Highlights

As elsewhere in the world, the global financial and economic crisis has taken a toll on the Middle East and Central Asia region. Given the region's diversity, the *Regional Economic Outlook* divides the countries of the Middle East and Central Asia into two groups: (1) countries of the Middle East, North Africa, Afghanistan, and Pakistan (MENAP)—which are further subdivided into oil exporters and oil importers; and (2) countries of the Caucasus and Central Asia (CCA).

MENAP oil exporters have been directly hit by the global financial crisis through a sharp decline in oil prices and a sudden drying up of capital inflows, but the impact has been greatly mitigated by countercyclical government spending.

- Drawing on substantial reserves built up prior to the crisis, governments responded with strong countercyclical policies, which have helped contain the impact on the non-oil sectors of their economies: non-oil GDP has slowed, but still is projected to grow at 3.2 percent in 2009. The corollary is that MENAP oil exporters' current account surpluses are falling from US$380 billion in 2008 to about US$50 billion in 2009.

- With higher oil prices and the anticipated reemergence of global demand, oil revenues will increase, allowing oil exporters to rebuild their international reserve positions—by more than US$100 billion in 2010. This, in turn, provides the basis for maintaining spending. With the Gulf Cooperation Council's share of world imports expected to increase from 2.7 percent in 2008 to 3.2 percent in 2010, the region's contribution to global demand will remain high.

- The crisis has revealed some vulnerabilities in the region's financial sector: weak risk management systems and overleveraged institutions. Measures to strengthen financial regulation and supervision—already being instituted in some countries—will remain crucial for safeguarding the financial system against future shocks.

- In 2010, for the group as a whole, oil and non-oil growth are projected at 4.4 percent and 3.9 percent, respectively. To help realize these economies' potential, public spending on infrastructure and social development will remain a key feature of economic policy. Looking ahead, governments will need to begin designing strategies to unwind the exceptional liquidity support provided to mitigate the impact of the crisis.

- In the medium term, financial market development—including diversification beyond a bank-based system—will remain a priority, as will efforts to improve the business climate to support economic diversification and generate employment.

MENAP oil importers have been moderately hit by the worldwide recession, with growth projected to fall from 5.0 percent in 2008 to 3.6 percent in 2009. A low degree of integration with global capital markets, limited exposure of the banking system to structured products, and a small manufacturing base have helped these countries avoid a substantial fallout from the crisis. Fiscal and monetary stimulus, as well as spillovers from increased public spending in neighboring oil exporters, are also helping sustain demand. For much the same reason that these countries have experienced a comparatively muted slowdown, they can only look forward to a very modest rebound. Higher oil prices are also of concern, especially for the poorer countries of the group.

- The global slowdown's main transmission channel has been a reduction in receipts from abroad. Merchandise exports and foreign direct investment have been hardest hit, and are projected to decline by 16 percent and 32 percent, respectively, in 2009. Tourism receipts and remittances are also lower, but not by as much.

- Oil importers in the Maghreb (Mauritania, Morocco, and Tunisia) have been highly exposed to the slowdown in the European Union—their main partner for trade and remittances. In Morocco, however, an exceptional agricultural harvest has mitigated the impact of the global economic slowdown on overall output.

- For 2010, a slow recovery in partner country economies, combined with limited scope for further countercyclical policy action, imply that growth—projected at 3.8 percent—will remain relatively flat.

- High debt levels in most MENAP oil importers limit the space for fiscal stimulus, and the scope for monetary easing will be constrained by an anticipated increase in global interest rates from current historical lows. With narrowing room for continued stimulus, policymakers need to focus more on supply side reforms that will help boost private sector activity and employment and enhance competitiveness. In countries without fixed exchange rate regimes, greater flexibility in exchange rates will facilitate these goals.

The global crisis has severely impacted the CCA, with growth for the region projected to drop from 6.6 percent in 2008 to 1.5 percent in 2009. But this average masks important differences across countries. Most CCA energy exporters are projected to record solid growth in 2009, given limited linkages to international markets, long-term energy export contracts, and supportive policies. The energy importers, however, are facing a marked slowdown in growth and deteriorating living standards as a result of a sharp drop in remittances from Russia. A modest recovery for the CCA as a whole is expected in 2010.

- Three of the four energy exporters—Azerbaijan, Turkmenistan, and Uzbekistan—are projected to register robust growth in 2009, supported mainly by public spending made possible by ample public savings accumulated during previous boom years. Kazakhstan, however, is in the midst of a banking crisis and is likely to see negative growth of about 2 percent in 2009. With global energy demand increasing again, the energy exporters should continue to see solid growth rates in 2010.

- CCA energy importers are being hit to varying degrees. Armenia, which is more integrated into global markets, is likely to suffer a contraction of more than 15 percent in 2009, while Georgia, the Kyrgyz Republic, and Tajikistan are faring better. The recovery in 2010 is projected to be slow and gradual.

- Policymakers have responded to the downturn by easing fiscal and monetary policies and strengthening social safety nets. In the energy importers, where governments have little space to implement such measures, donors, including the neighboring states of Russia and China, and the IMF have provided support.

- In 2010, where possible, fiscal policy should continue to be supportive of growth and prioritize social protection. Additional donor support on concessional terms will be needed for the energy importers to prevent a buildup of unsustainable debt levels. The energy exporters should use part of their anticipated increase in revenue from rising energy prices to push ahead with structural reforms.

- Financial sectors across the region are under stress, most notably in Kazakhstan, where restoring financial health remains a priority. Countries should continue to preserve exchange rate flexibility or move toward flexible exchange rate regimes over time to protect or develop export-oriented sectors.

In sum, where feasible, countries should continue to support domestic demand to mitigate the impact of the crisis on their citizens while keeping debt sustainability in view. For the region's low-income countries, higher donor support will be necessary to maintain needed economic development and prevent poverty rates from rising further. Across the region, governments should further strengthen financial systems and take care not to lose momentum on structural reforms aimed at diversifying their economies, creating employment opportunities, and allowing them to take advantage of the global economic recovery.