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The **Macroeconomics** of the **Arab States** of the **Gulf**



RAPHAEL ESPINOZA | GHADA FAYAD | ANANTHAKRISHNAN PRASAD

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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

Contents

<i>List of Figures</i>	xiii
<i>List of Tables</i>	xv
<i>List of Abbreviations</i>	xvii
1. Introductory Chapter	1
1.1 Introduction	1
1.2 Structural Characteristics	4
1.3 Macroeconomic Policy During the Crisis	7
References	11
2. The Determinants of Long-Term Growth in the GCC Countries	13
2.1 Introduction	13
2.2 Economic Data	16
2.3 Diversification and the Drivers of Long-Term Growth	20
2.3.1 Diversification	20
2.3.2 The Stock of Capital	21
2.3.3 Human Capital	24
2.4 A Growth-Accounting Exercise	25
2.5 Total Factor Productivity and Country Characteristics	29
2.5.1 Type of Capital	29
2.5.2 Institutions and the Empirical Growth Literature	30
Initial Income per Capita and Convergence	31
Size of the Government	33
Inflation and Macroeconomic Stability	33
Volatility and Growth	34
Openness to Trade	35
Institutions	35
References	37
3. The Macroeconomic Impact of Migration	40
3.1 Introduction	40
3.2 Background on GCC Labor Markets	42

Contents

3.2.1	Immigration and Remittances	42
	Immigrants' Rights	42
	Composition of Foreign Workforce	43
	Remittances	44
3.2.2	Labor Market Segmentation and Wage Disparities	45
3.2.3	Unemployment	47
3.2.4	Nationalization	49
3.3	Diversification in the GCC	50
3.4	Simple Theoretical Model	51
3.5	Estimation	56
3.6	Results	59
3.7	Conclusion	61
	Technical Appendix	62
	References	63
4.	Government Spending, Subsidies, and Economic Efficiency	65
4.1	Introduction	65
4.2	Government Spending and the GCC Development Strategy	67
	4.2.1 Public Investment	67
	4.2.2 Support to the Corporate Sector and Subsidies	70
4.3	An Inverse Ramsey Model	73
4.4	Distortions in Labor Markets	78
4.5	Conclusion	83
	References	84
5.	Fiscal Policy for Macroeconomic Stability	86
5.1	Introduction	86
5.2	Background	88
5.3	The Empirical Literature on Fiscal Multipliers	90
5.4	Econometric Estimates of Fiscal Multipliers	92
	5.4.1 Panel Model	93
	5.4.2 Fiscal Policy and Economic Cycles	95
5.5	Contribution of Fiscal Policy to Economic Cycles	102
5.6	Conclusion	108
	References	110
6.	Monetary Policy with a Fixed Exchange Rate Regime	112
6.1	Introduction	112

6.2 Experience with Inflation in the GCC Countries	113
6.3 Behavior of GCC Monetary Policy vis-à-vis the United States	115
6.4 Interest Rate Pass-Through	116
6.5 Monetary Transmission in the GCC—A Panel VAR Approach	121
6.5.1 Data	123
6.5.2 Annual Data Panel VAR	123
6.5.3 Quarterly Data Panel VAR	131
6.6 Summary and Policy Implications	134
References	134
7. Nonperforming Loans and Financial Stability	136
7.1 Introduction	136
7.2 Determinants of Nonperforming Loans	139
7.3 A Panel Model for GCC Banks	141
7.4 Concluding on the Systemic Importance of Credit Risk	145
Appendix	148
References	149
8. Financial Markets in the GCC Countries	151
8.1 Introduction	151
8.2 Background on GCC Stock Markets	152
8.2.1 GCC stock Markets' Integration: Global and Regional Spillovers	154
8.3 Banking System	155
8.4 Econometric Methods	160
8.4.1 Conditional Value at Risk (Co-VaR) Methodology	160
8.4.2 Distress Dependence Methodology	161
8.5 Results	162
8.5.1 International Spillovers	162
8.5.2 Local Spillovers within and Between UAE and Saudi Arabia	163
8.6 Conclusion	167
References	167
9. The Importance of the GCC for the Wider Region	168
9.1 Economic Openness and Spillovers	168

Contents

9.1.1 The Importance of Migration and Remittances	169
9.1.2 International Trade	170
9.1.3 Complementarity between Migration and FDI	172
9.1.4 Foreign Aid	174
9.2 Concluding on the Importance of the GCC	176
References	178
<i>Index</i>	181

List of Figures

1.1	GCC: Proved reserves and projected depletion of oil and gas, selected years	5
1.2	Sachs and Warner's (2001) natural resource curse	6
2.1	World rankings of income per capita (2009)	19
2.2	Oil production and per capita income in the region (1990–2005)	20
2.3	Total factor productivity relative to the US (total GDP and non-oil GDP) (logarithmic scale, 2008)	27
2.4	Contributions to the annual percentage change in GDP per worker (1990–2009)	28
2.5	Imports of capital, by type (darker color for increasingly R&D-intensive capital)	30
2.6	Contributions to TFP (1991–2009), in difference from median non-oil-exporting country	32
3.1	Remittance outflows in percent of GDP, average 2000–10	45
3.2	Saudi to non-Saudi monthly wages in the private sector by education, 2009 (ratio)	47
3.3	Wage ratios by sector and nationality in Bahrain, 2002–10	48
3.4	Youth and total unemployment rates (in percent, latest available date)	48
3.5	Share of non-oil exports in total exports (in percent)	51
3.6	Share of petrochemical exports in total non-oil exports (in percent)	52
4.1	Budgetary spending, by outlay	66
4.2	Investment/non-oil GDP and oil GDP/non-oil GDP (1980–2009)	69
4.3	Total Factor Productivity and the Public Investment Management Index	69
4.4	Subsidies and size of the oil sector	74
4.5	Subsidies and welfare losses	77
4.6	Equilibrium in the labor market	81
5.1	Non-oil real GDP growth and real growth in total government expenditure	94
5.2	Fiscal multiplier (impact of total government spending on non-oil GDP)	101
5.3	Impact of world growth on non-oil growth in the GCC	102
5.4	Pro-cyclicality of fiscal policy: Response of government spending to non-oil GDP shocks, in percent deviation from baseline	103

List of Figures

5.5	Saudi Arabia (non-oil GDP growth on LHS scale, contributions on the RHS)	105
5.6	UAE (non-oil GDP growth on LHS scale, contributions on the RHS)	106
5.7	Kuwait (data post-1996 is from IMF; data pre-1996 is from UN). Dummies for estimation in 1991 and 1992	107
5.8	Qatar (non-oil GDP growth on LHS scale, contributions on the RHS)	107
5.9	Oman (non-oil GDP growth on LHS scale, contributions on the RHS)	108
5.10	Bahrain (non-oil GDP growth on LHS scale, contributions on the RHS)	109
6.1	CPI inflation, in percentage points	113
6.2	Interbank and retail interest rates (in percent)	118
6.3	Dynamic adjustment of deposit and lending rates to shocks in the interbank rates	119
6.4	Annual data panel VAR	124
6.5	Quarterly data panel VAR	128
6.6	Robustness to VAR specification and composition	132
7.1	NPL ratio and economic activity in the GCC	138
7.2	Bank heterogeneity and the business cycle	139
7.3	Logit transformation of the NPL ratio	142
7.4	Dynamics of NPLs with maintained macroeconomic shocks	145
7.5	Feedback effect—panel VAR impulse response functions	146
8.1	GCC: Market indices, January 2007–March 2012	156
8.2	Expected default frequencies of local UAE banks, 2008–10	159
8.3	Expected default frequencies of Saudi banks, 2008–10	159
8.4	International spillovers to UAE banks: Effect of distress in Europe and the United States, 2008–10	162
8.5	International spillovers to Saudi Arabian banks: Effect of distress in Europe and the United States, 2008–10	163
8.6	Bank stability index of local banks, 2008–10	165
8.7	Intra-regional spillovers between UAE and Saudi Arabian banks, 2008–10	166
9.1	Remittances from the GCC in 2010	170
9.2	Geographical distribution of GCC merchandise trade, 2000–10	171
9.3	Merchandise trade with the GCC, 2011	171
9.4	GCC outward FDI, 1985–2009	173
9.5	GCC aid outflows by source country, 2002–10	174
9.6	Arab aid through development funds, 2002–10	175
9.7	Sectoral distribution of Arab aid through development funds, 2002–10	176

List of Tables

1.1	GCC selected economic indicators, 1981–90 average, 1991–2000 average, 2001–10 average	3
2.1	Nominal GDP and annual growth rate of real GDP and real GDP per worker (1990 to 2009)	14
2.2	Employment and population in the GCC, in millions	16
2.3	Nominal value added by sectors, in percent of nominal non-oil GDP	22
2.4	Investment and growth in the stock of capital	24
2.5	Growth accounting of GDP per capita, (contributions, in percentage points, 1990–2009)	28
3.1	Share of high-skilled migrants by region in 2000	44
3.2	Government views and policies on immigration, 2009	44
3.3	Public-sector employment as a share of total employment of nationals in the GCC	46
3.4	Effect of remittance outflows on the REER, 1980–2009	60
4.1	Subsidies and opportunity costs/implicit subsidies, 2010	71
5.1	Standard deviation of GDP growth per capita in percent, 1976–2007	87
5.2	Characteristics of GCC economies and government expenditure	89
5.3	Data sources	93
5.4	GCC panel fiscal multipliers—dependent variable: non-oil real GDP growth	96
5.5	GCC panel fiscal multipliers, controlling for inflation and oil prices	98
5.6	Elasticity of spending to a permanent increase in oil price in the VARs	101
5.7	Non-oil GDP growth: Forecast Error Variance Decomposition two years ahead	104
6.1	Cointegration vector	120
6.2	Forecast Error Variance Contribution	121
6.3	Correlation matrix of innovations	123
6.4	OLS estimates of the annual VAR	126
7.1	Summary statistics on nonperforming loans, 1995–2008	137

List of Tables

7.2	Macroeconomic and firm-specific determinants of NPLs	144
7.3	Bankscope coverage in the GCC	148
8.1	Foreign investment ceiling for listed stocks in the GCC markets	153
8.2	Market capitalization losses	155
8.3	Correlations of stock market indices with S&P 500	155
8.4	Stock market volatilities	157
8.5	GCC: Loans, deposits, and foreign assets and liabilities, 2011	157
8.6	Co-VaR estimates for UAE banks, 2008–10	164
8.7	Co-VaR estimates for Saudi Arabian banks, 2008–10	165
9.1	Growth spillover model	177

1

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.¹ 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

¹ The GCC comprises six member countries, namely, Bahrain, Kuwait, Oman, Saudi Arabia, Qatar, and the United Arab Emirates.