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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/56-2

2:30 p.m., June 20, 2018

2. Oman—2018 Article IV Consultation

Documents: SM/18/135 and Supplement 1; SM/18/142

Staff: Roudet, MCD; Goodman, SPR

Length: 19 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	**Alternate Executive Directors**
	G. Gasasira-Manzi (AE), Temporary
	A. Olhaye (AF), Temporary
	J. Corvalan (AG), Temporary
	G. Khurelbaatar (AP), Temporary
	A. Souza (BR), Temporary
	H. Ma (CC), Temporary
	J. Rojas (CE)
	N. Feerick (CO), Temporary
	O. Bayar (EC)
	A. Castets (FF)
	K. Merk (GR)
S. Gokarn (IN)	
	T. Persico (IT), Temporary
	Y. Minoura (JA), Temporary
	K. Badsi (MD), Temporary
H. Beblawi (MI)	
	T. Manchev (NE), Temporary
T. Ostros (NO)	
	L. Palei (RU)
	S. Rouai (SA), Temporary
	S. Ismail. (ST), Temporary
	P. Inderbinen (SZ)
	O. Haydon (UK), Temporary
(US)	

G. Bauche, Acting Secretary
S. Kalra, Summing Up Officer
D. Jiang, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Communications Department: R. Anspach, W. Murray, G. Rice. European Central Bank: T. Persico. Fiscal Affairs Department: P. Dudine, N. Gueorguiev. Finance Department: M. Fisher, M. Nkusu-Mulumba, A. Tweedie, O. Unteroberdoerster. Information Technology Department: F. Gheriss. Legal Department: K. Christopherson Puh, A. El Murr, G. Mathias Alves Pinto. Middle East and Central Asia Department: J. Azour, B. Baltabaev, T. Callen,

A. Husain, B. Joshi, S. Roudet, V. Stepanyan, T. Stone. Monetary and Capital Markets Department: M. Savastano, R. Veyrune. MESSAGE: J. Rudolph OEDUS at the table. Office of Executive Directors: K. Mannefred. Office of Risk Management: V. Arora. Research Department: G. Dell'Ariccia. Strategy, Policy, and Review Department: S. Abbas, H. Bredenkamp, C. Garcia Verdu, M. Goodman, V. Kramarenko, M. Muhleisen, D. Zakharova. World Bank Group: P. Anos Casero. Western Hemisphere Department: J. Canales Kriljenko, R. Cardarelli, Y. Carriere-Swallow, N. Chalk, L. Lusinyan, A. Werner Wainfeld, C. Wong. Alternate Executive Director: S. Geadah (MI). Senior Advisors to Executive Directors: W. Abdelati (MI), M. Choueiri (MI), M. Sidi Bouna (A F). Advisors to Executive Directors: A. Ahmadov (SZ), F. Al-Kohlany (MI), P. Al-Riffai (MI), F. Dogan (EC), J. Essuvi (AE), G. Kim (AP), M. Merhi (MI), C. Rebillard (FF), P. Chotard (FF).

2. OMAN—2018 ARTICLE IV CONSULTATION

Mr. Beblawi and Mr. Al-Kohlany submitted the following statement:

On behalf of the Omani authorities, we thank staff for the constructive Article IV consultation discussions and for the useful reports. The authorities were in general agreement with the staff assessment and recommendations, particularly, regarding sustaining fiscal consolidation, maintaining financial sector stability, and supporting growth through promoting private sector development, economic diversification, and job creation.

Improved confidence, due to recently launched reforms, supported a modest pick-up in Oman's non-oil GDP growth to 2 percent in 2017. The authorities share staff's positive assessment of the economic outlook, which projects non-oil growth to continue to pick up over the medium term as it benefits from strong diversification efforts, and the coming online of major infrastructure projects to offset the impact of gradual fiscal consolidation. The authorities' prudent policies over the past years, guided by the 9th National Development Plan (DP), should continue to safeguard financial stability and support growth in the nonhydrocarbon sectors.

Fiscal Policy

Oman's fiscal position improved significantly due to a series of policy measures adopted in the past few years and also benefited from a recovery in oil prices. Spending restraint has brought down current expenditure by 21 percent of non-oil GDP between 2014 and 2017, and the capital investment level was preserved. The Ministry of Finance instituted a near freeze of hiring and promotions, limited compensation increments, and streamlined allowances. The cost of subsidies continued to decline as fuel subsidies were cut and electricity prices for large consumers were raised. The authorities issued instructions to all spending units to curtail non-essential current expenditure and to increase spending efficiency.

Earlier this year, the authorities successfully mobilized $6.5 billion in international bonds, covering the bulk of the fiscal financing needs for the year and reflecting international market confidence in the Omani economy. The authorities recognize that continued efforts are needed to preserve fiscal space for growth-enhancing spending, while maintaining fiscal sustainability, recognizing that oil resources are nonrenewable. Accordingly, fiscal consolidation and reforms continue to rank high on their agenda.

The authorities take note of staff's recommendation for more ambitious consolidation efforts going forward. However, the authorities expect a more rapid reduction in the government deficit and financing needs, reflecting different oil price assumptions, and larger-than-expected savings from expenditure rationalization measures. The staff's assessment of Oman's fiscal position and financing needs is based on oil prices that are significantly lower than the authorities' projection or current market prices. Adjusting the baseline oil price closer to current market levels, at 72 dollar/bbl, could reduce the projected fiscal balance for 2018 by about 4 percent of GDP from 5 percent to 1.3 percent. Despite the improved oil price outlook, the authorities believe that fiscal adjustment should continue, albeit at a measured pace, to alleviate the potential adverse impact on economic activity and the financial sector.

To ensure fiscal sustainability, the authorities intend to undertake additional measures to increase non-oil revenues, further curtail current and capital spending, and improve the effectiveness and efficiency of government spending. Diversifying the revenue base is a priority. Important actions already taken in this regard include raising the corporate income tax, improving the efficiency of tax and fees collections, and increasing the price of government services. They plan to introduce excise taxes and VAT within the framework of a GCC-wide tax reform initiative. The introduction of these taxes will not only improve non-oil revenues, but will also further strengthen the institutional structure needed to lessen Oman's dependence on oil.

Monetary and Financial Sector Policies

The exchange rate peg has served the Omani economy well. The authorities remain fully committed to the peg, including through undertaking the necessary fiscal adjustment, adjusting interest rates as necessary, and implementing structural reforms. Reserves are at a comfortable level, with CBO gross reserves at 5.6 months of imports. Together with the State General Reserve Fund, external assets bring the reserves level up to 156 percent of the ARA metric.

The authorities welcomed staff's assessment that the financial system in Oman is sound. Banks are capitalized well above prudential norms, liquid, and profitable. The CBO's stress tests—available in the published 2017 Financial Stability Report—indicate that banks are resilient to severe solvency and liquidity shocks. Credit continues to grow without any increase in non-performing loans (NPLs), which remain below 2.5 percent, and loan-loss provisioning remains stable. The authorities expect credit growth to strengthen further as the diversification efforts yield results over the medium term. The CBO is on track with its implementation schedule of Basel III capital and liquidity standards. The authorities plan to adopt a robust liquidity forecasting and management framework and are reviewing the current instruments with a view to boost the development of interbank markets and allow for more active liquidity management.

The CBO is of the view that the use of countercyclical measures helped to maintain financial stability and bank resiliency without weakening the resilience of the sector. NPLs would have been only 0.4 percent higher, absent CBO's relaxation of loan classification. The effect of the authorities continued commitment to strengthening the financial sector during the last economic downturn helped to maintain lending to the private sector and has promoted non-oil output stability. The authorities will continue to closely monitor the impact of these measures to prevent a buildup of excessive risks and make the necessary adjustments as the economic cycle strengthens.

The authorities are determined to address any vulnerabilities in the sector and further enhance the robustness of the banking regulation and supervision. They have issued guidelines to identify, supervise, and regulate Domestic Systemically Important Banks. They are finalizing the Bank Resolution Framework and issued instructions to improve Financial Inclusion. Furthermore, the authorities issued guidelines to address problems related to Correspondent Banking Relationships and on the adoption of IFRS9.

To promote capital market development, the Capital Market Authority (CMA) issued a new corporate governance code for listed companies. They also issued regulations for Sukuk to support the development of the Islamic capital market in Oman and regulations for marketing insurance products and real estate investment trusts. Other regulatory reforms are in process, including a new securities law. More funds were mobilized from the domestic market during 2017 for five public offerings, including the offering of 35 percent of Muscat City Desalination Company.

The authorities remain committed to strengthening the AML/CFT framework and its effective implementation. A new AML/CFT law was issued and the CBO issued a recent circular with instructions to banks for implementing the law. The authorities are putting in place a comprehensive mechanism to manage risks and the development of the national risk assessment is ongoing.

Boosting Private Sector Employment

There is strong political ownership and resolve to implement comprehensive structural reforms in line with the authorities' 9th DP, which aims to create employment for Omanis through private sector-led economic diversification, including manufacturing, logistics, and tourism. The staff's analysis in the SIP concurs with the significant potential of these sectors to support the medium-term growth outlook. Progress in diversifying the economy is regularly monitored against key performance indicators, across more than 90 projects covering the key sectors identified in the DP. This rigorous monitoring is carried out by the Implementation Support and Follow-up Unit (ISFU), a dedicated unit setup to ensure the timely implementation of the Sultanate's economic diversification program (Tanfeedh) and improve alignment with the respective implementing government agencies and private entities.

To advance diversification, the government is streamlining processes and removing obstacles faced by the private sector. They eliminated the requirement for minimum capital to start a business. They also established a one-stop-shop, Invest Easy, as a single point of access to all government e-services related to starting a business. The authorities plan to automate and simplify all business licensing processes and fully integrate and assimilate requirements of 24 government entities into the Invest Easy system by 2020. Exporting and importing was facilitated by creating an online single-window system and reducing the time required for documentary compliance, which has helped in reducing the burden of customs and other administrative procedures, and improved revenue collection and transparency.

Privatization is also high on the authorities' agenda. They established a committee to supervise the privatization of state-owned enterprises and requested privatization plans from all state-owned holding companies. Six state owned enterprises have been identified for privatization so far, and proceeds would go toward reducing the government's borrowing needs. Going forward, emphasis will also be placed on encouraging Public Private Partnerships, with support from the World Bank, for the development of the regulatory framework and related law.

The authorities are establishing the Center for Competition Protection and Prevention of Monopoly, with the mandate to enforce the Protecting Competition Law fairly, with due process, and in line with the best practices and principles of a free market economy.

Omani nationals are being encouraged to seek opportunities in the private sector, and the authorities are regularly communicating to the public the limited scope for public sector jobs going forward. The 2018 budget statement stated that employment in the public sector shall only be based on staffing needs, and in line with the budget situation. The authorities recognize that labor market reforms are critical to foster job creation in the private sector. The authorities are working to align the labor market with employers to address skills mismatch and improving education outcomes. For example, the National Training Fund was established to enhance the employability of nationals by providing training and on the job training; a first batch of 4300 trainees is underway. Vocational education and applied science college by-laws and curriculums are also under review to meet the demands of businesses.

Technical Assistance

Our authorities value the engagement with the Fund and the continued support and insights provided through technical assistance (TA), which has helped Oman to improve its policy formulation and implementation. In particular, they appreciate the TA provided lately by MCM on strengthening monetary policy operations and by FAD on tax administration, and look forward to a continued close collaboration with the Fund.

Mr. Ostros and Mr. Bartkus submitted the following statement:

We thank staff for the report and Messrs. Beblawi and Al-Kohlany for their helpful buff statement. The oil price shock revealed vulnerabilities of Oman's economy that lacks diversification. While the near-term outlook is supported by higher oil prices, this should not lead to complacency. The authorities should remain focused on addressing the fiscal and external imbalances. As is well noted in the report, the downside risks remain sizeable and relate not only to factors under the authorities' control, but also global or regional factors, such as terms of market financing or geopolitical uncertainties.

We note that running large dual deficits risks eroding exchange rate sustainability and may undermine confidence in the overall policy consistency. The authorities should take this risk seriously into account in their policy design. Considering the authorities' firm commitment to the exchange rate peg, a strong emphasis by staff on the role that the fiscal policy should play not only in shock absorption but also in driving the external adjustment is well warranted and appropriate. Postponing the adjustment on hopes that the current more favorable oil prices could be sustained for longer would be rather irresponsible and risky.

In this regard, we support staff's call for considerable further consolidation, aiming to achieve a primary balance in the medium-term and by putting debt on a downward trajectory. A 20 percent of GDP adjustment over 5 years is unquestionably difficult under any circumstances and the authorities' concerns about its impact on economic activity, job creation and social outcomes are understandable. Though, it is equally important not to lose sight of the longer-term outlook, pricing in the risk of disorderly adjustment if the current consolidation gets delayed and, for example, external downside risks materialize at the most unfortunate time.

We share the assessment that the envisaged fiscal adjustment should be geared to contain current expenditure, particularly public-sector wages and spending on subsidies. The authorities should also seek to diversify the revenue base by increasing non-hydrocarbon revenue. Furthermore, streamlining capital outlays and strengthening public investment management remains important. The authorities should also take steps to develop the medium-term fiscal framework and strengthen fiscal institutions – that is crucial not only to contain implementation risks, but to ensure general policy consistency with the exchange rate regime chosen.

We welcome the CBO efforts to improve liquidity management and functioning of the inter-bank market, as well as the intentions to upgrade the framework for monetary policy operations. The authorities should also finalize the frameworks for emergency liquidity support and bank resolution while maintaining a proactive supervisory stance in dealing with the financial sector vulnerabilities noted by staff.

While the fiscal policy should play a key role in shock absorption, structural reforms are not less important in supporting economic flexibility and boosting growth potential. In this regard, we support a strong focus on the labor market; the need to improve its functioning and flexibility, tackle rigidities and excess employment in the public sector. Private sector led growth could be further supported by steps to improve the business environment. Though, we somewhat missed stronger emphasis on education and the need to address skill mismatches that are only vaguely mentioned in the report.

Mr. Gokarn and Mrs. Dhillon submitted the following statement:

We thank staff for the Article IV report and Mr. Beblawi and Mr. Al-Kohlany for the informative buff statement. We broadly support the thrust of the report and offer the following for emphasis.

We commend the efforts of the authorities to address the fiscal position, invigorate private sector growth and diversification. A visible pick-up in Oman's non-oil GDP growth to 2 percent in 2017, albeit modest, is reflective of the authorities' effective policies. However, we note that overall growth in 2017 turned negative at -0.3 percent, impacted by a significant contraction of oil output from the OPEC+ agreement. The outlook is fraught with downside risks from heightened regional geopolitical uncertainty, fiscal underperformance and tightened financing conditions. Going forward, we urge the authorities to persist with a robust reform agenda to tide over the oil price vulnerabilities and the accompanying double-digit fiscal and current account deficits.

Fiscal consolidation and reforms to target the high deficit and debt remain paramount. We positively note that the authorities successfully mobilized $6.5 billion in international bonds, even with the shadow of sovereign credit rating downgrades. Building fiscal space needs sustained efforts aimed at streamlining spending and capital outlays, enhancing revenue through diversification, value-added and excise taxes, subsidy management and improved budget planning. Understandably, this will also be a tough balancing act, especially on concerns of the socio-economic fallout of subsidy reforms on vulnerable households. The authorities have indicated a more rapid reduction in the government deficit and financing needs, reflecting different oil price assumptions, and larger-than expected savings from expenditure rationalization measures as compared to staff's assessment. Could staff offer their views on this counter assessment?

On Monetary and Financial Sector policies, Oman's sound banking sector with high capitalization, low non-performing loans, and strong liquidity buffers deserves praise. The authorities are determined to address any vulnerabilities in the sector to further enhance the robustness of the banking regulation and supervision. However, the dichotomous message on the relaxation of loan classification and provisioning requirements is striking, with it being welcomed on one hand and then the central bank being advised to replace it with non-discriminatory macro/micro prudential measures. We invite staff to elaborate on this and suggest possible alternative measures to address the macroprudential concerns. We also join staff in urging the authorities to enhance the legal AML/CFT framework and prioritize its effective implementation. Beyond this, the authorities' commitment to the exchange rate peg and Oman's' comfortable reserves are reassuring. The authorities plan to adopt a robust liquidity forecasting and management framework to boost the development of interbank markets and allow for more active liquidity management. We would like to hear more details on this from staff.

Finally, pro-business reforms including those for promoting foreign direct investment, SMEs and PPP could significantly increase trade and investment. Oman's unemployment level, particularly for youth, remains a pressing challenge. With this backdrop, the authorities' ownership and strong resolve to implement comprehensive structural reforms as per the 9th Development Plan for creating employment through private sector-led economic diversification involving manufacturing, logistics, and tourism is timely and relevant. This, complemented with the focus on privatization, offers a stronger basis for faster growth. Notably, six state owned enterprises have been mentioned for privatization. We would welcome staff insights on the potential of privatization and the timelines in this context.

With these comments we wish the authorities the best in their endeavors.

Mr. Armas and Mr. Corvalan Mendoza submitted the following statement:

We thank staff for the report and the selected issues paper and Mr. Beblawi and Mr. Al-Kohlany for their comprehensive buff statement.

The strengthening of the country's institutional capacity to deliver public goods becomes relevant at this stage of development, knowing that more than 200,000 nationals (out of a population 4.8 million people) are expected to participate in the labor market in the next decade, and the country is characterized as one of the fastest-growing populations in the world. These figures give us a rough idea of the socio-economic demands for public goods the country will face.

We support staff's advice to mobilize additional tax revenues to tackle the twin deficits. Fiscal and current account deficits are large and not sustainable. It all started to deteriorate in 2014, when the price of oil declined sharply and an important source of revenues for the government was reduced. Given that the country operates under an exchange rate peg regime, the larger the fiscal deficit, the faster the country draws down its current buffers (central bank reserves and State General Reserve Fund). The fiscal space needed to cope with the increasing demand for goods and services, as well as financing major infrastructure projects, requires a higher tax-to-GDP ratio.

It is advisable for the authorities to consider the implementation of new taxes and the creation of a non-oil revenue base. The window of opportunity to finalize legislative and administrative considerations is still open, as of today, given the favorable current prices of oil. This opportunity shall be used without delay. We are inclined to follow the staff's advice and technical assistance, to consider the introduction of property and income taxes in the medium term, and move swiftly on the implementation of VAT and excise reforms in the very near term. By the same token, a well-crafted strategy to keep expenditures in check is needed, to minimize further deterioration of the fiscal outcomes which may erode the country's limited buffers.

External buffers are being swiftly consumed and the market sentiment on the country's outlook is declining. If the twin deficit continues at the same pace we have seen in the past four years, the evolution of sovereign credit ratings might be compromised. As shown in the report, the S&P already categorized the foreign currency debt below the investment grade threshold in 2017. This situation will imply much more difficult external financing, at current low interest rates, in the near future. This outcome might deteriorate even further given that financial conditions are expected to tighten worldwide, because of monetary normalization trends in major economies.

The financial sector seems robust. Nevertheless, the relaxation of loan classification and provisioning requirements for restructured loans caught our attention. This financial recently-implemented policy may need the authorities' further reconsideration, to avoid the possibility of artificially creating an "ever green" scenario, where troubled loans appear normal with good assets on banks' balance sheets.

With these comments, we wish the people of Oman every success in their future endeavors.

Mr. Doornbosch and Mr. Manchev submitted the following statement:

We thank staff for the comprehensive set of papers and Messrs. Beblawi and Al-Kohlany for the informative buff statement. Despite the authorities' consolidation efforts over the past few years, Oman has experienced double-digit fiscal and current account deficits. Risks to the outlook remain tilted to the downside too, given the deficits' persistency, heightened regional and geopolitical uncertainty, and tighter financing conditions. Far reaching reforms will be needed to put the economy on the long-term sustainable footing. Since we broadly share the thrust of the staff appraisal, the following remarks are provided for emphasis.

Deeper and far reaching fiscal adjustment is needed to maintain confidence in the public finance and support the exchange rate peg. Developing a formal medium term fiscal framework and strengthening institutions will help increase transparency and credibility of the process. We note significant improvement in the authorities' fiscal position last year, but consolidation should continue and become more balanced through combining further expenditure rationalization with expedited measures for revenue mobilization, especially from the picking up non-hydrocarbon sector. It will be critical for Oman to sustainably achieve a primary budget surplus in the medium-term and thus reverse the adverse public debt trajectory. These efforts need to be accompanied by structural reforms to improve the business environment and private investment to facilitate job creation and achieve a more inclusive growth. On the demand side, the priority in public finance management should be to contain the public wage bill and further rationalize and steadily phase-out costly energy and water subsidies to stimulate more efficient use of resources and capital re-allocation. Can staff provide an update on the most recent budget and debt developments?

The government and other Omani's borrowers still enjoy comfortable access to external funding, but should be cautious about potential future pressures on the exchange rate peg. Steep decline of foreign reserves and government deposits with domestic banks, accompanied by an increase of both the public and total external debt, requires close monitoring and measures to increase financial sector resilience. In this regard, we welcome regulatory efforts to timely adopt the international standards for financial reporting and enhance the legal AML/CTF framework, as well as to ensure their effective implementation while attempting to avoid the crowding out effects on private credit. We, however, agree with staff that recently adopted relaxations in the capital adequacy, lending standards and maturity-mismatch limits may undermine financial discipline and encourage the Central Bank of Oman to gradually unwind them. The authorities also need to strengthen the liquidity and crisis management frameworks.

The authorities should take stock from the comprehensive staff analyses on the long-term net benefit of the fiscal and structural reforms. Total factor productivity in Oman has been low in the last 15 years, and the constrained fiscal space in the medium-term urgently calls for developing alternative drivers of growth going forward. Given the gloomy forecasts of global oil prices, the authorities should use this window of opportunity to strengthen the business environment, reform education, and encourage private sector development to create sufficient jobs for the growing young Omani population. The reforms will also help Omani's economy achieve a more diversified and inclusive growth model in the long-term.

Finally, we encourage the authorities to consent to the publication of the 2018 Article IV consultation documents. Speedy completion of the ongoing AML/CFT risk assessment and publication of its findings are important steps in securing the correspondent-banking relationships and market confidence.

Mr. Jin and Ms. Ma submitted the following statement:

We thank staff for the comprehensive set of papers, and Messrs. Beblawi and Al-Kohlany for the helpful buff statement. Despite modest economic growth and the authorities' commendable ongoing reforms, fiscal and current account deficits are projected to remain large. Additional reform measures are therefore warranted to safeguard fiscal and external sustainability, promote development of the private sector, and enhance the economy's long-term resilience to oil prices. As we broadly concur with the thrust of staff's appraisal, we would limit our comments to the following for emphasis.

More ambitious fiscal adjustment is needed to put debt on a downward trajectory. While we welcome the authorities' fiscal consolidation efforts to curb current expenditure and diversify the revenue base – in particular, the plan to introduce excise tax and VAT under the GCC tax reform initiative – we call for caution in their projected fiscal path that critically depends on a more optimistic assumption of oil prices. In order to "fix the roof while the sun shines," we see merit in staff's proposed consolidation path including curbing the wage bill through structural reforms, and reducing subsidies, among others. Noting the authorities' concern over the potential adverse impact of fiscal adjustment, we would like to invite staff to shed more light on the public opinions and possible sequencing of the reforms to garner social support.

We agree that the exchange rate peg provides an important policy anchor and should be maintained. However, the rapid increase of external debt in 2014-17 and its sensitivity to exchange rate shocks highlight the importance of fiscal sustainability underpinning the fixed exchange rate regime. The strategy of mostly relying on external bond placement, while preventing crowding out the private sector credit, is subject to changes of the global financial conditions.

Stronger regulation is needed to safeguard financial stability. Notwithstanding sound indicators of financial stability, we encourage the authorities to remain vigilant to vulnerabilities arising from the recent counter-cyclical regulatory loosening, and to unwind the measures when conditions allow. Timely implementation of the Bank Resolution Framework would also help bolster financial resilience.

We take positive note of the strong political commitment to comprehensive structural reforms. As estimated by staff, structural reforms will bring about sizable growth dividends for Oman. Labor market and civil service reforms are essential to enhance private-led growth. Improving efficiency of the educational system would boost TFP while reducing the public wage bill. Regarding the planned reforms on PPP, could staff further elaborate on the details and the implications for public finance?

Mr. Mojarrad and Mr. Sassanpour submitted the following statement:

We thank staff for a set of well-written papers and Mr. Beblawi and Mr. Al-Kohlany for their informative buff statement. We are pleased that staff and the authorities are in broad agreement on key policy priorities, including reinforcing fiscal consolidation, preserving financial stability, and promoting private sector growth and employment. However, while recognizing the downside risks to the outlook, the authorities underscore the important upside risks, including from higher-than-projected oil prices and the impact of new oil sector investments. We concur with the thrust of the staff report.

The authorities are to be commended for cutting the fiscal deficit substantially, in response to the loss of hydrocarbon revenues since 2014, by raising non-hydrocarbon revenues and reducing current expenditures, notably by containing the wage bill and reducing fuel subsidies. As highlighted by staff, fiscal and external adjustments are closely linked in Oman, and indeed the twin deficits have declined in tandem, but remain large. We commend the authorities' resolve to stay on course and bring down the fiscal deficit sufficiently to limit the increase in public debt and ensure external sustainability over the longer run. On the revenue front, the recent increases in the corporate profit tax rate and in prices of government services, combined with the early implementation of the excise tax and VAT within the GCC framework, should improve non-hydrocarbon revenues. Introducing a property tax and a low flat rate income tax, as suggested by staff, also merits consideration. As highlighted in the SIP, containing public sector wage bill, and especially limiting generous allowances as part of a comprehensive civil service reform, should be a major source of saving, while reducing adverse spillovers on private sector employment. Fuel subsidies have been eliminated, but the electricity subsidy bill and transfers are still large and need to be gradually phased out. It is also important that adequate compensatory measures are in place to protect the most vulnerable and to build social consensus for reforms. Conducting social analysis impact of fiscal measures should help in this regard.

A strong and credible fiscal stance would help maintain the viability of the currency peg that has anchored the economy, delivered low and stable inflation, and has been a major source of investor confidence. Oman's resilient financial sector has also contributed to confidence, and we welcome plans to further strengthen bank supervision and resolution frameworks and put in place regulations for the development of the Islamic capital market and marketing of real estate investment trusts and insurance products. Although NPLs are low and well-provisioned, we encourage close monitoring of bank lending to prevent the build-up of excessive risks, especially considering the high exposure of banks to the real estate and households.

Going forward, a major challenge is to limit the impact of fiscal retrenchment on non-hydrocarbon activity through structural reforms to diversify the economy and unleash job-rich private sector-led growth, consistent with the 9th Development Program and Tanfeedh. A number of important initiatives have already been taken to promote private sector investment by improving the business climate. Raising productivity is key to boosting Oman's long-term growth potential, as supported by staff analysis in the SIP. The planned reform of the PPP framework and easing restrictions on non-oil FDI would enhance private sector activity. We are also encouraged by the authorities' privatization plans—as elaborated by Mr. Beblawi and Mr. Al-Kohlany—to reduce public debt and at the same time enlarge the scope of private sector activity and boost productivity and efficiency. Civil service reform and addressing labor market inefficiencies would also go a long way towards stronger private sector growth and job creation.

We wish the authorities all the success.

Ms. Villa and Mr. Ismail submitted the following statement:

We thank staff for the comprehensive set of reports and Messrs. Beblawi and Al-Kohlany for their informative buff statement. Oman is facing important challenges emanating from increasing vulnerabilities following the 2014 oil price shock. Faced with fiscal and external imbalances, rapid buildup of debt and modest growth outlook, the authorities have appropriately launched reforms to bolster the fiscal position and boost private sector-led growth. At the same time, it is also essential to reinforce financial sector resilience given macro-financial linkages. We broadly concur with the staff appraisal and offer the following comments for emphasis.

Continued fiscal adjustment and steadfast implementation of fiscal reforms are warranted to put public finances on a sustainable trajectory and ensure external sustainability. Significant gains have been achieved in the reduction of the headline deficit as the authorities continued to curtail spending and also benefited from higher oil prices. Nevertheless, timely and phased implementation of measures to develop non-oil sources of revenue, tackle public wages rigidities and implement sound price-subsidy reforms remain critical policy priorities for fiscal sustainability. Continued improvements in fiscal frameworks and institutions to support fiscal consolidation efforts are also encouraged. Financing the fiscal deficit should continue to strike the right balance between preserving external buffers and avoiding the crowding out of credit to the private sector, amid tightening global financial conditions.

The Central Bank of Oman should remain vigilant over developments in the financial sector. While we take comfort in the sound financial indicators, the authorities should continue to closely monitor banks' asset quality. At the same time, prudential measures should seek to bolster the sector's resilience without compromising banks' ability to supply credit to the private sector and to secure from external funding sources. The Fund should also recognize the need of members to use all available measures in their policy toolkit to preserve macroeconomic and financial stability. Our Chair has always maintained that Fund characterizing and policy advice on measures relating to capital flows should not be mechanical. Could staff share the background and concerns of the CBO when they first imposed the limit on banks' exposure to non-residents? In addition, could staff elaborate on the relative effectiveness of their proposed alternative measures as discussed with the authorities? We welcome the CBO efforts to strengthen its liquidity and crisis management and preparedness framework. We also positively note the commitment and developments to strengthen the AML/CFT framework.

The authorities should use this opportunity to design policies that can contribute to the long-term growth prospects in Oman. Labor market and civil service reforms should seek to establish a sustainable public-sector wage bill that sufficiently reflect the quality of public services whilst providing the necessary skillsets and incentives for Omani nationals to work in the private sector. In this regard, staff's recommendation for targeted and temporary wage subsidies to encourage private sector employment merits attention. In their quest to achieve greater economic diversification, the authorities should continue its efforts to enhance the business climate and foster private sector investment, under the Tanfeedh development program. The envisaged privatization of six state owned enterprises is a welcomed step towards promoting a private sector-led growth.

With these comments, we wish the authorities every success in their future endeavors.

Mr. Merk and Mr. Maluck submitted the following statement:

We thank staff for the informative report and Mr. Beblawi and Mr. Al-Kohlany for their helpful buff statement.

We broadly concur with the thrust of the staff's appraisal. In the aftermath of the oil price shock 2014 large fiscal and current account deficits have emerged, vulnerabilities increased, and the economic outlook has been downgraded. We welcome the launch of some fiscal reforms by the authorities and the development of a structural reform agenda to improve diversification of the economy and foster private sector led growth.

Since in staff's baseline the fiscal deficit is projected to remain large, further reforms to improve the fiscal framework and institutions are crucial. Fiscal and external balances improved somewhat due to higher oil prices and because of some reforms to improve the fiscal framework, but the fiscal and current account deficits are likely to persist and central government debt is expected to rise in the staff's baseline. We therefore echo staff that more has to be done to bring fiscal and external balances on a sustainable path. We especially see room for additional reforms to contain the public wage bill and to phase out energy and water subsidies. We share staff's view that budget planning must be strengthened and expenditure controls should be implemented. The formal adoption of a medium-term fiscal framework could help to strengthen confidence. On the revenue side, we concur with staff that an increase of the non-hydrocarbon revenue could help to balance the fiscal adjustment. The introduction of excises and VAT should not be further delayed.

We agree with staff that the peg to the U.S. dollar is appropriate and fiscal adjustment is crucial to ensure external sustainability. In this regard we welcome the excellent and succinct presentation of the role of fiscal adjustment in supporting the external adjustment in the staff report. On financial sector stability, we welcome staff's assessment that the financial sector appears sound and resilient. Strengthening the central bank's liquidity management and crisis management would strengthen the system's resilience further. Moreover, we agree with staff that efforts to enhance the legal AML/CFT framework and its effective implementation are important.

We share staff's appraisal on structural reform priorities. Diversifying the economy is imperative and the promotion of private sector development is the way to go to enhance productivity and to create jobs. We strongly agree with staff's view that structural reforms, tackling labor market inefficiencies and improving the business climate are essential. We also concur that the Tanfeed program is a promising approach to utilize the diversification potential of the Oman's economy and we encourage the authorities to make progress in implementing this reform agenda.

Mr. Alkhareif and Mr. Keshava submitted the following statement:

We thank staff for the well-written reports and Mr. Beblawi and Mr. Al-Kohlany for their informative buff statement. We welcome the authorities' prudent policies and the launching of reforms to strengthen the fiscal position and boost private sector-led growth and diversification. In this connection, we are encouraged that non-oil growth picked up last year, albeit modestly, and the medium-term outlook is generally favorable thanks to the authorities' diversification efforts and the expected completion of major infrastructure projects, which will help offset the impact of the gradual fiscal consolidation.

We welcome the significant improvement in the fiscal position last year due to the policy measures as well as a recovery in oil prices. We are also reassured by the authorities' commitment to implement further reforms, including to introduce VAT and excise taxes, in accordance with the planned timeline and to further curtail current and capital spending, which will be steps in the right direction to ensure fiscal sustainability. The stress on implementing reforms at a measured pace is also appropriate to alleviate the possible impact on economic activity, job creation, and social outcomes, as underlined by the authorities. We take positive note of the ongoing efforts to develop medium-term fiscal scenarios for guiding fiscal policy and limiting debt accumulation. On the financing strategy, the emphasis on covering the financing needs mainly through external borrowing is appropriate, as it helps prevent the crowding-out effect on the private sector.

We agree that the exchange rate peg has served the economy well and remains appropriate, as it has provided the economy with an effective nominal anchor. In this connection, we welcome the authorities' strong commitment to the current exchange rate arrangement. In the financial area, the banking system remains sound, as demonstrated by high capitalization, low NPL ratio, high loan-loss provisioning, and steady profitability. Banks have also maintained strong liquidity buffers. We also take positive note of the authorities' stress tests, which indicate that banks are resilient to severe solvency and liquidity shocks. At the same time, we agree with staff that the central bank should remain vigilant and monitor closely potential financial sector vulnerabilities, and that banking sector regulation and supervision should remain robust. On the AML/CFT, we welcome the measures taken to strengthen the framework and the commitment to its effective implementation. We look forward to the completion of the ongoing national risk assessment.

Finally, efforts should continue for economic diversification to further catalyze private sector-led growth, job creation for nationals, and strengthen the resilience of the economy. In this connection, promoting SMEs' development, including by facilitating the access to finance, should be a priority to enhance growth and job creation. We are encouraged by the authorities' efforts to improve labor skills and employability of nationals and to streamline processes and remove obstacles faced by the private sector, which would contribute to enhancing the business environment and attracting additional investment. In addition, the emphasis placed on encouraging PPPs and privatization could play crucial role in enhancing operational efficiency and reducing the fiscal burden.

With these remarks, we wish the authorities further success.

Mr. Rojas Ramirez submitted the following statement:

Oman's economy has been affected by international hydrocarbon prices and low growth. To cope with this situation, the authorities have implemented fiscal reforms to reduce deficits, attaint fiscal sustainability, and preserve a sound external position and a well-capitalized banking and financial system. We thank staff for its report and Mr. Beblawi and Mr. Al-Kohlany for their informative buff statement.

On the fiscal stance, the economy has been affected by the decline in fiscal revenues due to low oil prices; however, the government has been able to hit markets and use financial buffers. The Omani authorities are committed to fiscal stability and placing public finance on a sustainable trajectory by implementing measures to improve non-hydrocarbon revenues and an efficient expenditure framework. On the revenue side, we encourage authorities to continue the implementation of tax reforms such as the VAT and broadening the tax base. Improving budget planning and execution is crucial on the expenditure side to curtail current and capital spending and rationalize public investments. In the medium term, strengthening fiscal institutions is necessary for economic stability, economic diversification, and inclusive growth.

The Oman banking system is sound and well capitalized. Banks present low non-performing loans with a high provisioning loss. We note that the system remains with strong liquidity buffers, good profitability and adequate levels of capital, with some vulnerabilities that the CBO is already addressing. We welcome authorities' efforts for enhancing the AML/CFT framework and its implementation.

We encourage the authorities to continue economic diversification by promoting private sector participation, improving investment climate, and fostering domestic job creation. We welcome Tanfeedh, a program for promoting sectorial diversification.

Mr. de Villeroché, Ms. White, Mr. Castets, Mr. Chotard, and Mr. Masood submitted the following joint statement:

We thank staff for a very clear and comprehensive report, as well as Mr. Beblawi and Mr. Geadah for their insightful buff statement. We agree with the recommendations made in the staff report and make the following comments for emphasis:

Recent Macroeconomic Developments and Outlook

We welcome steps taken by the authorities over the past few years to expand the nonhydrocarbon revenue base, reform energy prices, and curtail government expenditure. These are welcome measures that will help to improve the fiscal position and private sector growth. However, we agree with staff's continued focus on the fiscal and external positions given persistent fiscal and current account deficits, and agree with the recommended policy responses.

Fiscal Policy

On the immediate fiscal outlook, we agree with staff's assessment that significant additional fiscal adjustment is required to maintain confidence and fiscal and external sustainability. Fiscal consolidation is required to manage upcoming debt repayments and to increase the buffer against external shocks following continued double-digit current account deficits over the last three years resulting from the oil price shock. Recent pick-up in oil prices should not lead down efforts to diversify fiscal revenues. What impact do staff assess changes to the OPEC agreement will have on the fiscal balance? We agree with staff recommendations to develop a medium-term fiscal framework as well as a medium-term debt management strategy. How serious is the risk to debt sustainability in the medium term if U.S. interest rates increase more than expected (and quantitative tightening continues)?

Monetary Policy, External Sector and Financial Sector

We agree with staff's assessment that the financial sector is currently robust and that the peg to dollar remains critical, but that measures can be taken to address vulnerabilities. The introduction of OMIBOR and development of liquidity management tools for Islamic banks are welcome. The staff have supported Oman's debt financing strategy, including the use of bank deposits to finance its current account deficit. How do staff recommend Oman ensures there is sufficient liquidity in the banking sector in the event that external borrowing becomes difficult?

Measures to address systemic risk related to banks' foreign exposure are necessary however we agree with staff's assessment that non-discriminatory micro or macroprudential measures are preferable to a limit on banks' exposure to non-residents.

On the external sector, it seems that the current account deficit is to some extent caused by increasing workers' remittances, though the report does not provide detail on this issue. Could staff update us on it? Would staff recommend the authorities to implement measures to contain this trend, as other GCC countries have?

Structural Reforms

Structural reforms that enable a thriving private sector will be critical in the context of a constrained budgetary environment. Targeted capital investment efforts could contribute to increasing the efficiency of hydro-carbon production, and reduce wastage. Encouraging training and innovation within the sector will also have large knock-on benefits. We would emphasize the need to further foster private sector investment and economic diversification, within the five economic sectors identified to have diversification potential. Improving the business environment, increasing labor productivity, and relaxing labor laws is also crucial to attracting foreign investment and creating private sector jobs. In this regard, we encourage the authorities to aim at reducing the wage gap between public and private jobs. On this issue, we particularly thank staff for the very insightful SIP, with concrete and precise ways to address this issue. We believe such changes are key to improving investor confidence and boosting long term economic growth. We noted the Omanization policies that in some instances will provide incentives for the private sector to hire Omani nationals. We agree with staff that it is important that this does not adversely affect the private sector by reducing the skills available to them.

It will be important to implement structural reforms carefully to ensure that any negative impacts on citizens are well managed. How do staff recommend the authorities introduce social protection for citizens likely to be affected by structural reforms? Can staff recommend support the Authorities on distributional impact of reforms?

Mr. Palei and Mr. Tolstikov submitted the following statement:

We thank staff for the set of well-written papers and Mr. Beblawi and Mr. Al-Kohlany for their informative buff statement. The Omani economy is gradually adjusting after the 2014-15 oil-price shock. The shock led to double-digit fiscal and current account deficits, leading to sharp increase in public debt and reduction of external buffers. The authorities' prudent economic policies and partial recovery of oil prices helped stabilize the situation. Non-oil GDP growth is picking up, while fiscal and external deficits are improving. At the same time, further efforts are needed to advance fiscal consolidation, maintain financial sector stability, and support non-oil growth and diversification of the economy.

Fiscal consolidation remains a priority. Over the past three years, Oman's public debt has grown from about 5 percent of GDP to 46 percent of GDP and it is set to increase further. While fiscal policy measures introduced recently have helped curtail non-priority current expenditure and reduce fiscal deficit, additional fiscal consolidation is needed to stabilize debt at a level below the authorities' limit of 50 percent of GDP. To develop non-oil revenue sources, the authorities could advance the introduction of the VAT and excise taxes in accordance to GCC-wide framework. They should also continue their efforts in reducing public wage bill and untargeted subsidies.

Oman's fiscal position is highly dependent on the oil price developments. Under staff baseline scenario, oil prices will soften somewhat in the medium-term, which may result in further accumulation of the government and external debt. At the same time, we note the authorities' more benign oil price expectations and their concerns about the costs of faster fiscal consolidation. Given still substantial size of fiscal buffers, the authorities can proceed with fiscal consolidation at a measured pace. The focus should be on maximizing the efficiency of public expenditures and their contribution to non-oil growth. Development of a formal medium-term fiscal framework would also improve fiscal policy guidance and help limit debt accumulation.

The Omani banking sector remains sound and robust. Banks are well capitalized, liquid and profitable, and NPLs are low. Implementation of Basel III capital and liquidity standards is on schedule. We welcome recent improvements in liquidity management and functioning of the inter-bank markets, as well as strengthening of supervision of Domestically Important Systemic Banks. At the same time, the CBO should strengthen monitoring of financial sector vulnerabilities and the buildup of financial risks.

Creating conditions for boosting private sector-led growth and job creation for nationals should remain the main goal of structural reforms. Further steps are needed to increase the attractiveness of private sector jobs for Omanis, while enhancing competitiveness of local workforce. The employability of local workforce could be improved through better education and training. Streamlining of business registration and licensing, facilitating access to land and financing, and modernization of insolvency framework are essential to further improve business environment. The diversification efforts should be supported by simplification of export and import procedures and development of competition protection framework.

With these remarks, we wish the authorities further success.

Mr. Bayar and Mr. Dogan submitted the following statement:

We thank staff for the well-written set of reports, and Messrs. Beblawi and Al-Kohlany for the informative buff statement. Following the sharp decline in oil revenues in 2014, Oman's economic situation has sharply deteriorated, as manifested in the buildup of twin deficits, an increase in external and public debt, and the erosion of external buffers. Against this backdrop, we welcome the authorities' efforts to ensure the sustainability of public finances, reduce banking sector vulnerabilities, as well as implement structural reforms aimed at diversifying the economy, and making growth more sustainable and inclusive. We agree with the thrust of staff's appraisal, and would like to make the following comments for emphasis.

Fiscal policy should hinge on an ambitious set of measures to secure the necessary fiscal consolidation, underpinned by a medium-term fiscal framework. We concur with the authorities' objective of a public debt-to-GDP ceiling of 50 percent of GDP, which requires the implementation of a steadfast fiscal policy, including efforts to mobilize non-hydrocarbon revenues by broadening the tax base and streamlining tax exemptions. In addition, the authorities should re-double their efforts to rationalize public expenditures, including through revisiting inefficient subsidies, further containing the fiscally unsustainable wage bill, and prioritizing public investments. While we understand the authorities' concerns about the possible economic and social impact of the suggested fiscal measures, we see a gradual but decisive approach—more in line with the staff advice—as warranted, given the growing vulnerabilities of the economy that could expose Oman to abrupt market-driven adjustments. The accumulation of actual and contingent liabilities, particularly those arising from state-owned enterprises, are another source of concern. We note, in this regard, the authorities' intentions for a privatization program, and wonder about the size of the expected receipts and the concomitant impact on debt dynamics.

Safeguarding monetary and financial stability requires maintaining the exchange rate peg, while strengthening the financial supervisory and regulatory framework. While we agree with staff that the exchange rate peg regime remains appropriate at the current juncture, we encourage the authorities to regularly review the regime given the fast pace of change in global monetary conditions. We positively note that the banking sector remains sound and well-capitalized, with low non-performing loans. Nevertheless, special-mention loans, and banks' asset and deposit concentrations are worrisome. The Central Bank of Oman (CBO) should continue to focus its efforts on strengthening financial oversight and supervision, and developing a prudent liquidity and risk management framework. In this vein, while we appreciate the economic and financial backdrop that has recently motivated the authorities to relax regulatory standards, we are concerned that such policies may lead to a buildup of risks in Oman's financial system, and we, therefore, would encourage the authorities to consider unwinding these steps. The recent issuance of the CBO's circular with instructions to banks on implementing the AML/CFT law is a positive step toward financial resilience, and we would welcome further efforts to expand the legal framework to effectively cover other financial and non-financial institutions. We encourage the authorities to address key issues and challenges that hinder financial inclusion.

Structural reforms should aim to prioritize non-oil sector growth, promote private sector development, and address labor market rigidities. We broadly welcome the 9th Development Plan and the Tanfeedh initiative, and encourage the authorities to accelerate the implementation of the identified reforms. Enhancing private sector development is crucial and should be complemented by measures to improve the business environment, including addressing the misalignment between public and private sector wages. Improving the quality of the education system, enhancing the provision of vocational training, and tackling the skills mismatch would also be helpful in this regard.

Mr. Beblawi made the following statement:

I would like to convey the appreciation of the Oman authorities, as well as my own, and that of my office colleagues, to Mr. Roudet and his team for their constructive engagement and valuable policy advice. I would also like to thank Directors for their statements and interest.

In addition to my written statement, I will make a few points. On fiscal policy, I would like to reiterate the authorities' full commitment to the ongoing fiscal reform and to achieving fiscal sustainability. The staff report acknowledges the robust and sizable fiscal adjustment that was achieved, which has brought down current expenditures by nearly 10 percentage points of GDP over the last three years. These significant fiscal measures were well recognized by many Directors in their gray statements, and the authorities are committed to further strengthening their fiscal position.

As discussed in the buff statement, they are working to boost non-oil revenues, contain current expenditure growth, improve spending efficiency, and prioritize capital expenditure. Recognizing the limits of exhaustible oil resources, the authorities believe that non-oil growth and private sector development are key to achieving sustainable long-term growth. The authorities are implementing an ambitious agenda to improve the business environment and diversify the economy.

Ongoing projects in this area include: the new Muscat International Airport, which became operational early this year; the Liwa Plastic Industrial Complex in Sohar; refinery projects in Sohar; and the ongoing broader development of Duqm and the Sohar special economic zones.

Several Directors highlighted the need to support job creation outside the public sector. The authorities are already working to improve employment opportunities for Omanis and the private sector through programs to improve education and training, address the skills mismatch, create an enabling environment for entrepreneurship, and encourage small- and medium-sized enterprises (SMEs).

The Central Bank of Oman will continue to strengthen its monetary policy framework and appreciates the Fund's technical assistance (TA) in this area.

Finally, the banking system remains strong and well capitalized, with low levels of nonperforming loans (NPLs). The authorities continuously work to strengthen the regulatory and supervisory framework.

I would like to conclude by thanking Directors again for their support to Oman.

Mr. Inderbinen made the following statement:

We thank the staff team for the good documentation and Mr. Beblawi and Mr. Al-Kohlany for their informative written statement and the remarks that Mr. Beblawi made.

The oil price shock did reveal fiscal and external vulnerabilities in Oman, and we welcome the reforms that have been initiated over the past years. The authorities' prudent policies and reform measures have been important in containing risks. We particularly welcome the efforts to bolster the fiscal position, diversify the economy, and improve the business climate.

Nonetheless, we concur with the staff and many other Directors that more can be done. Given the large deficits projected over the longer-term, there would clearly be much merit in further fiscal reform along the metrics the staff gives in paragraph 16 of the staff report.

A reduced fiscal deficit would also help maintain the confidence of international debt markets and the viability of the peg to the U.S. dollar.

It is good to note from the buff statement and from Mr. Beblawi's remarks that the authorities continue to give high priority to further consolidation and fiscal reform. They would, however, be well advised to anchor their efforts on a conservative price estimate for oil.

Promoting private sector development and productivity will be critical to support diversification and job creation, particularly for the young. For this, it is key to reduce the wage gap between the public and private sectors and to reduce government employment. The staff's selected issues paper on this matter is very insightful.

A key issue in this regard is persistent skill mismatches; and the authorities' efforts to improve education—in particular, to increase vocational training—are promising. Given the importance of this issue, we believe that a comprehensive strategy would clearly be beneficial. We also agree with Mr. Ostros and Mr. Bartkus that addressing skills mismatches in the Omani economy would deserve continued attention in future Article IV reports, also given the priority and the ongoing efforts that the authorities are investing in this area.

With this, we wish the authorities much success in their further reforms.

The staff representative from the Middle East and Central Asia Department (Mr. Roudet), in response to questions and comments from Executive Directors, made the following statement:[1]

The staff has provided the written answers to the questions raised by Directors in their gray statements, and I would like to focus on a few key topics.

As noted by some Directors, the staff's macro-fiscal projections are subject to upside risks due to the rapid increase in oil prices over the past several months. The staff's baseline scenario was established based on the April World Economic Outlook's (WEO) oil prices, the latest official Fund baseline at the time of the discussions with the authorities in early May. Markets have moved significantly since then, and both spot and future market prices now point to higher prices than envisaged at that time.

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

As already acknowledged in the report, these higher prices would entail a more favorable fiscal deficit path, smaller financing needs, and lower government debt by the end of the projection period.

The report presented an upside risk scenario, and it happens to be based on oil price assumptions that are broadly in line with the latest WEO baseline released just after the report was issued to the Board. This upside risk, however, does not change the thrust of the staff's policy advice. Even under the revised WEO assumptions, financing needs will remain significant over the next few years, reflecting increasing rollover needs. At the same time, a gradual easing in oil prices over the medium term and a pickup in interest payments would entail fiscal deficits on the order of 4 percent of GDP over the medium term, and government debt still north of 40 percent of GDP by 2023. The current account deficit would also pick up to about 5 percent of GDP by the end of the forecast period. Deeper fiscal adjustment, therefore, remains important to put debt on a downward trajectory, maintain market confidence, and ensure external sustainability.

Some Directors raised the question of the sequencing of fiscal reforms and the challenge of addressing the potential social impacts of these reforms on the most vulnerable. The key challenge for the authorities is to find a balance between tackling fiscal and external vulnerabilities while maintaining social consensus. The adjustment strategy recommended by the staff aims at balancing these considerations.

While it will have costs for short-run growth and possibly job creation, the staff is of the view that these would ease over time, as dividends from structural reforms bear fruit. Moreover, the increase in government expenditures over the past decade was particularly large and biased toward rigid current spending, and its gradual reduction relative to GDP should carry a smaller cost in terms of growth. Revenues are still highly undiversified and heavily susceptible to oil price fluctuations.

Against this backdrop, the staff believes that a balanced approach to the composition of adjustment that tackles underlying spending and revenue weaknesses and creates space for high-impact, growth-enhancing investment, would help limit these costs.

The staff has also highlighted the importance of conducting a social impact analysis of key fiscal reforms. This will help design proper protection mechanisms for the most vulnerable; for example, compensation schemes to protect low-income households from high electricity and water prices, as recommended by the staff. This would, in turn, be critical to maintain support for continued reforms. In this respect, upon a request from the authorities, the staff could provide support in helping them conduct this analysis. The Fiscal Affairs Department (FAD) for instance, has provided TA in these areas in other countries.

I would like to conclude by thanking the authorities for their hospitality and open dialogue, as well as Mr. Beblawi and his colleagues for their support.

The Acting Chair (Mr. Zhang) noted that Oman is an Article VIII member and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They noted that fiscal and current account deficits since 2014 had pushed government and external debt up and reduced external buffers. Directors concurred that ongoing reforms and the recovery in oil prices would help reduce fiscal and external deficits significantly over the next couple of years. While non-oil growth is expected to recover gradually and there is a potential upside from the recent increase in oil prices, persistent twin deficits are expected to lead to further increases in government and external debt over the medium term. Directors also highlighted risks to the outlook from possible fiscal underperformance, tighter financing conditions, and heightened regional political uncertainty. Against this backdrop, Directors welcomed the authorities' efforts to bolster the fiscal position and encouraged implementation of structural reforms to boost private sector-led growth, increase economic diversification, create jobs and foster inclusive growth.

Directors encouraged the authorities to accelerate reforms to bolster fiscal and external sustainability, maintain confidence, and support the exchange rate peg. Deeper fiscal adjustment is critical to put public finances on a sustainable trajectory. Directors called for steadfast efforts to implement ongoing reforms, including the introduction of a VAT and excise taxes, under the planned timeline. Additional reforms are needed for more rapid reductions in the fiscal deficit and debt, through measures to tackle current spending rigidities, streamline capital outlays and enhance efficiency, while further raising non-hydrocarbon revenue. In this context, Directors recommended the introduction of a formal medium-term fiscal framework and improvements to budget planning and expenditure controls.

Directors concurred that the exchange rate peg had delivered monetary policy credibility with low and stable inflation. They also noted that fiscal adjustment is key to ensure external sustainability over the long term.

Directors commended the authorities for the soundness of the financial system and encouraged them to maintain robust banking sector regulation and supervision. Continued efforts are also required to identify and closely monitor any emerging pressures on asset quality and any potential build up in financial sector risks. Directors stressed the need to ensure that the prudential framework and financial sector buffers remain strong. They encouraged the central bank to strengthen its liquidity and crisis management and preparedness frameworks to further bolster resilience. Efforts to enhance the AML/CFT framework and its effective implementation are also important.

Directors underlined the need for structural reforms to promote private sector development and productivity to enhance competitiveness, diversification, and job creation for nationals. They recommended addressing labor market inefficiencies by better aligning public-sector wages and benefits with the private sector, making the labor market for nationals more flexible, and tackling skill mismatches through better education and on-the-job training. Directors emphasized the importance of enhancing the business climate, including through reforms to modernize the insolvency framework, lowering the burden of administrative procedures and enacting planned legislations on FDI and public-private partnerships. They encouraged the authorities to accelerate their program to boost private sector investment

It is expected that the next Article IV consultation with Oman will be held on the standard 12-month cycle.

APPROVAL: April 17, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Staff's responses to technical and factual questions are below. Broader policy questions in the areas of macro-fiscal projections, the sequencing of fiscal reforms, and addressing the potential social impact of reforms will be addressed in staff's oral intervention at the Board meeting.

Fiscal Policy and Debt Sustainability

1. ***The authorities have indicated a more rapid reduction in the government deficit and financing needs, reflecting different oil price assumptions, and larger-than expected savings from expenditure rationalization measures as compared to staff's assessment. Could staff offer their views on this counter assessment?***

- The staff has acknowledged upside risks related to oil prices in the staff report. Indeed, staff's baseline scenario was established based on the April WEO oil prices. Markets have moved significantly since then, and current and future markets prices now point to higher prices than envisaged in staff's baseline. As shown in staff's higher oil price scenario (text table in staff report), the oil prices (spot and futures) at the time of issuing the staff report—which happen to be broadly consistent with the latest (early June) WEO baseline—entail a more favorable fiscal deficit, smaller financing needs, and lower government debt by the end of projection horizon.

- As far as possible larger-than-expected savings from expenditure rationalization measures are concerned, staff is of the view that the baseline scenario already incorporates significant such savings. Following several years of consolidation efforts, generating higher savings would require underpinning structural reforms as recommended by staff under the adjustment scenario.

2. ***Can staff provide an update on the most recent budget and debt developments?***

- The staff's baseline numbers have been established based on the most recent available data for 2017. Preliminary data for the first three months of 2018 point to a fiscal deficit of about half the level of that recorded in the same period in 2017, reflecting the rapid increase in oil prices and broadly consistent with staff projections for 2018. As regards government debt, the staff report reflects the latest available data (at end-December 2017).

3. ***Noting the authorities' concern over the potential adverse impact of fiscal adjustment, we would like to invite staff to shed more light on the public opinions and possible sequencing of the reforms to garner social support.***

- As in many other countries, public opinion is wary of potential structural changes. This is perhaps even more the case in Oman, a country where nationals have been used to significant entitlements. The key challenge for the authorities is therefore to strike a balance between advancing reforms and maintaining consensus. Communication is key in this regard, as maintaining support for structural change requires explaining the need for reforms and the associated long-term benefits.

- As far as the sequencing of fiscal reforms is concerned, staff has emphasized the need for a gradual approach and the need to protect the most vulnerable households, for example through targeted compensation schemes. The staff's recommendation to conduct social impact analysis of the key reforms is key in this respect.

4. ***Notably, six state owned enterprises have been mentioned for privatization. We would welcome staff insights on the potential of privatization and the timelines in this context.***

5. ***We note, in this regard, the authorities' intentions for a privatization program, and wonder about the size of the expected receipts and the concomitant impact on debt dynamics.***

- The authorities' privatization program is still in its early stages. Although some companies that could be privatized have been named (mainly in the utility sector—electricity distribution, water, and trash removal), little information has been shared with staff on timelines and details on the structure of the planned privatizations.

- The authorities have stressed their intention to use the privatization proceeds to reduce government debt. Nonetheless, these are likely to be somewhat limited in relation to the size of public debt, and the planned privatizations are mainly intended to help improve the performance of these enterprises and boost productivity.

6. ***What impact do staff assess changes to the OPEC agreement will have on the fiscal balance?***

- Notwithstanding the uncertainty regarding the outcomes of OPEC+ country discussions, it is difficult to assess the potential impact of a change in the agreement, as it would likely have an impact on both prices and production/export volumes. A relaxation of the deal—leading to higher production quotas for Oman—could provide a boost in terms of government revenue, as oil exports start picking up earlier than assumed under staff's baseline. At the same time, such a development could also lead to downward pressures on prices compared to a situation where the OPEC+ deal remains in place, partly offsetting some of these gains.

7. ***How serious is the risk to debt sustainability in the medium term if U.S. interest rates increase more than expected (and quantitative tightening continues)?***

- The staff's debt sustainability analysis indicates that under a scenario involving an additional 200 basis points increase in interest rates over 2019–23 (in addition to the 130 basis points increase already factored in into the baseline), higher interest payments would push debt to 72 percent of GDP by the end of the period, compared to 56 percent of GDP under the baseline. This assumes no policy response to offset the impact of higher rates.

Financial Sector, Monetary, and Exchange Rate Policies

8. ***How do staff recommend Oman ensures there is sufficient liquidity in the banking sector in the event that external borrowing becomes difficult?***

- In the event of more limited access to external market financing, the authorities would be faced with a choice between implementing more rapid adjustment to reduce financing needs, drawing down government's external buffers at a faster pace, tapping alternative sources of external financing (including from regional or other partners), augmenting domestic debt issuance or drawing down bank deposits—with the consequence of a tighter domestic liquidity situation. The staff's recommend fiscal path is aimed at reducing financing needs and ensuring continued confidence to avoid such situation. Improvements to the liquidity management framework would also help ensure sufficient liquidity in these circumstances (see below).

9. ***The authorities plan to adopt a robust liquidity forecasting and management framework to boost the development of interbank markets and allow for more active liquidity management. We would like to hear more details on this from staff.***

- The authorities have expressed interest in strengthening the monetary policy framework and technical capacity at the CBO in support of the current exchange rate arrangement. In response, MCM has recently provided technical assistance (TA) in this area. The TA focused on steps necessary to better anchor short-term market rates with the policy rate, including by pursuing more active operations to steer domestic interbank rates towards the target policy rate. To do so, the authorities would need to develop their liquidity forecasting framework, including through daily analysis and reporting on liquidity conditions and forecasts. Monetary policy instruments, including standing facilities, should be reviewed to ensure their terms and pricing are well-articulated and encourage interbank market participation. Open-market operations (OMOs) and related instruments should be developed to steer term liquidity and interbank market conditions. Increased reliance on OMOs would encourage the development of interbank markets.

10. ***Could staff share the background and concerns of the CBO when they first imposed the limit on banks' exposure to non-residents? In addition, could staff elaborate on the relative effectiveness of their proposed alternative measures as discussed with the authorities?***

- This limit on banks' exposure to non-residents was introduced in 2014. It was subsequently tightened (2016) and then relaxed recently. The CBO explained to staff that the measure had initially been introduced to address concerns about systemic risk related to some of the banks' foreign exposures. The staff has expressed reservations because the measure applies across the board to all non-resident exposures (including those presenting a lower risk profile) and discriminates based on residency, thereby affecting capital flows. In light of this, the measure has been classified as both a capital flow management measure and a macro-prudential measure (see also 2017 Article IV report).

- The staff has encouraged to replace the measure with non-discriminatory micro- and/or macroprudential measures that address underlying risks without discriminating against non-residents—e.g. applying country credit risk weighting and/or requiring banks to factor in country-specific risks in their risk assessment. The staff believes these measures would allow to address the root causes of the authorities' concerns while avoiding distortionary effects on capital flows. The authorities indicated they were ready to consider the proposed alternatives.

11. ***However, the dichotomous message on the relaxation of loan classification and provisioning requirements is striking, with it being welcomed on one hand and then the central bank being advised to replace it with nondiscriminatory macro/micro prudential measures. We invite staff to elaborate on this and suggest possible alternative measures to address the macroprudential concerns.***

- The staff report makes a distinction between various sets of measures implemented by the authorities. First, staff is of the view that the relaxation of loan classification and provisioning requirements for borrowers experiencing difficulties due to payment delays related to government contracts and of provisioning requirements for restructured loans may encourage banks to postpone necessary adjustments for borrowers experiencing difficulties of a more structural nature. This is especially the case because these measures, which had initially been implemented temporarily, has been extended. To ensure risks are being actively managed, staff recommended gradually unwinding these two relaxations.

- As regards the measure on banks' exposure to non-residents (a different measure both in terms of coverage and purpose), staff has expressed reservations for different reasons (see above). Alternative measures have been proposed, which the authorities have agreed to consider. Against this backdrop, staff welcomed the recent increase in the limit on banks' exposure to non-residents.

Structural Policies

12. ***Regarding the planned reforms on PPP, could staff further elaborate on the details and the implications for public finance?***

- The authorities have been developing their regulatory framework for PPPs in cooperation with the World Bank. Their intention is to draw on international best practice to allow for value-for-money creation and better exploit the benefits of private sector expertise in implementing projects, while safeguarding public resources. The draft PPP law is under discussion at Cabinet level.

13. ***On the external sector, it seems that the current account deficit is to some extent caused by increasing workers' remittances, though the report does not provide detail on this issue. Could staff update us on it? Would staff recommend the authorities to implement measures to contain this trend, as other GCC countries have?***

- Remittances (included in current transfers in staff's balance of payment) have been declining in recent years, contributing positively to the changes in the current account balance. This trend has reflected a reduction in expatriate remittances in an environment of lower oil prices. The authorities' Omanization policies—consisting of encouraging employment of nationals in lieu of expatriate labor through a combination of quotas for visas and employment of nationals—are expected to sustain this trend and to help reduce unemployment for nationals. Success in diversifying the economy and boosting private sector led growth will be even more critical for generating jobs for nationals on a sustained basis.

14. ***How do staff recommend the authorities introduce social protection for citizens likely to be affected by structural reforms? Can staff recommend support the Authorities on distributional impact of reforms?***

- The staff has highlighted the importance of conducting social impact analysis for the key fiscal as well as structural reforms. This will be instrumental in designing proper protection mechanisms for the most vulnerable—for example compensation schemes to protect low-income households from higher electricity and water prices. This will in turn be critical to maintain support for continued reform efforts. Upon request, staff could provide support to the authorities in this endeavor. FAD, for instance, has provided TA in these areas in other countries.