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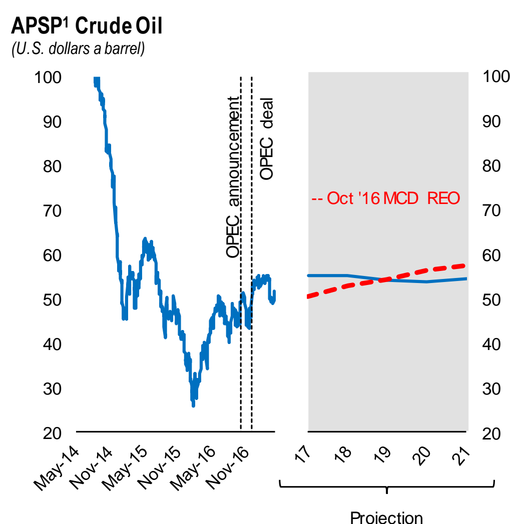
Regional Outlook Reflecting Global Developments

The global factors shaping the world economic outlook for 2017 will be reflected in the outlook for the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region through their impact on commodity prices, export demand, remittance flows, exchange rates, and financial conditions. Global growth is gaining momentum and is projected to reach 3.5 percent in 2017 and 3.6 percent in 2018, a steady improvement over the 2016 growth rate of 3.1 percent. Forecasts for growth in the United States and Europe, in particular, have been revised up since the fall. And, while the outlook for emerging market and developing economies has been revised slightly down, growth projections for China have been marked up. The global outlook is consistent with somewhat higher commodity prices and stronger global trade, which will support economic activity in the MENAP region; stronger growth in China will also support anticipated investment in some countries. However, the outlook also implies higher interest rates, which will, to different degrees, increase fiscal vulnerabilities across the region.



Sources: Bloomberg, L.P.; and IMF staff calculations.
[1] Note: Average of U.K. Brent, Dubai Fateh, and West Texas Intermediate crude oil prices.
MCD REO = *Regional Economic Outlook: Middle East and Central Asia*.

Risks to the global outlook remain skewed to the downside. These include the potential inward shift in policies toward protectionism, and possible faster-than-expected U.S. monetary policy normalization, which could trigger a more rapid tightening of global financial conditions and further appreciation of the U.S. dollar.

The outlook for the oil market is also uncertain. Last year's agreement by major oil-producing countries to cut crude oil output (the "OPEC+" agreement) has helped increase oil prices, although prices remain variable. The baseline medium-term oil price outlook is little changed from that of the October 2016 *Regional Economic Outlook*. The key uncertainties are related to the degree of compliance with the agreement, prospects for higher production by countries either exempt or not participating in it, and lower oil demand given the downside risks to global growth.

These global factors, including the anticipated cut in oil production by MENAP oil exporters, provide the backdrop for the regional outlook (see table).

Real GDP Growth, 2015–18

	2015	2016	2017	2018
World	3.4	3.1	3.5	3.6
MENAP	*2.7*	*3.9*	*2.6*	*3.4*
MENAP oil exporters	*2.1*	*4.0*	*1.9*	*2.9*
of which: non-oil GDP growth	*0.7*	*0.4*	*2.9*	*2.7*
MENAP oil importers	*3.9*	*3.7*	*4.0*	*4.4*

Sources: National authorities; and IMF staff calculations.

Acknowledgments

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MENAP Oil-Exporting Countries: Lift from OPEC+ Deal, but Adjustment Still Needed

The OPEC+ agreement has helped improve the outlook for oil prices in the near term, but prices remain volatile. Under the baseline projection for oil prices, fiscal and external positions in oil-exporting countries of the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region are expected to strengthen. That would support the projected firming of non-oil growth, even though overall growth will moderate in 2017 due to the cuts in oil production. Over the medium term, oil prices are expected to remain low and highly uncertain, so further sustained fiscal adjustment remains critical. This fiscal consolidation means non-oil activity will remain modest in most countries. Moreover, countries need to maintain their focus on implementing their economic diversification plans—and the supporting structural reforms—to strengthen economic resilience. In conflict countries, oil production has surprised on the upside, but long-term economic recovery is predicated on improved security conditions.

Oil Production and Fiscal Plans Driving Growth Outlook

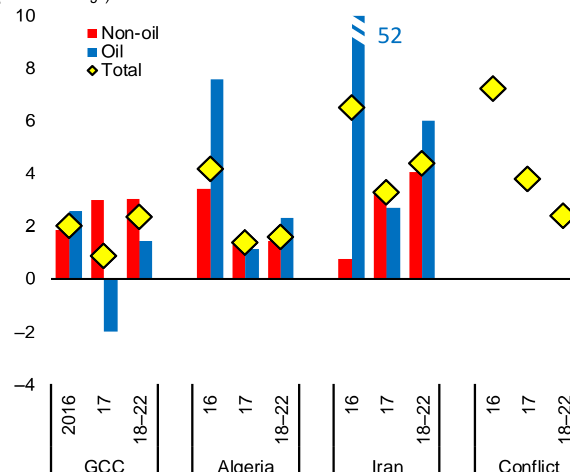
Growth in MENAP oil-exporting countries is expected to slow in 2017 because of the oil production cuts agreed to under the terms of the recent OPEC+ deal (see *Global Developments* section). In contrast, although the outlook varies across individual countries, overall growth in the non-oil sector is expected to accelerate in 2017 as the pace of fiscal consolidation eases.

In particular, non-oil growth in the countries of the Gulf Cooperation Council (GCC) is projected to strengthen from almost 2 percent in 2016 to 3 percent in 2017, while Iran is expected to see non-oil growth accelerate from ¾ percent in 2016 to almost 3½ percent in 2017. In contrast, non-oil growth in Algeria is expected to continue to slow.

Over the medium term, although overall growth in the GCC and Algeria will be supported by a projected recovery in oil production, non-oil growth will remain constrained by continued fiscal tightening in countries with significant adjustment needs (Algeria, Bahrain, Oman, Saudi Arabia). In Iran, the outlook continues to be hampered by remaining sanctions and domestic structural weaknesses, such as in the financial sector.

Prospects for countries affected by conflict remain very uncertain; they are driven by the security situation and the related impact on oil production, and a lack of reliable data makes it difficult to assess the non-oil economy. Libya increased oil output significantly at the end of 2016, boosting growth prospects for 2017. Iraq surpassed oil production expectations in 2016,

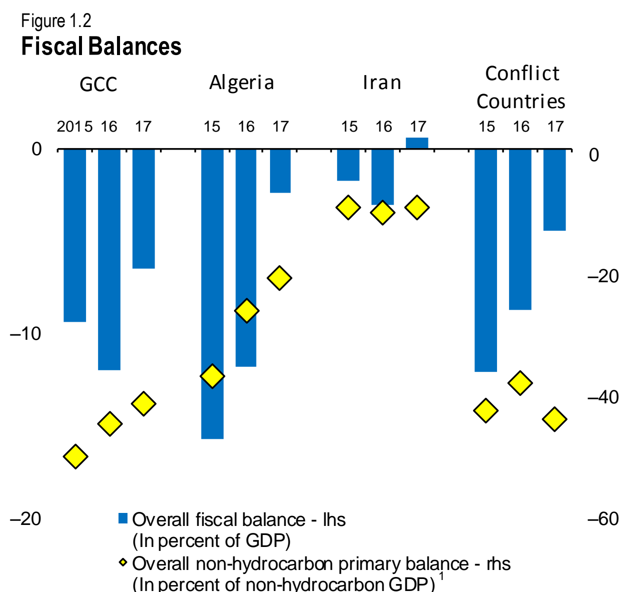
Figure 1.1
Total, Oil, and Non-Oil Real Growth[1]
(Percent change)



Source: IMF staff calculations.
Note: GCC = Gulf Cooperation Council.
[1]For conflict countries, only overall growth is shown because of large swings in oil and non-oil growth. Conflict countries include Iraq and Yemen.

but limited fiscal space for oil-related investments implies little potential for further growth in oil output in the near term (Figure 1.1).

Fiscal Adjustment Needs to Continue over the Medium Term



Sources: IMF staff calculations.
Note: GCC = Gulf Cooperation Council; lhs = left-hand side; rhs = right-hand side.
[1]For some countries non-hydrocarbon primary balances are adjusted for one-off items or country idiosyncracies. Conflict countries include Iraq and Yemen.

Across MENAP oil exporters, the sharp fall in oil prices between late 2014 and the second quarter of 2016 was reflected in a surge in fiscal deficits (blue bars in Figure 1.2). The average fiscal deficit reached about 10 percent of GDP in both 2015 and 2016. However, the underlying fiscal stance, which is measured by the non-oil primary balance and excludes the effect of oil price movements, improved substantially in 2016, with non-oil primary deficits reduced by 5¼ percentage points of non-oil GDP in the GCC (driven by Oman and Qatar) and 11 percentage points in Algeria (diamonds in Figure 1.2). This improvement resulted from energy price reforms and spending cuts (Algeria, Oman, Qatar, Saudi Arabia), as well as increases in non-oil revenue in some countries (Algeria, Oman, Saudi Arabia). In Iran, the fiscal stance was loosened slightly to support non-oil growth, while in countries in conflict as a whole it tightened.

The projected increase in oil prices and continued consolidation will reduce 2017 overall fiscal deficits significantly to 4¼ percent of GDP on average. Planned adjustment in the GCC and Algeria, for example, implies that non-oil primary deficits will improve by 3¼ and 5½ percentage points of non-oil GDP respectively. Adjustment measures include further increases in energy prices (Algeria and Bahrain, planned in Saudi Arabia), expatriate labor fees (Bahrain, planned in Saudi Arabia), excise taxes (Algeria, GCC), increases in tax rates (Algeria, Oman), control of current spending (Algeria, Bahrain, Oman, Qatar), and reductions in capital spending (Algeria, Oman). In Iraq, the fiscal stance is expected to loosen somewhat as the receipt of previously delayed donor financing relaxes the cash constraint faced in 2016. In Iran, the fiscal stance is expected to tighten slightly.

IMF staff projections suggest that the fiscal deficits of MENAP oil exporters could fall below 1 percent of GDP by 2022—a big improvement over 2016. These projections are conditional on the sustained implementation of ambitious fiscal reforms. For example, policymakers plan further energy price reforms (Algeria, Iraq, GCC), while the GCC is planning to introduce a value-added tax in 2018. This envisioned fiscal adjustment is necessary for long-term fiscal sustainability, despite already significant efforts. However, the pace of consolidation should be calibrated to country-specific circumstances. Countries with large buffers, such as Kuwait, Qatar and the United Arab Emirates can adjust more gradually to minimize adverse effects on non-oil activity; countries with smaller buffers will need to move faster. When choosing a specific consolidation path, countries should prioritize growth-friendly measures such as further energy price reforms

(Box 1.1), additional cuts to current spending, and measures to increase revenues, including through improved tax administration (see the October 2016 IMF Departmental Paper *Diversifying Government Revenue in the GCC: Next Steps*).

Successful implementation of fiscal plans will be helped by strengthening fiscal institutions. Although a work in progress across the region, there have been notable advances in setting up medium-term fiscal frameworks (Algeria, Kuwait, Qatar, Saudi Arabia) and debt management offices (Kuwait, Saudi Arabia). Iran is revamping its public financial management system, including introducing accrual accounting, modernizing the Financial Management Information System, and developing a Treasury single account.

Cumulative overall budget deficits for the five-year period between 2016 and 2021 are estimated at $375 billion, down from $565 billion in the October 2016 *Regional Economic Outlook* (REO). This is a substantial improvement predicated on the sustained implementation of these ambitious fiscal plans and helped by projected oil price trends. Recognizing the need to strike a balance between drawing down assets and issuing debt, countries have increasingly used debt to finance deficits, and this is expected to continue in 2017 (see Chapter 5 of the October 2016 REO). External sovereign issuance reached $50 billion in 2016, more than five times the 2015 amount, which also played a key role in financing external deficits. Conditions in global markets remain favorable for oil exporters with market access, which will likely encourage continued issuance of international debt.[1]

In particular, sovereign yields on GCC U.S. dollar–denominated bonds increased by about 10 basis points between November 1, 2016, and March 24, 2017, much less than the 60-basis point increase in the benchmark 10-year U.S. Treasury bond. However, reliance on external financing is vulnerable to sudden changes in global risk aversion, so the associated risks need to be actively managed.

Domestic debt issuance would reduce risks related to external financing, and would help develop local financial markets. However, any domestic issuances need to be considered carefully to avoid crowding out private sector credit, especially where liquidity conditions are already tight.

External Balances Improving

After a couple of years of sizable deficits, higher oil prices and fiscal consolidation are expected to return the total current account of MENAP oil exporters to broad balance this year. However, external challenges remain, which the projected fiscal adjustment discussed above will also help alleviate. In GCC countries, reflecting their fixed exchange rates, real exchange rates have appreciated due to the recent strengthening of the U.S. dollar, reducing competitiveness and raising demand for imports. Algeria has seen both its nominal and real effective exchange rates appreciate in recent months as well. In Iran, preparations for exchange rate unification are continuing. The ongoing conflicts in Yemen and Libya have caused sharp depreciations in parallel exchange rates, reflecting security concerns and foreign exchange shortages.

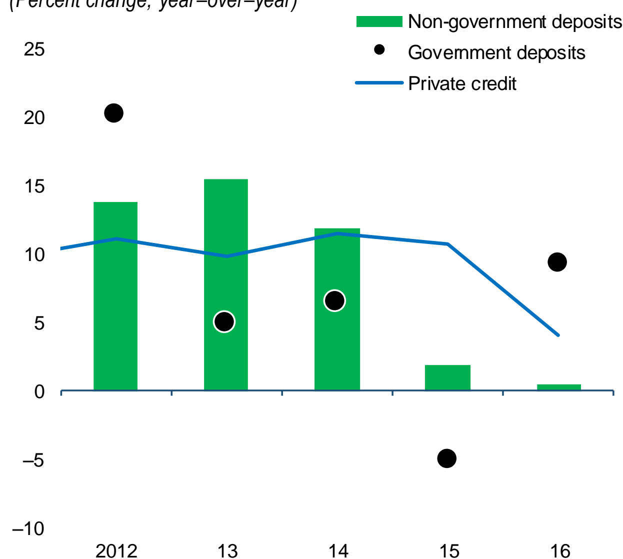
[1]For example, in March, Oman covered more than 70 percent of its 2017 financing need through a Eurobond issue and Kuwait raised $8 billion through its debut bond issue, while, in April, Saudi Arabia raised $9 billion in a debut international sukuk.

Financial Sector Appears Healthy Overall; Credit Starting to Slow

Banks in the region remain generally well capitalized. However, profitability is declining, liquidity has tightened in most countries—although it has eased in recent months in Saudi Arabia and the United Arab Emirates—and pressures on asset quality are emerging in some countries. There are pockets of vulnerability; the Iranian banking sector needs recapitalization and restructuring, and Iraq is working toward addressing challenges with state-owned banks. Banking sector regulatory reforms are progressing, and a number of countries are strengthening their resolution frameworks, including introducing bankruptcy laws (passed in the United Arab Emirates and planned in Saudi Arabia) and developing crisis management frameworks (Kuwait).

Credit markets were initially shielded from the slowdown in deposit growth that resulted from lower oil prices (Figure 1.3). To support credit, banks increased foreign wholesale funding (Bahrain, Qatar) and substituted from foreign assets (Oman, Saudi Arabia, United Arab Emirates). However, credit growth slowed significantly in 2016. Beyond 2016, credit demand could decelerate further as higher U.S. interest rates are reflected in lending rates, although idiosyncratic factors—the 2022 FIFA World Cup (Qatar) and Expo 2020 (Dubai)—will support credit demand in Qatar and the United Arab Emirates.

Figure 1.3
GCC: Credit and Deposit Growth
(Percent change, year–over–year)



Source: IMF staff calculations.

Countries will need to adapt to this environment of lower oil prices and liquidity to ensure the continued availability of credit to support the private sector. Recent measures include the relaxation of the loan-to-deposit ratio, the introduction of longer-term repos (Saudi Arabia), and tailoring programs of Treasury bill auctions to liquidity conditions (Qatar). Central banks will need to become more active liquidity managers, which will require improvements in the institutional framework in some countries—this process is underway, for example, in Algeria, where the central bank recently reintroduced refinancing instruments. Continued efforts to improve private sector access to finance will be needed to support successful diversification.

Structural Reforms: From Design to Implementation

Persistently lower hydrocarbon revenues mean that the current development model based on a redistribution of oil wealth through government jobs and generous subsidies is no longer sustainable. The challenge, therefore, is to develop a new model of economic growth that is both resilient and inclusive. In particular, there is a need to reduce the dependence on oil and generate private sector jobs for the rapidly growing labor force.

Last year saw the design of ambitious strategic development plans. But countries need to

maintain a steady focus on the implementation of those plans and on other supporting reforms.

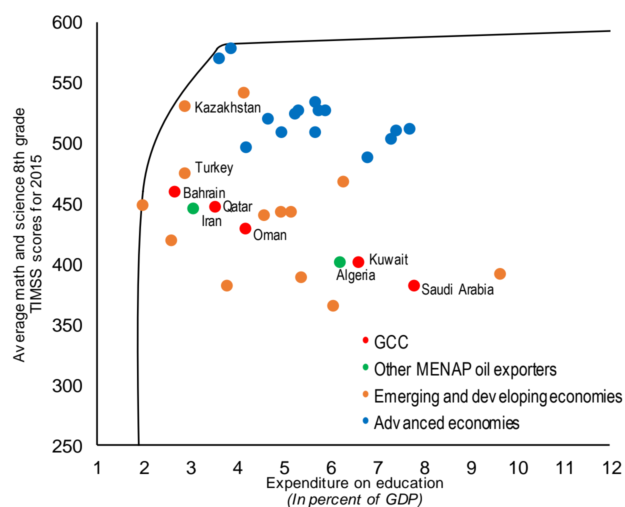
Efforts to encourage greater foreign investment are underway. New investment laws in Algeria (passed by Parliament) and Oman (currently under consideration) could boost foreign direct investment, while allowing foreign ownership outside free economic zones in the United Arab Emirates could have the same effect. Saudi Arabia has introduced reforms to its equity and bond markets, including the easing of restrictions on foreign investment.

More needs to be done, however, to improve the business environment as progress has been uneven. For example, the recent opening of the Kuwait Business Center (a business-facilitating one-stop window) is an important step in the right direction. But, while Algeria and the United Arab Emirates improved their World Bank Doing Business rankings by seven and eight places, respectively, on average MENAP oil exporters gained only one place. And MENAP oil exporters not affected by conflict lost three places, on average, in the World Economic Forum's competitiveness rankings.

Since public sector employment growth will be much more limited in the future, new private sector jobs will be needed for the 6.5 million labor force entrants expected by 2022 in Algeria, Iran, and the GCC. Labor market reform, including as part of improving the broader business environment, will be key to this process. In Saudi Arabia, authorities are planning to increase fees on expatriate labor. These will need to be part of a broader package of labor market reforms to encourage the increased employment of Saudi nationals in the private sector.

Enhancing human capital will also be critical to policymakers' efforts to boost productivity and address the challenge of creating jobs for young jobseekers. For example, MENAP oil exporters need to improve the quality of their education to catch up with emerging markets such as Kazakhstan and Turkey, which score better in the *Trends in International Mathematics and Science Study* (TIMSS – Figure 1.4), a ranking of the performance of students around the world.
In conflict countries, stabilization of the security situation will be the key prerequisite. For example, school dropout rates exceeded 50 percent in Syria in 2013, the most recent year for which data are available.

Figure 1.4
Student Performance Compared to Education Spending



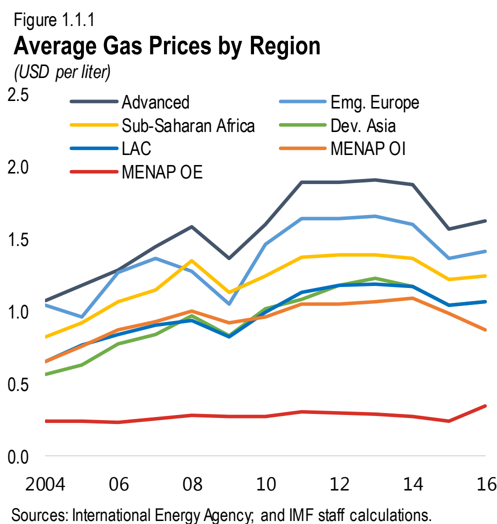
Sources: TIMSS and PISA evaluations, and IMF staff calculations.
Note: For Algeria and Mexico, PISA scores were mapped into comparable; TIMSS scores based on the performance of their peers in both evaluations.
PISA = Programme for International Student Assessment; TIMSS = Trends in International Mathematics and Science Study.

Box 1.1. Pre-Tax Energy Subsidy Reform in MENAP Oil-Producing Countries

MENAP oil exporters have taken significant steps in energy price reform to adjust to the ongoing environment of lower oil prices. However, more needs to be done, not only to underpin the needed fiscal consolidation but also to promote greater economic efficiency.

Despite recent price adjustments, MENAP oil exporters still maintain by far the lowest energy prices in the world (Figure 1.1.1). The provision of cheap energy has been an important policy mechanism to allow consumers to benefit from their country's oil wealth. But this policy has also come with significant side effects. It creates the incentive to use energy-based technologies, which pushes the structure of economies toward energy- and capital-intensive industries. It reduces the cost of energy-inefficient transportation, buildings, and infrastructure, which makes it difficult to reduce energy intensity in the future and has implications for congestion and pollution; and it typically requires expensive subsidies.

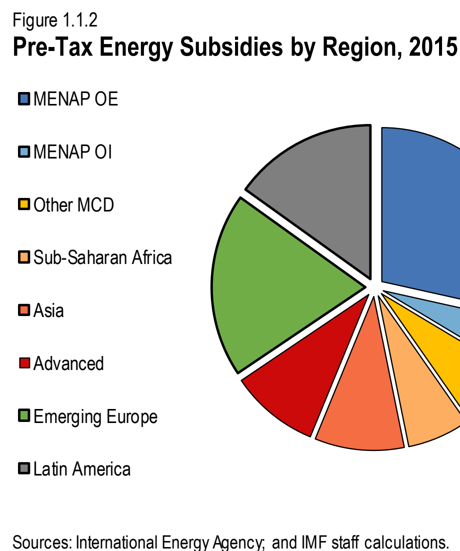
Figure 1.1.1
Average Gas Prices by Region
(USD per liter)



Sources: International Energy Agency; and IMF staff calculations.

MENAP oil exporters have the largest energy subsidy bill in the world.[1] As a group, these countries accounted for more than one-fifth of global energy subsidies in 2015 (Figure 1.1.2), estimated at $115 billion (or just over 5 percent of their GDP) out of $436 billion total worldwide.[2] This captures forgone revenue that could otherwise have been captured by aligning retail prices to market-based prices. However, subsidies often represent an actual budget expenditure or transfer. Reducing subsidies can generate budget resources for other forms of critical spending (such as growth-enhancing capital investment, education, health, and social protection).

Figure 1.1.2
Pre-Tax Energy Subsidies by Region, 2015



Sources: International Energy Agency; and IMF staff calculations.

[1]Algeria, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates; Libya is excluded due to data limitations.

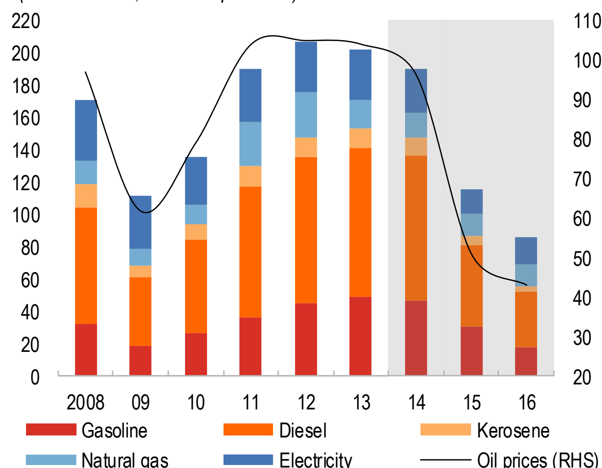
[2]To facilitate cross-country comparison, energy subsidies are calculated using the price gap method, which multiplies the difference between a country's energy price and a benchmark price (usually the US pre-tax price) by the consumption level of that energy product.

Box 1.1 *(continued)*

Figure 1.1.3

Energy Subsidies in MENAP Oil-Exporter Countries

(Billions of USD, and USD per barrel)

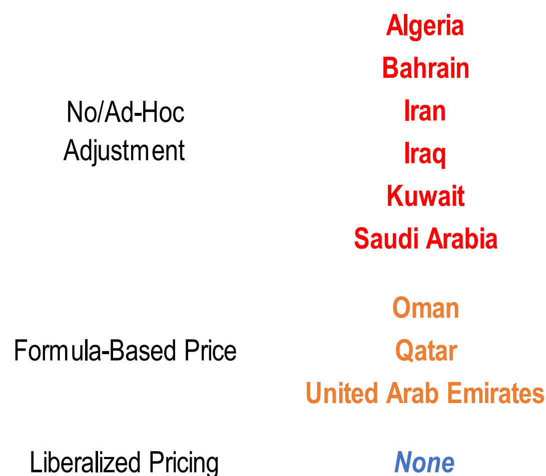


Sources: National authorities; and IMF staff estimates.
Note: RHS = right-hand side.

Initial steps in energy price reform are welcome, but more should be done now**.** Energy subsidies in MENAP oil exporters dropped from $190 billion in 2014 to an estimated $86 billion in 2016 (Figure 1.1.3). However, these savings were driven largely by the decline in international prices. Nevertheless, countries that have taken steps to introduce a formula-based pricing regime have enjoyed a relatively greater reduction in subsides (Figure 1.1.4). For example, subsidies in Oman, Qatar, and the United Arab Emirates dropped by 61 percent on average between 2014 and 2016, compared with an average decline of 54 percent across the remaining MENAP oil-exporting countries. Overall, price regulation leaves countries vulnerable to higher subsidies if international prices rise, although less so in countries with a formula-based pricing approach.

Figure 1.1.4

Petroleum Price Adjustment Regimes, 2016



No/Ad-Hoc Adjustment	Algeria Bahrain Iran Iraq Kuwait Saudi Arabia
Formula-Based Price	Oman Qatar United Arab Emirates
Liberalized Pricing	*None*

Sources: Country authorities; and IMF staff calculations.

Successful elimination of price gaps and subsidies calls for a well-developed strategy**.** International experience shows energy sector reforms take years to fully implement and require a firm and sustained commitment from policymakers. Success is much more likely if stakeholders are involved in the design of reforms from the start and if goals and objectives are clearly communicated to the public. In particular, the opportunity costs of energy subsidies should be disclosed (for example, crowding out investment and other critical expenditures). Reforms should be depoliticized and perceived as such, ideally by moving toward either market-based or formula-based adjustments. Adjustments could be gradual in order to allow households and industries to adapt, including by moving toward more energy-efficient technologies. Although subsidies are regressive and accrue relatively more to the wealthy, their elimination is likely to disproportionally hurt the poor. Therefore, properly designed safety nets are essential to shield the most vulnerable. Other compensatory measures, preferably front-loaded and temporary, may also be needed to ease the adjustment.

Subsidies are currently relatively low, which means that the time for further reforms in energy pricing is now. Adopting a more market-based pricing framework would help preserve the savings achieved, even if global oil prices were to rise again.

MENAP Oil-Importing Countries: A Fragile Recovery

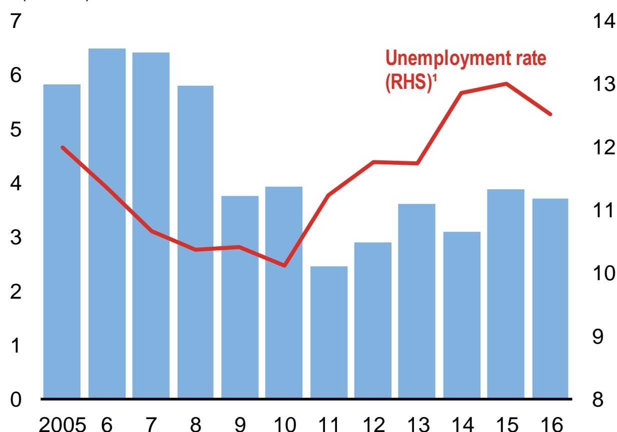
Underpinned by past reforms, improved confidence, and increasing external demand, output growth in most MENAP oil importers is gradually recovering. But unemployment is still too high, especially among the youth, conflicts and refugee pressures continue to weigh on the regional outlook, and vulnerabilities remain elevated. To strengthen their resilience and promote inclusive growth, oil importers need to continue their fiscal consolidation efforts while protecting much-needed social spending and public investment. Broad-based, job-rich growth will also require the implementation of structural reforms that improve the business climate and boost productivity.

From a Low Base, Growth Is Improving

The period following the global financial crisis and the Arab Spring has been a difficult one for MENAP oil importers. Although low oil prices have provided some respite over the past couple of years, security concerns and regional conflicts continue to take a toll on confidence and activity—resulting in growth rates that have failed to address high unemployment or improve living standards (Figure 2.1). That said, recent indicators suggest a gradual recovery is underway.

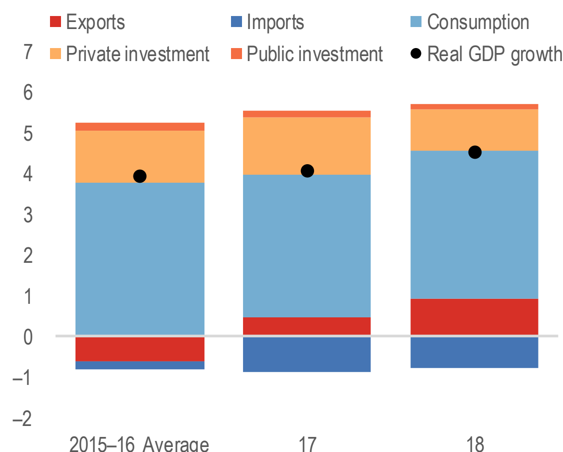
Regional growth is expected to increase from 3.7 percent in 2016 to 4 percent in 2017 and to 4.4 percent in 2018. In part, this rebound will reflect a fading of idiosyncratic shocks from 2016 (drought in Morocco, weak cotton harvest in Pakistan). More generally, the improved outlook reflects the continued dividends from past reforms, which have reduced fiscal deficits and improved the business climate (Morocco, Pakistan), supported by a scaling up in public investment (Pakistan). In addition, growth will be supported by the broader global recovery, which is expected to boost demand from the region's main export markets (Figure 2.2).

Figure 2.1
GDP Growth and Unemployment Rate in MENAP Oil Importers
(Percent)



Sources: National authorities; and IMF staff estimates.
Note: RHS = right-hand side.
[1] Simple average for Egypt, Morocco, Pakistan, Sudan, and Tunisia.

Figure 2.2
Contributions to Growth: Investment Picks up and Exports Rebound
(Percent change, 2015–18[1])



Sources: National authorities; and IMF staff estimates.
[1] MENAPOI aggregate excludes Sudan and Syria.

Against this backdrop, however, activity across the region's oil importers will vary significantly. Growth will be particularly robust in Djibouti, where foreign-financed infrastructure spending will remain a key driver, and in Pakistan, where implementation of the China-Pakistan Economic Corridor will boost investment. In Jordan and Lebanon, on the other hand, growth will remain relatively modest, owing to the ongoing impact of regional conflicts on tourism, confidence, and investment. And in Tunisia, the projected near-term recovery has been revised down slightly, as a result of continued uncertainty and weak tourism.

Inflation Pressure Easing in the Medium Term

Although inflation in many countries is expected to increase in 2017, it should ease over the medium term. Continuing a trend since 2016, average regional inflation will rise again in 2017, reaching almost 13 percent. A portion of this increase reflects higher international oil prices. But in many instances, rising inflation also reflects reductions in energy subsidies (Egypt, Sudan), implementation of a value-added tax (Egypt), the removal of tax exemptions (Jordan), rising food prices (Djibouti, Egypt, Somalia), and the pass-through of recent exchange rate depreciations (Egypt, Sudan). In the case of Egypt, the move to a flexible exchange rate regime was accompanied by a sharp depreciation of the pound, which has pushed inflation above 25 percent. As the impact of these one-off factors fades over time, and supported by prudent fiscal and monetary policy, inflation is expected to moderate over the medium term.

Sound Fiscal Policies Needed to Boost Resilience

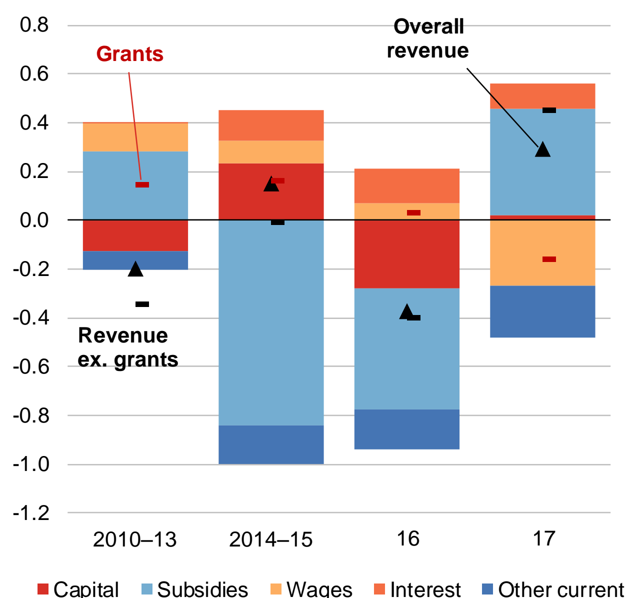
Despite improvements over the past few years, large fiscal vulnerabilities remain. Public debt levels remain high, exceeding 90 percent of GDP for a number of MENAP oil importers (Egypt, Jordan, Lebanon). Such large debt stocks not only undermine investor confidence, they can also add to financial stability risks, given large holdings of debt by the banking sector and generally shallow financial markets. Moreover, the associated debt-service burden is significant for a number of MENAP oil importers (Egypt, Lebanon, and Pakistan, where it absorbed between 28 and 48 percent of revenues in 2016), leaving less scope for social spending or public investment.

However, recent fiscal trends are encouraging. For the broader region, the average fiscal deficit fell from a peak of 9¼ percent of GDP in 2013 to about 7 percent of GDP in 2016. In large part, this improvement reflects reduced fuel subsidies (Egypt, Morocco, Sudan), lower transfers to energy-related state-owned enterprises (Jordan, Lebanon), and efforts to increase revenue (Pakistan) (Figure 2.3).

Figure 2.3

Change in Expenditure and Revenue

(PPT change from prior year, percent of GDP)



Sources: National authorities; and IMF staff estimates.
Note: PPT = percentage point.

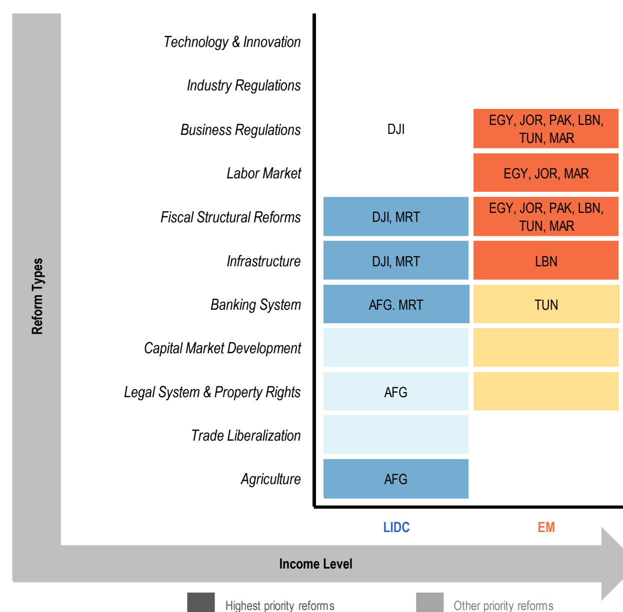
Nevertheless, maintaining the pace of consolidation will remain a challenge. In 2016, revenues were weaker than expected compared with the October 2016 REO due to weaker tax collection (Morocco, Tunisia), delayed reforms (Tunisia), and subdued growth (Jordan, Morocco, Tunisia). Moreover, although the savings from low oil prices and reduced subsidies have allowed for increased spending on infrastructure, health care, education, and social services (Egypt, Morocco, Pakistan, Tunisia), it will be increasingly difficult to maintain this spending now that oil prices are expected to be higher. There is, therefore, a need to push subsidy reforms through to completion (Egypt, Sudan, Tunisia) and to contain losses from state-owned enterprises—including through automatic tariff mechanisms for energy companies (Jordan, Lebanon, Tunisia).

More generally, a key priority for oil-importing countries is to generate higher revenues by broadening the existing tax base. This will require measures to rationalize multiple value-added tax rates (Morocco, Tunisia), while simplifying the tax rate structure and eliminating exemptions (Djibouti, Egypt, Jordan, Lebanon, Morocco, Pakistan, Sudan, Tunisia). It will also require renewed efforts to strengthen tax administration (Afghanistan, Mauritania, Morocco, Pakistan, Somalia, Sudan, Tunisia). In this context, the IMF's technical assistance and engagement in some conflict-affected countries (Box 2.1) is helping strengthen revenue administration (Afghanistan, Iraq).

With Limited Fiscal Space, Durable and Inclusive Growth Requires Continued Structural Reform

Across MENAP oil importers, growth rates are too low to reduce unemployment or provide a broad-based and resilient improvement in incomes. And fiscal constraints will prevent country authorities from boosting growth through public spending alone. Therefore, there is a strong need for structural reforms that promote private sector activity and boost productivity (Figure 2.4).

Figure 2.4
Structural Reform Priorities



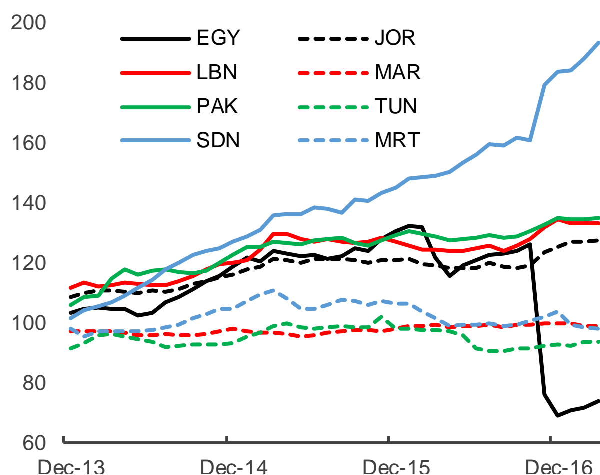
Note: Darker shades imply larger gains from reforms, from *Structural Reforms and Macroeconomic Performance* (IMF Policy Paper, 2015). Country priorities from a survey of IMF staff country teams. Country abbreviations are International Organization for Standardization (ISO) country codes.

Progress has already been made in this direction, including upgraded investor protection and regulations (Jordan, Mauritania, Morocco, Tunisia) and the easing of key infrastructure bottlenecks, such as poor energy supplies (Egypt, Jordan, Pakistan). But further measures are still needed to promote competition (Egypt, Jordan, Morocco), reduce the infrastructure gap (Lebanon), and address the chronic skills mismatch between jobseekers and employers (Djibouti, Egypt, Jordan, Morocco, Tunisia). More broadly, persistently high unemployment calls for further progress with labor market reform, including efforts to increase female labor force participation (Egypt, Jordan, Morocco).

Productivity-enhancing reforms are also needed to improve competitiveness. Despite steady external demand, many MENAP oil importers have seen a drop in their export shares (see the

October 2016 REO), suggesting weakening competitiveness and growing vulnerability to external shocks. Part of this decline can be explained by regional security concerns and fewer tourists (Egypt, Jordan, Lebanon, Tunisia), as well as by a breakdown in traditional trade routes (Jordan, Lebanon). Another factor may be the recent strengthening of the U.S. dollar, which has helped boost real exchange rates—particularly for countries with rigid exchange rate arrangements (Figure 2.5). A larger part, however, may reflect instead an underlying productivity problem for exporting firms. Structural reforms to improve competitiveness—combined with exchange rate flexibility for countries with an appropriate monetary anchor—will help these firms compete on a more solid footing, enabling them to benefit more completely from the anticipated global recovery.

Figure 2.5
REER Index
(January 2010 = 100)



Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes. REER = real effective exchange rate.

A Sound Financial Sector Will Also Underpin Growth

Sustained, broad-based growth requires a healthy financial system. For the most part, banks within the region are stable, liquid, and adequately capitalized. However, given five consecutive years of subdued growth, along with an uncertain outlook, these banks face a challenging environment, particularly with relatively high levels of nonperforming loan ratios. Nonetheless, credit growth remains moderate, with developments largely unchanged compared with the October 2016 REO (the exception here is Egypt, where tighter monetary policy could weigh on lending growth in 2017). The authorities need to strengthen their regulatory and supervisory frameworks (Djibouti, Mauritania, Tunisia); their insolvency and bankruptcy regimes; and, in some cases, their deposit insurance arrangements (Egypt, Jordan, Pakistan, Tunisia).

Risks Remain to the Downside, Partly Reflecting the Uncertain Global Environment

The outlook remains vulnerable to changes in oil prices and the global outlook, and to geopolitical developments.

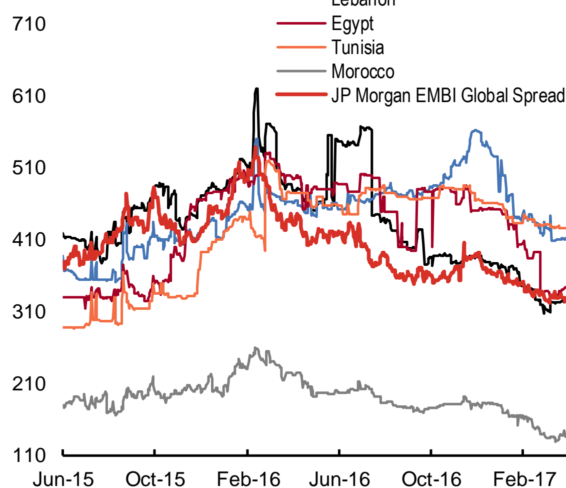
- Although the medium-term outlook for oil prices is broadly unchanged compared with the October 2016 REO, the near-term path is about $5 a barrel higher (see *Global Developments* section). Oil import prices in 2017, therefore, will be almost 30 percent higher than last year, and any further increases could undermine consumption, increase fiscal risks, and worsen external imbalances. However, this downside risk would be partly offset by higher remittances and other foreign support from oil-exporting countries in the region, principally benefiting Egypt, Jordan, Lebanon, and Pakistan.

- Global policy uncertainty has also increased (see *Global Developments* section). A general increase in protectionism could undermine

the global recovery and weaken demand for MENAP oil-importer exports, which would particularly impact countries with strong links to global trade and shipping (Djibouti).

- Countries are also exposed to changes in global financial conditions. While sovereign spreads for many oil importers have narrowed recently (Figure 2.6), U.S. interest rates have risen, and tighter and more volatile global financial conditions could increase borrowing costs for MENAP oil importers and their banks, adding to fiscal sustainability concerns, weighing on bank balance sheets, and undermining private sector activity. Such tightening could be particularly challenging for countries such as Egypt, Jordan, Lebanon, Pakistan, and Tunisia, which will be competing for funds in international markets.[1]

Figure 2.6
Five-Year CDS Spreads
(Basis points)



Sources: Bloomberg, L.P.; and IMF staff calculations.
Note: CSD = credit default swap.

- In this context, although current account deficits are expected to narrow slightly over the near term (from more than 4.8 percent of GDP in 2016 to 4.3 percent by 2018), external imbalances will remain sizable for many countries (Djibouti, Egypt, Jordan, Lebanon, Mauritania, Tunisia), suggesting a continuing need for fresh external inflows.

- A worsening of security conditions or social tensions (Afghanistan, Egypt, Lebanon, Pakistan, Somalia, Sudan, Tunisia), slower implementation of reforms (Afghanistan, Egypt, Jordan, Mauritania, Morocco, Pakistan, Tunisia), and increased spillovers from regional conflicts (Jordan, Lebanon, Sudan, Tunisia) could derail policy implementation and weaken economic activity.

However, upside risks are also emerging for some countries. In Sudan, the recent easing of U.S. sanctions could boost investment, while in Lebanon, the initiation of a series of reforms after the end of an extended political impasse may increase confidence, strengthen capital inflows, and accelerate growth.

[1]Egypt and Tunisia have already successfully tapped international markets in January and February, respectively.

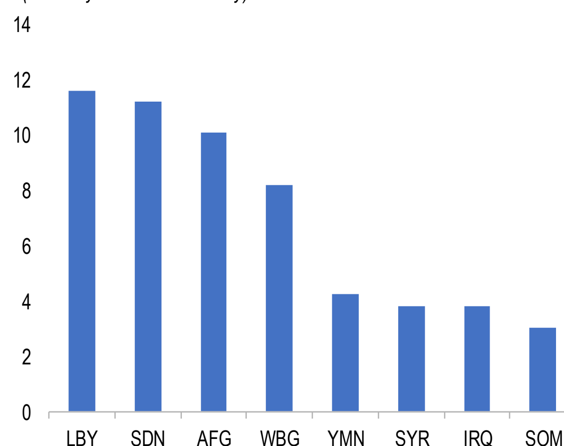
Box 2.1 How the IMF Is Working in MENAP's Conflict-Affected Countries

Together with international partners, the IMF helps countries affected by conflict cope with the adverse economic consequences and avoid economic collapse and supports rebuilding efforts once conflicts ease. The IMF also assists neighboring countries with mitigation of the associated economic spillovers.

In addition to severe humanitarian costs, conflicts have massive economic costs, not only for the countries directly affected, but also for their neighbors.[1] Countries exposed to conflict may face deep recessions, high inflation, worsening fiscal and financial positions, and weaker institutional quality. In addition, their ability to provide basic services collapses, with dire consequences for health and education and limiting their capacity to respond to other disasters, such as famine and epidemics. Neighboring countries experience spillovers through large flows of refugees; the impact on trade; and the economic effects of increased insecurity, including on investor sentiment. Once conflicts ease, the challenge is to achieve a sustainable recovery, including through rebuilding institutions and infrastructure and strengthening economic and social resilience.[2]

To help mitigate the economic implications of conflicts and their spillovers, the IMF provides tailored policy advice in the following areas: (1) building reliable macroeconomic frameworks; (2) monetary and exchange rate policies; (3) prioritizing spending, including to protect critical social spending, and securing debt sustainability; and (4) fostering inclusive growth. Where appropriate, the IMF also delivers significant amounts of technical assistance to its members (Figure 2.1.1),[3] including through the Middle East Technical Assistance Center in Lebanon. This assistance focuses mainly on rebuilding and strengthening economic institutions, especially central banks, to support the resilience of the payment and banking systems (Afghanistan, Iraq, West Bank and Gaza); improving economic policymaking, such as public financial management (Afghanistan, Iraq)

Figure 2.1.1
Technical Assistance to Conflict Countries, FY2010–16
(Person years of field delivery)



Source: IMF Institute for Capacity Development.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

[1]The following countries are experiencing the direct or indirect impacts of conflicts in the MENAP region: Afghanistan, Egypt, Iraq, Jordan, Lebanon, Libya, Pakistan, Somalia, Sudan, Syria, Tunisia, West Bank and Gaza, and Yemen.

[2]See Rother, B, and others, 2016, *The Economic Impact of Conflict and the Refugee Crisis in the Middle East and North Africa*, IMF, Staff Discussion Note.

[3]Although the West Bank and Gaza is not a member, the IMF provides technical services, including policy advice in the macroeconomic, fiscal, and financial areas, as well as technical assistance.

Box 2.1 *(continued)*

and tax policy and administration (Tunisia, Somalia); complying with regulations on anti–money laundering and combating the financing of terrorism (Libya, West Bank and Gaza); and preparing statistics (Afghanistan, Iraq, West Bank and Gaza). For example, under the umbrella of a multi-donor trust fund, the IMF has been providing broad-based and tailored technical assistance to Somalia, which has helped the government develop the capacity to prepare a national budget and the central bank develop modern banking supervision tools. The IMF closely coordinates its technical assistance support with external partners (Somalia).

In addition to its own financing support (Afghanistan, Iraq), the IMF also helps mobilize additional resources from donors and other international financial institutions (Iraq, Jordan, Somalia) and plays a key role in supporting the dialogue of the international community by providing an assessment of economic developments and participating in donor meetings (Libya, West Bank and Gaza).

The acute nature of the refugee crisis in the MENAP region—with more than 10 million registered refugees[4] having originated from the MENAP region (mostly from Afghanistan, Somalia, Sudan, and Syria), of which more than half are being hosted in the region itself (mostly in Iran, Jordan, Lebanon and Pakistan)—requires significant and coordinated international support. Recognizing this need, the IMF has been a strong voice in encouraging fundraising efforts to deal with this refugee crisis, such as the high-level conference on *Supporting Syria and the Region* in London in 2016. IMF arrangements in countries affected directly or indirectly by conflicts have been tailored to take into account the impact of refugees and the internally displaced (Iraq, Jordan).

[4]Data does not include Palestinian refugees in Jordan, Lebanon, Syria, and West Bank and Gaza who are registered with the United Nations Relief and Work Agency for Palestine Refugees in the Near East.

MENAP Region: Selected Economic Indicators, 2000–18

(Percent of GDP, unless otherwise indicated)

	Average 2000–13	2014	2015	2016	Projections 2017	2018
MENAP[1]						
Real GDP (annual growth)	5.0	2.8	2.7	3.9	2.6	3.4
Current Account Balance	9.2	5.3	-4.1	-3.4	-1.1	-0.8
Overall Fiscal Balance	2.7	-2.8	-8.6	-9.0	-5.1	-4.1
Inflation, p.a. (annual growth)	7.0	7.0	5.8	5.6	8.2	6.8
MENAP oil exporters						
Real GDP (annual growth)	5.2	2.6	2.1	4.0	1.9	2.9
of which non-oil growth	7.0	4.0	0.7	0.4	2.9	2.7
Current Account Balance	13.4	8.7	-4.0	-2.7	0.4	0.6
Overall Fiscal Balance	6.6	-0.5	-9.2	-9.9	-4.3	-3.1
Inflation, p.a. (annual growth)	7.6	5.8	5.3	4.6	5.9	6.4
***Of which:* Gulf Cooperation Council (GCC)**						
Real GDP (annual growth)	5.0	3.3	3.8	2.0	0.9	2.5
of which non-oil growth	7.0	5.3	3.8	1.9	3.0	2.7
Current Account Balance	17.3	13.7	-2.6	-2.0	1.8	2.1
Overall Fiscal Balance	10.8	3.1	-9.4	-12.0	-6.5	-4.0
Inflation, p.a. (annual growth)	2.8	2.6	2.5	2.9	3.5	4.6
***Of which:* Non-GCC oil exporters**						
Real GDP (annual growth)	5.4	1.9	0.1	6.2	3.0	3.4
of which non-oil growth	6.9	2.4	-3.1	-1.4	2.8	2.7
Current Account Balance	7.7	0.0	-6.4	-3.9	-2.1	-2.2
Overall Fiscal Balance	2.4	-4.8	-9.0	-7.4	-1.7	-2.1
Inflation, p.a. (annual growth)	12.9	9.5	8.8	6.7	8.7	8.4
MENAP oil importers						
Real GDP (annual growth)	4.5	3.1	3.9	3.7	4.0	4.4
Current Account Balance	-2.6	-4.4	-4.3	-4.8	-4.9	-4.3
Overall Fiscal Balance	-5.5	-7.7	-7.3	-7.2	-6.6	-5.9
Inflation, p.a. (annual growth)	5.8	9.4	6.6	7.7	12.8	7.6
MENA[1]						
Real GDP (annual growth)	5.0	2.7	2.6	3.8	2.3	3.2
Current Account Balance	10.0	5.9	-4.4	-3.7	-1.0	-0.6
Overall Fiscal Balance	3.5	-2.6	-9.1	-9.6	-5.2	-4.1
Inflation, p.a. (annual growth)	6.8	6.8	6.0	6.0	8.7	7.1
Arab World						
Real GDP (annual growth)	5.3	2.3	3.4	3.2	2.0	2.9
Current Account Balance	11.0	6.2	-5.5	-5.2	-1.8	-1.4
Overall Fiscal Balance	4.0	-2.9	-10.6	-11.1	-6.5	-4.9
Inflation, p.a. (annual growth)	4.1	4.8	4.7	5.3	8.1	6.2

Sources: National authorities; and IMF staff calculations and projections.

[1]2011–18 data exclude Syrian Arab Republic.

Notes: Data refer to the fiscal year for the following countries: Afghanistan (March 21/March 20) until 2011, and December 21/December 20 thereafter, Iran (March 21/March 20), and Egypt and Pakistan (July/June).

MENAP oil exporters: Algeria, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, the United Arab Emirates, and Yemen.

GCC countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.

Non-GCC oil exporters: Algeria, Iran, Iraq, Libya, and Yemen.

MENAP oil importers: Afghanistan, Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Pakistan, Sudan, Syria, and Tunisia.

Arab World: Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, United Arab Emirates, and Yemen.