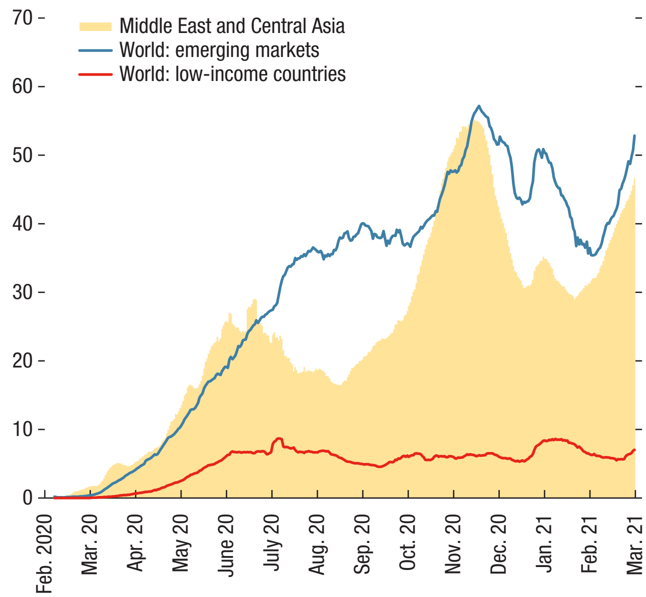
Regional Developments and Outlook

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.

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.

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 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

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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 (*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.

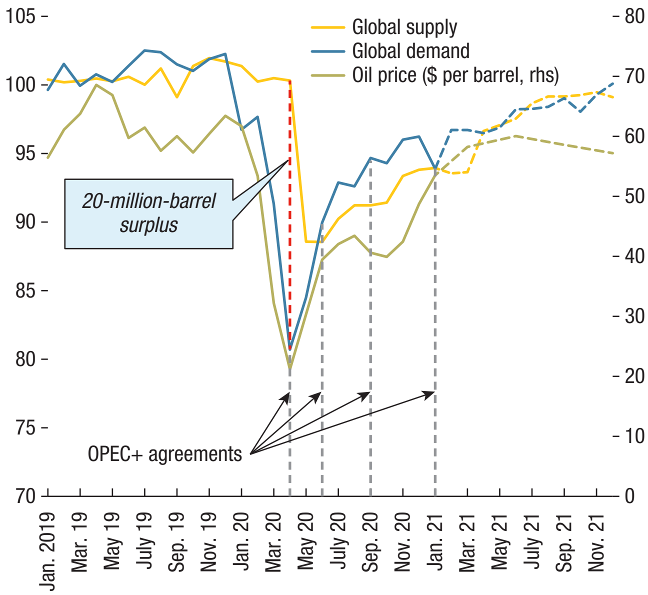
Global financial conditions have remained broadly accommodative, given low global interest rates and spreads, supporting sovereign issuances in the region (Chapter 2). Capital flows to emerging markets stabilized in late 2020 and rose at the start of 2021. After outflows of at least $6 billion out of 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

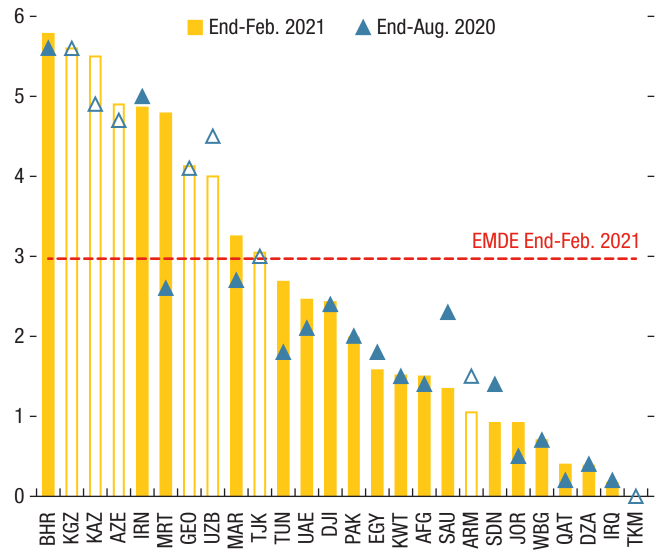
[1]According to the Duke Global Health Innovation Center, current models predict that there will not be enough vaccines to cover the world's population until 2023 or 2024. Manufacturing capacity can be expanded with targeted investment but only to an extent and it will remain a rate limiter.

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.

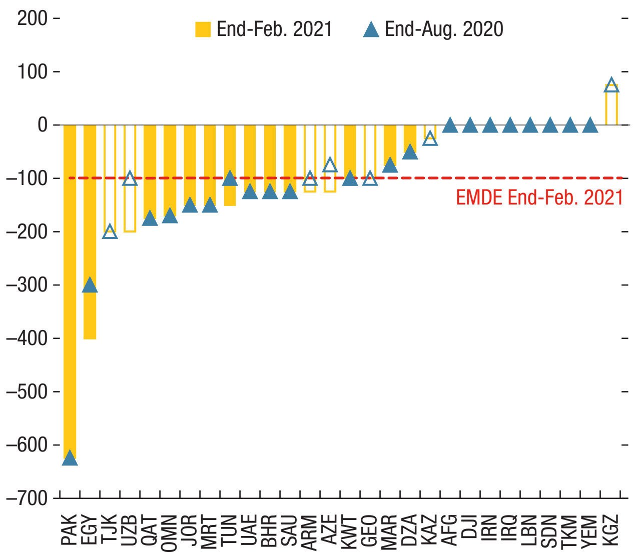
Exchange rate flexibility absorbed part of the shock in some cases. Several countries with flexible exchange rates saw their currencies depreciating early in the pandemic (Armenia, Georgia, Kazakhstan, Kyrgyz Republic, Morocco, Pakistan, Tajikistan, Tunisia), and they have since partially reversed in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

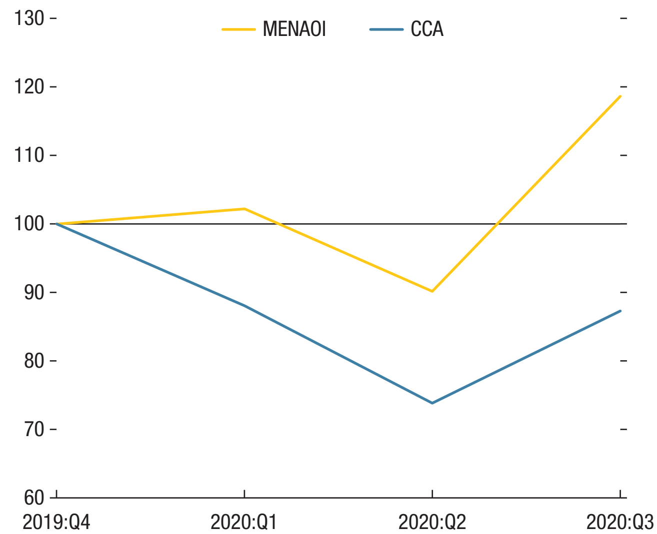
Activity was more resilient during the second half of 2020. The more targeted lockdowns used during the second wave had a smaller impact on mobility, which was reflected on activity. Available real GDP data in the region point to a strong rebound in the third quarter of 2020 as countries relaxed lockdown 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).

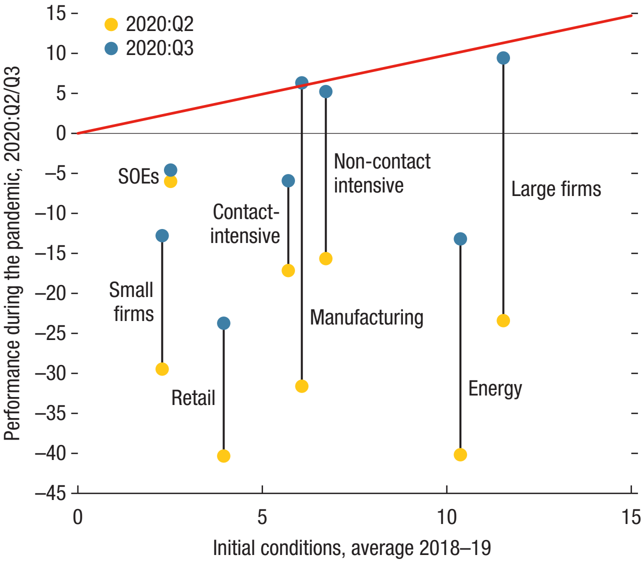
Workers' remittances also held up better than expected. Flows rebounded in the third quarter of 2020 after a sizable drop in the second quarter (Figure 1.5), reflecting a combination of factors, including a broad improvement in third quarter growth in remittance-sending countries, an accelerated switch 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).

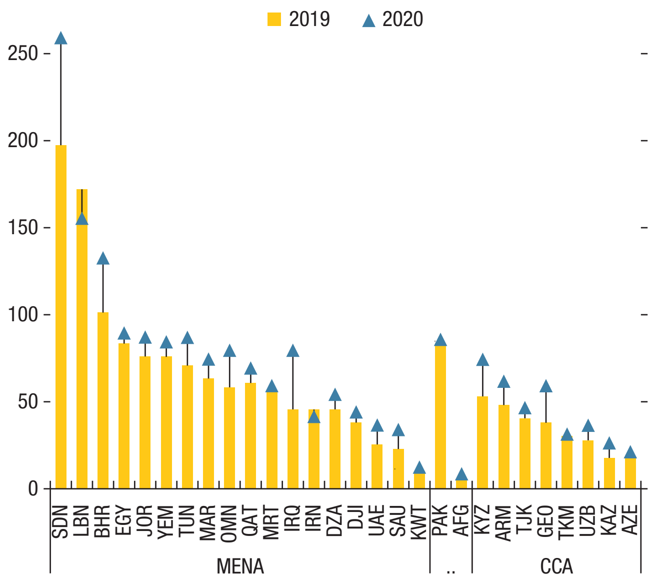
Fiscal accounts deteriorated sharply across the region in 2020, reflecting lower revenue because of contracting domestic demand and the slump in oil prices, as well as policy support measures to mitigate the pandemic's impact. Oil exporters recorded a larger deterioration in their public finances than 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.

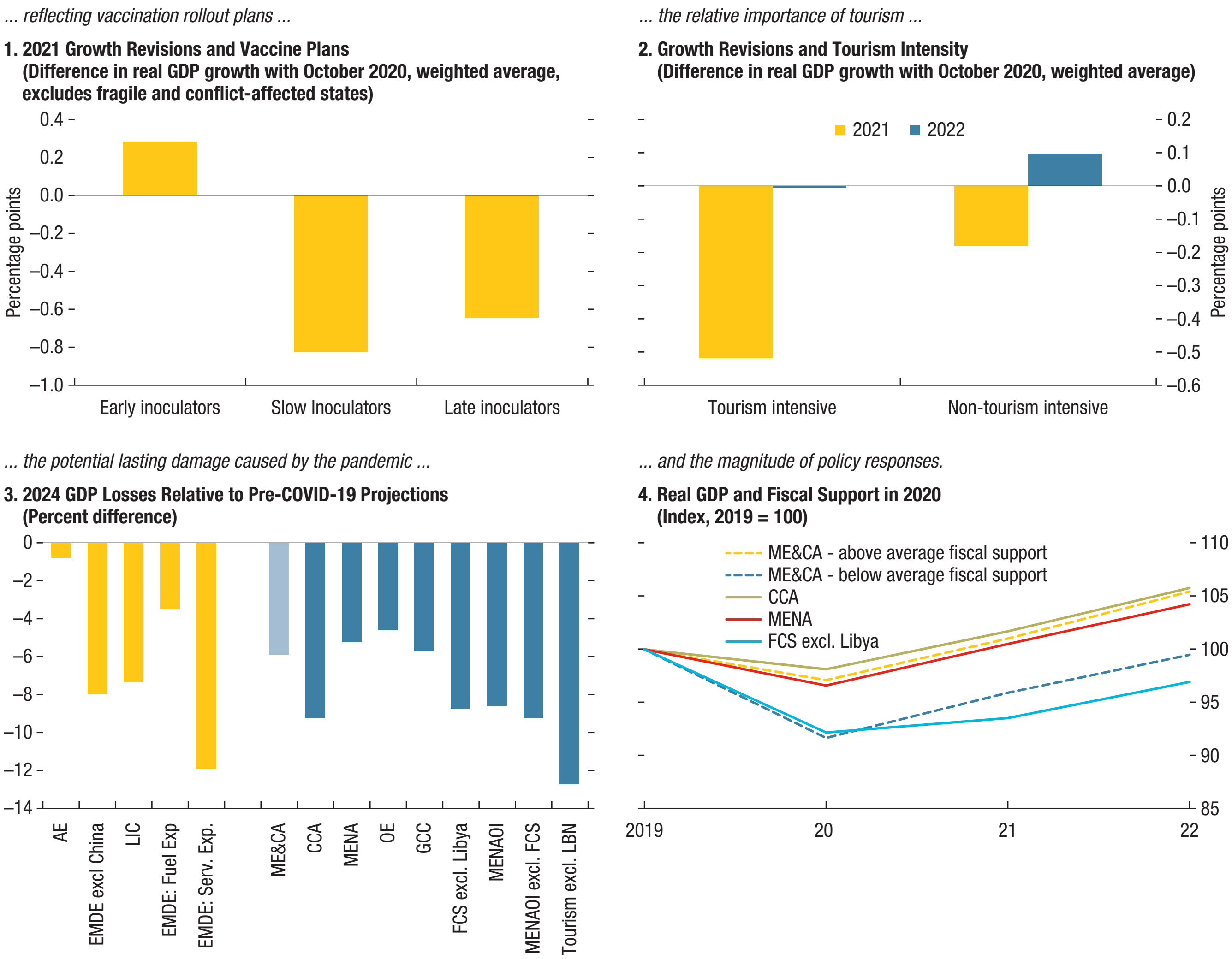
Policy and Structural Differences Will Also Be Key

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 ...



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

[2]See 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.

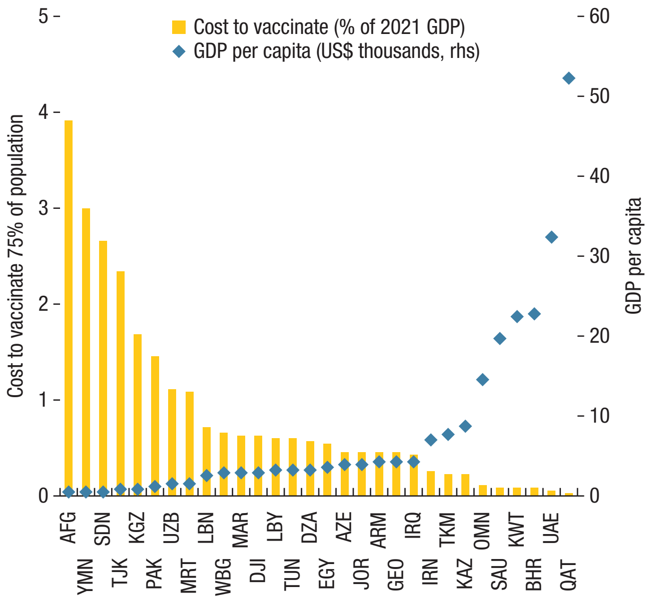
Exceptional Uncertainty Around the Outlook

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 ¼ percentage point in 2021, accelerating to an additional ¾ 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 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 unrests[5] 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...

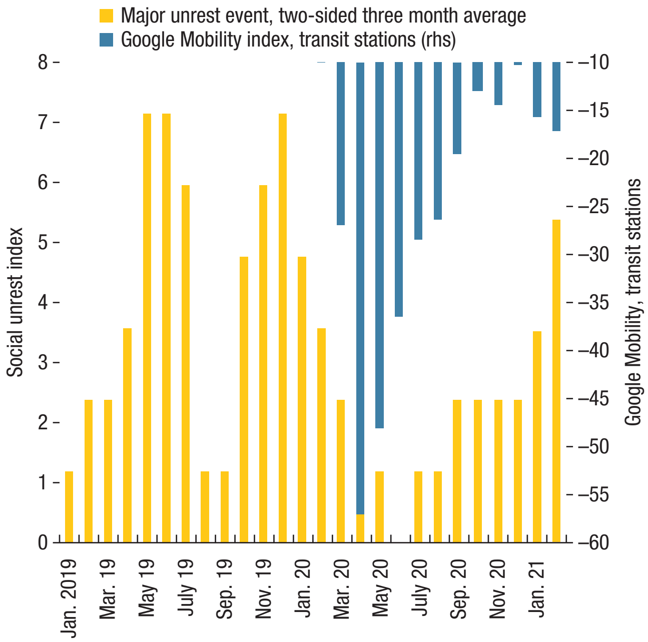
2021 will be the year to shape the recovery and lay the groundwork for more inclusive, resilient, and green economies. The immediate challenges

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

[4]During 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.

[5]See 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.

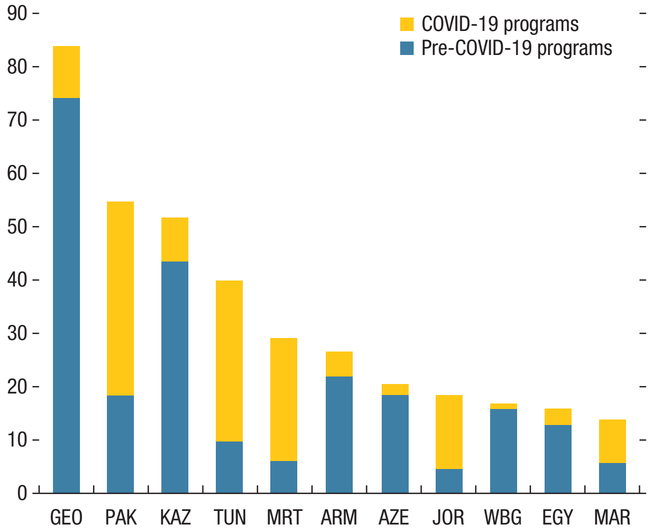
. . . While Building Forward Better

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

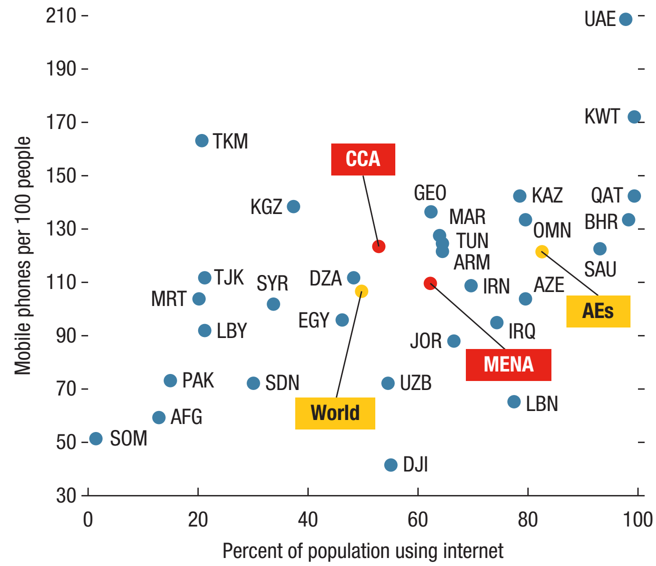
Figure 1.11. Coverage of Cash Transfer Programs

(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.

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.

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.

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.