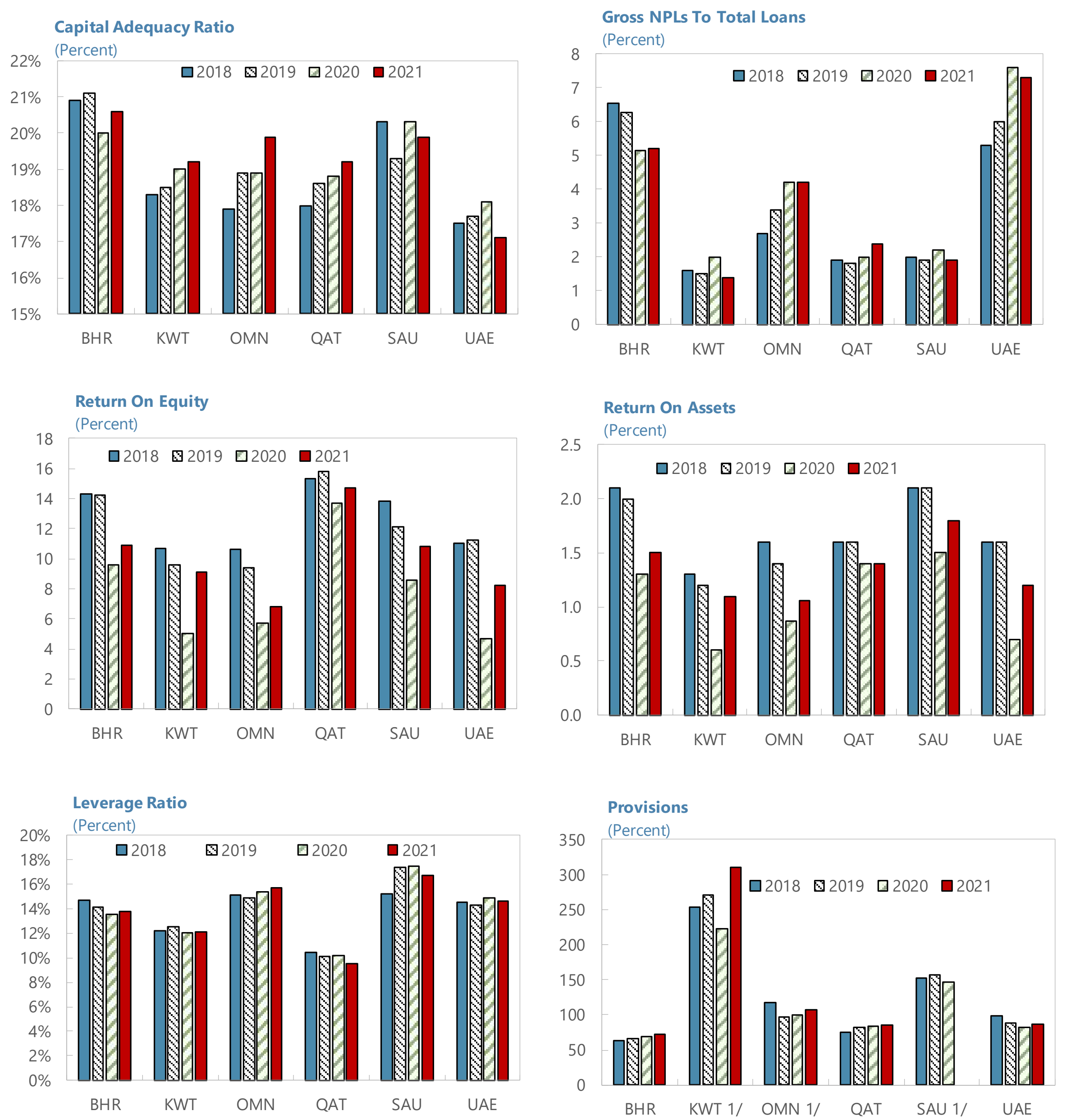


Sources: Bloomberg L.P; and IMF staff calculations.

[11] See Feeling the Heat: Adapting to Climate Change in the Middle East and Central Asia (imf.org) and A Low-Carbon Future for the Middle East and Central Asia: What are the Options? (imf.org)

economy is particularly welcome for GCC corporates as they have had their financial performance deteriorating over time already pre-Covid, leaving them with reduced strength to deal with future economic shocks (Box 4).

Figure 16. GCC: Financial Soundness Indicators



Sources: Country authorities; Haver Analytics, and IMF staff calculations.

1/ Total (General +Specific) Provisions.

Box 4. Corporate Sector Vulnerabilities in the GCC

Even before the COVID-19 pandemic hit, corporates in the GCC region were exhibiting a trend of developing vulnerabilities. Corporate-level financial data on 363 GCC corporates over the 14-year period between 2007 and 2021 suggests that corporate performance—measured by revenue growth, profitability, leverage, liquidity, and capital expenditure—has deteriorated over time.[1] The double shock of COVID-19 and oil prices in 2020 exacerbated these vulnerabilities further, even though monetary and fiscal policy support helped cushion their impact. Although not at critical levels, profitability, debt service, liquidity, and revenue have been declining - translating into less buffers to cope with the subdued demand and low levels of capital expenditure.

While some results vary between countries and industries, the trends were observable throughout the region, suggesting similar drivers. Profitability, measured as return on equity (ROE), of the median firm in the GCC fell from 15.2 percent in 2007 to 4.1 percent in 2021. Compared to previous crises (i.e., global financial crisis and 2014 oil shock), corporates have significantly lower profitability. Corporate leverage, measured by total debt over total equity, close to 40 percent, resulted in some built up in 2020 due to the collapse in aggregate demand caused by COVID-19 and the easing of financial conditions. Historically, corporates in the region had abundant income to pay recurring debt costs. However, the deterioration in the interest coverage ratio (ICR) since 2015 suggests that corporates are more vulnerable to cope with tighter financial conditions than in the past. This could potentially result in a deterioration in banks' asset quality and materialization of contingent liabilities, and thereby the intensification of the (sovereign-bank-corporates) nexus could increase risks to financial stability. Liquidity, measured as current assets over current liabilities, is another dimension in which GCC corporates performance has deteriorated, with short-term liabilities growing at a faster pace than liquid assets, reducing corporates' excess capacity to meet unexpected obligations in the short term. With lower revenue, profitability, and higher debt burdens, capital expenditure as a share of revenue has been declining in GCC countries, though strongly recovered after the pandemic crisis especially in the communication and health care sectors.

A strong economic recovery and favorable outlook should lead to improving corporate financial performance. High oil prices, coupled with planned investments and structural reforms, would further stimulate non-oil activity, and thereby support a more benign profitability outlook and improve debt service capacity. Nonetheless, a sharp decline in oil prices or a prolonged period of low growth would run the risk of sparking pockets of corporate distress while with predominantly flexible interest rates on corporate loans tightening financial conditions will also exert some pressure.

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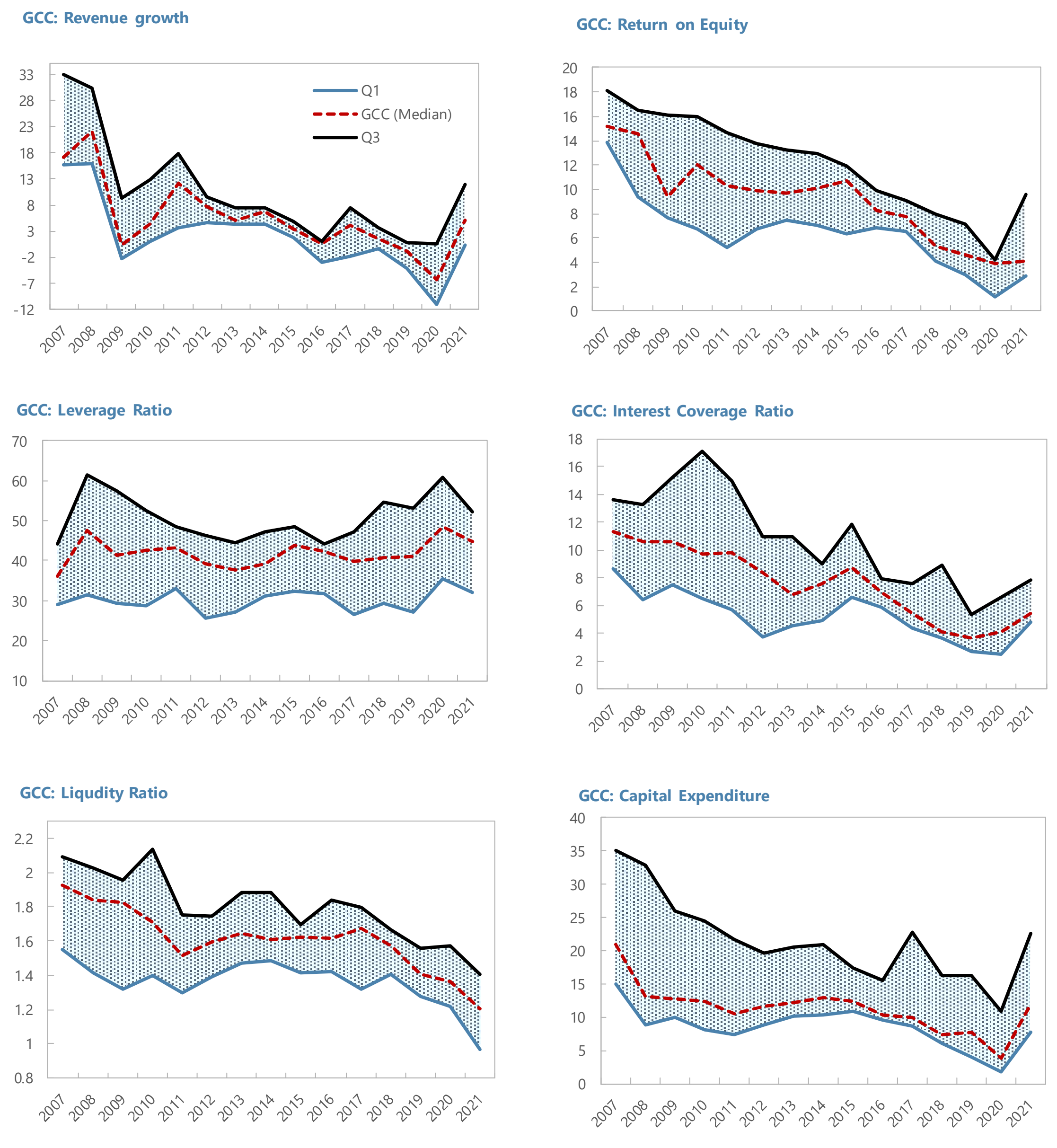
[1] Data constraints limited the analysis of the performance of SMEs, and of financial vulnerabilities in SOEs compared to private corporates.

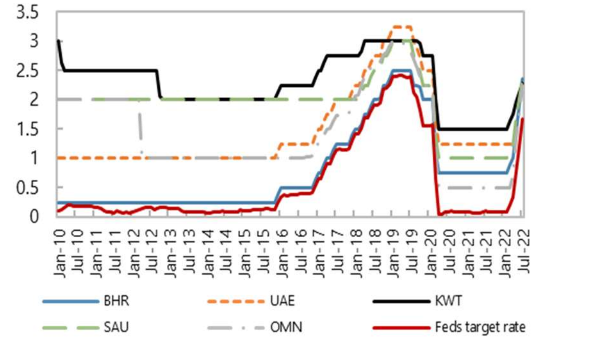
Figure 17. GCC: Selected Corporate Sector Indicators



Sources: S&P Global Market Intelligence; and IMF staff calculations.

16. The impact of tighter global monetary policy conditions is expected to be limited in an environment of high liquidity and oil prices. GCC central banks raised their policy rates following the U.S. federal funds rate and further hikes are expected in line with the US monetary policy tightening cycle (Figure 18). In most countries, a banking structure with low wholesale funding and a large share of non-interest-bearing deposits is expected to improve banks' net interest margins, particularly as corporate sector borrowing is at variable rates reset every 3 to 6 months.[12] On the other hand, the banking sector in Qatar has a large exposure to foreign liabilities (though have declined recently) and could be more susceptible to tightening global financial conditions.[13] Staff's analysis indicates that further tightening is likely to have a limited impact on non-oil GDP growth, banks' profitability, credit growth and asset quality in the GCC in a high oil price environment that increases liquidity in the system (Appendix III).

Figure 18. GCC: Policy Rates
(Percent)

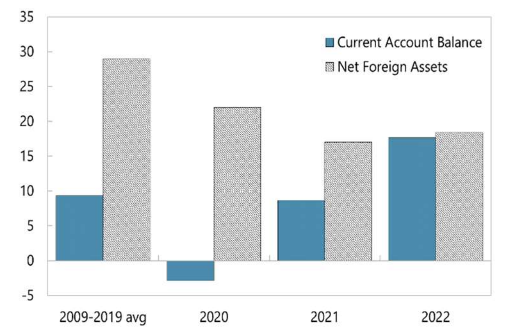


Sources: Haver Analytics, national authorities; and IMF staff estimates.

External Sector Developments and Vulnerabilities

17. The rebound in oil prices has substantially improved external balances, nevertheless some countries remain vulnerable to shocks (Figure 19). The average current account surplus for GCC countries is expected to improve by a further 8 ½ percent of GDP in 2022, before decreasing to an average of 13.7 percent in 2023. Higher oil and other commodity prices (i.e., gas and aluminum) more than offset the rebounding demand for imports, and increased prices for some imports (food and non-hydrocarbon commodities), with real effective exchange rates (REER) only slightly appreciating (Figure 20). Over the medium term, current accounts are expected to return to levels consistent with medium-term fundamentals and desirable policies.

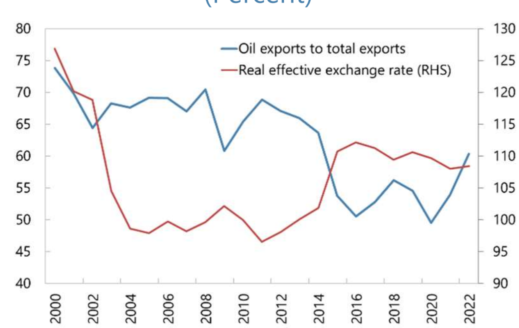
Figure 19. GCC: Current Account and Net Foreign Assets
(Percent of GDP)



Sources: National authorities; and IMF staff estimates.

18. Reserve accumulation and net foreign asset positions are also expected to improve as governments are saving a large share of hydrocarbon windfalls. With the current account for the GCC turning back into a surplus in 2021

Figure 20. GCC: Share of Oil Exports to Total Exports and REER
(Percent)



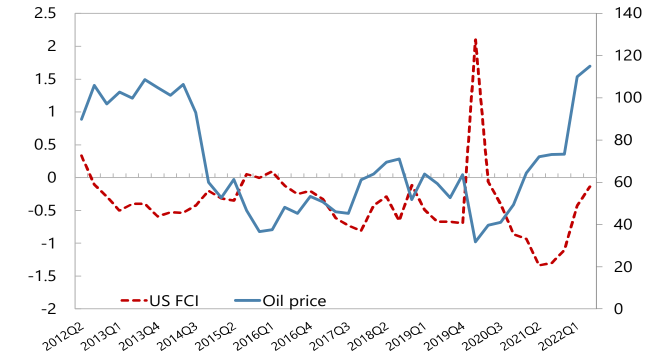
Sources: National authorities; and IMF staff estimates.

[12] Saudi Arabia: Selected Issues (imf.org)

[13] Qatar: 2022 Article IV Consultation-Press Release; and Staff Report (imf.org)

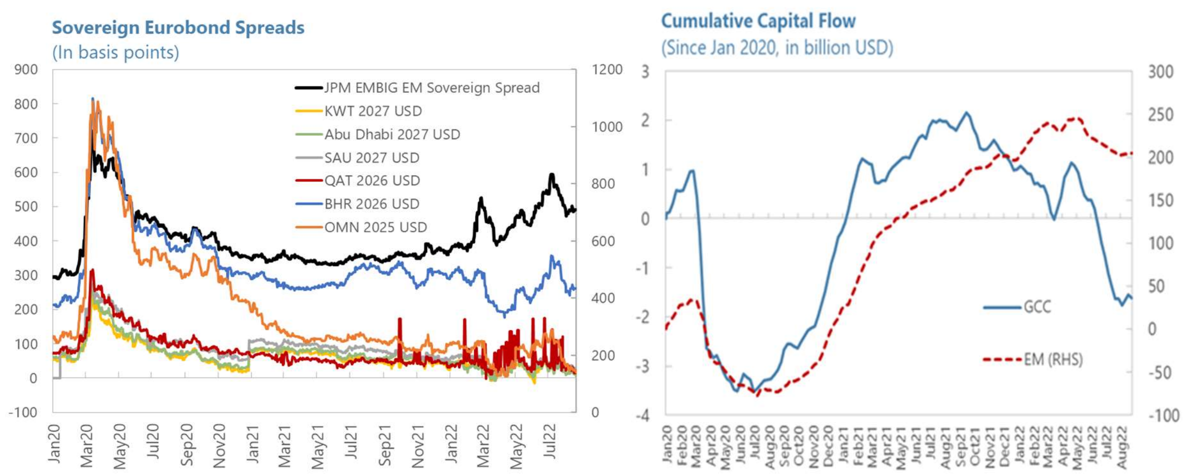
and continuing to improve, net foreign asset positions have significantly strengthened though in some countries' outflows (e.g., Saudi Arabia, Qatar) have contained the improvement (Figure 20). External bond spreads remain overall significantly lower and more resilient to shocks than the average of emerging markets, despite strong movements in capital flows (Figures 21 and 22). Positive external spillovers from the GCC countries, include the recovery of outward remittance flows and increased GCC financial support to vulnerable countries in the Middle East, North Africa and Pakistan (MENAP) region.[14]

Figure 21. GCC: US Financial Condition Index and Oil Prices



Sources: Bloomberg L.P, Haver Analytics; and IMF staff estimates.

Figure 22. GCC: Spreads and Capital Flows



Sources: Bloomberg L.P. Haver Analytics; and IMF Staff Estimates.

Risks to the Outlook

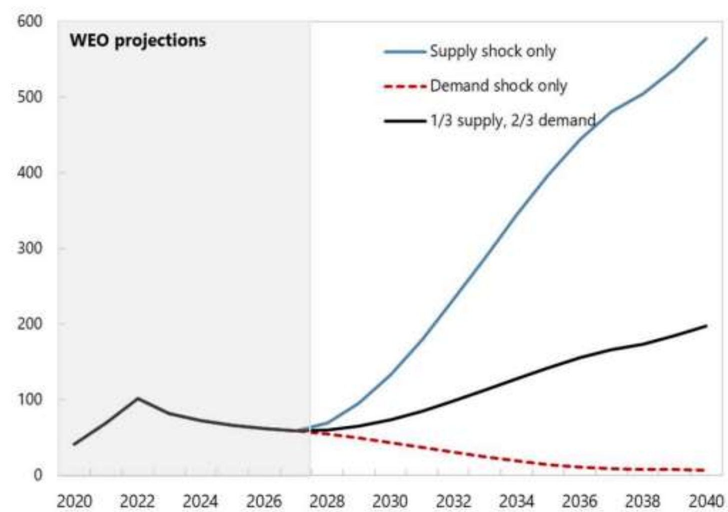
19. There are notable risks and uncertainties around the outlook for GCC countries - in line with the global outlook. On the upside, higher than expected oil production, sustained high oil prices, and accelerated implementation of structural reforms and investments could further improve the outlook. On the downside, risks include another COVID surge, domestically or abroad, lower oil prices due to lower global activity if the war in Ukraine has lasting effects, eventually combined much tighter-than-expected global financial conditions, pressures to spend oil windfalls

[14] For example, in Saudi Arabia outward remittances (which represent the equivalent of 5 percent of Saudi Arabia's GDP) increased by 16 percent in 2021 compared to 2020.

and deviate from fiscal prudence (including outside of the central government budgets), and risks to the reform agenda including due to inflationary pressures. Further global supply chain pressures could also constrain the imports of capital equipment and thus hamper the rolling out of diversification and investment strategies.

20. Climate change and related mitigation policies pose additional risks. While oil companies in the GCC have signaled their commitment to significant investment supporting a stabilization of the oil market and to ensure energy security, GCC countries face physical risks from increasing climate stress (high temperature, drought, etc.) and the associated substantial adaptation costs. Beyond the current issue of energy security, as the world moves to renewables in the longer term, the demand for fossil fuels will eventually decline, creating a challenge for GCC countries. It is also likely that achieving the GCC emissions targets will require a combination of both supply (restricting investment flows into oil without CO2 carbon capture and storage and investing hydrocarbon proceeds in renewables) and demand policies (e.g., shift to low-carbon consumption).[15] During the energy transition, as the world moves towards a net zero emissions target, imbalances between oil supply (currently constrained due to past underinvestment) and demand (which will decline more gradually) may lead to more volatility of oil prices. However, if supply constraints remain binding, then oil prices could remain persistently high, a positive shock to the GCC, notwithstanding the concomitant need for mitigation policies (Figure 23).[16]

Figure 23. GCC: Oil Price Projections Under Net-Zero 2050 Scenarios



Sources: IMF staff projections.

C. Policy Priorities

Policies for Potential Growth, Fiscal Sustainability, and Financial Stability

As the economic recovery is now well-established following higher hydrocarbon prices and despite global economic shocks, policies should address medium- and long-term challenges. Most of these challenges are not new but made more pressing by the effects of the Covid crisis, previous slump in oil prices and increasing pressures from climate change. This means also that it is critical to maintain the

[15] Emissions targets vary between GCC countries, see paragraph 37.

[16] The demand shock reflects the IEA net zero emissions scenario.

reform momentum that has been achieved recently, which should not be derailed by high hydrocarbon prices.

Policies to Ensure Fiscal Sustainability While Aiming for Higher Potential Growth

21. Higher hydrocarbon prices should provide momentum for enhancing fiscal buffers and pursuing fiscal structural reforms. The COVID crisis accompanied by an abrupt decline in demand for hydrocarbon had put pressure on government balance sheets and brought forward medium-and long-term fiscal policy challenges, stressing the need to avoid procyclical fiscal policies. In the near term, when fiscal space allows it, as in most GCC countries, targeted support to deal with shocks (e.g., high energy and food prices) that affect the most vulnerable should be prioritized while leveraging on the progress achieved during the pandemic in modernizing and digitalizing the provision of social benefits.

22. To secure fiscal sustainability and meet intergenerational equity needs, GCC policymakers should carefully manage higher hydrocarbon proceeds to rebuild or stabilize fiscal buffers and reduce public debt burdens, while avoiding past procyclical patterns. Additional fiscal efforts might also be needed to meet the increasing challenges posed by climate change and energy transition as well as facilitate the diversification of economies. These efforts would include measures to diversify and mobilize non-oil revenue, introduce climate related public investment management strategies, while at the same time developing and updating green finance frameworks and markets given the potentially high climate change adaptation, mitigation and transition costs. The growth-friendly medium-term consolidation efforts should be supported by a combination of revenue and expenditure reforms, including to further greening the economy. Priority reforms include:

- **Mobilizing non-oil revenue,** as the tax gap in the GCC remains high (estimated at 16 percent of non-oil GDP in 2019) and there is evidence of untapped non-oil revenue potential. Based on current efforts this would include broadening the tax base by reducing exemptions, revisiting regressive fees and introducing CIT (such as planned to be implemented in the UAE for June 2023) - including in the wake of signed agreements on minimum taxation, introducing (such as envisaged in Qatar, Kuwait) and increasing (such as done in Bahrain) VAT taxes and excise tax rates, as well as developing other forms of taxation (e.g., personal income taxes, property taxation - both types also effective in curbing inequality).[17] Improving the efficiency of tax collection should rest on strengthening tax administration and proceeding firmly with the digitalization of processes.

- **Containing the wage bill** by proceeding with planned public wage and employment reforms (UAE), rationalization of public wage bill (Qatar), as well as streamlining resources and increasing manpower efficiency (Bahrain). Efforts undertaken early on in Saudi Arabia to rationalize the

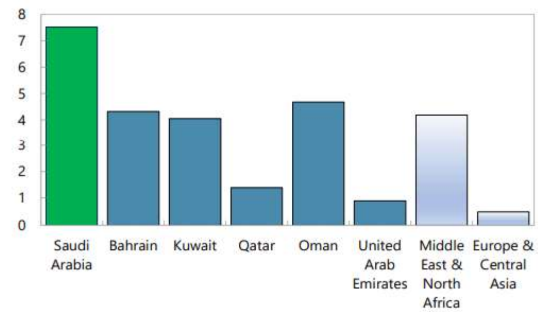
[17] Four GCC countries have implemented a VAT: Saudi Arabia (with a general rate now at 15 percent), UAE (at 5 percent), Bahrain (doubled its rate to 10 percent in 2022) and Oman (5 percent). Saudi Arabia has a corporate income tax (at a rate of 20 percent for foreign companies with local companies paying Zakat).

wage bill are already bearing fruits and should be sustained and well anchored. These efforts will also help to incentivize private sector employment.

- **Revisiting and gradually phasing out poorly targeted subsidies**, alongside measures to strengthen social safety nets. Energy subsidies are fiscally costly and crowd out spending on education, health, and other social expenditures that are critical for inclusive growth (Figure 24).[18] Gradually removing energy and utility (e.g., water) subsidies will also help to promote efficient energy and water usage and support GCC mitigation targets in reducing greenhouse emissions. This effort (e.g., the aim to eliminate energy subsidies by 2030 in Saudi Arabia or Qatar's energy subsidy reform to reduce subsidies on diesel and gasoline) could usefully leverage on the progress made in a number of countries (e.g., Saudi Arabia) on targeting, streamlining, modernizing and digitalizing the provision of social benefits.[19]

Figure 24. GCC: Energy Subsidies

(In percent of GDP)



Sources: IMF (2021)

- **Scaling up productive investments and investments in renewables,** by improving the targeting expenditures that will achieve climate mitigation objectives.

23. Structural fiscal reforms should be underpinned by rules-based credible medium-term fiscal frameworks (MTFFs) with fiscal anchors. Some GCC countries have achieved commendable progress in this area by developing medium-term fiscal frameworks that clearly incorporate multi-year revenue initiatives and spending priorities (e.g., Qatar, Saudi Arabia) and by working on the introduction of performance-based budgeting in the medium-term (Saudi Arabia), but more complete rollouts are still needed across the region. As well as stronger linkages with budget planning and execution, the MTFFs should be closely coordinated with medium and long-term government development strategies and plans and supported by sound fiscal institutions. Additionally, given the increasing role of GCC Sovereign Wealth Funds, there is a need to enhance sovereign asset-liability management frameworks closely aligning them with MTFFs. To further enhance the credibility of fiscal policy, regular public communication of fiscal plans and outcomes, as well as of the government strategy on oil revenue management and its impact on reserves and domestic liquidity would be beneficial.

24. Credible fiscal rules will help delink government spending from oil price fluctuations and will support an appropriate medium and long-term fiscal policy path. These rules should ideally be derived from a long-term fiscal anchor – e.g., based on the permanent income hypothesis

[18] Subsidizing the consumption of fossil fuel has also significant negative externalities that can be captured in estimates of the implicit and explicit cost of subsidies Fossil Fuel Subsidies (imf.org). The combined cost of those is substantial in GCC countries.

[19] Saudi Arabia: 2022 Article IV Consultation-Press Release; and Staff Report (imf.org)

– and offer clear guidance for policymakers and economic agents on the long-term objectives for fiscal policy (i.e., achieving intergenerational equity, supporting development and diversification strategies, while at the same time taking into account transition risks related to climate change).[20] A risk-based fiscal framework that takes into account such long-term challenges will be critical to ensure long-term fiscal sustainability. Identifying specific measures aimed at achieving levels of non-oil revenue targets can help make the transition less disruptive. In the near term, spending pressures tend to move in tandem with the global commodity cycle. Fiscal rules that limit spending growth can be particularly helpful to build buffers during the upcycle of commodity prices. GCC countries should work towards establishing such credible fiscal rules and if already being devised, as in Saudi Arabia, strengthening them for better enforcement and credibility.

25. Sound debt management should continue to support fiscal policy and capital market development. A strategy that includes lengthening debt maturities, reducing refinancing costs, pre-financing in favorable times, and building a yield curve in domestic and international markets would support debt sustainability. Plans to develop a framework for assessing and monitoring guarantees and other potential contingent liabilities linked to increased private sector participation, including through PPPs, are important steps forward towards sound debt and fiscal risk management practices (e.g., in Saudi Arabia), as are steps to build capacity in debt sustainability analysis. Improved coordination among fiscal authorities (central and local governments, GREs, and SWFs) especially as entities that are not strictly part of the central government take a greater role in domestic investment strategies - but also central banks would help to improve cash flow management (including through treasury single accounts) and strengthen risk management practices. For example, the UAE's new Dirham Monetary Framework (DMF) and recent federal debt issuances will support domestic capital market development but will require strong coordination between the CBUAE and the federal government.

26. Further progress in transparency is needed to strengthen fiscal governance through:

- **Fiscal coverage**, which should be expanded beyond the operations of central government in some GCC countries and reflect a more comprehensive picture of fiscal sustainability as data limitations on general government statistics and more broadly on public sector balance sheets, including on off budget subsidies (e.g., for energy, contingent liabilities, GREs' debt, and Public Private Partnerships (PPPs), Sovereign Wealth Funds (SWFs)) limit the possibility to accurately assess the underlying fiscal stance and cloud effective policy making decisions. To fully account for the investment strategies and realizations of SWFs and strengthen governance and policy making, more transparency on the SWF operations and flows with the central government would be important.[21]

- **More regular publication.** Regular publication of the pre-budget statements, quarterly budget outcomes, mid-year review and year-end reports (as in Saudi Arabia) and fiscal adjustment

[20] Saudi Arabia: Selected Issues (imf.org) for a discussion of fiscal rules and anchors.

[21] Qatar: 2022 Article IV Consultation-Press Release; and Staff Report (imf.org)

target (e.g., Bahrain) significantly increases transparency. It is important to continue these efforts, including by providing additional details on revenue and expenditure items, continuing to gradually extend institutional coverage, and reporting on the deviations between budget outcomes and plans.

- **Strengthened disclosure and management of fiscal risks,** which will help to enhance the credibility of budget frameworks. This includes risks related to contingent liabilities, PPPs, and more broadly commitments that go beyond the central government (for example through development funds or sovereign wealth funds) and should be ideally integrated in an asset liability management framework.

- **Improved transparency in public procurement**, where significant progress has already been made in some countries (e.g., Saudi Arabia) would enhance fiscal management and assist the government's anti-corruption efforts.

Policies for Financial Risk Mitigation and Robust Financial Sectors

27. As financial sectors expand again in the context of high oil prices and liquidity, maintaining bank soundness is essential to contain systemic risk.[22] Overall, financial sectors in the GCC appear sound and able to accompany the ongoing recovery in the non-oil sector and longer-term structural transformation, but legacy risks, current stresses and emerging vulnerabilities need to be managed and anticipated:

- As policy support measures have been withdrawn in most of the GCC countries, underlying financial vulnerabilities could surface in pockets of vulnerabilities (e.g., in SME financing, real estate and mortgage lending). Close monitoring of credit standards among SMEs and corporations needs to be paired with intense supervision of banks and other financial institutions. This requires detailed on and off-site inspections, including to ensure adequacy of credit risk assessments and provisioning, and stress-testing. Regular reporting on loans under the few remaining deferral schemes and the stock of those restructured after support measures are lifted will remain important in monitoring asset quality performance.

- Specific vulnerabilities potentially emerging, such as in the rapid development of mortgage and real estate financing and given banks' growing exposure to construction and real estate loans, would for instance warrant the development of real estate price indicators to help assess financial stability risks (e.g., in Bahrain). Given uncertainties and the tightening of global financial conditions, reduced profits of corporates, credit risk remains a concern, requiring enhanced supervisor scrutiny, including through regular thematic inspections in banks and continued in-depth assessments of loan portfolios and provisioning practices. Prudent management of corporate leverage in the recovery period, in particular in some sectors that may benefit from a

[22] Assessing Banking Sector Vulnerabilities in the Gulf Cooperation Council in the Wake of COVID-19 (imf.org)

rapid inflow of funds (e.g., real estate, construction) could allow for more sustainable developments over the medium term.

- Pre-existing vulnerabilities also need to be addressed, including reducing loan-to-deposit ratios—where they remain above the regulatory norms—and significant FX mismatches or reliance on wholesale and nonresident funding (e.g., Qatar).

28. Expediting the strengthening of insolvency and resolution frameworks should be a priority. Progress has been achieved in some GCC countries (e.g., UAE, Bahrain and Saudi Arabia). However, continued efforts to strengthen insolvency and resolution frameworks would help banks deal swiftly with the limited part of the loan books most affected by the Covid crisis, while limiting any long-lasting effects on growth prospects stemming from weak corporations. Policies to ensure recognition of impairment and resolution of bankrupt borrowers (while targeting distressed but viable borrowers) and ensuring adequate bank buffers remain in place could help reduce the length and severity of any negative credit cycle in the future.

29. Continued support of fintech and digitalization could provide an important source of growth to the financial sector that needs to be balanced against possible risks. The fintech sector is growing rapidly in GCC countries with the support of the authorities. In line with its aim to be a regional fintech hub, the UAE introduced regulatory sandboxes (in 2016 in Abu Dhabi and 2017 in Dubai), while the federal government is developing a comprehensive legislative framework to regulate Fintech and related financial services, with 7 digital banks recently licensed and 10 Fintech accelerators put in place. In Saudi Arabia, the Central Bank has launched together with the Capital Markets Authority the Fintech Saudi initiative in 2018, has granted licenses to three digital banks as of February 2022 and has established a cybersecurity framework to identify and address cyber risks. In Bahrain, the Central Bank established a dedicated Fintech & Innovation Unit and introduced a Regulatory Sandbox encouraging fintech firms whereas in Qatar a National Fintech Strategy was announced and the Qatar FinTech Hub (QFTH) launched in 2019. Kuwait and Oman have also introduced fintech regulatory sandboxes in 2018 and 2020 respectively. The innovation drive should continue to remain balanced against the risks, including to financial stability, arising from new technologies and innovative fintech business models. Finally, the authorities should continue to apply a mix of activity- and entity-based regulation proportionate to the size, complexity, and risk of fintech firms.

30. Continued reforms are needed to further develop financial markets and the non-bank sector and increase financial inclusion.[23] Priority reforms include developing a yield curve, increasing market liquidity through secondary markets trading and developing domestic corporate bond markets. There is also a need to focus stock market reforms on enhancing corporate governance and investor protection, removing restrictions on foreign ownership, and encouraging financial market competition. Green and sukuk market segments have also the unique potential to

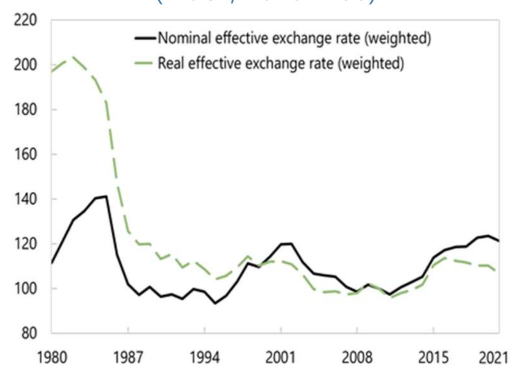
[23] Gulf Cooperation Council: How Developed and Inclusive are Financial Systems in the GCC? (imf.org)

contribute to the development of local markets in the GCC, and such issuance (e.g., green bonds and green sukuk) has been recently developing.

Revive Economic Diversification and Lift Medium-Term Growth and Competitiveness to Ensure a Smooth Adjustment to a More Sustainable Future

31. Pegged exchange rate regimes remain appropriate for GCC economies despite global economic volatility and shocks. It is a policy that has been serving GCC countries well by providing a credible monetary anchor. However, the pegs should continue to be reviewed regularly to ensure they remain appropriate and do not hinder competitiveness. So far, indications are of a limited impact of the USD appreciation on competitiveness as REERs have held relatively steady, largely thanks to relatively lower inflation in GCC countries (Figure 25). Overall, the external position of GCC countries remains broadly in line with or slightly weaker than medium-term fundamentals and desirable policies, and GCC countries have overall adequate buffers to maintain their pegs. Reforms to deepen money and capital markets and further strengthen the monetary policy framework should continue to ensure institutions are in place to support more independent monetary policies in the future if this becomes appropriate. Fiscal consolidation and competitiveness-enhancing structural reforms will help strengthen the external position further and support the exchange rate pegs.

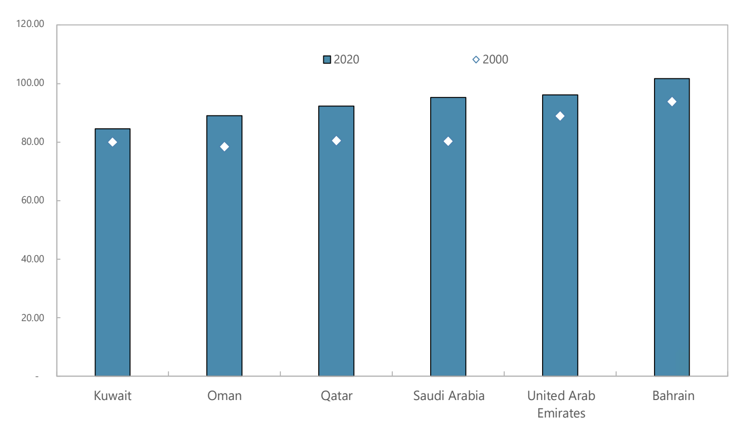
Figure 25. GCC: Effective Exchange Rates, 2019-2022
(Index, 2010=100)



Sources: EcData; and IMF staff calculations.

32. Preserving and continuously enhancing competitiveness remains critical for diversification and investment, especially in the context of a global transition to lower carbon-intensive economies. GCC countries have managed to accelerate their diversification efforts across output, export and revenue dimensions (Figure 26), though in some cases

Figure 26. GCC: Diversification Index



Sources: Prasad A., Refass S., Saidi N., Salem F., Shepherd B., Global Economic Diversification Index 2022. Dubai: Mohammed bin Rashid School of Government.
Note: The series are based on a multidimensional index which quantifies diversification across three angles: trade, output, and revenue as well as an overall weighted index. An increase in the index is interpreted as an increase in diversification for the relevant indicator.

FDI inflows remain relatively low.[24] The progress can be attributed to the multifocal reforms undertaken across the region. As the GCC charts its diversification path, a move toward environmentally sustainable growth will also be essential - with lower expected global demand for hydrocarbons including from worldwide policies to confront climate change making the transformation towards more complex products and services even more urgent. With a potentially important contribution to economic and financial diversification, sovereign wealth funds' interventions in the domestic economy — including in Giga projects—should continue to be subjected to rigorous cost-benefit analysis to ensure that risk-adjusted returns remain high and generate greater private sector involvement.

33. Reforms to address long-standing structural issues, promote competitiveness and boost non-oil growth continued during the pandemic. The region has weathered the Covid 19 crisis relatively well, with limited scarring overall but structural weaknesses, including over-sized public sectors in some countries, low female labor force participation, insufficient training and upskilling of the labor force (in particular, in innovative sectors), low productivity and limited private sector activity crowded out by dominant SOEs remain as bottlenecks for further progress. Steps taken to attract private and foreign investment (e.g., Qatar, Saudi Arabia), improve the regulatory and business environment, align business procedures with international standards and reduce costs associated with setting up a business are welcome. Opportunities for economic transformation have also emerged during the pandemic, including through digitalization and climate-related investment, which have the potential to accelerate diversification and a greener recovery.

34. Good progress has been made in labor market reforms, but more is needed to foster higher productivity growth and promote diversification. Recent progress includes: (i) changes to the Kafala sponsorship system in Oman, Qatar and Saudi Arabia that will enhance expatriate labor's job mobility, (ii) reforms to raise female labor market participation (e.g., doubling Saudi Arabia's woman labor force participation rate in the past three years); (iii) legislations that prohibit gender-based discrimination in employment (Saudi Arabia, Bahrain and the UAE) and push for a gender balance agenda through a Gender Balance Council (UAE); (iv) attraction of highly skilled expatriate professionals through a number of reform efforts, including visa reforms and changes to employment contracts (Bahrain and UAE) ; (v) digital residency services for expatriate workers and new employment and training portal (Bahrain); and (vi) introduction of a minimum wage and abolishment of the sponsorship system for foreign workers (Qatar). Further reforms needed to boost labor productivity include:

- **Encouraging private sector labor force participation of nationals**, in particular among females. Several countries in the region (e.g., UAE, Saudi Arabia) are seeking to develop private sector employment among nationals. This is critical for enhancing labor productivity and competitiveness and requires leveling the playing field by removing explicit and implicit barriers

[24] Saudi Arabia: 2022 Article IV Consultation-Press Release; and Staff Report (imf.org)

for women to enter certain sectors or jobs and by providing more maternity and childcare support. This also implies lifting barriers to entrepreneurship and small business creation.

- **Adopting and implementing more flexible policies for expatriates** — including highly educated—who are an important part of the labor force and source of talent in the GCC to avoid abrupt declines in labor supply. More flexibility will also reduce the wage gap between nationals and expats, which will also encourage firms to hire more nationals.

- **Improving the quality of education and training to transform the labor force for the future**. The education sector in the GCC should be reformed to reduce structural mismatches in labor markets and develop the current workforce by removing skills gaps and better aligning educational programs with employer needs. Additionally, improving the quantity and quality of education at all levels, including vocational training for middle-aged workers, will create a more productive workforce. Furthermore, reducing the public-private wage gap will boost employment in the private sector, while addressing the productivity-wage gap will ensure competitive wages.

35. Lifting inclusive potential growth would also require:

- **Reducing distortions from public sector intervention that would hinder resource reallocation and the development of markets**. Making sure large-scale public-sector interventions made domestically primarily through sovereign wealth funds (SWFs) are based on appropriate project selection to avoid spending that would have low multiplier effects on growth or even crowd out private investment would be key. Facilitating resource reallocation within and across sectors, including from non-viable firms to viable ones by further improving and utilizing bankruptcy frameworks will be key, as well as appropriate training and education policies.

- **Enhancing SME development.** Countries like Saudi Arabia have also worked towards enhancing SME and local content development while strengthening their governance framework[25]. Bahrain also announced initiatives under its Economic Recovery Plan including comprehensive credit and movable collateral registries, new infrastructure (e.g., the American Free Trade Zone and the aluminum downstream park) and launched a revamped National Employment Plan to further boost employment of Bahrainis in the private sector.

- **Minimizing inefficiencies that accompany industrial policies**. To maximize the benefits to economic growth, incentives should be carefully designed with a focus on transparency and accountability to address governance vulnerabilities, with special emphasis on export orientation and diversification rather than import substitution. This should be done with a focus on technology and innovation, and by holding firms accountable for the support received, such as on the basis of strict performance criteria. For example, economic and industrial clusters can make important contributions by helping to attract investment, induce agglomeration effects,

[25] Saudi Arabia has also announced the establishment of an SME Bank.

create jobs and boost exports – both directly and indirectly when they succeed in building linkages with the broader economy and when accompanied by an integrated strategy (including a conducive business environment, technology upgrading and skills training). But care should be taken to minimize fiscal risks from tax exemptions by instituting strict exit criteria, sunset clauses and ensuring incentives are time-bound. Furthermore, other industrial policy instruments such as local procurement strategies need to be developed jointly with other policies while ensuring there is no hindrance to foreign competition.

- **Enhancing regulations, governance and anti-corruption frameworks** to further mobilize private sector and foreign direct investment in the non-oil sector and raise productivity. This includes reducing restrictions on foreign ownership, aligning tax treatments of local and foreign firms, reducing preferential treatments for government related entities, improving transparency and accountability in the public sector, and further strengthening AML/CLT frameworks. Progress is being made on anti-corruption (e.g., in Saudi Arabia[26]) and improved governance frameworks but significant advances are still needed. Though greater transparency of economic, fiscal and financial data is being gradually achieved, greater data and information availability will also help in addressing the need for a better business environment and ultimately long-term diversification.

- **Promoting digitalization** to prepare for the future of work, enhance productivity and protect macro-financial stability. GCC countries have acted swiftly to accelerate digitalization during the pandemic and the digital transformation accelerated by the pandemic will benefit countries, sectors and firms that invested in digital technology before and during the COVID-19 crisis. GCC countries have rightly put significant emphasis on digitalization, and this has led to substantial progress in a number of areas with potential economic impact over the medium term, in a number of areas including the public and financial sectors (Box 5).

[26] Saudi Arabia: 2022 Article IV Consultation-Press Release; and Staff Report (imf.org)

Box 5. Digital Transformation in the GCC

Digital technologies are transforming the economic and financial landscape and have the potential to generate efficiencies and greater productivity, spur innovation and improve services. The COVID-19 pandemic has accelerated the digitalization agenda and has created new opportunities for the digital economy as an increased number of activities have shifted to online platforms (e.g., e-education, tele-health, digital banks, virtual courts, and e-businesses). This growing role of digitalization, e-government and e-commerce have the potential to boost productivity given the young and tech-savvy population in GCC. However, it is crucial to ensure that proper regulatory frameworks are in place to tackle challenges pertaining to data protection and cyber security. Digital transformation also bears social dividends. For example, digital adoption can help improve education and health outcomes, and strengthen households' resilience to future shocks (as digitalization allows governments to quickly scale up social assistance programs or enhance the education system's preparedness to future pandemics).

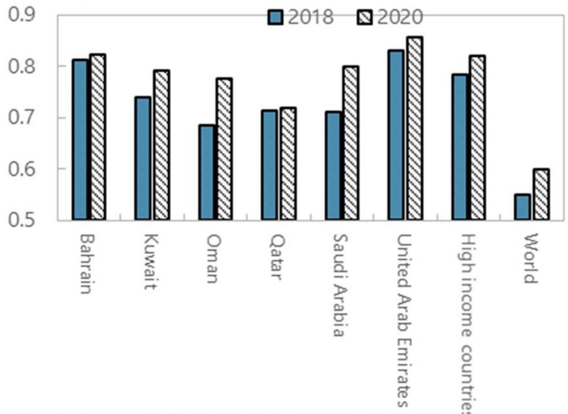
ICT adoption and E-government development has accelerated in the GCC and is close to that of advanced economies. A continued increase in E-government is evident in the region with the UAE ranking 21 in the 2020 UN E-government survey, while most GCC countries are among the top 50, with Saudi Arabia, Kuwait and Oman moving to very high EGDI group for the first time in 2020. Moreover, the number of individuals with internet access has moved to more than 95 percent for all GCC countries, which is a level above the average for high-income countries (89.6 percent).

Digitalization of the financial system is also proceeding at a fast pace with the number of active fintech companies increasing rapidly. Developing the proper regulatory framework to keep pace with the Fintech ecosystem should continue to be a priority, including by ensuring adequate consumer protection without stifling innovation. GCC countries are also currently exploring CBDCs. Reportedly, as of May 2022, Saudi Arabia and UAE are in the pilot stage of CBDCs with the plan for a possible full launch, while others are either in development (Bahrain) or research stage (Kuwait, Oman and Qatar). These CBDC projects will require careful monitoring of risks associated with monetary policy implications (non-interest bearing CBDC), technical constraints (cyber risks and data protection) and socio-economic challenges (low adoption and financial illiteracy).

GCC countries have embedded digital transformation initiatives in their national visions to diversify their economies. Saudi Arabia implemented its National Digital Transformation Strategy and accelerated the digitalization agenda during the COVID pandemic, which led to the adoption of e-Health (Sehati), virtual court (Najiz), distance learning (Madrasati), and ease of doing business for enterprises (Etimad and Fasah). The UAE has also launched several digital projects as part of its Vision 2030, including the Dubai Internet City which acts as a hub for technological innovation to attract ICT companies. Qatar has a similar initiative, TASMU Smart Qatar, that emphasizes cooperation across sectors as part of its national vision. Bahrain, Kuwait and Oman have also taken initiatives to further foster their digital transformation agenda including Bahrain's Digital Government Strategy 2022, Kuwait's digital roadmap as part of its Vision 2035 and its increased focus on Internet of Things (IoT) systems and Oman's e.Oman strategy that focuses on e-Government and ICT infrastructure.

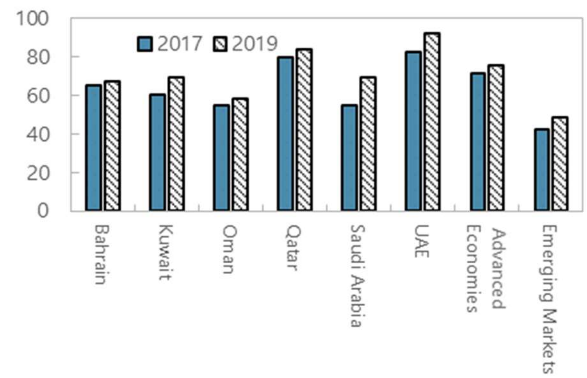
Box 5. Digital Transformation in the GCC (concluded)

E-Government Development Index (EGDI)

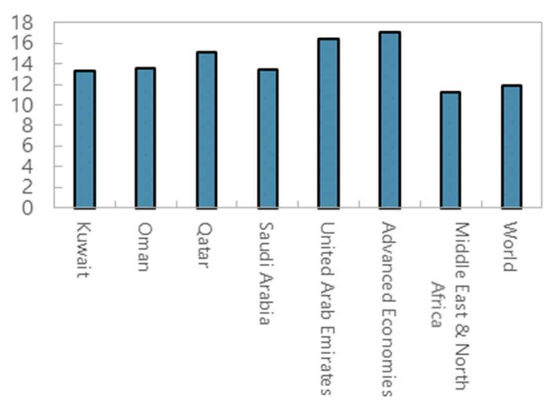


Note: Index ranges for 0 to 1, with 1 being the highest level of development.

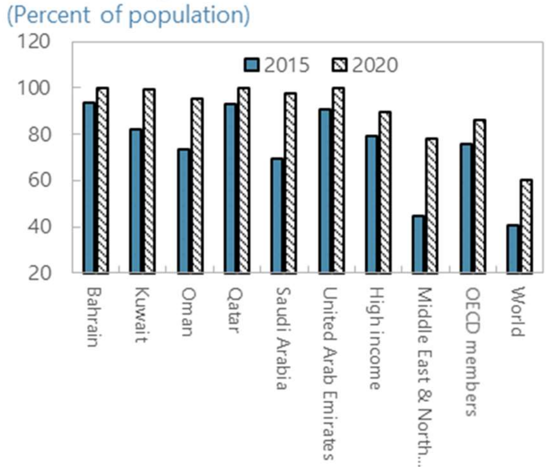
ICT Adoption
(Score)



Digital Readiness Index
(2019)



Internet usage
(Percent of population)

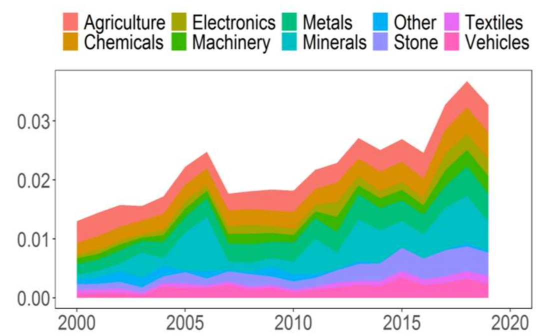


Sources: World Development Indicators; World Bank; UN E-Government Survey; CISCO; and IMF staff calculations.

36. Continued GCC integration will support economic and financial development. The January 2021 Al-Ula Declaration has been welcome and should allow further development of intra-regional trade, tourism, and financial flows. Cooperation in the context of tensions on food security and supply chains has further cemented integration. GCC countries' trade integration with the rest of the world was on an improving trend pre-Covid. Intra GCC exports still amounted to a limited share of total exports though still relatively more diversified than the trading baskets with respect to the rest of the world (Figure 27 and 28).[27] The implementation of different tax and customs policies as well as non-trade barriers call for enhanced cooperation. Digitalization and the transition toward a greener economy also provide new opportunities for regional corporation by setting common standards and creating a larger regional market. If integration progresses further, the longer-term growth gains could be substantial with significant room to enhance intra-GCC trade. Closer integration paired with further improvements in the business environment could also attract additional FDI inflows to the region.

Figure 27. GCC: Value of GCC Exports Within GCC

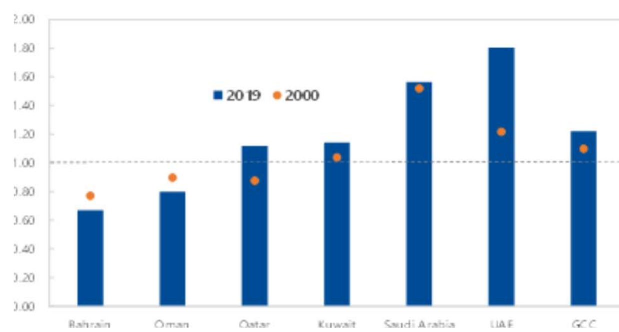
(Percentage of GDP)



Sources: EcData; and IMF staff estimates.

Figure 28. GCC: Average Trade Centrality Indicator Relative to EM Average

(Excluding crude oil and related products, ratio)



Note: This measure is the PageRank centrality and takes into account the size of exports for any given country, the number of its trader partners, and the relative weight of these partners in global trade (see Brin and Page 1998 for a description of its computation)

37. Pressing ahead with the common challenges of climate adaptation, mitigation, and transition management is essential to foster greener growth and address climate risks. To this end, GCC governments have committed under their Nationally Determined Contributions (NDCs) to reduce greenhouse gas emissions. For instance, Bahrain and Saudi Arabia

[27] The centrality index measures a country's interconnectedness within the web of global trade, considering the size of its exports, the number of its trade partners, and the relative weight of these trade partners in global trade (De Benedictis and others 2014). A higher centrality index implies greater trade integration. The GCC's role in global trade has been generally increasing, with the GCC average centrality index greater than the EM average and improving over time (with the 2019 ratio higher than 2000 for GCC in general).

declared commitments to reach net zero emissions in 2060 and Oman as well as the UAE by 2050.[28] Qatar has committed to a 25 percent reduction of its trend greenhouse gas (GHG) emission by 2030 while Kuwait has committed to cut its emissions of CO2 equivalent by 7 ½ percent by 2035 compared to that of 2015. Governments have also set ambitious targets to derive electricity from renewables. Achieving national green initiatives will require detailing how these will be reached, including the magnitude of the investment necessary and feasibility through technology. To deliver on their commitments and targets, GCC countries will also need to ensure full integration of climate-related priorities into their macroeconomic policy frameworks while continuing to develop, mainstream, and scale up green financing. Implementing those policies—including by scaling up ongoing investment in clean energy sources as well as sustainable infrastructure—would be essential to finding a balance ensuring energy security through fossil fuel production, predominantly in the short term, and necessary policies for transition and mitigation. Accelerating the phasing out of untargeted energy subsidies would be critical in meeting mitigation pledges.

D. Concluding Remarks

38. With higher hydrocarbon prices but increased risks at the global level, policy priorities depend on the available policy space and should avoid pitfalls of the past. In the near term, with a subsiding pandemic and a stronger economy in the back of higher but still volatile hydrocarbon prices, policies will need to remain flexible to respond to economic shocks in a targeted manner, be they induced by geopolitical, climate related or health developments while keep an overarching objective of fiscal consolidation and saving hydrocarbon windfalls. With higher oil prices, the reform momentum should be kept, procyclical spending should be avoided, and the windfall used to rebuild policy space. Fiscal prudence should be maintained by keeping expenditures on items such as the wage bill and capital expenditures at their planned level irrespective of higher hydrocarbon prices. Targeted support should be prioritized, drawing on the progress made in modernizing social benefits during the pandemic, while identifying fiscal savings from cutting or reallocating non-priority spending should continue in countries where fiscal space is more limited.

39. Medium-term policy priorities should focus on securing sustainable fiscal positions, macro-financial stability, and strong inclusive and green growth. Fiscal policy should be geared toward achieving growth friendly consolidation with the aim to ensure long-term fiscal and external sustainability. Priority should be given to strengthening fiscal frameworks, further mobilizing non-oil revenues, and increasing spending efficiency – including when undertaken outside of the budget, for example through Sovereign Wealth Funds. Overall, financial sectors appear sound and able to support the recovery and structural transformation, but legacy risks, current stress, and emerging vulnerabilities need to be managed. GCC economies are particularly vulnerable to risks related to

[28] The Middle East Green Initiative, launched in 2021, reflects the regional effort in coordinating an appropriate climate response. Egypt and the UAE will also lead the coordination of global climate action during the COP conferences in 2022 and 2023.

climate change be it related to energy transition, climate adaptation or mitigation. Ongoing reforms to drive up productivity and diversification should be accelerated to meet these challenges.

Table 2. GCC: Selected Economic Indicators[1]

(October 2022 WEO)

	2014	2015	2016	2017	2018	2019	2020	2021	proj 2022	proj 2023
Real GDP Growth	**3.6**	**4.2**	**2.4**	**-0.2**	**2.0**	**1.0**	**-4.5**	**3.1**	**6.5**	**3.6**
(Annual change; percent)										
Bahrain	4.4	2.5	3.6	4.3	2.1	2.2	-4.9	2.2	3.4	3.0
Kuwait	0.5	0.6	2.9	-4.7	2.4	-0.6	-8.9	1.3	8.7	2.6
Oman	1.3	5.0	5.0	0.3	1.3	-1.1	-3.2	3.0	4.4	4.1
Qatar	5.3	4.8	3.1	-1.5	1.2	0.7	-3.6	1.6	3.4	2.4
Saudi Arabia	3.7	4.1	1.7	-0.7	2.5	0.3	-4.1	3.2	7.6	3.7
United Arab Emirates	4.4	5.1	3.0	2.4	1.2	3.4	-4.8	3.8	5.1	4.2
Real Non-oil GDP Growth	**5.7**	**4.3**	**1.8**	**2.0**	**-0.2**	**2.5**	**-3.6**	**4.5**	**4.0**	**3.7**
(Annual change; percent)										
Bahrain	4.7	3.1	4.5	5.5	2.9	2.2	-6.0	2.8	4.0	3.6
Kuwait	4.9	4.2	1.4	1.7	2.9	-1.1	-7.5	3.4	3.9	3.4
Oman	3.2	5.3	6.0	1.7	-0.3	-0.9	-4.5	1.8	2.6	2.6
Qatar	10.6	9.1	5.8	-1.0	2.2	2.2	-4.5	2.8	4.0	2.7
Saudi Arabia	4.9	3.2	0.2	1.3	-1.5	2.8	-2.5	4.9	4.2	3.8
United Arab Emirates	6.4	5.0	3.2	4.8	0.7	3.8	-4.3	5.3	4.0	3.9
Consumer Price Inflation	**2.5**	**1.9**	**2.1**	**0.2**	**2.2**	**-1.5**	**1.2**	**2.2**	**3.6**	**2.6**
(Annual average; percent)										
Bahrain	2.6	1.8	2.8	1.4	2.1	1.0	-2.3	-0.6	3.5	3.4
Kuwait	3.1	3.7	3.5	1.5	0.6	1.1	2.1	3.4	4.3	2.4
Oman	1.0	0.1	1.1	1.6	0.9	0.1	-0.9	1.5	3.1	1.9
Qatar	4.2	0.9	2.7	0.4	0.3	-0.7	-2.7	2.3	4.5	3.3
Saudi Arabia	2.2	1.2	2.1	-0.8	2.5	-2.1	3.4	3.1	2.7	2.2
United Arab Emirates	2.3	4.1	1.6	2.0	3.1	-1.9	-2.1	0.2	5.2	3.6
General Gov. Overall Fisc	**2.7**	**-6.5**	**-9.3**	**-5.8**	**-1.9**	**-1.7**	**-8.9**	**-0.6**	**7.3**	**6.0**
(Percent of GDP)										
Bahrain[2]	-3.5	-18.3	-17.4	-14.0	-11.8	-9.0	-17.9	-11.1	-4.7	-6.0
Kuwait[2]	21.5	4.5	0.8	2.3	7.1	2.9	-12.9	-0.4	14.1	14.1
Oman[3]	-1.6	-13.5	-19.6	-10.5	-6.7	-4.8	-16.1	-3.2	5.5	2.3
Qatar[3]	15.4	21.7	-4.8	-2.5	5.9	4.9	1.3	4.4	12.5	16.0
Saudi Arabia[2]	-3.5	-15.8	-14.1	-9.2	-5.7	-4.4	-11.2	-2.3	5.5	3.9
United Arab Emirates[4]	1.9	-3.3	-2.8	-1.7	1.1	0.4	-5.2	2.1	7.7	4.9
Current Account Balance	**14.4**	**-2.4**	**-2.8**	**2.8**	**8.5**	**5.5**	**-1.2**	**8.2**	**16.7**	**13.7**
(Percent of GDP)										
Bahrain	4.6	-2.4	-4.6	-4.1	-6.4	-2.1	-9.3	6.7	8.6	5.0
Kuwait	33.4	3.5	-4.6	8.0	14.4	12.5	3.2	16.3	29.1	23.0
Oman	4.5	-13.9	-16.7	-13.4	-4.2	-4.5	-17.0	-6.1	6.2	3.6
Qatar	24.0	8.5	-5.5	4.0	9.1	2.4	-2.0	14.7	21.2	22.1
Saudi Arabia	9.8	-8.7	-3.7	1.5	8.8	4.8	-3.2	5.3	16.0	12.3
United Arab Emirates	13.5	4.9	3.7	7.1	9.8	8.9	5.9	11.4	14.7	12.5

Sources: National authorities; and IMF staff calculations.

1/ GCC aggregates in the form of growth rates or shares of GDP are weighted.

2 Central Government

3/ Central government and estimated net income of sovereign wealth funds.

4/ Federal government and emirates.

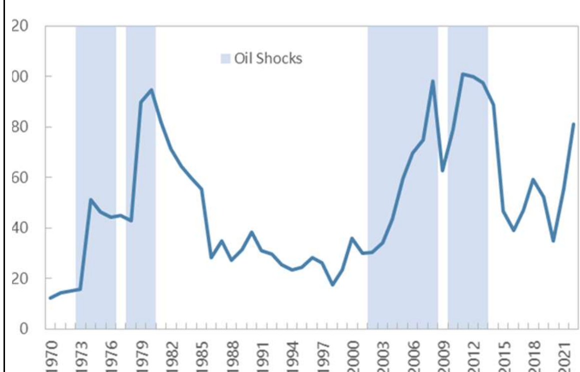
Appendix I. GCC's Fiscal Policy Responses to Hydrocarbon Windfalls: Past and Present[1]

Fiscal policies in the GCC region have long been shaped by distinct periods of hydrocarbon windfalls. During those periods, countries deepened their dependency on oil and gas, increased wages and hirings in the public sector, expanded social safety nets, and ramped up capital expenditure. However, since 2014, the region has accelerated its fiscal and structural reforms. To maintain the current reform momentum, continuing strengthening further fiscal frameworks would be essential.

Looking Back at GCC Fiscal Policies

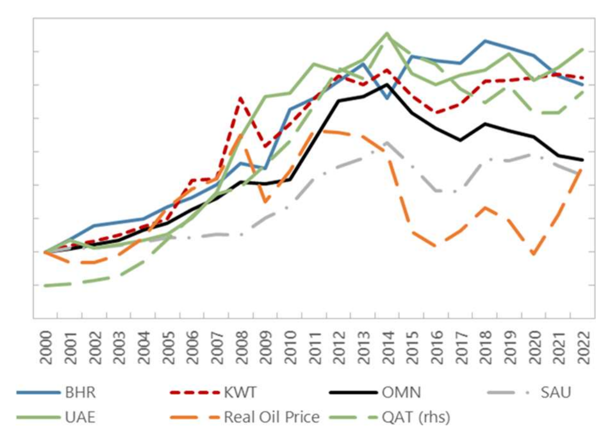
1. **The region witnessed several periods of sharp increases in oil prices (Figures 1a-b).** Oil prices surged in the 1970s, followed by a sharp reversal in the early 1980s and a long period of low oil prices in the 1990s. Another surge occurred from early 2000s to 2014 (interrupted temporarily during the 2008/9 financial crisis), before a period of relatively stable oil prices between the 2014 oil price shock and the COVID-19 crisis in 2020. Since 2021, oil prices have spiked due to demand and supply factors, as well as recent geopolitical developments. Broadly, the same trends apply to gas (albeit smoother). To shed some light on how oil prices affected public finances in the GCC region,[2] the analysis below is focused on past policy responses during the latest episodes of surging oil prices (mainly limited to 2002-2008 and 2010-2014 periods because of data availability).

Figure 1a. Real Oil Price
(2010 $/bbl)



Sources: National authorities; and IMF staff estimates.

Figure 1b. Real Expenditure



Sources: National authorities; and IMF staff estimates.

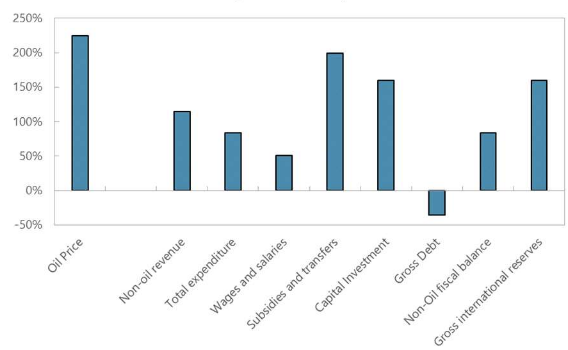
[1] Prepared by Abdullah AlHassan.

[2] WEO data span from 1990 to 2021.

2. Higher oil revenues led to large fiscal surpluses, lower debt and substantial financial buffers (especially during 2002-2008) despite the acceleration of expenditure (Figure 2 and 3, Table 1).[3] The prominent role of hydrocarbon production in the GCC region had in the past led to a pro-cyclical link between oil prices and government spending (Figure 1b), such that the non-oil primary balance deteriorated sharply by around 85 and 40 percent in real terms during 2002-08 and 2010-14, respectively. That is because in both periods of oil windfalls (2002-08 and 2010-14), governments in the region increased wages, public sector hiring, fuel subsidies, social spending (subsidies and transfers), affordable housing to citizens, and infrastructure spending. Fiscal reforms were more limited/delayed during those periods.

Figure 2. Percent Change in Real Terms, 2002-08

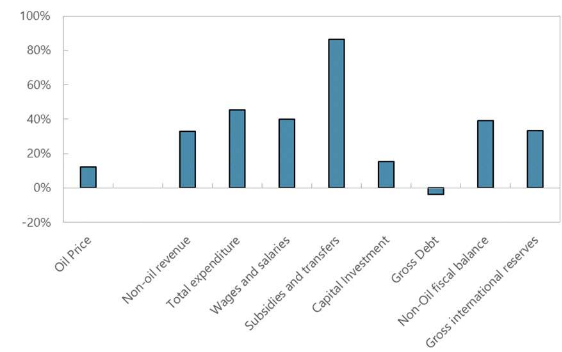
(GCC Median)



Sources: National authorities; and IMF staff estimates.

Figure 3. Percent Change in Real Terms, 2010-14

(GCC Median)



Sources: National authorities; and IMF staff estimates.

Table 1. GCC: Evolution of Fiscal Indicators 2002-08 and 2010-14

(GCC Median)

	Percent change in real terms		In percent of non-oil GDP, unless otherwise indicated					
	2002-2008	**2010-2014**	**2002**	**2008**	**Change**	**2010**	**2014**	**Change**
Real Oil Price (2010 $/bbl)	225%	12%	30.3	98.2	68.0 $	79.0	88.7	9.6 $
Non-oil revenue	115%	33%	12.6	13.6	0.9 pp	14.3	14.2	-0.1 pp
Total expenditure	84%	45%	64.8	64.9	0.1 pp	67.6	69.3	1.7 pp
Wages and salaries	51%	40%	21.3	15.3	-6.0 pp	15.2	18.4	3.1 pp
Subsidies and transfers	199%	86%	3.3	5.8	2.6 pp	5.1	10.4	5.3 pp
Capital Investment	160%	15%	9.3	11.2	1.9 pp	14.8	16.6	1.7 pp
Gross Debt	-35%	-4%	43.8	15.4	-28.4 pp	21.8	15.6	-6.2 pp
Non-Oil fiscal balance	84%	39%	-46.0	-44.7	1.3 pp	-52.2	-56.3	-4.1 pp
CB Reserves (Billion USD)	159%	33%	6.2	14.3	8.2 $	26.3	37.7	11.4 $

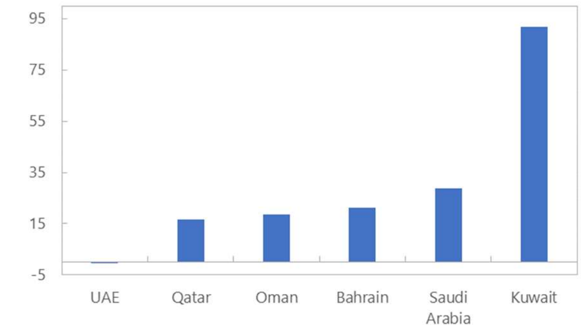
[3] The analysis is reported both in real terms and as a percentage of non-oil GDP. Procyclical fiscal policies had been partially masked when measured in percent of non-oil GDP given the significant increase in nominal non-oil GDP (increasing by around 300 percent and 140 percent on average during 2002-08 and 2010-14, respectively). Also, there is a base effect (e.g., for non-oil revenue). Furthermore, the analysis is based on central banks' reserves but due to data unavailability, it does not consider assets in SWFs which in some GCC countries remain very large.

Is This Time Different?

3. Fiscal balances will improve considerably in the near term and moderate over the medium term. Due to the significant increase in oil prices between April 2021 and April 2022 and ongoing fiscal consolidation, the cumulative primary balances are expected to be 25 percent of GDP higher during 2022-2026 than projected in the April 2021 WEO. Procyclical fiscal policies have been avoided for the most part, with the focus being kept on targeted expenditures to address the impact of higher energy and food prices (Table 2).

Figure 4. Difference of Primary Balance Between 2021 April and 2022 April WEO projections for 2022-26

(Percent of GDP, cumulative)



Sources: National authorities; and IMF staff estimates.

Table 2. GCC: Announced Measures in Response to High Energy and Food Prices, and Oil Windfalls (2021-2022)

Revenue	Bahrain: Extended exemption of all tourism-related industries from tourism levies for 3 months. Oman: Added 25 food commodities to the VAT-exempted food basket.
Wages	Bahrain: Provided 3 month wage support for all Bahrainis working in targeted sectors.
Pensions	Bahrain: Retroactively increasing pension disbursements. Saudi Arabia: One-time salary for social insurance beneficiaries. UAE: Abu Dhabi raised pensions of citizens working in public schools to 80 percent of their total salary.
Food subsidies	Oman: Temporary support for fertilizers, wheat, and rice. Saudi Arabia: Cash transfers to social security beneficiaries, the Citizen Account Program, and the Small Livestock Breeders Support Program; and support for strategic stocks of basic commodities. UAE: Increased food subsidies.
Energy subsidies	Oman: An additional 15 percent in electricity subsidies during the summer time in 2022; and a cap on selected fuel prices until end-2022. Saudi Arabia: a cap on fuel prices. UAE: Increased subsidies for electricity, water, and fuels for citizens.
Other social spendinc	Bahrain: One-month disbursement for low income households. Oman: One-off social support for a targeted group. Saudi Arabia: One-off support to the Citizen Account Program. UAE: Supporting the Social Welfare Program of low-income citizens.
Capital expenditure	Oman: Temporary increased in capital expenditure.

Sources: Announced measures by country authorities.

4. Since 2015, GCC countries have accelerated fiscal and structural reforms to allow a better management of hydrocarbon related volatility, but more can be done to improve fiscal institutions and frameworks. The sharp decline in oil prices in 2014 has triggered a sizeable fiscal consolidation effort in most of the GCC countries, where policymakers have adopted a mix of spending cuts and non-oil revenue-raising measures (such as the introduction of VAT and/or raising the VAT rate) to reduce fiscal deficits. All countries have formulated strategic visions, focusing on reducing the proportion of GDP derived from the energy sector, labor market reforms, women empowerment, social services reforms, and further oversight of SOEs. Oman and Saudi Arabia have put in place medium-term fiscal frameworks.

5. Despite these reforms, and given the growing role of SWFs and SOEs, developing robust sovereign asset-liability management frameworks and enhancing fiscal governance are paramount in identifying and mitigating sovereign risk exposures. While central governments have contained capital spending, this has been replaced by increased capital and development projects spending by the rest of the public sector (i.e., SWFs and SOEs), calling for further reforms to monitor contingent fiscal risks and making further progress in fiscal transparency beyond the central government. A robust Sovereign Asset Liability Management Framework should (as a first step) rely on a comprehensive understanding of the public sector balance sheet (PSBS) that covers entities beyond the central government, including the Sovereign Wealth Funds and the central bank.

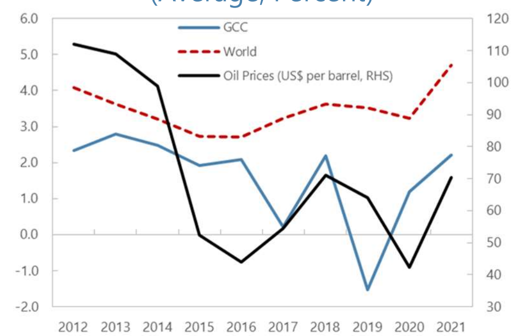
Appendix II. Inflation Dynamics in the GCC[1]

Inflation in the GCC has remained relatively stable over the past decade and below 3 percent on average. However, inflation has picked up in several GCC countries since the end of last year, mainly due to an increase in food and transport prices. An empirical analysis to study the drivers of inflation suggests that inflation abroad is one of the main determinants of inflation dynamics in the GCC. Moreover, our estimates also suggest that the recent appreciation of the nominal effective exchange rate in line with that of the USD appears to shield GCC countries from inflationary pressures.

1. **Inflation has remained relatively stable over the past decade despite challenges posed by fluctuations in international commodity prices.** Since 2012, average inflation in GCC has been less than 3 percent a year. In the past, positive oil price shocks have often been associated with increased government spending resulting from higher oil revenues while exerting upward pressure on consumer prices. Given that GCC countries are mostly relying on fiscal policies and changes in exchange rates do not affect the volume of overall exports,[2] the GCC monetary policy frameworks targeting a stable exchange rate seem to have contributed to stabilizing inflation.

Figure 1. Inflation and Oil Price

(Average, Percent)

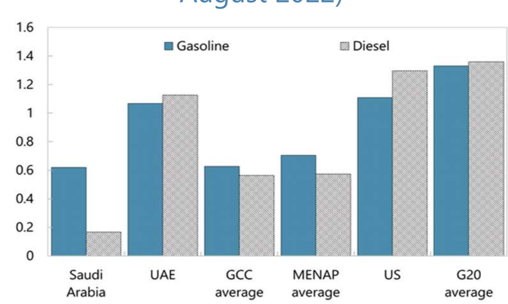


Sources: National authorities; and IMF staff estimates.

2. **Contained domestic energy prices, due to subsidies and price caps, have contributed to relatively low levels of inflation in recent years.** Retail sale prices of gasoline and diesel remain lower in GCC countries compared to G20 countries as of August 2022 (Figure 2). In Saudi Arabia, a cap on local gasoline prices was put in place in 2021 and electricity prices have also remained capped, though a step increase in diesel prices and other fuel products took place in 2022. In the UAE, diesel prices were frozen by the Fuel Price Committee after the onset of the coronavirus pandemic in 2020. The controls were removed in March 2021 to reflect market movements,

Figure 2. Retail Sales Prices of Gasoline and Diesel

(USD equivalent, including taxes as of August 2022)



Sources: globalpetrolprices.com; and IMF staff estimates.

[1] Prepared by Charlotte Sandoz and Fozan Fareed, with the assistance of Abolfazl Rezghi.

[2] SAMA, 2016 "Inflation mechanisms, expectations and monetary policy in Saudi Arabia."

but the levels remain lower than the ones observed in G20 countries. Kuwait's fuel prices have been fixed and Oman authorities have also imposed administered prices and subsidies on selected fuel items.

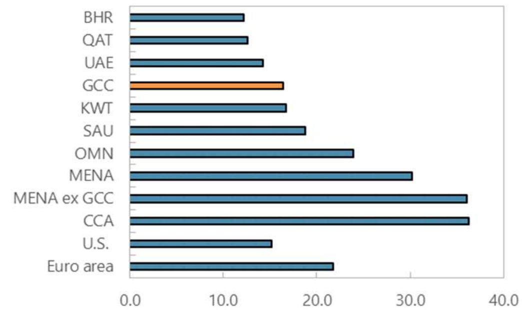
3. **The composition of the CPI baskets can also explain the relatively low level of inflation in GCC countries to some extent.** Countries where food represents a larger share of consumption have been feeling the impact of inflation most strongly. GCC countries have lower shares of food in their CPI baskets, based on their consumption patterns, compared to other countries in the MENA region (Figure 3). Moreover, contained rental prices and their high share in the CPI basket also contributed to low inflation levels in GCC in recent times. For example, the housing rental component is about 21 percent of the overall CPI basket in Saudi Arabia, which has either stayed constant or even declined slightly in the recent past amidst higher supply, increased home ownership and changes in the characteristics of housing demand (e.g., less for villas which are overrepresented in the CPI, and more for smaller units and apartments).

4. **However, inflation in the GCC has started to increase since last year, following a similar trend as the one observed in trading partners, while remaining below regional peers.** Inflation has been on the upward trend, increasing from 0.7 percent (y/y) in July 2021 to 3.2 percent (y/y) in July 2022. There was a pickup in inflation in mid- 2020 which was mainly driven by inflation in Saudi Arabia which jumped to over 6 percent (y/y) as a result of the tripling of the VAT rate to 15 percent in July 2020. As of July 2022, inflation in the GCC ranged from 2.6 percent (y/y) in Oman to 5 percent (y/y) in Qatar (Figures 5, 6 and 7).

5. **The recent increase in GCC inflation seems to be mainly driven by food and transport.** Food inflation has increased from 2.2 percent (y/y) in April 2021 to 6 percent (y/y) in June 2022. While food

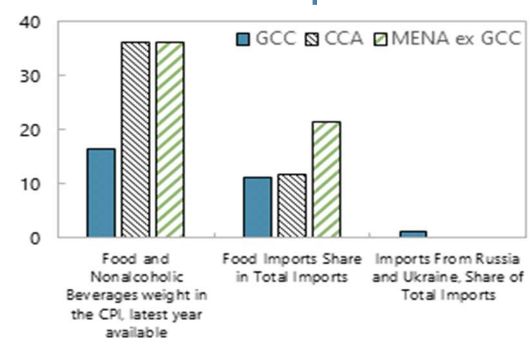
Figure 3. Food and Beverages Weight in the CPI

(Latest year available)



Sources: Haver Analytics, country authorities; and IMF staff calculations.

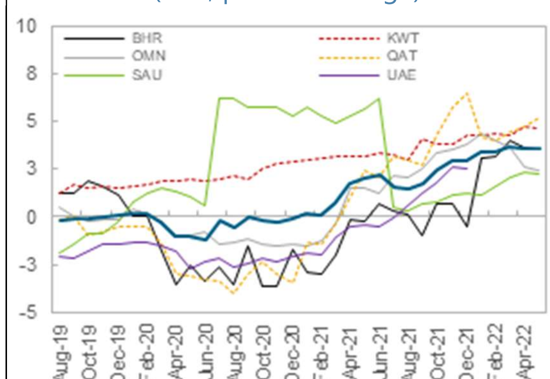
Figure 4. Food CPI Weight, Food Imports and Dependency on Russia-Ukraine Imports



Sources: UN Comtrade; and IMF staff calculations.

Figure 5. Monthly Inflation in GCC

(YoY, percent change)

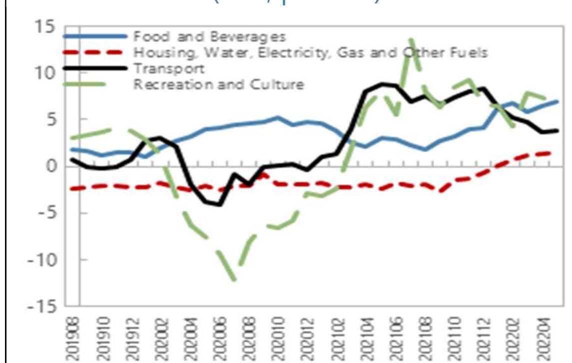


Sources: Haver Analytics, national authorities; and IMF staff calculations.

inflation has been on an upward trend, it has remained below MENA peers, which can be explained by the prevalence of administered prices, subsidies on certain food products, stockpiling of basic food items (e.g., wheat) and low share of food imports. The transport basket also picked up as prices of cars saw a sharp increase internationally during the past year and transport services, mainly international transport by air and travel by sea, also picked up.

Figure 6. GCC: Inflation by Category

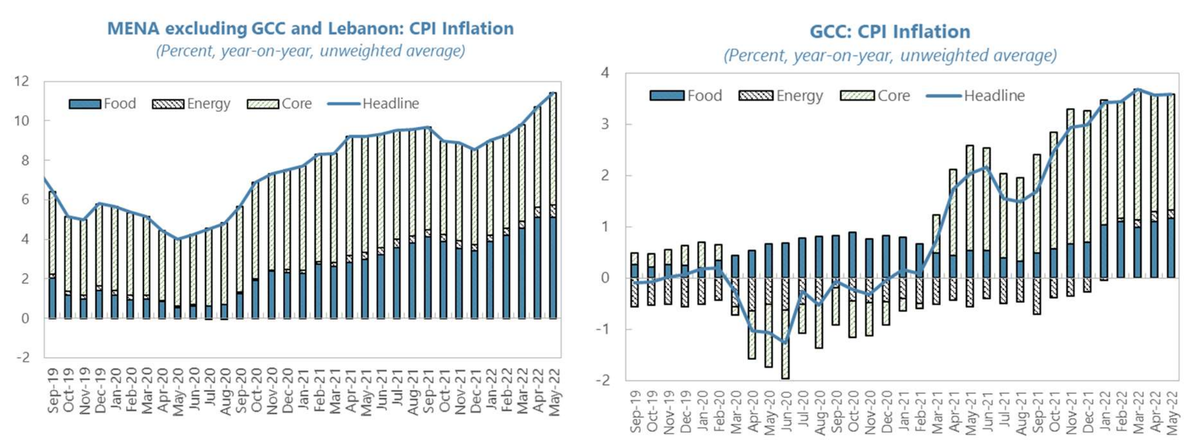
(YoY, percent)



Sources: Haver Analytics, national authorities; and IMF staff calculations.

6. Given the high import dependency of the GCC countries, we use a Global VAR (GVAR) model to investigate the spillover of global inflation to the region. The GVAR model incorporates regional and global inflationary pressures as well as domestic factors such as money supply and effective exchange rate. The model consists of 38 countries covering about 90 percent of the world GDP. The GVAR includes five domestic variables for each country (real GDP, inflation, growth of money supply, nominal effective exchange rate (NEER), interest rates), which are endogenous to each economy. Except for the US, a weighted average of trade partner's domestic variables is entered in the model as foreign variables, which are treated as weakly exogenous following Dees et al. (2007). For the US model, we only include foreign CPI and foreign growth of money supply as foreign variable consistent with our weak exogeneity tests. Oil price and the price of agricultural materials are included in the GVAR as global variables endogenous to US foreign variables but weakly exogenous to all other countries.

Figure 7. GCC Inflation



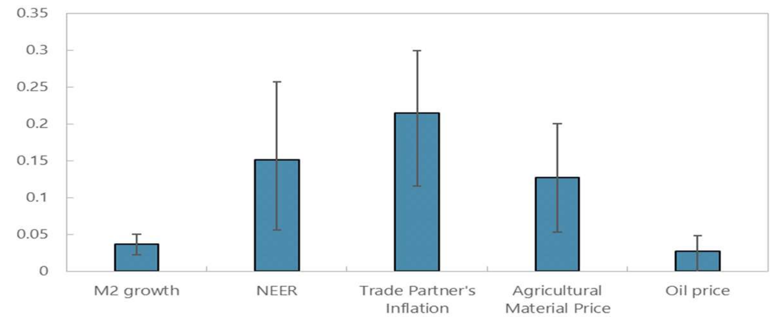
Sources: Haver Analytics, national authorities; and IMF staff estimates.

7. GVAR estimations indicate that domestic inflation in the GCC is mainly driven by imported inflation from its main trading partners, which has been recently pushed upwards by rising oil and food prices, supply chain disruptions and tensions on the labor market.

Results show that an initial 1 percentage point increase in inflation abroad leads to a 0.22 percentage point increase in inflation in the GCC based on historical data (Figure 8). Given recent global developments—where foreign inflation has been driven up by an unusual supply of shocks associated with the pandemic and later on with the war in Ukraine, inflation in the GCC is expected to increase in the coming months. Empirical evidence also shows that higher food and energy prices would mostly impact GCC domestic inflation through the foreign inflation channel (higher costs of trading partners) for some of the reasons mentioned earlier (e.g, caps on fuel prices). For instance, the estimated pass-through for Saudi Arabia shows that a rise in oil and food prices does not translate, on average, into an increase in domestic inflation.[3]

Figure 8. Cumulative Impulse Response Functions of GCC Domestic Inflation to Each Individual Shock after a Year

(ppt)



Note: Bars are median generalized impulse responses to a 1 ppt increase in annual inflation abroad, growth of money supply, or a 10 percent increase in oil prices, NEER, and agriculture material prices, together with the 15th and 85th percentile error bands.

Sources: Haver Analytics, IFS, and Bloomberg databases; and IMF staff estimates.

8. **The recent appreciation of the nominal effective exchange rate in line with that of the USD appears to shield GCC countries against inflationary pressures.** The recent appreciation of the US dollar is expected to help contain inflation by reducing import costs. However, over the medium term, domestic currency overvaluation can hinder economic diversification efforts and weaken the credibility of the pegs.

[3] Saudi Arabia: 2022 Article IV Consultation-Press Release; and Staff Report (imf.org)

Appendix III. Impact of U.S. Monetary Policy Decisions on the GCC Economy and the Banking Sector[1]

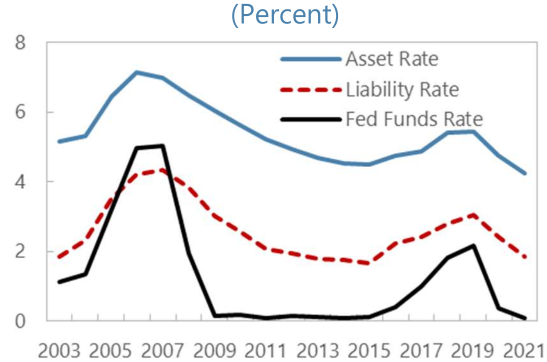
Central bank policy rates in the GCC mostly follow U.S. policy rates given the pegged exchange rate regimes, with implications for the overall economy and the banking sector. Our analysis finds that U.S monetary policy tightening would have a limited impact on the non-oil economy and the banking sector in an environment of high oil prices and liquidity.

1. **The primary objective of monetary policy in GCC countries is to ensure exchange rate stability.** Monetary policy is anchored by the fixed exchange rate of the national currency to the U.S. Dollar - or in the case of Kuwait, to an undisclosed basket of currencies tilted towards the U.S. dollar - and open capital accounts. GCC central banks remain committed to the nominal anchor as its monetary policy objective is to maintain monetary and financial stability to support economic growth. The exchange rate pegs are maintained by managing the magnitude of short-term interest rate differentials with U.S interest rates.

2. **Monetary policy rates in GCC countries tend to move in line with the U.S. federal funds rate (Figure 1).** Since the start of the pandemic, most GCC centrals banks have moved their policy rates broadly in line with the U.S. Federal Reserve, which is consistent with previous U.S. tightening and easing cycles. The banks' liability and asset rates also tend to move strongly with policy rates.[2] The spread between these rates (asset and liability rates) underlines the dynamics behind the margins of banks. This raises the important question of how changing U.S. policy interest rates impact the GCC economy and the banking sector.

Figure 1. U.S Federal Funds Rates and GCC-Wide Bank Rates

(Percent)



Sources: S&P Analytics; and IMF staff estimates.

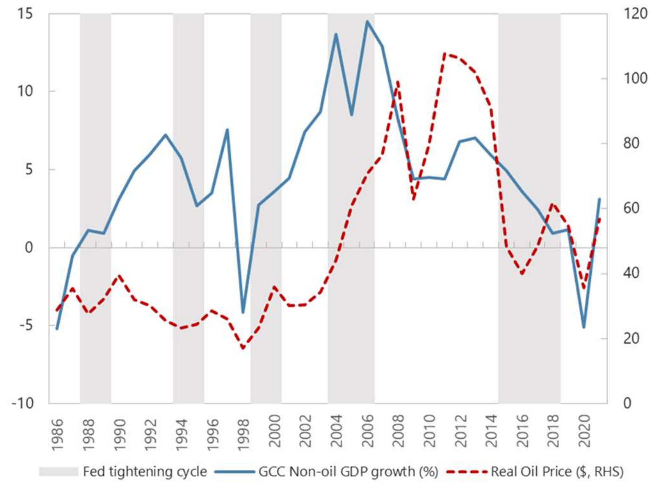
3. **Historically, non-oil GDP growth in GCC appears to be more sensitive to U.S. monetary tightening episodes when oil prices are low.** The level of oil prices – through its effect on domestic liquidity – could potentially dampen or amplify the impact of nominal policy rate changes on non-oil GDP growth (Figure 2). Specifically, depending on liquidity conditions – associated with oil prices – market interest rates may deviate from policy rates (Adedeji, 2019). Too abundant liquidity due to high oil prices could lead banks to supply more loans to other financial institutions. This in turn could put downward pressure on banks' funding costs and prompt them to pass it on to borrowers in the form of lower undesired divergence with policy transmission. In this regard,

[1] Prepared by Fozan Fareed and Nordine Abidi.

[2] The liability rate is defined by banks' interest expense scaled by interest-bearing liabilities whereas the asset rate is measured as total interest income scaled by interest earning assets.

monetary policy tightening that coincides with increased liquidity associated with higher oil prices could tend to have a more limited growth impact. While the opposite would be the case if monetary tightening is accompanied by lower oil prices and less liquidity.

Figure 2. Monetary Policy Tightening, Oil Prices, and Non-Oil GDP Growth



Sources: Haver Analytics, national authorities; and IMF staff calculations.

4. **The main objective of this annex is to provide empirical evidence on the impact of U.S. monetary policy decisions on the GCC economy and its banking sector.** First, we analyze the impact of U.S. monetary policy tightening on GCC's economic and financial variables using a panel vector autoregression (panel-VAR). In the baseline specification, following IMF's 2014 Spillover Report (IMF, 2014), the dependent variables include non-oil GDP growth, stock market indices and long-term sovereign bond yields. Control variables in this specification include the U.S. effective Fed Fund rates, the Chicago Board Options Exchange volatility index (VIX- as a measure of global uncertainty), domestic inflation and oil prices. The dynamic relationship between the dependent variables (Y) and control variables (X) is modeled as follows:

$$Y_{i,t} = \sum_{l=1}^{l=L} A_l \, Y_{i,t-l} + \sum_{l=0}^{l=L} B_l \, X_{t-l} + u_{i,t}$$

Table 1. Overview of Past Fed Tightening Actions

First Tightening Action	Initial FFTR Target (%)	Final Tightening Action	Final FFTR Target (%)	Total Tightening (percentage points)	U.S. Business Expansion Peak	GCC Non-Oil GDP response *	GCC Median Non-Oil GDP response *
31-Mar-1983	8.5	Aug. 9, 1984	11.5	3	N/A	0.04	-0.06
29-Mar-1988	6.5	16-May-1989	9.81	3.31	Jul-90	2.98	3.08
Feb. 4, 1994	3	Feb. 1, 1995	6	3	N/A	4.58	3.5
30-Jun-1999	4.75	16-May-2000	6.5	1.75	Mar-01	5.14	4.43
30-Jun-2004	1	29-Jun-2006	5.25	4.25	Dec-07	11.88	12.90
Dec. 16, 2015	0.00-0.25	Dec. 19, 2018	2.25-2.50	2.25	Feb-20	-1.00	1.17

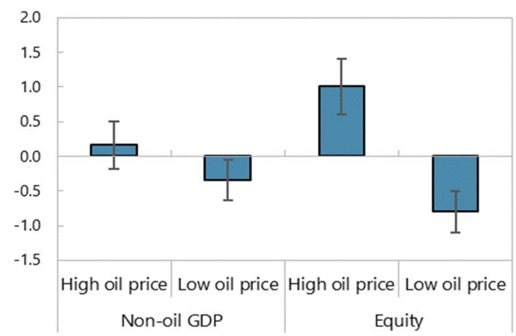
Sources: Federal Reserve Board of Governors, Federal Reserve Bank of St. Louis and NBER.
Note: "N/A" indicates that a recession didn't follow the tightening episode.
*Average three years growth (from the final year of tightening plus two years)

5. We estimate this model using quarterly data covering the period 2018Q1-2021Q4. With a small sample size and limited time dimension, we report 6-month average responses, instead of average responses over a longer horizon. The time span is determined by the availability of sovereign yield data. Long term sovereign bond yields in GCC are proxied by bonds ranging from 5- to 13-year maturity. The average time to maturity of sovereign bonds in the sample is less than 10 years.[3]

6. The VAR estimates suggest that Fed tightening has limited effect on non-oil economic activity, particularly in a high oil price environment. When oil prices are less than a certain threshold, monetary spillovers to GCC get amplified.[4] Our estimates suggest that a 100 basis points hike in the Fed rate when real oil prices are below $45 reduces non-oil GDP growth by about 0.3 percent in GCC (Figure 3). In contrast, the effect of Fed tightening is negligible when oil prices are high. Moreover, equity prices drop by about 0.8 percent when oil prices are low and increase by about 1 percent when oil prices are above the $45 threshold. These results are statistically significant at a 5 percent level except when oil prices are high for non-oil GDP. Therefore, in the current environment, high oil prices will likely mitigate spillovers from U.S. monetary policy normalization to GCC economies. These findings confirm the limited adverse effects of US monetary policy tightening cycles on GCC non-oil GDP, especially when oil prices are high.

Figure 3. Impact of a 100 bps Fed Tightening on Non-Oil GDP and Equity Markets in the GCC

(Percent)



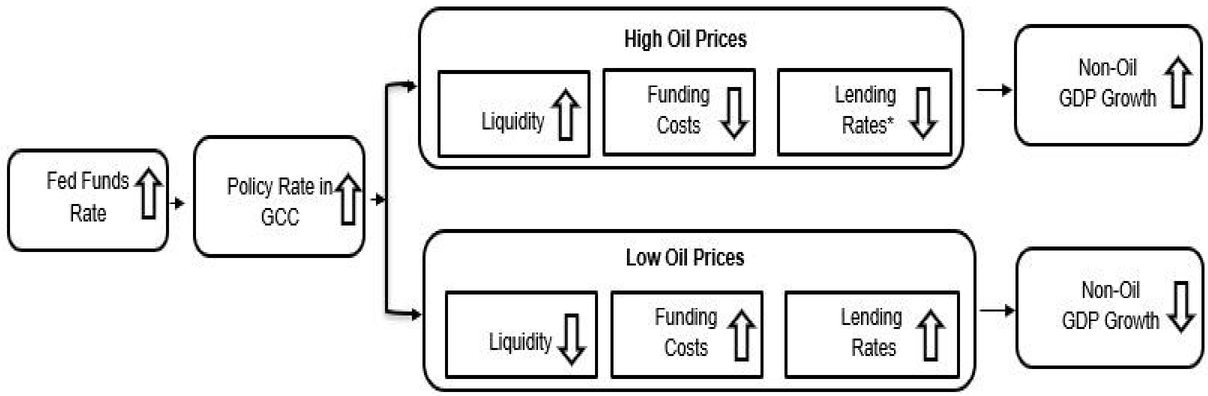
Note: the bars represent the average six-month response. The interval denotes 95% confidence interval

7. The transmission channels from U.S. monetary policy to GCC economies are likely to depend on oil prices. Indeed, liquidity swings – due to oil price volatility – could complicate the implementation of monetary policy, with liquidity imbalances reducing the pass-through of policy rates to market rates. For instance, market interest rates may increase to a larger extent than normally entailed by policy rates if oil prices and liquidity decline, with banks in turn charging higher rates for loans, slowing down the demand for credit and consequently economic growth (Figure 4).

[3] This method was also used in the recent REO, April 2022. This is similar to Adedeji et al. (2019) and Giovanni and Shambaugh (2008) who use foreign interest rates as exogenous variables. IMF (2014) decomposes the drivers of the US 10-year Treasury yield into money and real shocks.

[4] For the choice of the threshold, see IMF (2019).

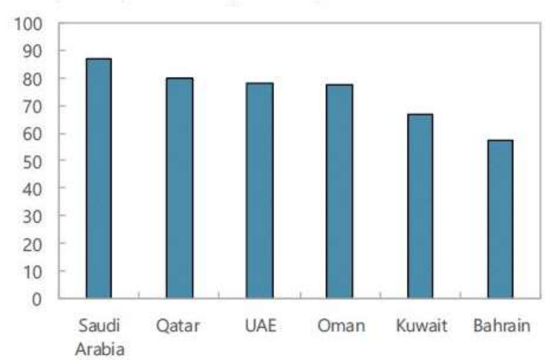
Figure 4. Oil Prices and Monetary Policy Transmission Channel



* The effects on lending rates can also be broadly neutral depending on the magnitude of the monetary policy tightening and oil prices.

Implications for the Banking Sector:

Figure 5. Deposit Fraction of Total Liabilities
(Percent)



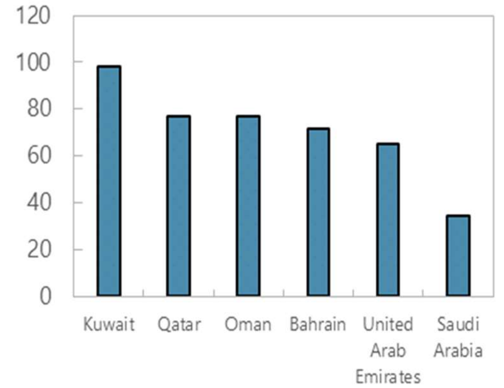
Sources: Fitch Connect, and IMF staff calculations.

8. **The banking sectors in GCC countries vary in terms of their deposit mix and prevalence of non-interest-bearing deposits.** While deposits dominate Saudi banks' liability structures, non-deposit liabilities such as wholesale funding are relatively important for banks in Kuwait, and Bahrain (Figure 5). Moreover, there is a significant heterogeneity across countries with respect to the share of non-interest-bearing deposits (Figure 6). In the case of Saudi Arabia, more than 60 percent of deposits are non-interest bearing, whereas this percentage is quite low for other countries such as Kuwait, Qatar and Oman. Banks with a high proportion of non-interest-bearing deposits are likely to be well positioned to benefit from the interest rate hikes. Similarly, banks with a low proportion of loans repricing are more likely to be adversely affected by the U.S. monetary policy tightening.[5]

[5] Banks with a high proportion of mortgage lending at fixed rates are more likely to be impacted by Fed tightening (Fitch, 2022).

9. Following IMF (2019), we analyze the impact of U.S. monetary policy tightening on the banking sector using a panel fixed effects model. We exploit bank-level panel data from 2003-2021 to isolate the impact of U.S. monetary policy tightening on banks funding costs, asset rates, credit growth, profitability, and asset quality.

Figure 6. Proportion of Interest-Bearing Deposits (2020)



Sources: S&P Analytics; and IMF staff calculations.

10. Our estimates suggest a significant pass through from U.S. interest rates to GCC banks' liability and asset rates. Results in Table 2 suggest that when U.S. rates rise by 100 basis points, GCC banks' liability rates rise by about 40 basis points and their asset rates by close to 35 basis points.[6] However, as with any empirical analysis, it is difficult to isolate the effect of changes in policy rates from other changes to the macroeconomic environment. In the context of the GCC, the regressions do allow us to account for other important factors such as shocks to oil prices or global financial market developments. These findings could be explained by the fact that banks in GCCs have a relatively high share of variable-rate loans, which allow increases in banks' funding costs to be swiftly passed on to customers.

Table 2. Pass-through from US Rates to GCC Bank Rates

VARIABLES	(1) Δ Liability Rate	(2) Δ Liability Rate	(3) Δ Liability Rate	(4) Δ Asset Rate	(5) Δ Asset Rate	(6) Δ Asset Rate
Δ Federal Funds Rate	0.369***	0.433***	0.402***	0.320***	0.380***	0.352***
	(0.035)	(0.042)	(0.044)	(0.037)	(0.040)	(0.043)
Δ Oil Price ($)		0.077	0.113		0.090	0.122
		(0.122)	(0.121)		(0.126)	(0.131)
Log (Uncertainty Index)		0.495***	0.499***		0.479***	0.482***
		(0.106)	(0.105)		(0.101)	(0.101)
Crisis Dummies			Yes			Yes
Bank F.E.	Yes	Yes	Yes	Yes	Yes	Yes
Constant	0.001	0.006	0.088	-0.023***	-0.019***	0.204***
	(0.002)	(0.004)	(0.080)	(0.002)	(0.004)	(0.026)
Observations	919	919	919	973	973	973
R-squared	0.153	0.169	0.176	0.131	0.147	0.154

11. Despite substantial differences in funding structures, banks' profitability seems to be insulated from shifts in U.S. policy rates. Our results suggest that the impact of tighter U.S monetary policy on banks' profitability is statistically insignificant (Table 3). Regressions controlling

[6] We also find similar results using changes in country-specific policy rates as the independent variable instead.

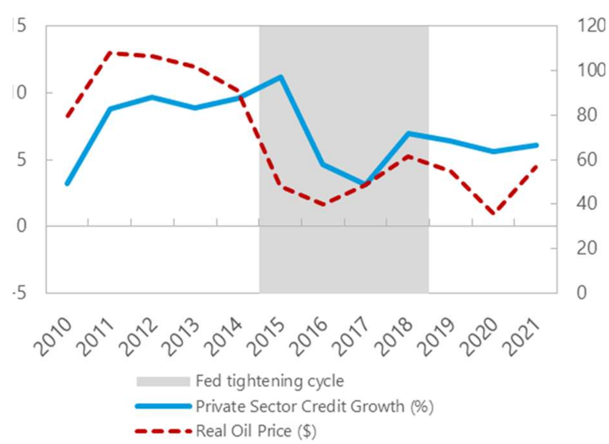
for bank and country time-invariant characteristics, oil prices and the Chicago Board Options Exchange Volatility Index (VIX), which reflects global uncertainty, confirm that an upward shift in interest rates is not significantly associated with net interest margins of banks. Overall, notwithstanding the differences in funding structures, bank profitability is likely to remain insulated from shifts in nominal policy rates.

Table 3. Pass-through from US Rates to Banks' Profitability

VARIABLES	(1) Δ NIM	(2) Δ NIM	(3) Δ NIM	(4) Δ NIM
Δ Federal Funds Rate	-0.001	-0.002	-0.011	-0.025
	(0.021)	(0.022)	(0.024)	(0.027)
Δ Oil Price ($)			0.058	0.075
			(0.061)	(0.062)
Log (Uncertainty Index)			-0.026	-0.024
			(0.054)	(0.054)
Bank F.E.	No	Yes	Yes	Yes
Crisis Dummies	No	No	No	Yes
Constant	-0.053***	-0.009***	-0.013***	-0.126***
	(0.011)	(0.001)	(0.004)	(0.036)
Observations	919	919	919	919
R-squared	0.000	0.029	0.031	0.039

12. Historically, there has been a limited impact of monetary policy tightening episodes on credit growth in periods when oil prices were high. Despite tightening episodes during 2004-2007, credit growth remained strong as oil prices were at relatively high levels (Figure 7). Regression results at the bank level also suggest that Fed tightening does not impact credit growth and asset quality, which may be another channel explaining the lack of adverse impact on non-oil GDP growth (Table 4). We find that credit growth is not affected even for banks with a higher pass-through.[7] Similarly,

Figure 7. Private Sector Credit Growth in GCC and Monetary Policy Tightening



Sources: Haver Analytics, national authorities; and IMF staff calculations.

[7] We construct a measure of the overall sensitivity of bank liabilities/assets to changes in U.S. monetary policy at the bank level: liability/asset pass-through (LPT). We estimate LPT using bank level regressions in which the dependent variable is the change in the bank's liability/asset rate, and the independent variable is the change in the U.S. Federal

(continued)

regarding asset quality as measured by the change in non-performing-loans, we also do not find any significant impact of U.S. monetary policy tightening. This result holds even for banks with a higher liability pass-through and when oil prices are low.[8]

Table 4. Pass-through from US Rates to Banks' Credit Growth and Asset Quality

	(1)	(2)	(3)
VARIABLES	**Δln(Credit)**	**Δln(Credit)**	**Δ(NPLs)**
Δ MP	0.145	0.330	0.026
	(0.290)	(0.427)	(0.058)
(Δ MP)*(LPT Dummy)		0.046	-3.395
		(0.316)	(2.537)
(Δ MP)*(LPT Dummy)*(Oil Dummy)		-0.057	3.328
		(0.492)	(2.522)
Constant	0.703	-1.219	0.498
	(0.510)	(1.282)	(0.339)
Bank F.E.	Yes	Yes	Yes
Crisis Dummies	No	Yes	Yes
Other Controls	Yes	Yes	Yes
Observations	778	778	934
R-squared	0.110	0.113	0.111

Funds Rate. LPT is likely to link closely with the interest-bearing fraction of deposits in countries where deposits dominate but may differ from the interest-bearing fraction of deposits in other GCC countries.

[8] See Saudi Arabia: Selected Issues (imf.org) for a detailed discussion on the calculation of passthroughs.