

INTERNATIONAL MONETARY FUND

REGIONAL ECONOMIC OUTLOOK

MIDDLE EAST AND
CENTRAL ASIA

Arising from the Pandemic: Building
Forward Better

2021
APR



World Economic and Financial Surveys

Regional Economic Outlook Update

**Middle East
and Central Asia**



APR 21

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Cataloging-in-Publication Data

Names: International Monetary Fund, publisher. | International Monetary Fund. Middle East and Central Asia Department, issuing body.

Title: Regional economic outlook update. Middle East and Central Asia.

Other titles: Middle East and Central Asia. | MCD REO. | World economic and financial surveys.

Description: Washington, DC : International Monetary Fund, 2021. | World economic and financial surveys, 0258-7440. | Apr. 21. | Includes bibliographical references.

Identifiers: ISBN 9781513576152 (English Paper)

9781513576176 (Arabic Paper)

9781513576183 (French Paper)

9781513576169 (Russian Paper)

Subjects: LCSH: Economic forecasting—Middle East. | Economic forecasting—Asia, Central. | Economic development—Middle East. | Economic development—Asia, Central. | Middle East—Economic conditions. | Asia, Central—Economic conditions.

Classification: LCC HC415.15.A1 R44 2021

The *Regional Economic Outlook: Middle East and Central Asia* is published twice a year, in the spring and fall, to review developments in the region. Both projections and policy considerations are those of the IMF staff and do not necessarily represent the views of the IMF, its Executive Board, or IMF Management.

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Acknowledgments

The Middle East and Central Asia Regional Economic Outlook (REO) Update is prepared each spring by the IMF's Middle East and Central Asia Department (MCD). The analysis and projections contained in the MCD REO are integral elements of the department's surveillance of economic developments and policies in member countries. It draws primarily on information gathered by MCD staff through their consultations with member countries.

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Gohar Abajyan, Oluremi Akin-Olugbade, Kate Nguyen, Jawed Sakhi, and Tucker Stone managed the database and provided research assistance.

Production support was provided by Haya Abu Sharar and Gintare Gedrimaite. Cheryl Toksoz of the Communications Department coordinated the editing and production of the REO. Nordine Abidi, Maria Atamanchuk, Aidyn Bibolov, Tannous Kass-Hanna, Moheb Thabet Malak, Issouf Samake, and Vahram Stepanyan reviewed the translations. They collaborated on the content with Mahmoud Asaad, Sherif Helmy, Heba Khalil, and Baya Kourdali (Arabic); Jean-Yves Lestienne and Monica Nepote-Cit (French); and Alexandra Akchurin and Denis Pshenichnikov (Russian), in coordination with Yelena Eydinova and Xiaochen Wang (Translation Coordination Center) from Language Services. Cooper Allen provided editorial support.

Country Groupings

The April 2021 *Regional Economic Outlook (REO) Update: Middle East and Central Asia*, covers countries in the Middle East and Central Asia Department (MCD) of the International Monetary Fund (IMF). It provides a broad overview of recent economic developments and of prospects and policy issues for the medium term. To facilitate the analysis, the 32 MCD countries and territories covered in this report are divided into three (nonoverlapping) groups, based on export earnings and level of development: (1) Oil Exporters (MCD OE), (2) Emerging Market and Middle-Income Countries (MCD EM&MI); and (3) Low-Income Developing Countries (MCD LIC). Additional analytical and regional groups provide more granular breakdown for analysis and continuity. The country and analytical group acronyms and abbreviations used in some tables and figures are included in parentheses.

MCD OE include Algeria (ALG), Azerbaijan (AZE), Bahrain (BHR), Iran (IRN), Iraq (IRQ), Kazakhstan (KAZ), Kuwait (KWT), Libya (LBY), Oman (PMN), Qatar (QAT), Saudi Arabia (SAU), Turkmenistan (TKM); and United Arab Emirates (UAE).

MCD EM&MI¹ include Armenia (ARM), Egypt (EGY), Georgia (GEO), Jordan (JOR), Lebanon (LBN), Morocco (MAR), Pakistan (PAK), Syria (SYR), Tunisia (TUN); and West Bank and Gaza (WBG).

MCD LIC include Afghanistan (AFG), Djibouti (DJI), Kyrgyz Republic (KGZ), Mauritania (MRT), Somalia (SOM), Sudan (SDN), Tajikistan (TJK), Uzbekistan (UZB); and Yemen (YMN).

Caucasus and Central Asia (CCA) countries include Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

CCA oil exporters (CCA OE) include Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.

CCA oil importers (CCA OI) include Armenia, Georgia, the Kyrgyz Republic, and Tajikistan.

Middle East and North Africa (MENA) includes Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, the United Arab Emirates, West Bank and Gaza, and Yemen.

MENA oil exporters (MENA OE) include Algeria, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, the United Arab Emirates, and Yemen.

MENAP oil importers include Afghanistan, Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Pakistan, Somalia, Sudan, Syria, Tunisia, and West Bank and Gaza.

MENA oil importers include Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Somalia, Sudan, Syria, Tunisia, and West Bank and Gaza.

Arab World includes Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, United Arab Emirates, West Bank and Gaza; and Yemen.

The **Gulf Cooperation Council (GCC)** comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

The **Non-GCC oil-exporting countries** are Algeria, Iran, Iraq, Libya, and Yemen.

¹Somalia is included in all regional aggregates starting publication of *Regional Economic Outlook* in October 2017. For Sudan, data for 2012 onward exclude South Sudan. Because of the uncertain economic situation, Syria is excluded from the projection years of REO aggregates.

Fragile states and conflict-affected countries (FCS) include Afghanistan, Djibouti, Iraq, Lebanon, Libya, Somalia, Sudan, Syria, Tajikistan, and Yemen.

North Africa countries include Algeria, Djibouti, Egypt, Libya, Mauritania, Morocco, Sudan, and Tunisia.

Conflict countries include Libya, Syria, and Yemen.

What is new: New aggregates, MCD OE, MCD EM&MI, and MCD LIC, were introduced starting April 2021 REO update.

Regional Developments and Outlook

A year into the coronavirus (COVID-19) pandemic, the race between vaccine and virus entered a new phase in the Middle East and Central Asia, and the path to recovery in 2021 is expected to be long and divergent. The outlook will vary significantly across countries, depending on the pandemic's path, vaccine rollouts, underlying fragilities, exposure to tourism and contact-intensive sectors, and policy space and actions. 2021 will be the year of policies that continue saving lives and livelihoods and promote recovery, while balancing the need for debt sustainability and financial resilience. At the same time, policymakers must not lose sight of the transformational challenges to build forward better and accelerate the creation of more inclusive, resilient, sustainable, and green economies. Regional and international cooperation will be key complements to strong domestic policies.

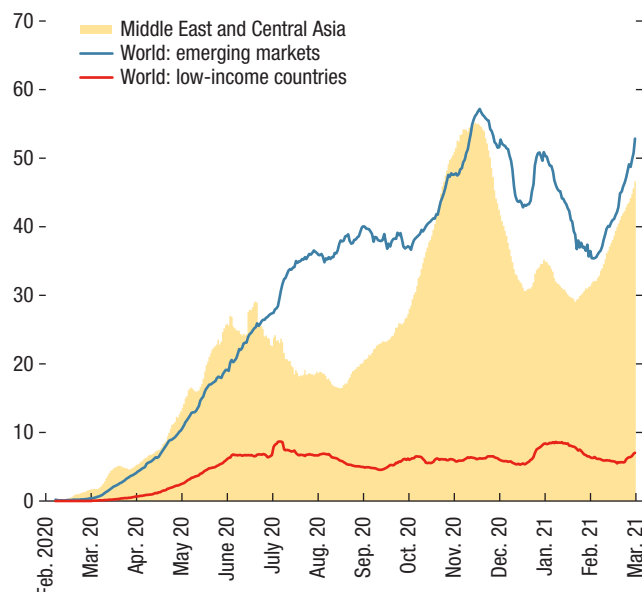
A Year into the Pandemic: Where Does the Middle East and Central Asia Region Stand?

Learning to Live with the COVID-19 Pandemic and Multispeed Vaccination Campaigns

A year after its emergence, the COVID-19 pandemic continues to ravage the global economy and the Middle East and Central Asia. The easing of restrictions imposed early last year (*first wave*) and the associated rise in mobility over the summer months led to virus resurgence late last year (*second wave*) (Figure 1.1). Several fragile and conflict-affected states (Somalia, Syria, Yemen) continued to report relatively lower infection and fatality rates. However, insufficient testing and health care capacities suggest that the true extent

Prepared by Olivier Bizimana, Joyce Wong, Gohar Abajyan, Oluremi Akin-Olugbade, Kate Nguyen, and Tucker Stone.

Figure 1.1. COVID-19 Infection Rates
(Per million, 7-day moving average)



Sources: Johns Hopkins University Center for Systems Science and Engineering (CSSE); and IMF staff calculations.

of the pandemic's spread is likely understated. In response, many countries reimposed partial lockdowns and other targeted restrictions in late 2020, with fewer constraints for work and travel compared with the first wave and therefore less decline in mobility. After rapidly declining in early 2021, both infection and death rates are again on an increasing path and eight countries are reporting new COVID-19 variants.

Meanwhile, the race between vaccine and virus entered a new phase. Vaccination campaigns have started in a few countries, but access to adequate vaccine supplies remains a challenge for many others.

Early inoculators: Most of the countries in this group (which includes Gulf Cooperation Council countries, Kazakhstan, and Morocco) started vaccinations in December 2020 or January 2021

and are expected to inoculate a significant share of their population by the end of 2021.

Slow inoculators: Limited advanced purchase agreements or lack of financing in these countries are expected to pose challenges to mass vaccinations. The 13 countries and territories in this group (Afghanistan, Algeria, Djibouti, Egypt, Iran, Iraq, Jordan, Lebanon, Libya, Pakistan, Tunisia, Uzbekistan, West Bank and Gaza) started inoculations with limited coverage and are generally not expected to inoculate a significant portion of their population until at least mid-2022, barring additional efforts, such as help from the international community.

Late inoculators: The remaining 11, especially low-income countries (LICs), will likely experience prolonged vaccination rollouts, and in the short term, vaccination will be limited to the doses provided by the World Health Organization's COVID-19 Vaccines Global Access (COVAX) facility, which covers up to 20 percent of a country's population. Given the low capacity for vaccine storage and distribution, countries in this group are not expected to achieve full vaccination until 2023 at the earliest, in the absence of further efforts to make vaccines available and affordable to all.¹ Nonetheless, there are emerging signs of regional cooperation in the Middle East and North Africa (MENA) region to help this group: in the UAE, the Hope Consortium is working on vaccine storage and distribution in the region, and the Vaccine Logistics Alliance is expected to support the delivery of two billion doses of vaccines this year under COVAX.

A Better-Than-Expected External Backdrop, But Emerging Vulnerabilities for Some

Activity in advanced and major emerging market economies bounced back better than expected

¹According to the Duke Global Health Innovation Center, current models predict that there will not be enough vaccines to cover the world's population until 2023 or 2024. Manufacturing capacity can be expanded with targeted investment but only to an extent and it will remain a rate limiter.

(*April 2021 World Economic Outlook*, Chapter 1). Similarly, global merchandise trade rebounded strongly in the third quarter of 2020 from the collapse in the first half of the year. Service trade, however, has been subdued, reflecting continued weakness in the tourism and travel sectors.

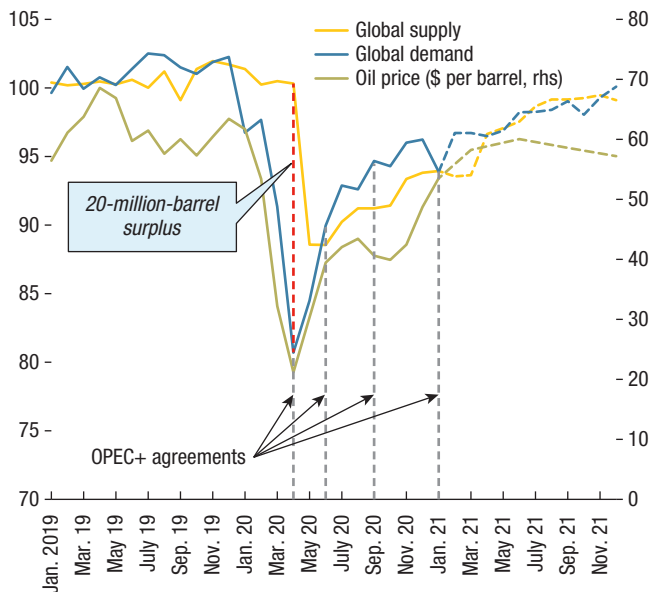
Commodity prices bounced back. Oil prices have recovered since the last quarter of 2020, reflecting improved global demand, combined with the Organization of Petroleum Exporting Countries and other major oil producers (OPEC+) agreements to extend oil production cuts, and Saudi Arabia's announcement of further production cuts (Figure 1.2). After falling to \$27 per barrel in April 2020, oil prices reached \$67 per barrel in mid-March 2021, trading at about 4.5 percent above the 2019 average. Oil futures curves point to prices hovering near current levels in the coming months, reaching \$57 per barrel at the end of 2021 before they moderate to \$53 per barrel in 2022 as supply picks up—still below the \$64 per barrel 2019 average. At the same time, non-fuel commodity prices (particularly food prices) rose substantially in the second half of 2020 and are expected to remain elevated this year. The IMF's food price index is projected to rise by nearly 14 percent in 2021.

Global financial conditions have remained broadly accommodative, given low global interest rates and spreads, supporting sovereign issuances in the region (Chapter 2). Capital flows to emerging markets stabilized in late 2020 and rose at the start of 2021. After outflows of at least \$6 billion out of the region in the first half of 2020, total inflows in the final six months of the year reached \$4 billion. By the end of February 2021, cumulative flows since the start of the pandemic had turned positive. However, this trend came to an end with the recent increases in U.S. long-term bond yields.

Strong Policy Responses

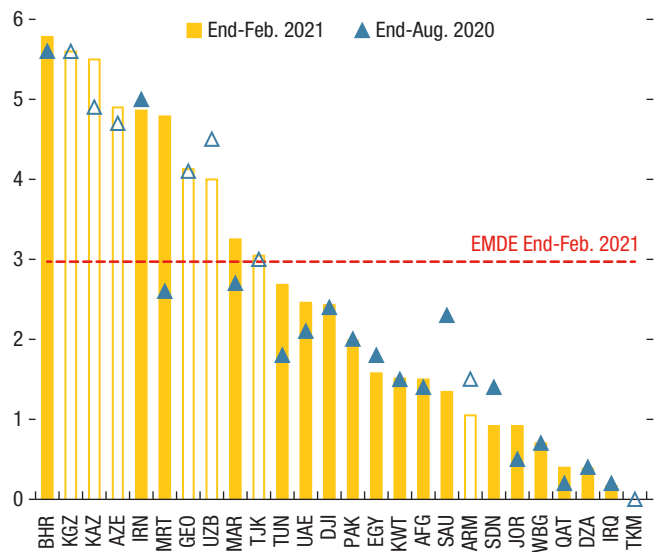
Fiscal packages were introduced to cushion the pandemic's impact (mostly before August) and averaged about 2 percent of GDP (Figure 1.3). Although many countries reprioritized spending

Figure 1.2. Global Oil Supply and Demand
(Barrels per day, millions)



Sources: US Energy Information Administration (EIA) Short-Term Energy Outlook; and IMF World Economic Outlook database.
Note: Projections are from EIA Regional Short-Term Energy Model.
rhs = right-hand scale.

Figure 1.3. Fiscal Support in Response to COVID-19
(Percent of 2020 GDP)



Sources: IMF COVID-19 Tracker; and IMF staff calculations.
Note: Filled bars includes Middle East and North Africa countries, and clear bars includes Caucasus and Central Asia countries. EMDE = emerging market and developing economies. Country abbreviations are International Organization for Standardization (ISO) country codes.

given constrained policy space, already strong health and welfare systems allowed several oil exporters to absorb additional health care costs within existing budget envelopes.

Exchange rate flexibility absorbed part of the shock in some cases. Several countries with flexible exchange rates saw their currencies depreciating early in the pandemic (Armenia, Georgia, Kazakhstan, Kyrgyz Republic, Morocco, Pakistan, Tajikistan, Tunisia), and they have since partially reversed in some cases. To reduce excessive volatility, foreign exchange intervention occurred in a few cases (Armenia, Egypt, Georgia, Kazakhstan, Pakistan).

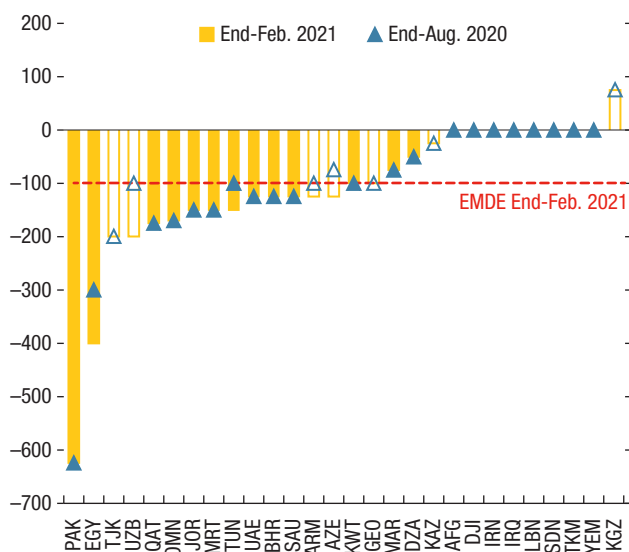
By the end of August, most central banks had also cut their policy rates. After the end of August, five central banks cut rates further, ranging from 25 to 100 basis points: Armenia, Azerbaijan, Egypt, Tunisia, and Uzbekistan (Figure 1.4). Total cuts were especially deep in Pakistan and Egypt, by a cumulative 625 and 400 basis points, respectively. Central banks also cut reserve requirements,

encouraged loan repayment moratoriums, provided liquidity, permitted banks to use their capital conservation buffers, and lowered liquidity requirements.

The Activity Bounced Back, but the Recovery Is Uneven among Sectors and between Countries

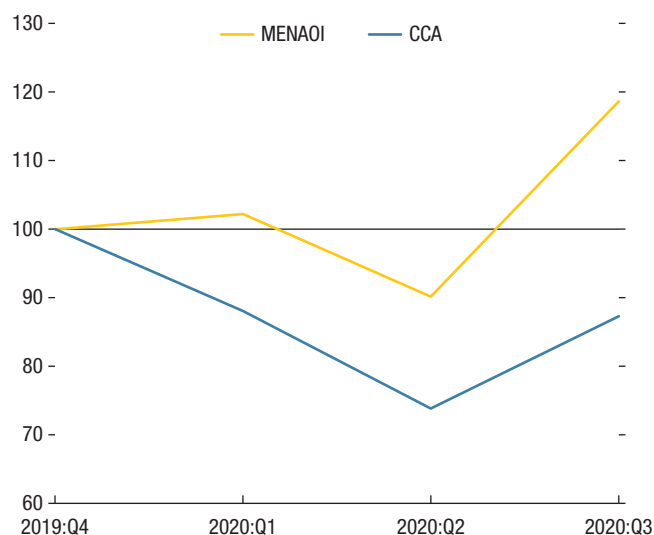
Activity was more resilient during the second half of 2020. The more targeted lockdowns used during the second wave had a smaller impact on mobility, which was reflected on activity. Available real GDP data in the region point to a strong rebound in the third quarter of 2020 as countries relaxed lockdown measures. Most purchasing managers' indices returned to expansionary territory by mid-2020 and continued to signal an upward trend in some oil exporters in late 2020 and early 2021 (Qatar, Saudi Arabia, UAE). However, they showed contraction in some oil importers (Egypt), though less so than

Figure 1.4. Monetary Policy Rate Adjustment
(Change in basis points since end-2019)



Sources: IMF COVID-19 Tracker; and IMF staff calculations.
Note: Filled bars includes Middle East and North Africa countries, and clear bars includes Caucasus and Central Asia countries. EMDE = emerging market and developing economies. Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 1.5. Remittances
(Index, 2019:Q4 = 100)



Sources: Balance of payments; IMF, national authorities; and IMF staff calculations.
Note: Indexed values are derived from amounts in US\$ billion. The data has been seasonally adjusted. CCA = Caucasus and Central Asia, MENAOI = Middle East and Central Asia oil importers.

during the pandemic’s first wave, as lockdowns were reimposed (Lebanon).

Workers’ remittances also held up better than expected. Flows rebounded in the third quarter of 2020 after a sizable drop in the second quarter (Figure 1.5), reflecting a combination of factors, including a broad improvement in third quarter growth in remittance-sending countries, an accelerated switch to formal transfer channels because of border closures, and incentives for electronic transfers (for example, Pakistan). Given seasonal employment patterns in Russia and depreciation of the ruble, the initial decline in Caucasus and Central Asia (CCA) remittances was bigger than in the MENA region.

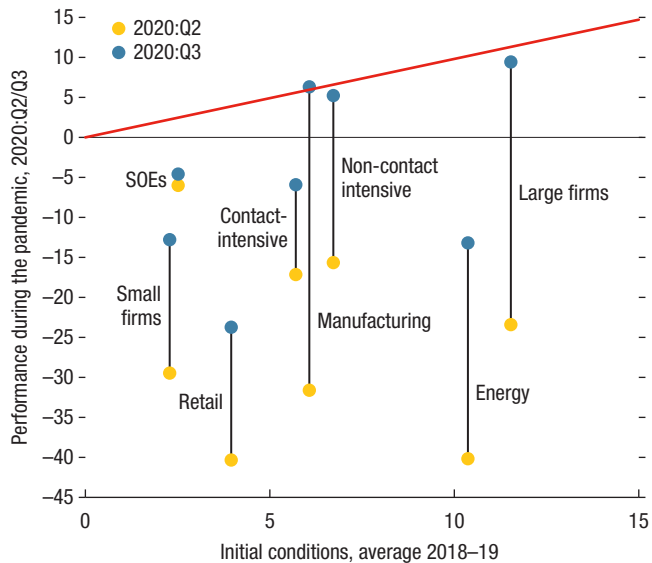
As a result, real GDP for the MENA region is estimated to have slumped by 3.4 percent in 2020, an upward revision of about 1.6 percentage points relative to October 2020 projections, reflecting stronger policy responses across countries and a substantial rebound in the second half of the year, particularly for oil exporters. The CCA region’s

GDP estimates have been upgraded slightly (+0.2 percentage point), displaying a contraction of about 1.9 percent. However, this masks differences across countries, as downgrades in some—mainly caused by specific domestic factors (Armenia, Azerbaijan, Turkmenistan)—were roughly balanced by upgrades elsewhere (Kyrgyz Republic, Tajikistan, Uzbekistan).

Inflation accelerated despite weak demand and lower energy costs. Contrary to emerging market economies elsewhere (excluding India), headline inflation inched up in many countries in the region—partly driven by higher food prices, reduced policy rates, and exchange rate depreciations in some countries—except for the Gulf Cooperation Council, Jordan, and Morocco, where inflation remained subdued.

Labor market conditions remained weak and uneven. Labor market outcomes have deteriorated significantly across the region, especially for youth. Available data on unemployment rates point to persistently high levels in the second half of 2020 after a spike in the first half ranging

Figure 1.6. MENA and Pakistan Firms' Revenue Performance
(Percent, year on year)



Sources: S&P Global Market Intelligence; Compustat; and IMF staff calculations.
Note: Revenue growth is the year on year growth rate of quarterly sales.
MENA = Middle East and North Africa; SOEs = state-owned enterprises.

from 5 percent in Kazakhstan to 25 percent in Jordan. Youth unemployment rates, which were already structurally high before the pandemic in many countries, reached nearly 32 percent in Morocco, 36.5 percent in Tunisia, and 55 percent in Jordan in the fourth quarter of 2020 (between 3 to 10 percentage points above precrisis levels). Firm-level data indicate that wages in contact-intensive sectors (particularly retail), which absorbed more than 55 percent of pre-pandemic private sector employment in the region, fell dramatically in the second quarter of 2020 and are yet to recover, but those of noncontact-intensive sectors (for example, consumer goods and manufacturing) were mildly affected and resumed positive growth in the third quarter. By contrast, wages in state-owned enterprises grew in each of the first three quarters of 2020, likely reflecting government support to state-owned enterprises and public employment.

Corporate rebound was also uneven. Corporations in the MENA region and Pakistan began recovering in the third quarter of 2020 (after a historic contraction during the first half of the

year) in an uneven manner, with contact-intensive sectors (particularly service and retail), smaller firms, and those that entered the pandemic with weaker fundamentals still not posting positive revenue growth. In contrast, noncontact intensive sectors (particularly manufacturing) and large firms have recouped most of their pre-pandemic performance (Figure 1.6).

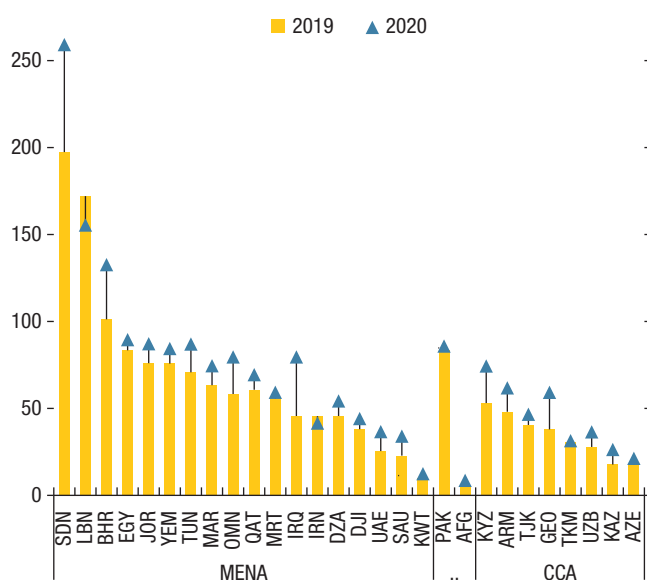
Fiscal accounts deteriorated sharply across the region in 2020, reflecting lower revenue because of contracting domestic demand and the slump in oil prices, as well as policy support measures to mitigate the pandemic's impact. Oil exporters recorded a larger deterioration in their public finances than oil importers did, reflecting lower oil revenue. For the MENA region, fiscal deficits widened to 10.1 percent of GDP in 2020 from 3.8 percent of GDP in 2019. For the CCA, the fiscal balance fell to -5.6 percent of GDP from a surplus of 0.5 percent of GDP in 2019.

Government debt increased sizably to 56.4 percent of GDP in the MENA region, from 47.6 percent in 2019, and to 33 percent of GDP in the CCA, from 25.9 percent in 2019 (Figure 1.7). However, these average levels mask a wide range of country situations, with more than one-third of countries in the Middle East and Central Asia having debt-to-GDP ratios above 70 percent of GDP, most of them in the MENA region. Public gross financing needs are also high (see Chapter 2).

Banks have remained resilient so far, but bank-sovereign links have increased. Banks in the region entered the crisis with relatively strong balance sheets, and capital positions remain at comfortable levels. However, the full impact of the crisis on the sector is yet to be observed, given the continued policy support and regulatory forbearance measures. Furthermore, because a large share of gross public financing needs was financed by domestic banks in 2020, the already significant banks' claims on the public sector increased further, even in net terms for some countries in the MENA region (Chapter 2).

The current account balances of oil-exporting countries deteriorated because of lower oil prices

Figure 1.7. Public Debt
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; and MENA = Middle East and North Africa. Country abbreviations are International Organization for Standardization (ISO) country codes.

and exports. By contrast current account deficits of oil importers improved (except for Georgia), driven by the collapse in domestic demand and the associated import compression, lower import prices (particularly oil), and recovering remittances.

Where Is the Region Heading? Divergent Recovery Paths

Although 2021 growth was revised upward since the October 2020 *Regional Economic Outlook: Middle East and Central Asia*, recovery paths are diverging across the region, depending on vaccine rollouts, exposure to tourism and contact-intensive sectors, and policy space and actions (Figure 1.8).

Vaccine Rollouts Will Be Critical to the Recovery

Early inoculators revised 2021 growth up relative to October projections, with GDP levels expected

to reach 2019 levels in 2022. By contrast, for the slow and late inoculators, GDP levels are expected to go back to 2019 levels sometime between 2022–23.

Policy and Structural Differences Will Also Be Key

Countries where fiscal support was strong during the pandemic experienced a smaller contraction and, therefore, are expected to recover faster than those that did not. Within the region, countries with above-average fiscal support in 2020 are expected to return to pre-pandemic GDP levels in 2022. In contrast, those with below-average support will not see a return to 2019 levels until 2023.

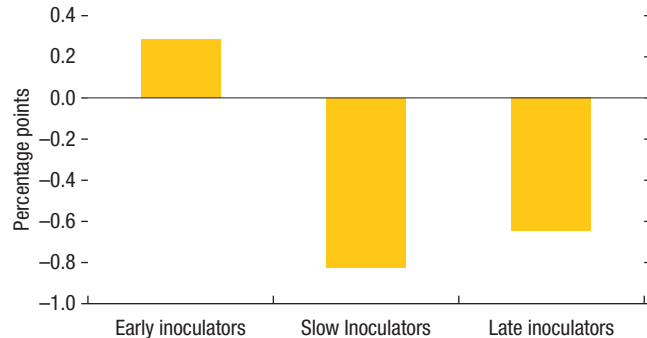
High financing needs could constrain the policy space required to support the recovery, as many countries would need to address fiscal and debt challenges. Average public gross financing needs in 2021–22 in the regions’ emerging markets are expected to remain elevated, reaching 37 percent of GDP in Bahrain and Egypt per year. External amortizations remain at manageable levels, but the median domestic amortization is high at about 10 percent of GDP per year. Such high baseline financing needs could deter further support, with implications for corporate balance sheets and performance, as fiscal support across countries appears positively associated with corporations’ revenue growth, profitability, and liquidity. In addition, since many countries are expected to continue relying on domestic banks to cover most of their budgetary financing obligations, this could lead to further crowding out of private credit.

Fragile and conflict-affected states will continue to face many hurdles that prevent a sustained near-term recovery. In addition to the longer-lasting impact of the COVID-19 shock relative to the rest of the region, given the lack of access to vaccines and policy space, the near-term outlook for these countries will continue to be challenged by ongoing armed conflicts and humanitarian emergencies (Afghanistan, Somalia,

Figure 1.8. The Speed of the Recovery Will Vary across the Region ...

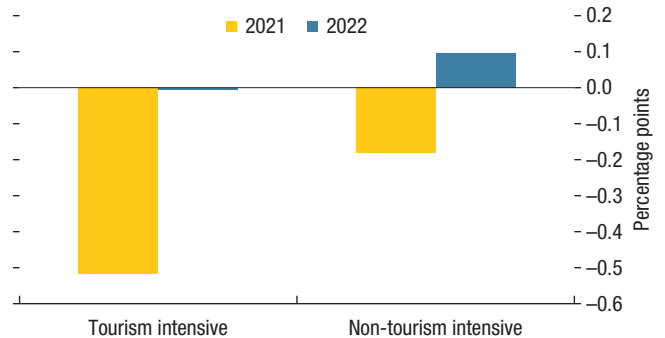
... reflecting vaccination rollout plans ...

1. 2021 Growth Revisions and Vaccine Plans
(Difference in real GDP growth with October 2020, weighted average, excludes fragile and conflict-affected states)



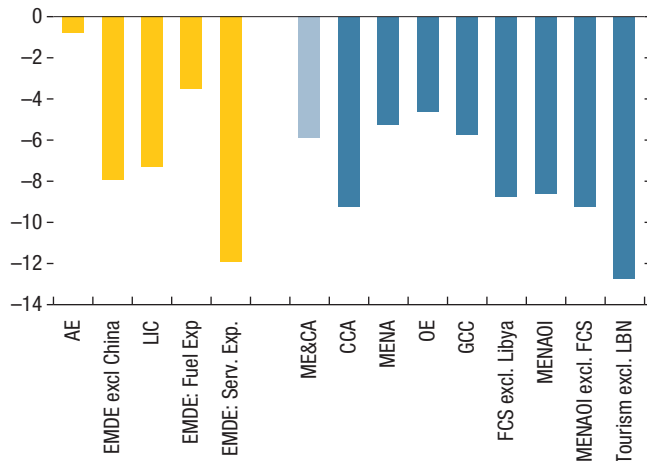
... the relative importance of tourism ...

2. Growth Revisions and Tourism Intensity
(Difference in real GDP growth with October 2020, weighted average)



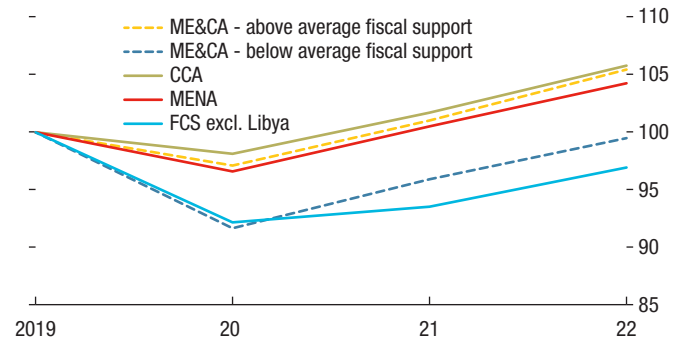
... the potential lasting damage caused by the pandemic ...

3. 2024 GDP Losses Relative to Pre-COVID-19 Projections
(Percent difference)



... and the magnitude of policy responses.

4. Real GDP and Fiscal Support in 2020
(Index, 2019 = 100)



Sources: IMF COVID-19 Policy Tracker; national authorities; and IMF staff calculations.

Note: AE = advanced economies; CCA = Caucasus and Central Asia; EMDE = emerging market and developing economies; FCs = fragile and conflict affected states; GCC = Gulf Cooperation Council; LIC = low-income countries; ME&CA = Middle East and Central Asia region; MENA = Middle East and North Africa; MENAOI = Middle East and North Africa oil importers; OE = oil exporters. Country abbreviations are International Organization for Standardization (ISO) country codes.

Syria, Yemen), and potential economic and political instability (Iraq, Lebanon, Libya, Sudan).

The outlook for contact-intensive services, particularly tourism, will continue to be influenced by restrictions on domestic and international nonessential travel and by mandated and voluntary social distancing measures. Hence, the recovery in countries that depend on these activities is expected to remain subdued in 2021. In particular, the tourism sector is projected to recover gradually sometime between 2022–23 in some countries (Armenia, Jordan, Morocco) and

by the end of 2024 or 2025 in others (Azerbaijan, Georgia, Lebanon).

Over the medium term, GDP levels are expected to remain below those implied by pre-pandemic projections, partly reflecting some lasting damage from the crisis through high unemployment, slower capital accumulation, and weak productivity, among other factors.² The

²See Chapter 2 of the MCD's October 2020 *Regional Economic Outlook* and IMF's Chapter 2 of the IMF's April 2021 *World Economic Outlook*.

amount of scarring is expected to be the largest for tourism-dependent countries and smallest for oil exporters, in line with global trends.

Outlook for Middle East and North Africa, Pakistan, and Afghanistan

Real GDP growth in the *MENA* region is projected to pick up to 4.0 percent in 2021, an upgrade of 0.9 percentage point relative to October. Growth is set to rebound slightly in Pakistan and more strongly in Afghanistan in 2021 (1.5 percent and 4.0 percent, respectively). Over the medium term, real GDP is expected to stay under precrisis projections by nearly 6 percentage points, reflecting smaller output losses in oil exporters than those in oil importers that are broadly in line with the rest of emerging market economies.

Activity in **oil-exporting countries** is set to rebound, reflecting a carryover from the last quarter of 2020, and amplified by the expected pickup in activity in the second half of 2021. Higher oil prices and early vaccine rollouts support the outlook for many Gulf Cooperation Council economies. The recent increase in oil prices will boost confidence, supporting non-oil GDP, which is projected to expand by 3.3 percent in 2021. Oil activity will remain subdued in the short term, reflecting the OPEC+ production curbs and continued US sanctions on Iran. While oil GDP is projected to expand by 5.8 percent in 2021, this primarily reflects the surge in Libya's oil production by +233 percent after the reopening of oil fields and ports in late 2020.

The recovery in **oil importers** is expected to be sluggish in the near term, with growth projected at 2.3 percent in 2021—a downgrade of 0.4 percentage point relative to October. Growth projections for Jordan, Morocco, and Tunisia, which are highly dependent on tourism, have been marked down, but those for Mauritania have been revised up, on the back of stronger expansion in the extractive sector and public investment. Egypt and Pakistan's economies, which were relatively resilient in 2020, are

forecast to experience a sluggish recovery in 2021. Lebanon is the only country in the region where activity is expected to contract further, reflecting the deep economic and financial crisis that has been worsened by the pandemic's second wave. In contrast, Sudan's move toward the Heavily Indebted Poor Countries Decision Point and re-engagement with the international financial community is expected to bring an end to the contraction in previous years and bolster confidence and activity in the medium-term.

Inflation in the region is forecast to increase to 12.8 percent in 2021, because of higher food prices in countries where food makes up a large share in the consumption basket, higher energy prices in oil-importing countries, pass-through of depreciations in some countries (Iraq, Lebanon, Yemen), and monetary financing in others (Lebanon, Yemen). Inflation is expected to remain at double-digits in fragile and conflict-affected states (Lebanon, Libya, Sudan, and Yemen) driven by domestic macroeconomic instability.

With the recovery underway, **fiscal balances** are expected to improve across the region, because of higher revenues and the expiration of pandemic-related measures, and the resumption of fiscal consolidation in some countries (for example, Egypt, Iraq, Jordan, Oman, and Pakistan) with elevated debt burdens. Nonetheless, oil importers are projected to record a more modest improvement in their fiscal deficits this year, as growth remains moderate. In contrast, the fiscal balances for oil exporters are expected to improve significantly, reflecting higher oil revenue.

The increase in oil prices is expected to markedly improve oil exporters' **external position**. Their current account balance is projected to increase by \$128 billion. In contrast, oil importers' current account deficit is forecast to slightly widen, due to higher oil prices and rising domestic demand. More broadly, however, tourism is expected to remain a drag on many economies in the near term.

Outlook for Caucasus and Central Asia

In 2021, growth in the *CCA region* is expected to recover the lost ground since the pandemic, while inflation is forecast to decelerate, fiscal deficits to decline, and external accounts to benefit from the global recovery. Output is projected to rise by 3.7 percent in 2021, returning to its precrisis level because of strong policy support last year. Growth is expected to pick up pace next year and reach 4.0 percent in 2025, with medium-term GDP levels remaining below their precrisis projections by about 9 percentage points, broadly in line with emerging market projections.

Activity in the region's **oil and gas exporters** is projected to grow broadly at the same pace as projected in October, with GDP expanding by 3.7 percent. Activity in Azerbaijan will be mildly adversely affected by oil production cuts under OPEC+ agreements, but Kazakhstan could increase its oil production. Uzbekistan is expected to benefit from a rebound in the mining sector and in transportation and hospitality.

Growth in the rest of the region has been marked down significantly, reflecting a downward revision in Armenia, because of the conflict last year and the prolonged and deep effects of the pandemic's second wave and weak tourism. Real GDP is expected to grow at a slower pace than previously forecast in Georgia and Kyrgyz Republic, due to the impact of the pandemic's second wave and continued weakness in tourism.

Inflation is forecast to decelerate to 6.9 percent in 2021, after a rebound due to higher food prices last year and currency depreciation. High food and energy prices are expected to push inflation up in some countries, but underlying price pressures are expected to remain contained, because of the large economic slack.

Fiscal deficits are forecast to decline by 2.4 percentage points of GDP to 3.2 percent of GDP in 2021, reflecting stronger improvement in oil and gas exporters on account of higher oil and non-oil and gas revenue, and the expected

expiration of fiscal support programs. The decline in fiscal deficits of oil importers is expected to be more modest and driven by the rebound in activity.

The **external accounts** are foreseen to benefit from a rebound in global demand, higher oil prices for oil exporters and recovering remittances, but tourism will likely remain a drag. The current account deficit is expected to drop by about 1.5 percentage points to 2.1 percent of GDP this year, mainly driven by improvement in oil and gas exporters, while the current account deficit of oil importers is set to remain broadly unchanged.

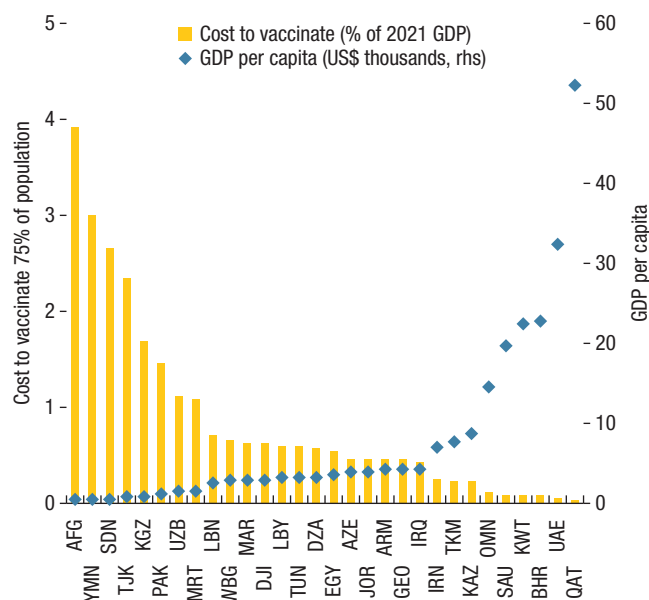
Exceptional Uncertainty Around the Outlook

The speed of the recovery could be faster if vaccine production is expanded and distribution accelerated—supported by global and regional cooperation. In such a scenario, growth in the region would be boosted by roughly $\frac{1}{4}$ percentage point in 2021, accelerating to an additional $\frac{3}{4}$ percentage point in 2022. Although the cost of vaccinations, particularly for LICs, could be non-negligible, the benefits would far outweigh such costs (Figure 1.9).

In contrast, new infections and variants could lead to renewed lockdowns. This risk would increase if vaccinations are delayed. Continued infections would also present difficult choices for exiting policy support, raising further government debt and financing risks.

The region remains vulnerable to a rapid rise in US bond yields. Further rapid increases in US rates could lead to tighter global financial conditions, renewed capital outflows, and higher sovereign spreads. Although comfortable reserve levels provide support for the region's emerging markets, vulnerabilities for countries with elevated external debt and limited fiscal space are higher. In addition, portfolio flows to the region have historically been almost twice as sensitive to changes in global uncertainty, and during earlier episodes markets have differentiated

Figure 1.9. Vaccination Costs vs GDP per Capita
(Percent of 2021 GDP, US\$ '000s)



Sources: World Bank; and IMF staff calculations.

Note: Assumes a cost of \$27 to fully vaccinate one person, based on a COVAX dose price of about \$11, and including transportation, cold-chain storage, and supply and delivery costs. rhs = right hand scale. Country abbreviations are International Organization for Standardization (ISO) country codes.

countries according to fundamentals and external buffers.^{3,4} Given domestic banks' already high exposure to government debt, particularly among oil importers, such a tightening would raise governments' reliance on financing from domestic banks. This, in turn, could further crowd out credit to the private sector at a time of heightened private financing needs, weighing down recovery prospects and threatening financial stability (Chapter 2).

Premature removal of policy support could lead to increased bankruptcies. Countries where emergency measures are set to expire in 2021 and

³See Chapter 4 of the October 2019 Regional Economic Outlook: Middle East and Central Asia.

⁴During the taper tantrum period of 2013, the region experienced sizable capital outflows, peaking at US\$2.7 billion cumulatively (over 11 months). Despite the recent capital outflows, since the end of January 2021, the region has experienced capital inflows of US\$490 million until mid-March, and spreads have remained low. Relative to the taper tantrum, external and public debt ratios are higher and fiscal accounts are more stretched, but reserve buffers are also stronger.

have little available policy space need to closely monitor the speed of the recovery. Withdrawing support too early could further weigh down corporations (particularly small ones and those in contact-intensive sectors) and households, potentially leading to bankruptcies, defaults, and higher unemployment. Weaker corporate and household balance sheets are already likely to increase nonperforming loans, which could potentially threaten financial stability.

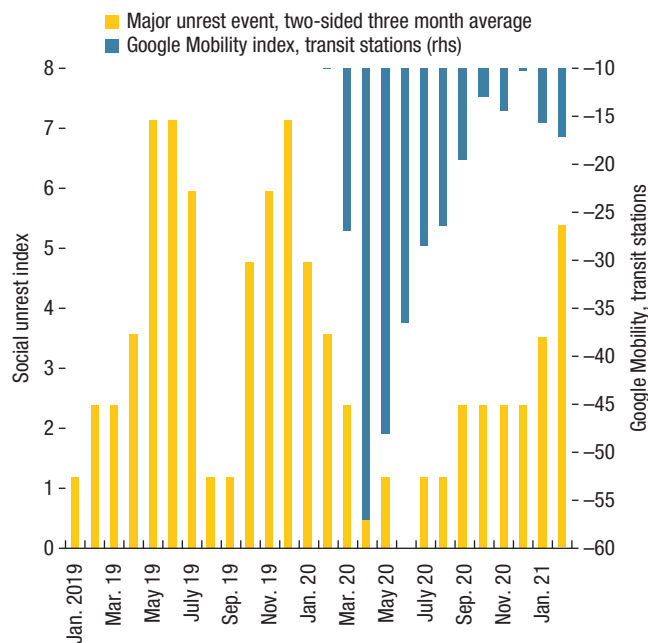
Incipient rise in social unrests⁵ due to lockdown fatigue and associated economic impact—particularly in countries with limited policy space—could accelerate (Figure 1.10). In fragile and conflict-affected states, where food storage infrastructure is weaker, volatility in food prices, and/or uneven access to vaccination could play a key role in triggering unrest while raising risks of food insecurity, with humanitarian consequences.

In the long term, the biggest risk is that an unequal recovery leads to a persistent widening of inequality. The pandemic has laid bare challenges in access to basic services and disproportionality affected the vulnerable, including youth and women and small firms. This, in turn, could increase poverty and cause income gaps that persist across generations, including between formal and informal sectors. In addition, without policy action, debt overhang and scarring from unemployment, bankruptcies of otherwise viable firms, and difficulties shifting to new sectors could add to existing vulnerabilities and lead to long-lasting anemic growth and increasing poverty. The result could be further social unrest, reinforcing a vicious cycle.

Balancing Act: How Should Countries Manage the Crisis and Accelerate Recovery...

2021 will be the year to shape the recovery and lay the groundwork for more inclusive, resilient, and green economies. The immediate challenges

⁵See Box 1.4 in Chapter 1 of the October 2020 World Economic Outlook.

Figure 1.10. Mobility and Social Unrest in ME&CA

Sources: Factiva; Google Mobility Reports; and IMF staff calculations.
 Note: ME&CA = Middle East and Central Asia region; rhs = right hand scale.

are formidable: as countries continue to save lives and livelihoods, they need to strike the right balance between fostering the recovery and safeguarding debt sustainability and financial stability. Lifelines should remain in place until recovery is entrenched, but need to be efficient and focused, since policy space is running thin for many countries. At the same time, the region must tackle transformational challenges to lay the groundwork for sustainable, inclusive, job-rich, and greener economies, by leveraging accelerating trends such as digitalization. International and regional cooperation should support strong domestic policies.

Saving lives and livelihoods remains a top priority. Improving the distribution of vaccines while ensuring that health systems remain adequately resourced is crucial to saving lives and minimizing the impact on livelihoods. While vaccine rollouts are proceeding, targeted local restrictions might be necessary to stem new flare-ups in virus cases.

For countries with some fiscal space (some CCA countries [Azerbaijan, Kazakhstan, Turkmenistan], some oil exporters [Kuwait, Qatar, UAE], and Mauritania, and Morocco) policy should remain flexible to respond to recurrent outbreaks with health, economic, and fiscal contingency plans. Well-targeted support should remain in place until the recovery is entrenched because derailing the recovery would risk future fiscal costs. If recovery is stronger than expected, countries should use available space to rebuild buffers.

For countries without fiscal space, support will require a careful balancing act to preserve debt sustainability. Fiscal consolidation will already begin in 2021, partly reflecting expiring measures and recovering revenues, and should be anchored on a credible, medium-term fiscal plan that relies on improved revenue mobilization—reining in tax exemptions, broadening the tax base—and higher spending efficiency, including through gradually eliminating subsidies and containing high wage bills. Expenditure reprioritization will be key to meet short-term needs. Any new targeted lifelines should be balanced with offsetting measures elsewhere. Because debt and financing risks have risen, countries should bolster their debt management strategies to address emerging liquidity risks, mitigate rollover and refinancing risks, expand the investor base, and monitor and prevent the materialization of contingent liabilities, including from the off-budget support provided during the pandemic.

For all countries, further support should be well targeted, distributed fairly, and focused on the post-COVID-19 economy. To limit the leakage of benefits while reaching those most in need, countries should explore implementation of proxy-means testing, together with options such as mobile money, in-kind transfers, cross-matching beneficiary databases, and the use of community-based methods. For firms, support should be limited to cases of market failure while leveling the playing field between state-owned enterprises and the private sector. Lastly, support policies should also encourage a shift to a

post-COVID-19 world through, for example, vocational training and hiring incentives.

Countries should also balance complementarities and substitutions between fiscal and monetary and financial measures. The choice between further monetary measures versus fiscal support should consider countries' fiscal space, the effectiveness of monetary transmission, and the evolution of domestic and global financial conditions. For countries with flexible exchange rates and well-anchored inflation expectations (some CCA countries and Egypt), central banks should maintain an accommodative stance but remain attentive to inflation risks (including from international food prices) and tightening of financial conditions. Exchange rate flexibility can act as an important buffer, and balance sheet effects should be monitored, especially for several highly dollarized CCA countries.

A gradual exit from targeted support will be key to ensure the financial sector's supportive role in private sector recovery. Given that balance-sheet vulnerabilities persist for contact-intensive sectors and smaller firms, liquidity support should continue to distressed, but viable, borrowers. Policymakers should continue supporting private credit growth while mitigating, over time, banks' overexposure to the sovereign and pursuing debt market development. Despite the banking sector's continued resilience, close monitoring of loan performance and corporate leverage, as emergency policies are withdrawn, will be important to preserve financial stability.

Global and regional cooperation regarding vaccine access would help cement the post-COVID-19 world. The strength of the global and regional recovery will hinge on the pandemic being under control everywhere. Hotspots anywhere in the world will imply risks of further variants. Therefore, countries' excess supplies (including from ramped-up domestic production) should be distributed to countries with insufficient supplies under the COVAX initiative, whose funding and coverage should be bolstered swiftly. In addition, improved vaccine contract transparency would ensure that countries are accessing them

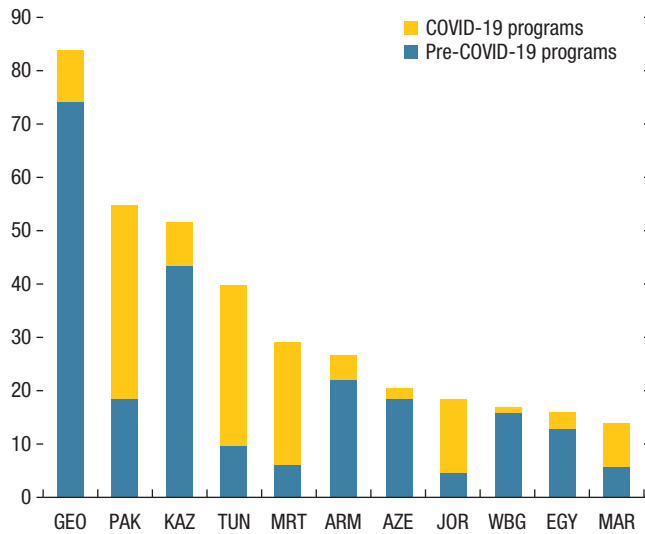
on reasonable terms. Low-income countries and fragile and conflict-affected states in the region will likely face logistics and distribution challenges with vaccine rollouts; regional sharing of expertise, equipment, and surplus vaccines could help ensure that these countries do not fall behind. As countries pivot from the crisis towards recovery, the IMF, which supported the region with more than \$17 billion in financing in 2020, will remain a steadfast partner through financing, technical assistance, and policy advice, in addition to coordinating support from international and regional institutions.

... While Building Forward Better

Policymakers cannot afford to lose sight of deep-seated transformational challenges, including tackling inequality, poverty, and corruption; promoting private sector jobs; addressing climate change; and improving governance. While some countries in the region have kept the course of reform even during the pandemic (Egypt, Jordan, Kazakhstan, Uzbekistan), now is the opportunity for bolder reforms, supported by growth-friendly, medium-term fiscal frameworks through which everyone pays their fair share. A new social contract should be put in place with more private sector jobs, and enhanced governance, transparency, and accountability for governments. Reforming the large public sector and state-owned enterprises would provide room for the private sector to grow and for the public sector to deliver better outcomes and help ensure fiscal sustainability. Labor market reform to reduce distortions favoring public sector jobs, reducing informality, and ensuring the creation of high-value-added jobs in the private sector, will shift economies away from the public sector employment paradigm. Streamlining rules while ensuring their fair enforcement and strengthening anti-corruption frameworks would enhance the population's trust in the government.

Boosting the efficiency of social spending, even without increasing spending, could help close up

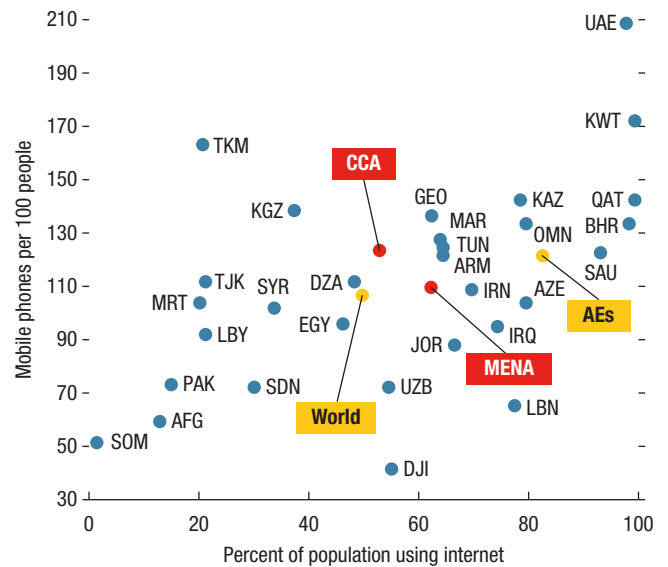
Figure 1.11. Coverage of Cash Transfer Programs
(Percent of population)



Sources: World Bank; and IMF staff calculations.
Note: Pre-COVID coverage rates are the last available for each country. Coverage denotes the proportion of beneficiaries versus total population. Country abbreviations are International Organization for Standardization (ISO) country codes.

to one-third of the region’s Human Development Index gap, according to IMF research. Lessons should be drawn from accomplishments during the pandemic, which saw important expansion of more targeted and conditional social assistance programs in the region (Figure 1.11). Enhancing access to technology and digitalization could help bolster reforms in all areas while ensuring that the region takes full advantage of important global trends. As the crisis abates, work should begin on reassessing emergency registries as countries enhance their social protection systems and make them more responsive for future shocks. Promoting financial access and investing in internet infrastructure (Figure 1.12), where needed, in particular, will be crucial to ensure that countries in the region have wide-reaching and well-targeted safety nets.

Figure 1.12. Internet Access and Mobile Penetration



Sources: World Development Indicators (WDI); and IMF staff calculations.
Note: AEs = advanced economies; CCA = Caucasus and Central Asia; MENA = Middle East and North Africa. Country abbreviations are International Organization for Standardization (ISO) country codes.

Climate change is already leaving its mark on the region, including through more frequent and intense extreme heat events and water stresses. These challenges are likely to deepen, highlighting the urgent need to identify policy priorities for adaptation and invest in climate-resilient infrastructure. The region’s oil exporters face the additional challenge of making the transition away from oil dependence as the world progressively shifts away from fossil fuels. Rebuilding financial buffers and pursuing economic and fiscal diversification while ameliorating any negative distributional impact on households, are key policy priorities in this regard. The current juncture provides an opportunity to leverage recovery programs, public spending, and regulations to help mitigate the impact of climate shocks. If managed correctly, the green transition could provide important employment and investment opportunities for the region.

Government Debt and Financing Legacy

Risks from the Pandemic

The coronavirus (COVID-19) crisis led to a surge in government debt and financing needs as many countries in the Middle East and Central Asia reacted swiftly to mitigate the pandemic's impact. Although several of these countries successfully accessed international financial markets, domestic banks covered a significant share of emerging markets' financing needs, further expanding their already significant exposure to the public sector. By contrast, most low-income countries (LICs) had a small response to the crisis because of financing and policy space constraints. Looking ahead, public gross financing needs in most emerging markets in the Middle East and Central Asia are expected to remain elevated in 2021–22, with downside risks in the event of tighter global financial conditions and/or if fiscal consolidation is delayed due to weaker-than-expected recovery. However, further reliance on domestic financing will reduce banks' ability to support the private sector's emergence from the crisis, thus prolonging the recovery. Credible medium-term fiscal and debt management strategies, together with policy actions to develop domestic capital markets and mitigate banks' overexposure to the sovereign would reduce financing risks, address the elevated debt burdens, and entrench financial stability.

Context: Pre-COVID-19 Landscape

Several countries in the Middle East and Central Asia entered the pandemic with elevated government debt and financing vulnerabilities, as the global financial crisis and the 2014–15 oil shock had reversed gains in debt reduction. By the end of 2019, one-third of countries had

Prepared by Middle East and Central Asia Department's debt working group. The authors of this chapter are Cesar Serra (lead), Jeta Menkulasi, Lawrence Norton, Sidra Rehman, and Suchanan Tambunlertchai, with excellent support from Tucker Stone and Jawed Sakhi.

government debt ratios above 70 percent of GDP, and five faced public gross financing needs above 15 percent of GDP.¹ Lebanon was in default, three LICs were in debt distress (Somalia, Sudan, Yemen),² and four were assessed at high risk of debt distress (Afghanistan, Djibouti, Mauritania, Tajikistan).

The debt holding structure in the Middle East and Central Asia's emerging markets reflects an undiversified and underdeveloped investor base, with a concentration of government debt holdings in the banking sector. These countries have relied on domestic creditors to cover a significant share of their budgetary financing needs. Among them, domestic banks have been the dominant investors (accounting for 81 percent of domestic debt, excluding central bank holdings), and, in a few cases, central banks have also played an important role (Figure 2.3, panel 1). Structural excess liquidity in some countries, incipient secondary markets and underdeveloped institutional investors in others, and limited alternative investments have created incentives for banks to hold government bonds to maturity, hindering domestic debt market liquidity and development.

The overexposure of domestic banks to the sovereign in several of the Middle East and Central Asia's emerging markets rose significantly after the global financial crisis and especially the 2014–15 oil shock. This exposure reflects not only lending to the general government but also to the large and important state-owned enterprises, and, in Lebanon, also to the central bank. Before

¹Public gross financing needs are defined as the sum of the overall fiscal deficit and government debt amortization. For the purpose of this chapter, emerging markets in the Middle East and Central Asia include emerging market and middle-income economies and oil exporters. LICs include Afghanistan, Djibouti, Kyrgyz Republic, Mauritania, Somalia, Sudan, Tajikistan, Uzbekistan, West Bank and Gaza, and Yemen. Libya and Syria are excluded because of lack of data, and data for Somalia, Sudan, and Turkmenistan are partial.

²Yemen's risk rating of external debt distress was assessed as high at the time of the last Debt Sustainability Analysis prepared in 2016. Since then, however, Yemen has accumulated external arrears.

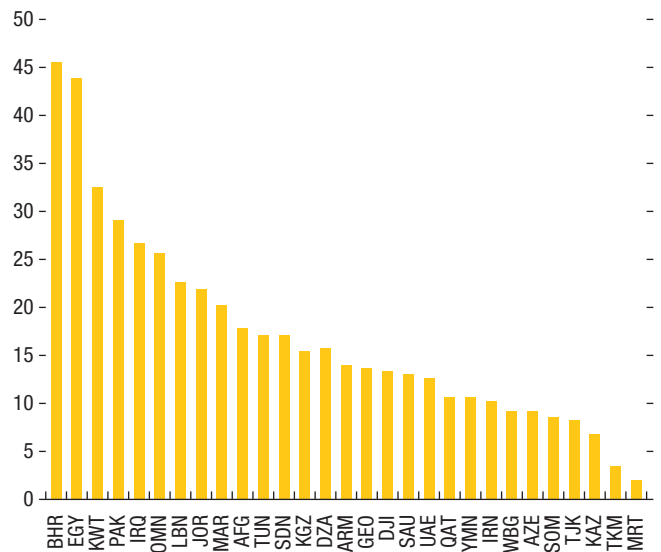
the COVID-19 crisis, domestic banks' exposure to the sovereign was above 20 percent of total banks' assets in Iraq, Jordan, and Qatar, reaching above 45 percent in Algeria, Egypt, and Pakistan, and up to 60 percent in Lebanon. By contrast, banks in other emerging markets had a public sector exposure of about 12 percent (Figure 2.3, panel 2). Such an overexposure is detrimental for domestic debt market development, as well as for the government and the private sector to secure financing at the lowest possible cost among a diversified pool of creditors.

Private external financing to governments in the Middle East and Central Asia has been more limited, given that only a few countries have been able to tap markets in a sustained manner. Official creditors have historically played an important role. In LICs, official creditors hold about 80 percent of government debt, with a growing share owed to non-Paris Club creditors (about 45 percent of external government debt).

A Year After the Start of the Pandemic: Vulnerabilities Are Rising

The pandemic's effect on revenue and the response to mitigate its impact led to a generalized widening of deficits in 2020, despite expenditure reprioritization efforts. Compared with pre-pandemic forecasts, primary deficits widened, on average, by 7 percent of GDP. Although some countries were able to contain debt issuance by using government deposits (Algeria, Azerbaijan, Oman, Qatar, Saudi Arabia, Tunisia, UAE) and/or sovereign wealth funds (Algeria, Azerbaijan, Bahrain, Kazakhstan, Kuwait, Oman, UAE), the combination of higher deficits and the economic contraction led to an average increase of 9 percentage points in the debt-to-GDP ratio. By the end of 2020, thirteen countries had government debt exceeding 70 percent of GDP (compared with nine by the end of 2019). Fourteen countries, compared with five in pre-pandemic times, had public gross financing needs exceeding 15 percent of GDP (Figure 2.1).

Figure 2.1. Public Gross Financing Needs, 2020¹
(Percent of GDP)



Sources: Country authorities; IMF World Economic Outlook; and IMF staff calculations.

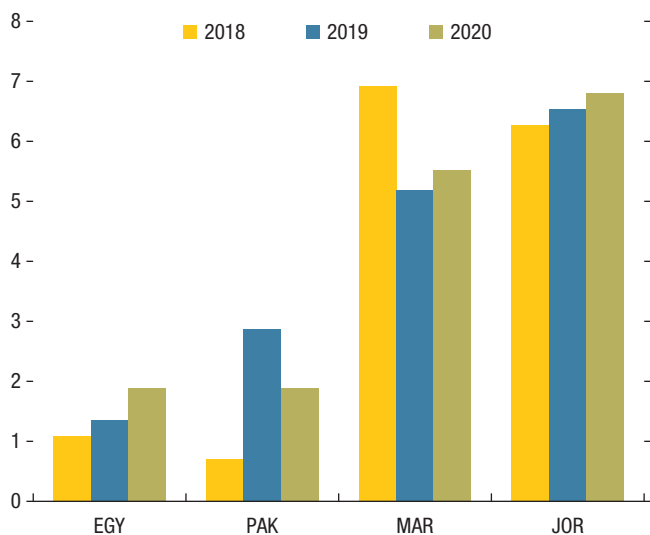
Note: Country abbreviations are International Organization for Standardization country codes.

¹Primary balance excludes donor grants for low income countries.

Higher domestic bank financing strengthened the sovereign-bank nexus in most of the Middle East and Central Asia's emerging markets. Similar to past trends, domestic banks played a key role in funding governments in 2020, covering more than 50 percent of public gross financing needs in Bahrain, Egypt, Jordan, Pakistan, and Tunisia. Adding central bank financing, the overall banking sector's share also reached more than 50 percent in Armenia, Iraq, and Lebanon. Although domestic financing was critical during the first phase of the crisis when international capital markets were disrupted, it intensified the sovereign-bank nexus in most cases (Figure 2.3, panels 2 and 3).

Countries increased domestic borrowing amid local currency yield curves shifting downwards, reflecting monetary policy easing over 2020. Some countries relied heavily on shorter-term domestic financing, reflecting borrowing cost considerations and nascent domestic markets for long-term instruments (for example, Egypt and Pakistan), but others issued long-term domestic bonds and

Figure 2.2. Average Maturity at Issuance of Local Currency Bonds
(Years, weighted by issuance)



Sources: Country authorities; Bloomberg Finance L.P.; and IMF staff calculations.

secured savings for years ahead (for example, Jordan and Morocco) (Figure 2.2).

One-third of the countries in the Middle East and Central Asia tapped into international markets, benefiting from favorable conditions, but some faced substantial volatility. Ten countries tapped markets since early 2020 (Armenia, Bahrain, Egypt, Jordan, Morocco, Oman, Qatar, Saudi Arabia, UAE, Uzbekistan), representing 26 percent of emerging market issuances (compared with their combined weight of 6 percent in emerging markets' GDP), but external financing relative to needs was limited in most cases (accounting, on average, for 20 percent of public gross financing needs). Favorable conditions not only helped these countries access markets but also increase the maturity on their placements. Notably, the average maturity of non-investment-grade issuances in the Middle East and Central Asia was like that of other non-investment-grade emerging markets, closing a gap that had persisted in previous years. Borrowing costs also gradually came down after the initial period of turmoil, reflecting the easing of global financial conditions. Nevertheless, average coupon rates for both investment-grade

and non-investment-grade issuers in the Middle East and Central Asia for 2020 were slightly higher than in similar emerging markets elsewhere (Figure 2.4).

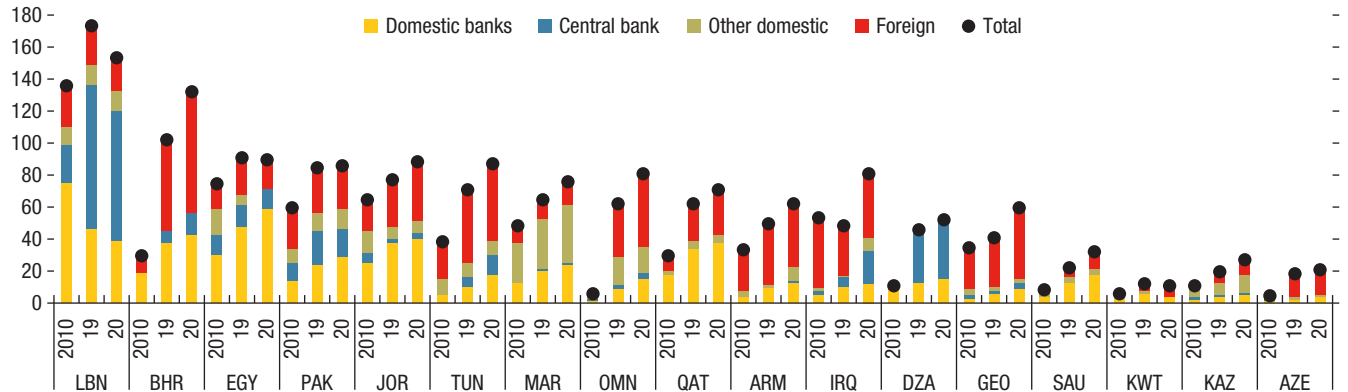
Nonresident participation in local currency government debt markets remained negligible in most countries in the Middle East and Central Asia. However, those exposed to short-term nonresident flows to local currency debt markets experienced substantial volatility during the year. For example, Egypt and Pakistan saw heavy outflows as foreign investors exited their positions in domestic government securities during March–May (amounting to more than \$15 billion and \$2.5 billion, respectively). In Egypt, prudent macroeconomic policies and high real yields supported the reversal of earlier outflows by year's end, despite a 400-basis-point reduction in policy rates. In Pakistan, foreign investors have not yet returned in significant volumes.

Most LICs in the Middle East and Central Asia had a small response to the crisis given financing constraints, relying on official and central bank financing. In 2020, the median increase in the primary deficit for this group was 2 percent of GDP, despite the significant challenges these countries faced from the pandemic, reflecting financing constraints and a lack of policy space. More worrying, countries most in need of spending (with a low Sustainable Development Goals index) cut their nominal expenditures markedly compared with pre-pandemic projections (Figure 2.5, panel 1).

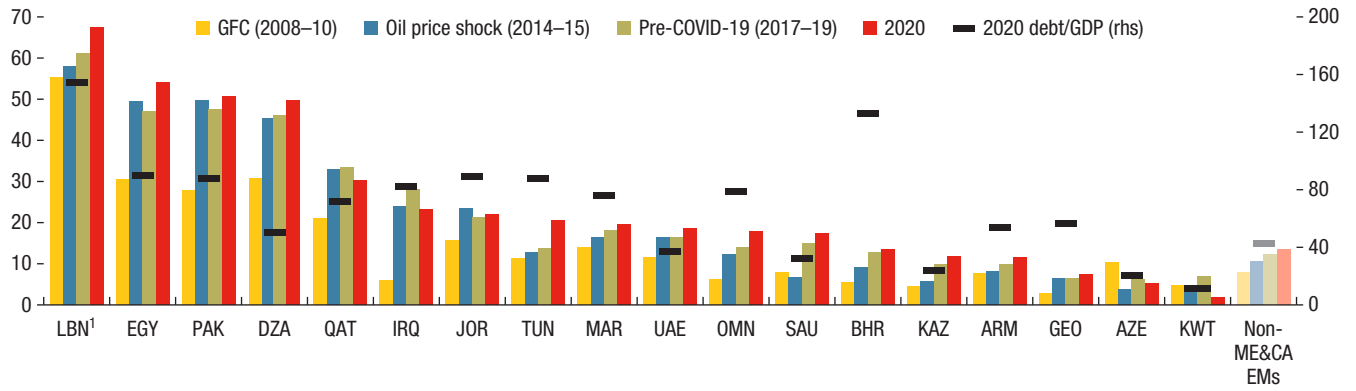
To a large extent, international efforts helped ease some of the immediate financing constraints. The IMF provided \$1.7 billion in overall financing to LICs in the Middle East and Central Asia, and other official donors contributed \$3.9 billion. Additionally, these countries benefited from debt service relief under the Group of Twenty Debt Service Suspension Initiative (DSSI), the IMF's Catastrophe Containment and Relief Trust, and, in Somalia, debt relief under the Heavily Indebted Poor Countries initiative. Notwithstanding these efforts, a few countries and territories (Sudan, West Bank and Gaza, Yemen) received lower

Figure 2.3. Debt, Financing, and the Sovereign-Bank Nexus in ME&CA's Emerging Markets

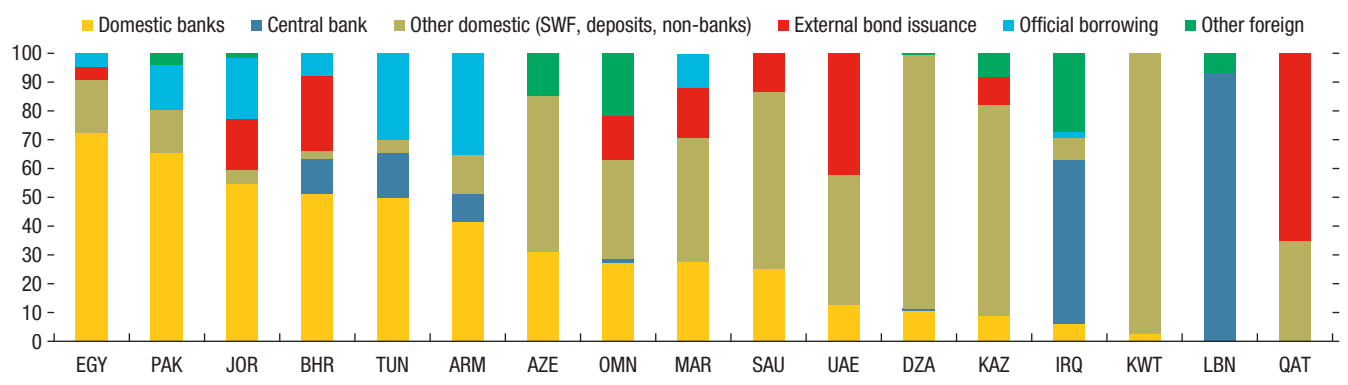
1. Government Debt Structure by Creditor (Percent of GDP)



2. Domestic Banks' Claims on the Public Sector (General Government and SOEs) (Percent of total banking system assets)

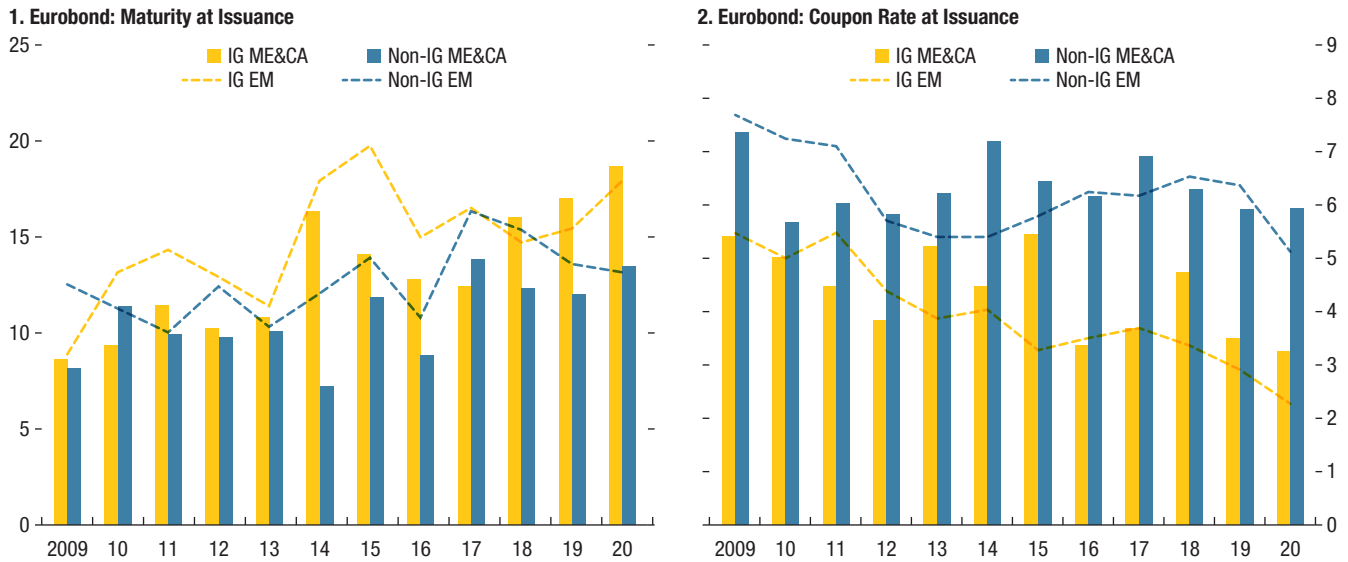


3. 2020 Public Gross Financing Sources (Percent)



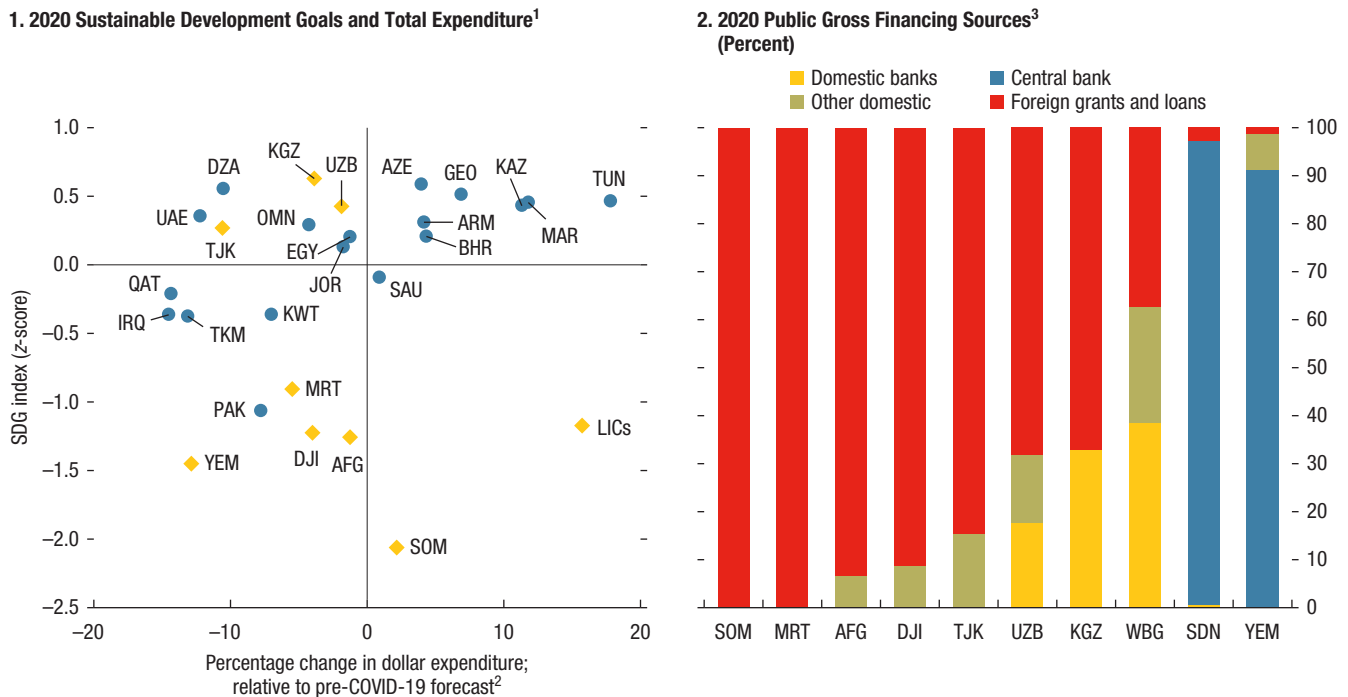
Sources: IMF International Financial Statistics; IMF World Economic Outlook; and IMF staff calculations.
 Note: GFC = global financial crisis; ME&CA = Middle East and Central Asia; SWF = sovereign wealth fund. Country abbreviations are International Organization for Standardization country codes.
¹For Lebanon, it refers to banks' claims on the public sector, including the Central Bank, as a share of total banking system assets.

Figure 2.4. International Market Access in ME&CA
(Weighted average)



Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: EM = emerging market; IG = investment grade; ME&CA = Middle East and Central Asia.

Figure 2.5. Limited Financing Constrained ME&CA-LICs Response to the Crisis



Sources: Sustainable Development Goals index database; IMF World Economic Outlook; and IMF staff calculations.
Note: LIC = low-income country. Country abbreviations are International Organization for Standardization country codes.
¹Iran, Lebanon, and Sudan are excluded.
²Pre-COVID-19 forecasts refer to January 2020 *World Economic Outlook* projections.
³External financing was secured from official sources except in Uzbekistan, which received both official and market financing.

Table 2.1. 2021–22 Public Gross Financing Needs and Sources (\$, billions)

	Overall Public Gross Financing Needs	Gross Domestic Sources	Gross External Sources
ME&CA-EMs	1,070	862	208
<i>of which: GCC</i>	248	130	118
ME&CA-LICs	29	11	19
Memorandum Items:			
ME&CA	1,100	873	227
MENA	919	735	185
CCA	27	15	11

Source: IMF staff estimates.

Note: CCA = Caucasus and Central Asia; EM = emerging market; GCC = Gulf Cooperation Council; LIC = low-income country; ME&CA = Middle East and Central Asia; MENA = Middle East and North Africa.

grants in 2020 compared with pre-pandemic expectations or, in some cases (Kyrgyz Republic, Sudan, Yemen), less than in 2019. Also, given limited external financing, a few LICs had to resort to central bank financing (Sudan, Yemen) (Figure 2.5, panel 2).

Financing Risks Ahead

Public gross financing needs are projected to increase during 2021–22, compared to pre-pandemic expectations. In the Middle East and Central Asia’s emerging markets, financing needs would increase to \$1,070 billion during 2021–22, from \$784 billion in 2018–19 (Table 2.1). These countries expect to cover these financing needs through \$862 billion from domestic creditors and \$208 billion from external sources. By contrast, LICs’ financing needs would slightly increase to \$29 billion during 2021–22 from \$27 billion in 2018–19. These countries will continue to rely on official financing but are projected to increasingly draw on domestic sources as the availability of external support remains limited.

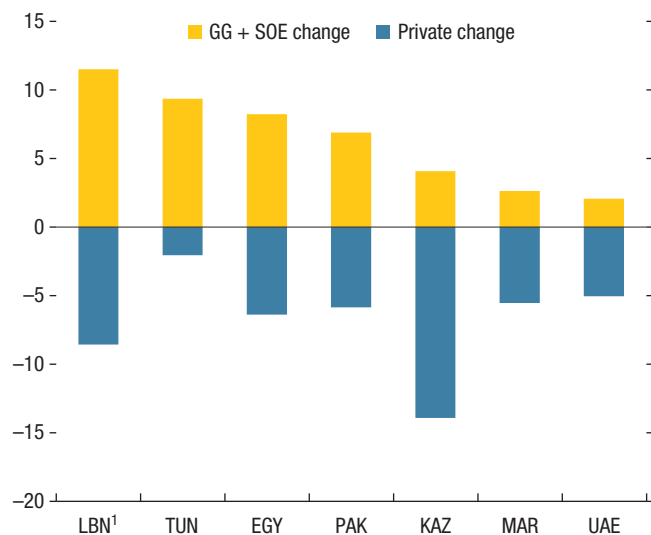
Average public gross financing needs during 2021–22 are expected to remain higher than 15 percent of GDP in most of the Middle East and Central Asia’s emerging markets. The median external debt amortization is low (about 4 percent of GDP), but rollover and refinancing risks of domestic debt are high, given the elevated domestic amortization in some countries, rising higher than 15 percent of GDP in Bahrain, Egypt,

and Pakistan (Figure 2.7, panel 1). In LICs, public gross financing needs are projected at an average of about 9 percent of GDP during 2021–22.

Since prospects for heavily tapping international markets are limited, domestic banks will need to continue covering a large share of the Middle East and Central Asia emerging markets’ high public financing needs in the years ahead. This could lead to further crowding out of private sector credit in several countries—as was evident after the 2014–15 oil shock—at a time of heightened private financing needs, with implications for the recovery ahead (Figure 2.6). In turn, a prolonged recovery and possible scarring of small and medium enterprises and the corporate sector more broadly in the aftermath of the pandemic could increase nonperforming loans, further reducing banks’ ability to provide needed financing to the economy. In a few countries, this could give rise to another round of monetary financing, intensifying fiscal dominance concerns. Lebanon’s experience highlights how exacerbated sovereign-bank interlinkages can derail macro, financial, and fiscal stability.

To what extent could financing risks be exacerbated in the case of shocks? A key question, particularly in emerging markets, is whether domestic banks will still be able to absorb the expected additional financing needs during 2021–22 and how large the demand for additional financing could be in the case of shocks if further reliance on the domestic banking sector is the only available option. A combined scenario including two shocks is considered:

Figure 2.6. Bank Credit Exposure to the Public versus Private Sector
(2013–20 percentage points change, percent of banking system assets)



Sources: Country authorities; IMF International Financial Statistics; IMF World Economic Outlook; and IMF staff calculations.

Note: GG = general government; SOE = state-owned enterprise. Country abbreviations are International Organization for Standardization country codes.

¹For Lebanon, the yellow bar refers to bank claims on GG, SOE and Central Bank.

- Faster-than-expected tightening of global financial conditions. Such a scenario would lead to revisions in pricing and quantity of market access. Yields (domestic and external) are shocked by 200 basis points, broadly similar to the impact on the Middle East and Central Asia's emerging markets during the 2013 "taper tantrum" and other high volatility episodes. The scenario also applies a rollover shock, whereby only one-half of maturing external bonds are rolled over during 2021–22, in line with stress testing in the recently revamped IMF Debt Sustainability Framework for Market Access Countries.
- Delayed fiscal adjustment. Countries expect to start gradual consolidation in 2021, but the fragile recovery and a prolonged rollout of vaccines may lead to lower-than-expected revenues and the extension of policy support in 2021. This scenario assumes that planned fiscal adjustment is delayed by one year, with the adjustment in 2021 shifting to 2022.

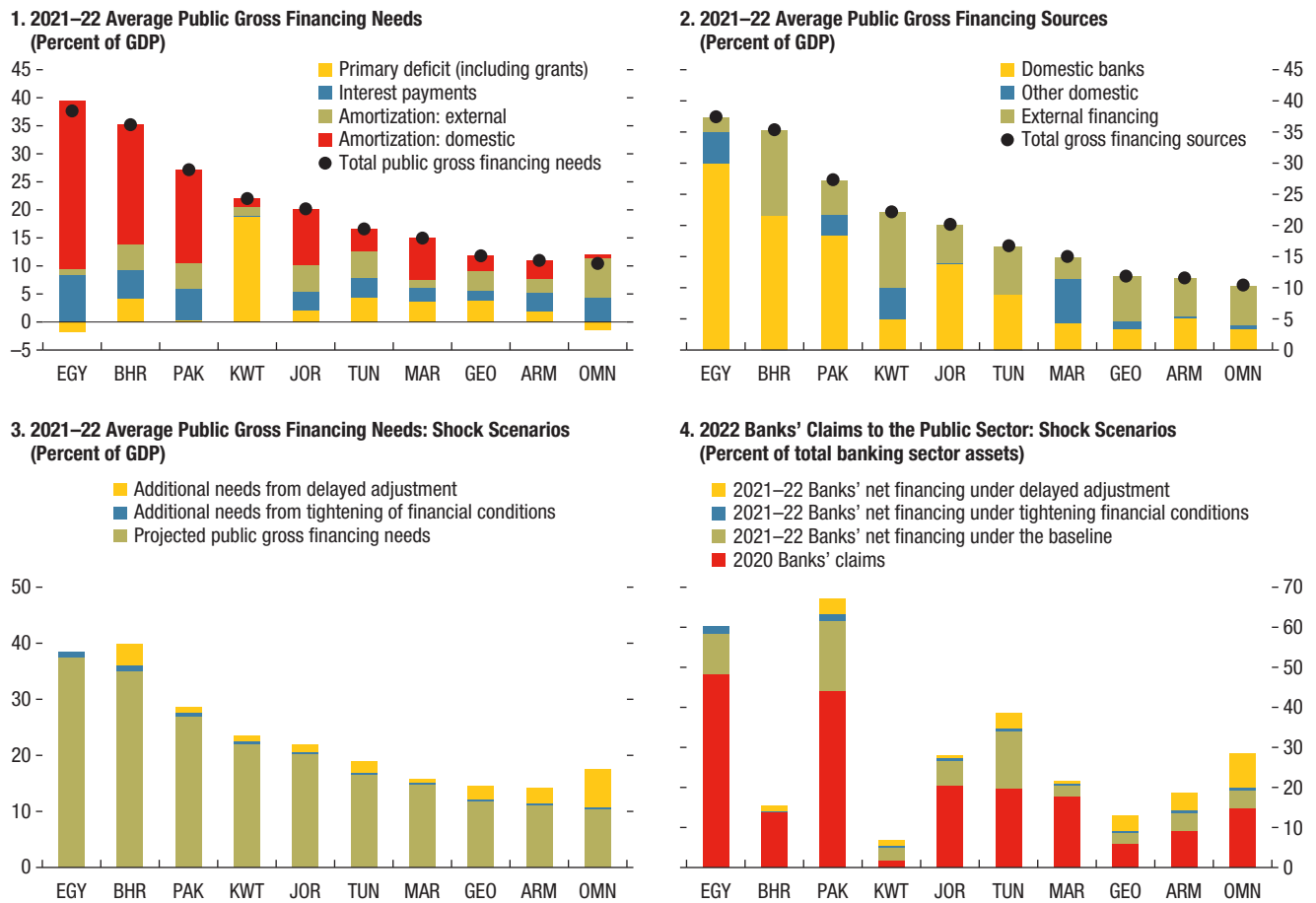
Under this scenario, average public gross financing needs during 2021–22 would increase by about 3 percent of GDP, about half of the pandemic's impact on public gross financing needs in the Middle East and Central Asia's emerging markets in 2020 (Figure 2.7, panel 3). Assuming that the additional budgetary needs stemming from the simulated combined shocks are funded by domestic banks in addition to the net bank financing already covering the expected 2021–22 needs, four governments in the region (Egypt, Oman, Pakistan, Tunisia) would absorb an additional 10 to 23 percent of banks' assets as government debt during 2021–22 (Figure 2.7, panel 4). Such a development would further intensify the banking sector's exposure to the sovereign, potentially reducing banks' capacity to lend to the private sector severely, and likely weakening prospects for a sustainable and strong recovery.

Policy Implications

Given rising vulnerabilities, countries need to implement policies and reforms to help reduce elevated public gross financing needs and, over time, mitigate the concentration of bank exposure to the sovereign, underpinned by a strong medium-term debt management strategy and the development of a clear and transparent communication plan with market participants. Coordination among debt management, monetary, fiscal, and financial sector regulatory authorities—both with respect to policies and specific measures—is also essential to form a common view on the overall absorption capacity of domestic financial markets and analyze the impact of measures that might affect the ability of the sovereign to borrow.

The challenges are larger for countries with limited or no fiscal space. These countries will need to start implementing growth-friendly consolidation plans, anchored on a credible medium-term fiscal framework. Those with market access should proactively mitigate rollover and refinancing risks as market conditions allow, including by engaging

Figure 2.7. Public Financing and Crowding-Out Risks Ahead in ME&CA-EMs¹



Sources: IMF staff projections; IMF International Financial Statistics; and IMF World Economic Outlook.
 Note: EM = emerging market; ME&CA = Middle East and Central Asia. Country abbreviations are International Organization for Standardization country codes.
¹The stress-testing exercise includes all market access countries with average public gross financing needs above 10 percent of GDP during 2021–22. Algeria and Iraq are excluded given their reliance on central bank financing. Egypt and Pakistan data are reported on fiscal year basis (that is, 2021 corresponds to July 2020–June 2021).

in liability management operations, as needed, to attain better terms on existing debt and improve the medium-term debt profile.

To reduce risks stemming from a concentrated government debt holding structure, countries should move along several levers. Domestic capital markets should be developed, supported by (1) addressing the structural excess bank liquidity in some countries that inhibits the development of money markets and promotes a buy-and-hold investment strategy; (2) increasing domestic savings, particularly in long-term instruments; and (3) establishing deep and liquid secondary markets, including through developing larger

benchmark government securities at all points of the yield curve.

The investor base should be gradually expanded to reduce overreliance on domestic banks and open up space for private sector financing by targeting large and heterogeneous investors with different risk preferences, investment maturity horizons, and trading motives to ensure a stable demand for government securities. Debt managers should focus on (1) expanding nonbank financing sources, including from institutional investors and retail participation; (2) offering an array of instruments tailored to different investor preferences (including

floating rate, inflation-linked, Islamic bonds (sukuk), and green securities); and (3) attracting nonresident participation, particularly in longer-term instruments, supported by liquid secondary markets and inclusion of local currency government bonds in flagship global indices.

In the financial sector, policymakers should continue supporting credit while mitigating, over time, banks' overexposure to the sovereign. In the near term, weaker banks' balance sheets and the need to rebuild capital buffers may bias banks' asset portfolio toward government bonds, given regulatory zero risk-weighting. To prevent further crowding out private sector credit, banks should be encouraged to recognize upfront losses but could be given some time to rebuild their capital positions. Enhanced transparency and disclosure practices could foster market discipline, helping reduce excessive sovereign holdings. Over the medium term, prioritizing stronger bank and sovereign balance sheets, improving governance, and developing alternative opportunities for

banks to diversify their lending—including from further progress on financial inclusion—would be important. In addition, bank regulators could consider introducing time-variant “through-the-cycle” risk weights and capital requirements that increase with sovereign concentration on banks' balance sheets to contain the sovereign-bank nexus while minimizing procyclical effects.

Countries with limited market access and large development needs, particularly LICs and fragile and conflict-affected states, face more daunting challenges. Many of these countries will need additional assistance to ensure progress toward the Sustainable Development Goals, including through concessional resources (particularly grants) and debt relief under the DSSI. Those facing significant difficulties servicing debt could benefit from timely and orderly restructuring of their commercial and bilateral debt, supported by the Common Framework for Debt Treatments on a case-by-case basis.

MENA, Afghanistan, and Pakistan: Selected Economic Indicators, 2000–22*(Percent of GDP, unless otherwise indicated)*

	Average 2000–17	2018	2019	2020	Projections	
					2021	2022
MENA¹						
Real GDP (annual growth)	4.5	1.2	0.8	-3.4	4.0	3.7
<i>of which non-oil growth</i>	5.5	1.9	2.5	-2.5	3.0	3.3
Current account balance	7.4	3.8	1.2	-3.2	0.7	0.4
Overall fiscal balance	1.7	-2.6	-3.8	-10.1	-5.8	-4.7
Inflation (year average; percent)	7.1	9.7	6.9	10.5	12.8	8.6
MENA oil exporters						
Real GDP (annual growth)	4.6	0.3	-0.3	-4.5	4.8	3.4
<i>of which non-oil growth</i>	5.8	1.2	2.2	-3.2	3.3	2.8
Current account balance	10.1	6.3	3.1	-2.7	2.3	2.0
Overall fiscal balance	3.6	-1.6	-3.1	-10.8	-5.3	-4.3
Inflation (year average; percent)	6.6	8.0	5.7	8.6	11.0	8.2
MENA oil exporters excl. conflict countries and Iran						
Real GDP (annual growth)	4.9	1.7	1.1	-5.6	2.6	3.7
<i>of which non-oil growth</i>	6.4	2.2	2.7	-4.4	3.6	3.0
Current account balance	11.9	6.6	3.9	-3.4	2.9	2.4
Overall fiscal balance	5.4	-1.0	-2.0	-10.5	-4.8	-3.1
Inflation (year average; percent)	3.2	2.3	-0.9	1.3	3.7	3.0
Of which: Gulf Cooperation Council (GCC)						
Real GDP (annual growth)	4.4	1.9	0.7	-4.8	2.7	3.8
<i>of which non-oil growth</i>	6.2	1.7	2.4	-3.9	3.5	3.4
Current account balance	13.6	8.6	5.8	-1.3	4.2	3.8
Overall fiscal balance	6.8	-1.6	-1.6	-9.2	-3.0	-1.4
Inflation (year average; percent)	2.6	2.2	-1.5	1.2	2.7	1.9
MENA oil importers¹						
Real GDP (annual growth)	4.1	3.5	3.3	-0.8	2.3	4.5
Current account balance	-4.0	-7.5	-6.7	-4.9	-5.6	-5.2
Overall fiscal balance	-6.6	-7.4	-7.0	-7.4	-7.6	-6.1
Inflation (year average; percent)	8.3	14.4	9.9	15.4	17.2	9.6
MENAP¹						
Real GDP (annual growth)	4.5	1.7	0.9	-3.0	3.7	3.8
<i>of which non-oil growth</i>	5.4	2.3	2.4	-2.2	2.8	3.4
Current account balance	6.8	3.0	0.8	-3.0	0.6	0.3
Overall fiscal balance	1.3	-3.0	-4.2	-9.9	-5.8	-4.7
Inflation (year average; percent)	7.1	8.9	6.8	10.5	12.2	8.5
MENAP oil importers¹						
Real GDP (annual growth)	4.2	4.1	2.9	-0.7	2.1	4.3
Current account balance	-2.8	-6.6	-5.8	-3.5	-4.2	-4.0
Overall fiscal balance	-5.9	-6.9	-7.5	-7.5	-7.3	-5.9
Inflation (year average; percent)	8.1	10.4	8.7	13.6	14.0	9.0
Arab World¹						
Real GDP (annual growth)	4.6	2.5	2.0	-4.2	4.3	4.0
<i>of which non-oil growth</i>	5.7	2.7	2.8	-3.1	3.2	3.6
Current account balance	8.1	3.5	1.4	-3.9	0.6	0.3
Overall fiscal balance	2.6	-2.7	-3.5	-10.6	-5.5	-3.9
Inflation (year average; percent)

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

¹2011–22 data exclude Syrian Arab Republic.

Note: 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).

MENA includes Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, United Arab Emirates, West Bank and Gaza, and Yemen.

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

MENA oil exporters, excl. conflict countries and Iran: Algeria, Bahrain, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

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

MENA oil importers: Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Somalia, Sudan, Syria, Tunisia, and West Bank and Gaza.

MENAP: MENA, Afghanistan, and Pakistan.

MENAP oil importers: MENA oil importers, Afghanistan, and Pakistan.

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

CCA Region: Selected Economic Indicators, 2000–22*(Percent of GDP, unless otherwise indicated)*

	Average 2000–17	2018	2019	2020	Projections	
					2021	2022
CCA						
Real GDP (annual growth)	7.2	4.4	4.8	–1.9	3.7	4.1
Current account balance	0.1	0.3	–2.3	–3.6	–2.1	–2.3
Overall fiscal balance	1.4	1.9	0.5	–5.6	–3.2	–1.8
Inflation (year average; percent)	9.0	7.9	6.6	7.4	6.9	6.2
CCA oil and gas exporters						
Real GDP (annual growth)	7.3	4.2	4.7	–1.4	3.7	4.0
<i>of which non-oil growth¹</i>	7.6	4.0	5.6	–1.4	3.5	4.0
Current account balance	1.3	4.1	–1.7	–3.1	–1.4	–1.8
Overall fiscal balance	2.1	2.5	0.8	–5.3	–2.9	–1.6
Inflation (year average; percent)	9.5	8.8	7.0	7.8	7.1	6.5
CCA oil and gas importers						
Real GDP (annual growth)	6.0	5.1	6.0	–4.6	3.8	4.7
Current account balance	–8.6	–7.5	–6.2	–7.6	–7.9	–6.4
Overall fiscal balance	–3.1	–1.9	–1.4	–7.3	–5.9	–3.4
Inflation (year average; percent)	6.5	2.6	3.8	5.2	5.7	4.2

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

¹Azerbaijan, Kazakhstan and Turkmenistan. Uzbekistan data for non-oil GDP is not available.

Note: CCA oil and gas exporters: Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan. CCA oil and gas importers: Armenia, Georgia, the Kyrgyz Republic, and Tajikistan.