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POLICY OPTIONS ON KEY MACROECONOMIC ISSUES

DRAFT REPORT

Summary

At its twenty-fourth session, the Economic and Social Commission for Western Asia (ESCWA) adopted resolution 270 (XXIV) of 11 May 2006 on macroeconomic policy for financial stability. The adoption of this resolution proved the region's readiness for any financial contingency that could affect the region's economic and social developments. Since September 2008, the global financial crisis, which stemmed from the loan crisis in North America and Europe, has shown the knock-on effects that such crises can cause on a worldwide scale. Nevertheless, the economic sentiment of the ESCWA region improved from pessimism to cautious optimism over the course of 2009. Several worst-case scenarios of the global financial crisis have not been realized in the present phase of global financial crisis; a balance-of-payment crisis and associated extreme currency devaluations did not occur even in the countries where the current account positions were weak; and the once feared reverse mass migration of expatriate workers from the member countries of the Gulf Cooperation Council (GCC) did not materialize.

The region's monetary authorities have successfully defended their respective banking sectors. Equally, the region's fiscal authorities successfully took an active stance to cushion the impact from the global recession. However, downside risks remain in the region's macroeconomic environment in 2010. Moreover, policy challenges for the region's structural impediments have remained, as identified by the Arab Economic and Social Development Summit in January 2009. One set of crucial challenges in the region is the continuing balance-sheet adjustments in the banking and private sectors where additional fiscal support could be required for a smooth implementation. For several ESCWA member countries, additional international support may be required; and given their role in the globally coordinated fiscal stimulus, these ESCWA member countries deserve such international support. Another set of challenges in the region relates to employment creation and the accumulation of human capital base. The region's labour market reforms have been progressing, with an increasing number of countries placing education in their fiscal priorities. This human-centred approach needs to be encouraged as a core measure aimed at strengthening both national economies and the economy of the wider ESCWA region through the leverage of regional integration.

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Introduction

1. At its twenty-fourth session, the Economic and Social Commission for Western Asia (ESCWA) adopted resolution 270 (XXIV) of 11 May 2006 on macroeconomic policy for financial stability. The adoption of this resolution proved the region's readiness for any financial contingency that could affect the region's economic and social developments. Since September 2008, the global financial crisis, which stemmed from the loan crisis in North America and Europe, has shown the knock-on effects that such crises can cause on a worldwide scale. Nevertheless, the economic sentiment of the ESCWA region improved from pessimism to cautious optimism over the course of 2009. Several worst-case scenarios of the global financial crisis have not been realized in the present phase of global financial crisis; a balance-of-payment crisis and associated extreme currency devaluations did not occur even in the countries where the current account positions were weak; and the once feared reverse mass migration of expatriate workers from the member countries of the Gulf Cooperation Council (GCC) did not materialize. The region's monetary authorities have successfully defended their respective banking sectors. Equally, the region's fiscal authorities successfully took an active stance to cushion the impact from the global recession. The region's strategic geographical location has been re-approved in the efficiency drive of international investors and traders.

2. However, downside risks remain. The crude oil price level, which is the critical indicator of the region's economic confidence, is visibly fragile as it has been mainly supported by the significant reduction of the Organization of Petroleum Exporting Countries (OPEC) production quota and the compliance of its member countries. Moreover, despite the establishment of a firm price range of around US$75 per barrel in crude oil since the second quarter of 2009, the demand for such fuel products as gasoline, naphtha and heating oil has remained weak. A prolonged low refining margin could affect the price of crude oil in 2010. While commercial banks in the region have weathered the global liquidity crisis, the issue has been shifted to the problem of liquidity at business entities and households for which the sufficient level of liquidity may not have been transferred. The low level of liquidity circulation can depress the level of asset price that could force commercial banks to undertake additional series of balance-sheet adjustments. In fact, property prices in the region have lost the strong momentum of the past several years, and a strong recovery in 2010 is not assured, even if the region's economy is forecasted to be on the recovery path.

3. Moreover, policy challenges for the region's structural impediments have remained. During the Arab Economic and Social Development Summit in January 2009, six specific challenges were identified, namely: (a) increasing poverty and unemployment among Arab citizens; (b) general deterioration of living conditions; (c) limited volume of Arab intraregional trade and local investments; (d) capital flight, brain drain and migration of skilled workers; (e) poor infrastructure in many Arab countries (road, water, electricity and communications); and (f) mismatch between the output of the education system and the labour requirements for development and global competition. While the Summit, which was hosted by Kuwait, was successful in passing a number of resolutions for joint Arab action, ESCWA member countries will need to focus on policy options that foster sound economic and social development, particularly in the aftermath of the global financial crisis.

I. RECENT MACROECONOMIC DEVELOPMENTS

4. As the world economy indicated a recovery from recession through the second and third quarters of 2009, the economic sentiment of the ESCWA region improved from pessimism to cautious optimism. In the region where the major crude oil exporters are located, the strong recovery of crude oil prices, in the range of $60-80 per barrel since the second quarter of 2009, contributed to an optimistic projection. Moreover, as described above, several worst-case scenarios that could have affected the region's output and demand have not been realized. The recovery of external demand as well as domestic demand with a support of active fiscal measures is expected to lead the recovery.

5. Meanwhile, the consumer price inflation peaked in the second half of 2008. As a general trend, the rate of consumer inflation has rapidly declined in several countries. Policymakers in several countries in the

region have even mentioned a possibility of deflation in 2009 and 2010. The rapid decline in the consumer inflation rate has been led by the price of food and property rentals, which were the very factors that led a historically high consumer inflation rate in 2008. However, the anticipated second-round effect of the inflation pressure of 2007-2008 did not materialize; and the upward wage adjustments, particularly in the public sector in 2007-2008, did not influence general price levels as had been expected. Traditionally, the region has experienced a low-inflation regime and the current trend may point to the convergence with the historical trend.

6. In the member countries of the GCC, despite the weak performance of stock markets and the real estate sector, the delay in private sector projects, and the rapid decline in commercial and residential rental prices, a considerable portion of economic actors and policymakers in this subregion still saw economic fundamentals as being sound. This optimism is a crucial drive for forward-looking behaviour of consumption and investment. In 2009, GCC countries are expected to register a weak economic growth in terms of average gross domestic product (GDP). This weak estimation stems mainly from the prompt compliance to the significant cut in OPEC production quota by the OPEC member countries in this subregion. As a result of strong readiness for fiscal support by the fiscal authorities, domestic demand in this subregion is not expected to shrink in parallel with the GDP estimates. It is the significant reduction in this component of net exports that caused the weak real GDP estimation. Non-OPEC member countries in this subregion are projected to show more modest decline in growth performances in 2009. Resilient business and consumer confidence has been observed in the GCC economies despite some pockets of weakness in certain sectors of the economy, particularly the real estate sector. The prospects for 2010 depend on the following: (a) the recovery of external demand and crude oil prices; (b) the continuous active fiscal stance; and (c) the smooth balance-sheet adjustments of economic actors, particularly commercial banks, business entities and households.

7. Outside the GCC, ESCWA member countries showed resilience in their growth performance in 2009. Despite potentially fragile external balances in terms of relatively weak current account positions, domestic demand continued to grow with strong capital account positions. Moreover, oil exporters in this subregion, namely, Egypt, Iraq, the Sudan, Syrian Arab Republic and Yemen, were not under the OPEC production quota and could avert a sharp decline in crude oil production levels. The lower reliance on manufacturing exports and on international capital markets insulated this subregion from the initial impact of global financial crisis. While the export level to the United States and Europe was severely impacted, its effect on the aggregated economy was limited. Moreover, the funding liquidity stayed available owing to the limited exposure to international money markets. The property markets were affected, but it can be characterized as a moderate decline at most. Much of the issue of economic development in this subregion remained linked to structural ones, chiefly chronically high unemployment. The prospects for 2010 depend on the following: (a) the recovery of external demand from the United States, Europe and the GCC economies; (b) the sufficient margin against any potential foreign exchange constraints; and (c) the active fiscal measures with international and regional support.

8. At the onset of the current global financial crisis, which combined with an abrupt plunge in crude oil prices, one of major social concerns in the ESCWA region related to the state of expatriate workers in the region’s major oil exporters, namely, GCC countries. The economic boom leading up to 2008 in GCC countries had expanded their foreign workforce. Despite active efforts on human resources development aimed at promoting national work forces in the private sector, GCC countries have continued to rely on expatriate workers, with the expansion of the private sector in the past few years attracting expatriate workers into GCC countries. As the global financial crisis initially impacted the region’s core activities in the private sector, namely, finance and construction, massive job losses and an exodus of expatriate workers from GCC countries was feared as a major repercussion of the crisis, thereby affecting both host countries and labour-exporting countries in the Arab region and Asia.

9. Contrary to several media reports, which suggested that a significant number of expatriate workers had left after being made redundant, no sign of large scale exodus of expatriate workers from the region has been

observed as of the end of 2009. A case in point is Lebanon, which is significantly dependent on employment opportunities in GCC countries and workers' remittances from these countries. No substantial number of returning expatriates has been reported and the country's gross foreign reserves have continued to increase well into 2009. For other major labour-exporting countries where data are available, the amount of workers' remittances from GCC countries have either increased, as in the case of Pakistan, or stabilized towards the second quarter of 2009, as in the case of Philippines. Within that context, workers' remittances to Egypt decreased in the first quarter of 2009, and witnessed a recovery in the second quarter. With an assumption that informal remittance flow is correlated to the formal flow through central banks, these selected figures show stable outflows of workers' remittances from GCC countries.

10. Despite the relatively stable employment conditions in GCC countries, the issue of unemployment and underemployment remain the region's major socio-economic issue. Chronically high unemployment rates persist, despite recent modest improvements in Egypt, Jordan, Saudi Arabia and Syrian Arab Republic. The economic slowdown in 2009 has added a stress in the employment condition as evidenced in the latest unemployment figure of several ESCWA member countries.

II. POLICY OPTIONS

A. POLICIES AGAINST CYCLICAL DOWNTURNS

11. Policymakers in the region faced an increasing policy dilemma in 2008 as the consumer inflation rate soared in their respective countries. Fiscal expansions were sought in order to achieve the development aspirations, while monetary authorities had to tighten their monetary stance in order to alleviate inflationary pressures. However, with the exception of Egypt where a floating exchange rate regime was adopted, monetary authorities in the region had a limited space for their policy options subject to the stability of foreign exchange rates. At the onset of the global financial crisis in September 2008, most of the Governments in the ESCWA region were released from this dilemma given that both active fiscal measures and monetary easing were required to prevent the global financial crisis from adversely affecting their respective domestic economies.

12. The fiscal policy response to the global financial crisis varied among ESCWA member countries. For the fiscal year covering 2009, expansionary fiscal stances were sought by GCC countries, which had accumulated sizeable fiscal surpluses since 2002. In the latest GCC budget formation, infrastructure investment, health and education, and social provisions were emphasized. The fiscal stance was more cautious in non-GCC ESCWA member countries owing to weak revenue prospects and public debt constraints. Fiscal austerity measures have been considered for the fiscal year covering 2010 in several countries. Given that the prudent fiscal policy implementation has been well established in the ESCWA region, a further weakening of revenue prospects is envisaged to translate into the declining Government budget spending. The importance of fiscal stimuli has repeatedly been emphasized globally as the key to safeguarding economic growth from the aftermath of the financial crisis. The non-GCC ESCWA member countries are placed in a position to request additional international support for their contribution to the fiscal stimulus at the global level in 2009.

13. The monetary policy response to the global financial crisis has led to a series of reduction in policy interest rates in the region since September 2008, together with the reduction in reserve requirements of commercial banks and the provision of extra liquidity facilities. This strong easing in the monetary stance is in line with other measures aimed at protecting the national banking sector from the financial turmoil. The notable exception is Egypt where the Central Bank of Egypt did not lower its policy interest rates until it confirmed a lower inflation figure in February 2009. It is also notable that Qatar has not resorted to an interest rate policy during this period for more targeted direct measures. In addition to the monetary easing, the policy measures to cope with the global financial crisis in most cases in the region included fiscal and institutional support to the financial sector. Kuwait, Qatar and the United Arab Emirates took measures to

enhance the balance sheets of commercial banks through fiscal support. Moreover, Jordan, Kuwait, Saudi Arabia and United Arab Emirates have taken the measure to guarantee bank deposits.

14. However, the liquidity management of monetary authorities in the ESCWA region continued to face difficulties stemming from the foreign exchange rate regime and the open capital account. The region's foreign exchange rate regime is represented by pegging their respective national currencies to the United States dollar or by pegging to the basket of foreign currencies. This foreign exchange rate regime serves its purpose of stability in foreign exchange transactions that involve trade, finance and investment. However, in combination with the open capital account, this regime makes it difficult for monetary authorities to manage domestic liquidity, represented by money supply.

15. Under this circumstance, a monetary authority has less control on the monetary base, which constitutes the total of the amount of cash in circulation and deposits of commercial banks with the monetary authority. As the monetary authority is obliged to exchange foreign currencies to the national currency, the net inflow of foreign funds, either by foreign investors or by domestic exporters, automatically increases foreign reserves of the monetary authority. The equivalent amount to the increase in foreign reserves is provided as cash or is credited to bank deposits with the monetary authority. Consequently, the increase in foreign reserves contributes to the growth in the monetary base. The monetary base is also called "high-powered money" as it can be based on a monetary expansion through domestic banking system. The policy options available for the monetary authority are indirect measures aimed at controlling the extent of monetary expansion at a given level of monetary base. Most monetary authorities attempt to control the monetary expansion at an appropriate level through a set of adjustments of liquidity, namely, adjustments of the composition of the monetary base. However, these measures are indirect against the policy goals in most ESCWA member countries.

16. A worrying sign for the ESCWA region is the contraction of domestic monetary expansion. This situation indicates weak lending activities of the banking system. Considering the monetary easing, additional liquidity provision and fiscal support to the banking system, the implication is that those measures have been absorbed into the balance-sheet adjustments of the banking sector, thereby limiting the effect of those measures. The core of the issue is the weaker asset price, particularly of real estate, by which the banking sector has to continue its balance-sheet adjustments.

17. Since the second quarter of 2009, the region's monetary authorities have repeatedly claimed the availability of "sufficient liquidity". In the same period, commercial banks and the business entities often pointed to the "lack of liquidity" as the major challenge for economic recovery. It is worth noting that what monetary authorities refer to as "liquidity" represents "outside liquidity" for commercial banks, by which commercial banks are able to borrow funds. Meanwhile, what commercial banks and the business sector define as "liquidity" is "inside liquidity", which is represented by cash reserves and by an assured projection of future cash inflows.

18. The shortage of outside liquidity for commercial banks is a symptom of an early stage of a financial crisis where the systemic risk of the financial sector prevails. The remedy for this systemic risk by a central bank is the liquidity injection into its banking system. However, against the shortage of "inside liquidity" of commercial banks and business entities, a different set of policy interventions is required. This is because the shortage of inside liquidity implies a necessity of balance-sheet adjustments by which commercial banks and business entities can wind down the indebtedness in line with the value of assets. The existence of the contrasting view on "liquidity" between the region's central banks, commercial banks and business entities is proof of the need for further balance-sheet adjustments.

19. It is important to note that the examples of Japan and the United States show that there could be a time lag of 18 to 24 months for a downward asset price adjustment to translate into real economy and its sentiment. The downward adjustment of asset value began in the second quarter of 2008 in the ESCWA region and the lagged impact could therefore appear between the last quarter of 2009 and the second quarter

of 2010. Considering this possible contingency, the role of the public sector is expected to increase to tie the course of economic development to its goal. In facing the international credit turmoil of the global financial crisis through the period of the fourth quarter of 2008, the ESCWA region’s monetary and fiscal authorities have successfully defended the region’s banking sector. This achievement needs to be extended to alleviate the core weakness stemming from the global financial crisis through a smooth facilitation of balance-sheet adjustments. In most cases, such balance-sheet adjustments require a strong fiscal support. Any monetary stimulus at this stage is still likely to be absorbed into the balance-sheet adjustments of economic actors, rather than increasing domestic demand as intended.

20. Consequently, a strong fiscal stance is still necessary to sustain domestic demand for consistent growth. Under this circumstance, the effect of fiscal stimuli by some countries could be severely limited if it is to take place without regional or global leverages. Efforts at a national level must be strengthened to prevent fiscal contraction from taking place on economic and social spending, including economic infrastructure, social protection, social safety nets, employment, education and health. A set of additional frameworks of global and regional cooperation is urged in order to strengthen such national fiscal efforts, which will overcome the problem of balance-sheet adjustments, thereby achieving the development goals in the aftermath of the global financial crisis.

B. POLICIES AGAINST STRUCTURAL IMPEDIMENTS

21. Most ESCWA member countries have embarked on their development aspiration through diversification and employment creation. Despite various policy endeavours in the recent past, as identified during the Arab Economic and Social Development Summit, the structural impediments for achieving developmental goals are still mounting. In particular, the region’s high unemployment rate – or high unemployment rate among nationals in several GCC countries – remains a cause of concern. Meanwhile, the reliance on foreign expatriate workers in the private sector of GCC countries has been progressing despite efforts of nationalization by those countries of the private sector workforce through human resource development strategies.

22. While GCC countries have been actively engaged in labour market reforms in recent years, the job security of respective nationals has become an urgent policy challenge as the economies have been slowing down. The concentration of the working-age population, partly due to the demographic transition and partly due to the immigration of foreign workers, is potentially beneficial and is known as the demographic window of opportunity. However, as employment opportunities quickly become scarce, the sustainability of sensitive balance of population between national and foreign expatriate workers, particularly of working age, has become a major social concern in GCC countries. In order to preserve social coherence and cultural identity, GCC policy towards foreign expatriate workers has become restrictive. However, a trend has been emerging in GCC countries aimed at reforming the issue of foreign expatriate workers by accepting certain flexibility in the contractual status of foreign expatriate workers, with a rigid limitation on the period by which foreign expatriate workers can continuously stay in the country. Whereas no conclusion has been reached on the staying limit, several countries, particularly Bahrain, have implemented the reform of the sponsorship system.

23. Bahrain’s reform in effect allows foreign expatriate workers to switch employment without the consent of employers. This move faced an opposing opinion from the business community as it was perceived as raising the wage level for a loss of the cost competitiveness of firms. Against this opinion, a Bahraini official stressed positive effects on Bahraini jobseekers. According to this official line of argument, given that there is no unemployment as traditionally defined, the real issue should be the low wages. Hence, as long as the sponsorship system is in place, wages and salaries would remain low and the Bahraini workforce would not experience increases in their wages. The logic presented by the official could be applied to other GCC countries and could suggest a series of new policy measures to be introduced in this area.

24. More recently, Saudi Arabia has approved a 20-year employment strategy. The strategy aims to create more than 200,000 jobs in the education sector as part of the Government's efforts to improve the condition and welfare of its nationals. In line with this strategy, the fiscal allocation to the education sector in Saudi Arabia has reached its historical high. The shift of fiscal allocation to the education sector has also been seen in other ESCWA member countries. This education-centred strategy coincides with the trend initiated in Bahrain, which could lead to higher wages for national work forces in the private sector. The implicit goal here is the promotion of national human capital accumulation in the private sector and the alleviation of the over-reliance upon foreign expatriate work force.

25. The intraregional trade and investment has yet to be seen at an ideal level. However, unless a reasonable level of accumulated human capital is in place in every ESCWA member country, the sound economic and social benefits of intraregional economic transactions could be less than ideal. One of the lessons learned from the global financial crisis is that an economy may not be resilient if human wealth is not fairly valued. If an individual's labour is not appropriately valued in terms of other incomes, this can lead to financial speculations or over-borrowing behaviour through financial leverages. The excess of financial leverage faced an adjustment of extraordinary scale globally. As the ESCWA region has weathered the initial phase of the global financial crisis, the region is well placed to forge a resilient regional cooperation strategy in line with a number of national trends and strategies where human potential is placed at the centre of economic activities and value.

26. The human-centred approach through education and labour market reforms lead to sustainable growth of human capital with a natural geographical proportionality. A decent level of wage in the private sector is a strong signal for educational preferences and, moreover, is a strong incentive for the unemployed to seek useful vocational training. If a stable cash flow is embodied in each worker's human capital investment, the need for financial speculation can be lessened. As most literature on development shows, physical investment in both the private and public sectors complements human capital investment. In order to maximize the vast natural, financial and human resource potential of the region, the human-centred approach at this time is particularly appropriate.

III. CONCLUDING REMARKS

27. Policymakers in the ESCWA region have successfully defended their respective national banking sectors and domestic demand from the global financial crisis. The swift response of monetary authorities and the decisive measures of the fiscal authorities succeeded in alleviating the impact of the global financial crisis, thereby preventing several worst-case scenarios from being realized. One set of crucial challenges in the region is the continuing balance-sheet adjustments in the banking and private sectors where additional fiscal support could be required for a smooth implementation. For several ESCWA member countries, additional international support may be required. For its role in the globally coordinated fiscal stimulus, those ESCWA member countries deserve such international support. Another set of challenges in the region constitutes employment creation and the accumulation of the human capital base. The region's labour market reforms have been progressing and a growing number of countries are putting education in their fiscal priorities. This human-centred approach needs to be encouraged as a core measure aimed at strengthening both national economies and the wider economy of the ESCWA region through the leverage of regional integration.

28. The ESCWA secretariat supports its member countries with regard to promoting the regional leverage of macroeconomic policies. In order to reap the benefits of the vast potential of the region, coordinated investments for the future, in physical and human forms, in both the public and private sectors is essential. The welcoming trend of the human-centred approach in the aftermath of the global financial crisis of 2008-2009 will convincingly be the key for the sustainable economic and social developments of the ESCWA region. Upon this macroeconomic policy core, the efforts of regional integration through legislative framework will contribute towards achieving the regional developmental aspiration for all the stakeholders involved.
