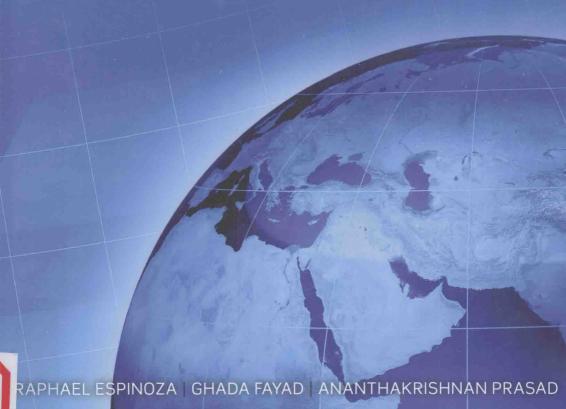
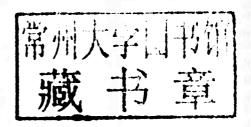
# The Macroeconomics of the Arab States of the Gulf



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Raphael Espinoza, Ghada Fayad, and Ananthakrishnan Prasad





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#### **Foreword**

The Gulf Cooperation Council (GCC) countries have made immense progress in developing their economies over the past ten years. While the prosperity of the region is undeniably linked to developments in the oil and gas sectors, it was prudent policymaking emphasizing domestic investments that led to the region's rapid growth and increased economic diversity. The importance of the GCC has now expanded beyond oil and gas markets into other sectors: it is a major market for migrant workers, a source of remittances, a financial center, and a hub for international trade and business services. That is why this book not only examines the region's management of macroeconomic cycles, but also analyzes issues around labor markets, immigration, diversification, and market efficiency.

Some of the region's challenges are clear. Commodity exporters such as the GCC often run the risk of overreliance on their natural resources, eventually resulting in a "resource curse". This can originate in inefficiencies in government, or the mismanagement of volatile national income.

Despite these challenges, the region has so far managed to use its oil wealth to provide services for its citizens and to attract the foreign workers and capital needed for the infrastructure developments that will lead to quality-of-life improvements.

Indeed, the GCC countries entered the global crisis from a position of strength. GCC governments had the policy tools and options available to them when they were needed to support domestic demand, provide liquidity support, and recapitalize banks. While the economic impact of most of these measures was intuitively understood by GCC policymakers, by and large only a few such decisions were based on rigorous data analyses. Going forward, ensuring that these policies are implemented for maximum benefit will require the kind of deeper analytical inquiry this book provides.

Fiscal and monetary policies are important aspects of that inquiry in the GCC. With pegged exchange rate regimes, monetary policy is constrained by financial integration, and fiscal instruments become the policymakers' main method of adjustment. But because these countries now rely heavily on foreign workers and imports, fiscal multipliers may be weak. An important empirical question thus becomes determining the impact of fiscal and

monetary policies on economic activity. It is questions such as these that this book attempts to answer. A fuller understanding of the interplay of these policy choices is vital to the work of the region's policymakers who are shaping the economic futures of these countries' citizens for years to come.

The global crisis revealed the region's strengths and weaknesses, making this a particularly appropriate time to analyze the GCC region's macroeconomic situation. Such analysis relies on the expertise of this book's authors but also on the spirit of trust and cooperation that has been cultivated between the International Monetary Fund and its member countries' authorities. To date, this is the only book available on the macroeconomics of the GCC countries, providing original insights into the functioning of the GCC markets and the policy challenges ahead.

This book, like other IMF work in the region, is part of an ongoing research agenda that recognizes the area's important contributions to global economic and financial stability. Maintaining and building on that stability are important steps toward broadening equality and fostering prosperity.

Christine Lagarde Managing Director International Monetary Fund

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The views expressed in this book are those of the authors and do not necessarily represent those of the IMF or IMF policy.

R. Espinoza G. Fayad A. Prasad

### **List of Abbreviations**

AIC Akaike Information Criterion BIC Bayesian Information Criterion

BSI Bank Stability Index
Co-VaR Conditional Value at Risk
CPI Consumer Price Index

CPIA Country Policy and Institutional Assessment

ECM Error Correction Model EDF Expected Default Frequency

FE fixed effects

FEVD Forecast Error Variance Decomposition

FFR Fed Funds Rate

FSI financial soundness indicator
GCC Gulf Cooperation Council
HDI Human Development Index
ICRG International Country Risk Guide
IEA International Energy Agency
IRF impulse response function
IV instrumental variable

JPoD Joint Probability of Default

LR likelihood ratio LHS Left-hand side

MENA Middle East and North Africa

NPL nonperforming loan

PIMI Public Investment Management Index

PMG pooled mean group

POLS pooled ordinary least squares PPP Purchasing Power Parity PWT Penn Word Tables

RE random effects

REDF Real Estate Development Fund REER real effective exchange rate

RHS Right-hand side

SBC Schwarz Bayesian Criterion TFP Total Factor Productivity VAR Vector Auto-Regression

VIX Volatility Index

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# **Introductory Chapter**

#### 1.1 Introduction

The countries of the Gulf Cooperation Council (GCC) have gone through considerable changes in the last decade, spurred by high oil prices and ambitious diversification plans. The changes have affected literally all sectors of the economy. Large-scale immigration has provided the labor force while capital inflows and financial development have leveraged oil wealth to finance diversification. Regional integration plans are advancing although it is not clear yet what the prospects are for monetary union.

As the GCC economies modernize, macroeconomic policies will gain importance. And with the increasing sophistication of their market economies, policymakers and analysts will need to further their understanding of the macroeconomic structure and of the linkages that are now at work in the region. The aim of this book is to provide original insights into the functioning of the GCC macroeconomy and the policy challenges ahead, and is based on quantitative assessments of the structure of the economy and of the key macroeconomic relationships. Econometric models can now be estimated in the GCC because the structural break that took place in the late 1970s is more than thirty years ago. A major drawback for statistical analysis remains, however, the absence of quarterly data for the national accounts. Analyses can benefit nevertheless from the cross-sectional dimension: panel models are often appropriate because the GCC is a fairly homogenous group. This is one reason why the focus of the book is on the GCC as opposed to a larger group

 $<sup>^{\,1}</sup>$  The GCC comprises six member countries, namely, Bahrain, Kuwait, Oman, Saudi Arabia, Qatar, and the United Arab Emirates.