I Overview

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With the steady increase in crude oil production and exports and the surge in oil prices in the mid- and late 1970s, Oman embarked upon an economic development path that transformed it into a prosperous country. Prudent utilization of oil revenues to develop social and physical infrastructure—with substantial investments undertaken in health, transportation, electric power, water supply, and communications—contributed to a rapid transformation of Oman's economic foundation and structure. Today Oman boasts an impressive physical infrastructure, much improved socioeconomic conditions, and a high standard of living.

Over the last two decades Oman has recorded one of the highest growth rates in the Middle Eastern region and in the world. Oman also experienced persistent growth in non-oil GDP, financial stability, confidence in the economy, and a stable currency, despite severe external terms-of-trade shocks resulting from sharply lower crude oil export prices in the 1980s and early 1990s. Real annual growth in the non-oil sector averaged 7.3 percent over 1980–97. Domestic inflation, measured in terms of the consumer price index, averaged 3.8 percent a year over the same period, supported by the fixed peg of the rial Omani to the U.S. dollar, by open trade and payments systems, and by a prudent stance of monetary policy. Oman's economic gains and growing private sector confidence and participation in the economy have been reflected in the prosperity and well-being of the Omani population in general.

However, this impressive economic performance, supported in part by an expansionary stance of fiscal policy—the official budget deficit averaged about 7.8 percent of GDP during this period—had its costs. Financing of this unsustainably large fiscal deficit entailed a substantial drawdown of foreign and domestic investments of the State General Reserve Fund (SGRF) and a loss of foreign exchange reserves of the monetary authority, as well as the accumulation of a sizable domestic and foreign debt. The decline in public sector saving, coupled with the Omani private sector's low propensity to save, adversely affected the saving-investment balance and increased the dependence of the economy on foreign saving and investment. Accordingly, the challenge now facing policymakers is how to sustain the impressive economic performance of the last two decades over the medium term, while restoring and thereafter maintaining macroeconomic balance. This challenge, in turn, will require substantial fiscal consolidation—which is currently under way—supported by expenditure cuts and efforts to increase non-oil revenue; strengthening of the mobilization of domestic saving (both public and private); diversification of the economy out of its still-excessive dependence on the oil sector; and a push to increase factor productivity through structural reforms in the real and the financial sector and through investment in human resources.

The government of Oman recognizes that because the oil sector's potential is already being fully utilized, Oman's medium-term strategy should focus on sustaining a high rate of growth in the non-oil sector, to raise income per capita and create jobs, while undertaking and sustaining serious fiscal consolidation. The need to diversify the economy and build up SGRF reserves for future use is much more pressing in the case of Oman than in other member countries of the Gulf Cooperation Council (GCC), given Oman's relatively short horizon of proven and commercially viable oil reserves (16 years at the current rate of extraction). Accordingly, the government has formulated the Fifth Five-Year Plan (FFYP, covering 1996–2000), which aims to achieve a balanced government budget by 2000; to increase the share of private sector investment in total investment from 40 percent to 53 percent; to mobilize substantially higher foreign investment; and to create better employment opportunities for the growing number of Omani nationals entering the labor force. The challenge is not an easy one, but Oman's strong economic and physical infrastructure provides a solid foundation on which to build.

The purpose of this background study is to contribute to a better understanding of developments in the Omani economy since 1980 and of the policy challenges the government faces in the medium term. The study focuses on some central aspects of Oman's economic experience, including the potential structural impediments to growth.

Section II reviews the principal factors underlying Oman's impressive economic performance during 1980–97 and highlights the country's central medium-term structural issues, such as the saving-investment imbalance, slow growth in factor productivity, and the need to diversify the production base. Within that period, the subperiods characterized by more rapid real growth in income per capita were associated with relatively rapid growth in investment; the economy recorded little diversification in real terms from the oil toward the non-oil sector; the saving-investment gap widened; and economic growth was primarily linked to increased use of capital and labor—the contribution of changes in total factor productivity was on average barely positive. The section concludes that sustaining growth in real income per capita over the medium term will require forceful efforts aimed at improving the saving-investment balance, coupled with a certain minimum rate of investment, higher factor productivity, and enhanced diversification of the economy.

Section III reviews Oman's relative economic and financial position within the GCC. It describes Oman's comparative dependence on oil, the openness of the Omani economy, the country's monetary policy, and its regional trade, as well as certain economic issues that Oman faces in common with other GCC countries. Oman's key economic developments and experiences until the mid-1990s have been similar to those of other GCC countries, because these economies are oil-dependent, maintain open and liberal exchange and trade systems, and have currencies that are effectively pegged to the dollar. The section concludes that although significant gains have been made since the inception of the FFYP in 1996, Oman still faces substantial challenges over the medium term in the regional context.

Section IV analyzes the stance of central government fiscal policy and its impact on Oman's non-oil economic growth. It reviews fiscal developments in Oman since 1981; provides econometric evidence for a strong, albeit increasingly less important, correlation between fiscal policy and non-oil real GDP growth; and analyzes the sustainability of Oman's fiscal situation using a variety of indicators. It finds that the government's fiscal adjustment strategy under the FFYP is appropriate for bringing about a sustainable fiscal situation, although more emphasis on non-oil revenue mobilization would be desirable. The section also concludes that the government's fiscal adjustment efforts in 1996 and 1997 represented an important step toward achieving fiscal sustainability in line with the objectives of the FFYP.

Section V reviews developments in the institutional and regulatory framework governing Oman's financial system, with a view to assessing the system's adequacy with regard to domestic financial resource mobilization and intermediation and the prospects for introducing indirect instruments of monetary policy. It examines the nature of the financial deepening that has occurred in Oman since 1972 and reviews the role of the central bank in that process. The section concludes that the financial system has been substantially deepened and liberalized over the last two decades, but that there is still room for new financial instruments and the adoption of indirect instruments of monetary policy.

Section VI provides empirical evidence on the degree of monetary independence in Oman during the past decade, analyzes the factors that influenced this independence, and examines the scope for such independence at present and in the immediate future. Past experience indicates that inefficiencies in the financial market, a lack of sufficient financial instruments, and restricted foreign access to the domestic market contributed to a degree of monetary independence in Oman. The domestic interest rate did not closely follow changes in the U.S. rate, and a spread was sustained, which corresponded to developments in the government's domestic financing needs. The use of the spread between the domestic and the U.S. interest rate to indicate Oman's degree of monetary independence has some shortcomings (notably, difficulties in incorporating structural differences between financial markets, and differences in market participants). Nonetheless, the spread can offer some indication in this regard. The analysis presented suggests that, with the availability of a wider range of financial instruments, recent financial reform efforts, and increased globalization of financial markets, domestic financial intermediation has increased and the scope for monetary policy independence in Oman has substantially narrowed. Its role in the future could primarily be confined to liquidity management, preferably through indirect monetary control instruments.

Section VII examines how Oman responded to four distinct oil price–induced terms-of-trade cycles during 1980–97. It decomposes the policy responses into three components: import intensity, economic compression, and export promotion. The quantitative significance of these policy responses was small because the expansionary and countercyclical stance of fiscal policy almost fully shielded the domestic economy from these external shocks during most of the period. The resulting lack of structural adjustment and the liquidation of SGRF investments have, however, accentuated Oman's vulnerability to future external shocks. The section concludes that because the government is committed to maintaining a fixed nominal exchange rate—which has served Oman well in the past—fiscal adjustment and reforms, labor market reforms to increase wage flexibility, and public sector support for education and training to increase the level of skills and productivity, as well as other real and financial sector structural policies, will be key to achieving the adjustment and diversification needed to make the economy less vulnerable to external shocks.

This study covers developments in Oman through 1997. However, economic developments in 1998—a year dominated by a sharp decline in oil prices and a consequent loss of export earnings—heightened Oman's policy challenges over the medium term. These events also demonstrated the need for expeditious implementation of reforms aimed at reducing Oman's dependence on the oil sector by alleviating the structural impediments to growth. The oil price–induced loss of export earnings, which amounted to $2 billion (14 percent of GDP), led to a sharp deceleration of non-oil real GDP growth (to about 4.5 percent), and the fiscal and external accounts recorded large deficits. The authorities' policy response included measures to further compress budgetary expenditures and to tighten private sector credit in order to contain pressures on the external position and limit recourse to foreign borrowing.

Fiscal adjustment efforts, amounting to about 3 percent of GDP, entailed expenditure retrenchments—mainly in the form of reduced civilian and military outlays as well as postponement of new development projects—and some revenue-enhancing measures. Notwithstanding these commendable efforts, because of Oman's excessive dependence on petroleum revenue, the government budget balance shifted from a surplus of about 3.5 percent of GDP in 1997 to a deficit of about 6.5 percent of GDP in 1998. This deficit was financed through recourse to bank credit and a substantial drawdown of the assets of the SGRF. Although this increase in the fiscal deficit—following very forceful and effective adjustment efforts in the preceding two years—was unavoidable given the sharp decline in petroleum revenue, continued sustained reduction in expenditure was appropriate. The substantial progress made in fiscal consolidation during 1996–97 enabled the government to avoid a much sharper deterioration in the fiscal position in 1998. It also laid the basis for restoring fiscal balance in the coming years, following the recent recovery in petroleum prices, in line with the objectives of the FFYP. Nevertheless, since the scope for further substantial expenditure cuts is rather limited (as discussed in Section IV), adoption of a balanced fiscal package with greater emphasis on non-oil revenue would constitute a better policy mix for attaining sustainable fiscal consolidation.

Within the framework of an open external sector and a fixed exchange rate regime, the authorities' monetary policy stance in 1998 was prudent and appropriate. One of the key measures entailed redefining the limit on banks' loan-deposit ratio (currently set at 85 percent). This closed a loophole whereby banks could expand their domestic lending base by creating deposits abroad through external borrowing. Another measure eliminates the ceiling on interest rates for personal (including consumer) loans and requires banks to limit such loans to 30 percent of their portfolios by the end of 2000. Another measure strengthened indirect monetary control operations by introducing an auction for repurchase agreements. Yet another improved the auction system for treasury bills and secondary market operations. Oman made further efforts to strengthen the supervisory and regulatory framework of the financial system in 1998. By the end of 1997 all domestic banks had met the mandated capital adequacy ratio of 12 percent of risk-weighted assets. Also, the share of nonperforming loans has been on a declining trend, and banks are generally in compliance with other prudential requirements and regulations. With a view to improving the transparency of stock market transactions, a new capital market law was introduced in February 1999, providing for the establishment of an independent regulatory and supervisory authority. In addition, a depository and transfer company was set up for recordkeeping and registration of securities, and prudential regulations were tightened through more stringent disclosure and reporting requirements.