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IMF Regional Economic Outlook for the Middle East and Central Asia Highlights the Need for Policies to Adjust Further to a World of High Oil Prices

The International Monetary Fund (IMF) today released the May 2006 *Middle East and Central Asia Regional Economic Outlook (REO)*. Mr. Mohsin Khan, Director of the IMF's Middle East and Central Asia Department, highlighted the report's main findings:

"High oil prices and a benign global environment underpinned the Middle East and Central Asia region's strong macroeconomic performance in 2005. Regional growth averaged over 6 percent, despite ongoing geopolitical tensions. Growth in the region substantially outpaced global growth—which remained strong, with inflation and interest rates at historically low levels. Inflationary pressures in the region were manageable, despite generally accommodative monetary policies that fueled rapid credit growth. Fiscal and external balances improved in most countries, and official reserves rose sharply, even after substantial external debt repayments.

"Policymakers in the region have so far acted as though the oil price rise is largely temporary. Most oil exporters continue to budget cautiously, apparently assuming that oil prices will decline. These countries are saving, on average, two-thirds of the higher oil revenues earned since 2002, and their high savings are showing up in the widening of global imbalances. Capital inflows from oil producers have helped some oil importing countries to finance their higher import bills and postpone adjustment.

"Both producers and consumers have limited the pass-through of higher fuel costs to domestic prices. The average pass-through for the region since 2002 is only 50 percent; for oil exporters, it is under 20 percent. Although this has helped contain inflation and limit the adverse impact on non-oil activity, the fiscal costs for some oil importers have been high.

"High oil prices have boosted regional liquidity, fueling booms in local stock and real estate markets. The stock market booms partly reflect improved fundamentals as well as substantial privatization programs in some countries. However, several equity markets appear to have become overvalued, and reversals have occurred since late 2005.

"The outlook for the region in 2006 is good, but governments will need to adjust policies to better suit a world of high oil prices and address emerging risks:

- Oil producers should seize the opportunity to increase investment in infrastructure and human capital. This higher spending will raise growth rates, lower unemployment and poverty, and help to reduce global imbalances.

- Both oil producers and consumers should reduce oil price subsidies and provide adequate compensation mechanisms for the poor. This will involve substantial fiscal tightening in some consuming countries.

- Real exchange rate adjustments will be needed in response to permanently higher oil prices. There will be pressure on real exchange rates in oil-exporting countries to appreciate. This can occur either through a nominal appreciation or through inflation. Clearly it is preferable if the required real appreciation takes place through a nominal change in the exchange rate, as inflation is costly and difficult to reverse. For oil-exporting countries that are pegged, and are open and have flexible labor markets, the pressures may not show up in the consumer price index, but in asset price inflation. Oil-importing countries will need to tighten monetary policy to limit credit growth and prevent higher inflation from becoming entrenched.

- Policies should be designed to limit the impact on financial systems of further sharp asset price reversals. Authorities in some countries may need to tighten supervision to limit banks' exposure to asset markets and promote adequate investor protection."

The full text of the May 2006 *Middle East and Central Asia Regional Economic Outlook* can be found on the IMF's website, www.imf.org.