# GULF ROUNDTABLE SUMMARY

## Making Sense of Gulf Economic Trends

“What happens in the Gulf affects the entire Middle East,” observed Mohsin Khan of the International Monetary Fund, but he estimates that the Gulf countries will fare far better than most through the current economic downturn. Khan, the director of the Middle East and Central Asia Department at the International Monetary Fund, made the comments at a CSIS Gulf Roundtable on November 12, 2008.

Khan framed his talk by explaining how, in the last decade, the epicenter of the region has shifted from the Levant to the Gulf. Money is the principal driver. The IMF estimates the combined GDP of the GCC countries will be just over $1 trillion in 2008, an amount approaching the GDP of major developing countries such as Brazil and Russia. Unlike those countries, however, the GCC’s reliance on fluctuating oil revenues and their currencies’ ties to the dollar make fiscal management especially difficult.

The core of the problem for GCC countries is that government spending fuels economic growth and inflation simultaneously, while these countries’ dollar peg means monetary policy cannot be used to manage the economy. The need for spending in the Gulf is clear. Countries such as Saudi Arabia have an aging infrastructure that needs refurbishment and replacement, while countries such as Qatar and the United Arab Emirates are building out their infrastructure for the first time. Since all of the GCC countries’ oil revenues accrue to the governments, government spending is the only way to share oil wealth broadly in society. That spending can kick off inflation, which has leapt from an average of 2 percent in 2004 to over 11 percent this year throughout the Gulf (and over 14 percent in Qatar). Sharply rising housing and food costs have comprised 60 percent of Gulf inflation, and with the beginnings of a decline in housing prices and flattening global commodity prices, those numbers should temper. Even so, in Dubai and Qatar, people are still paying “New York prices” in the residential markets. The building boom of the last several years did little to satisfy demand for housing, since so many of the new properties were speculative purchases by expatriates and never came on to the rental market.

Government efforts to fight rising prices in the Gulf are significantly constrained. Since the currencies of all of the GCC states except Kuwait are pegged to the U.S. dollar (and the “basket” of currencies Kuwait uses is heavily dollar-weighted), and

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Mohsin S. Khan is director of the Middle East and Central Asia Department at the International Monetary Fund, and a leading expert on Gulf economics. He joined the IMF in 1972 as an economist in the Financial Studies Division of the Research Department, where he has held a range of senior positions, including Advisor, Assistant Director, and Senior Advisor. He was Deputy Director of the Research Department before becoming Director of the IMF Institute in 1996. In 2003 he was appointed Director of the Middle East and Central Asia Department of the IMF. Dr. Khan has published widely on macroeconomic and monetary policies in developing countries, economic growth, international trade and finance, Islamic banking, and IMF programs. In 2003 he was awarded the Islamic Development Bank Prize in Islamic Economics for outstanding contributions to the field. Dr. Khan holds a B.Sc. in economics from the London School of Economics, an M.A. from Columbia University, and a Ph.D. from the London School of Economics. ■

### THE GULF ROUNDTABLE SERIES

The CSIS Middle East Program launched the Gulf Roundtable in April 2007 to examine the strategic importance of a broad range of social, political, and economic trends in the Gulf region and to identify opportunities for constructive U.S. engagement. The roundtable defines the Gulf as the United Arab Emirates, Saudi Arabia, Oman, Qatar, Bahrain, Kuwait, Iraq, and Iran. The roundtable convenes monthly, assembling a diverse group of regional experts, policymakers, academics, and business leaders seeking to build a greater understanding of the complexities of the region. Topics for discussion include the role of Islamist movements in politics, the war on terror, democratization and the limits of civil society, the strategic importance of Gulf energy, media trends, trade liberalization, and prospects for greater regional integration. ■

since 70 percent of their currency receipts are denominated in dollars, the U.S. Federal Reserve effectively shapes their monetary policy. According to Khan, this leaves fiscal restraint as the only policy tool to fight inflation. Gulf economies are thus caught between the need to limit spending so as to curb inflation, and the need to spend to help grow their economies. In the balance between the two, governments have chosen overwhelmingly to continue to expand their economies.

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Extreme oil price volatility complicates the governments' problem still further. Oil was at $53 per barrel in 2005, shot up to $147 this summer, and now rests under $60. While there is a tendency to spend when the income is high, for the most part the GCC countries have been extremely conservative with spending plans "because they remember the 1990's oil collapse when oil prices [approached] single digits." Consequently, in the last five years the Gulf countries have amassed staggering savings: about half a trillion dollars in official reserve assets as well as one to two trillion dollars worth of assets controlled by sovereign wealth funds, all for a native population of less than 30 million.

Beyond inflation, the global financial crisis has been a less dire challenge than in other regions. In general, GCC banks avoided subprime loans and other structured assets. The outflow of capital from speculators and foreign banks has savaged the local stock markets, but local banks remain relatively solid.

In response to the global financial challenges, the UAE and Saudi Arabia continue to pump cash into their previously overheating economies. Kuwait, Saudi Arabia, and the UAE now guarantee all bank deposits. Kuwait and Qatar are even attempting to prop up their stock markets by directing their sovereign wealth funds to invest in their domestic markets. The financial crisis is hitting Dubai harder than most places, and the cost of capital for construction projects there has skyrocketed. The more startling impact will be on poorer countries. With significantly lower oil revenues accruing to the Gulf states, foreign direct investment in countries such as Jordan and Egypt will decline, and worker remittances will plummet. If the Gulf economies have a major slowdown, "the region will take a bigger hit," Khan argued.

Whether the Gulf countries continue with plans to expand their oil production capacity will also have important long term repercussions. If they don't continue to expand capacity, he explained, "then oil prices will shoot up when the global economy turns around." In that scenario, "$147 per barrel of oil will be cheap." In any case, Khan judged that energy will remain the driving force of Gulf economies, despite efforts to diversify. Tourism and other services could generate some additional economic activity, but Saudi Arabia—drawing on its abundant cheap energy—is the only country with the prospect of creating a real manufacturing sector.

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All of this is occurring while the GCC member countries are working to form a monetary union. While steps have been taken in the last decade to form such a union, Khan argued that meeting the target date of 2010 will be a real challenge. Ultimately, he said, the key obstacles are more political than they are economic. ■



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