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

RAPHAEL ESPINOZA | GHADA FAYAD | ANANTHAKRISHNAN PRASAD



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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

Foreword

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
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| | |
|--------|---|
| 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 |

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.