1. Regional Developments and Outlook: From Crisis Management to Transformational Recovery

With uneven vaccination rollouts, the recovery in the Middle East and Central Asia (ME&CA) is expected to be multispeed and fragile and countries need to maintain focus on managing the pandemic. The ongoing subdued recovery is expected to solidify in 2022 as the vaccine rollouts progress. Meanwhile, new challenges are emerging with rising inflation due to pandemic-related supply shortages and higher commodity prices. Hence, headwinds to the outlook and uncertainty about how quickly the pandemic can be overcome have increased. Economic scarring could be extensive given weak employment, increased inequities and poverty, corporate sector vulnerabilities, and debt sustainability risks. Near-term policy trade-offs have become more acute, with fiscal space already eroded, declining monetary policy space, and increasing geopolitical and social unrest risks. As the region prepares for a new journey in the post-pandemic world, the crisis presents opportunities that could lead to a transformational recovery marked by more resilient, inclusive, and greener economies. Domestic policies would need to be comprehensive and exploit synergies to enable this transformation. Global and regional cooperation will also be crucial for vaccine deployment and leveraging digitalization, adaptation to climate change, and transition to lower carbon dependence to strengthen the region's medium-term growth prospects.

Global Backdrop: A Dichotomy between the Haves and Have Nots

A multispeed global economic recovery continues amid a resurgent pandemic, with differing vaccine rates and policy support emerging as the principal factors driving divergent recovery paths across countries and regions (October 2021 *World Economic Outlook*). Activity in most advanced economies continues to normalize, while many other countries are contending with more fragile recoveries. Uncertainty about the path of the pandemic has increased. Global financial conditions have remained supportive, but global inflation is rising, partly due to pandemic related supply shortages, and employment is subdued. Commodity prices have surprised on the upside since April, with average petroleum spot prices expected to be $65.7 in 2021, before declining to $56.3 in the medium term—which is above the 2020 average of $41.3 but below the 2019 average of $61.4. The Organization of Petroleum Exporting Countries and other major oil producers (OPEC+) has agreed to gradually phase out 5.8 million barrels per day of production curbs by September 2022. Food prices have soared to their highest level since 2014 (an expected increase of 27.8 percent in 2021, compared to 13.9 percent in April) and are expected to increase further by 1.9 percent in 2022.

Not Out of the Woods

The ME&CA region is facing a new wave, with about two thirds of the region's countries facing a new pandemic outbreak. However, infection and death rates are relatively contained in countries that had made early progress toward vaccinating their populations (Figure 1.1). Social and economic restrictions, albeit less stringent than in early 2020, have generally remained in place, but mobility rates have somewhat decoupled from containment measures.

Vaccine rollouts are progressing, but overall vaccination rates remain low from a global perspective, reflecting a combination of supply and procurement bottlenecks and logistical obstacles. As of September 21, countries in the region fall into three broad categories: 1) five countries where more than 60 percent of the total population

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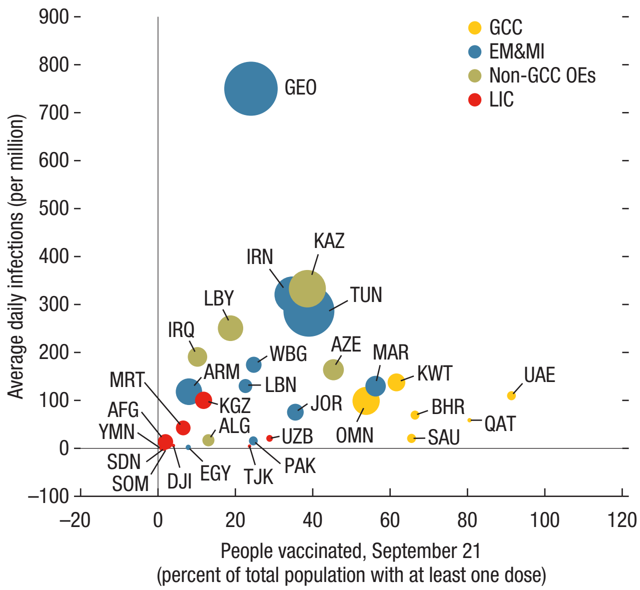
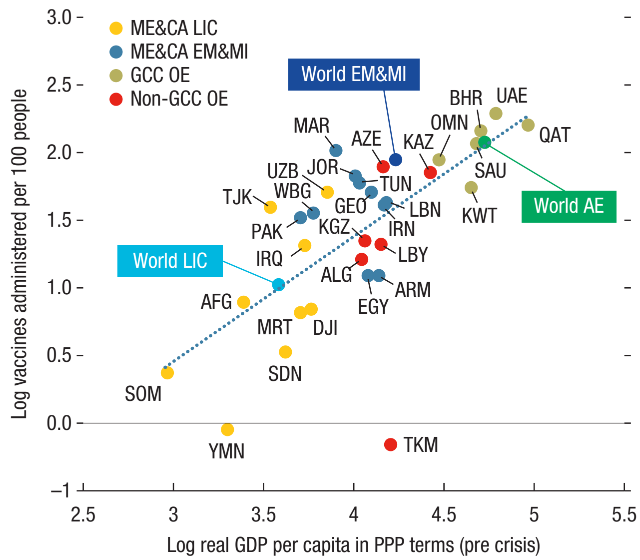
Figure 1.1. Average Daily Infections and Deaths versus People Vaccinated

(Infection and death rates[1] during Jun. 30–Sep. 21)



Sources: Airfinity, Our World in Data; UNICEF; and IMF staff calculations.
Note: Low infection rates for some countries could reflect underreporting given limited testing capacities. Country abbreviations are International Organization for Standardization country codes.
[1]Death rates are reflected in size of bubbles.

Figure 1.2. Higher Vaccination Rates in More Affluent Countries



Source: IMF, World Economic Outlook database; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization country codes. AE = advanced economy; CCA = Caucasus and Central Asia; EM&MI = emerging market and middle-income country; GCC = Gulf Cooperation Council; LIC = low-income country; ME&CA = Middle East and Central Asia; OE = oil exporter; PPP = purchasing power parity.
[1]Vaccines administered as of 09/21/2021.

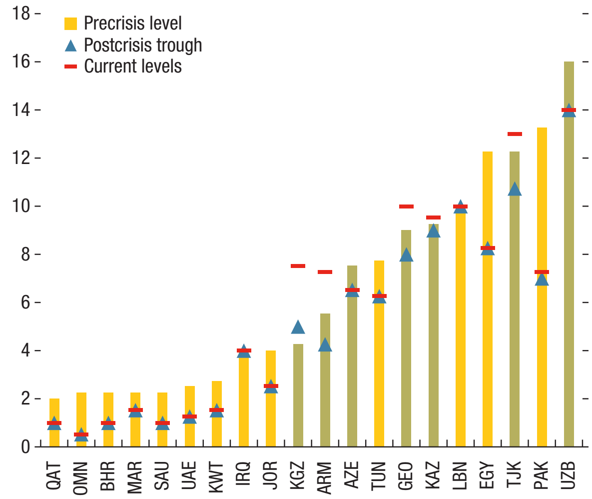
has received at least one dose; 2) 17 countries follow with important progress, including 13 with coverage higher than 20 percent; and 3) the remaining 10 countries, which have vaccinated less than 10 percent of their population. Consistent with global trends, more affluent countries in the region—some oil exporters and emerging market and middle-income countries (EM&MI)—have procured vaccines from a more diverse number of sources and had more successful rollouts than low-income countries (LICs), which have faced delayed and uneven delivery so far (Figure 1.2). However, recent donations—covering sufficient doses to inoculate 7 percent of the region's LICs' population on average—have tripled the number of average daily doses administered in LICs since August.

Policy support. The wide range of policy responses played a key role in protecting livelihoods and vulnerable populations and in mitigating economic, banking, and corporate sector risks (October 2020 *Regional Economic Outlook: Middle East and Central Asia*).

- *Fiscal.* Most countries that experienced a resurgence of the pandemic during 2021 extended emergency measures, in line with their fiscal space (for example, Algeria, Bahrain, Georgia, Kazakhstan, Morocco, and the UAE). Some countries introduced new measures in 2021 (for example, support for small and medium enterprises and vulnerable households in Oman, and new cash transfers in Sudan). In other countries, emergency spending measures were kept the same, reduced or allowed to expire while some below-the-line liquidity support measures without a direct budgetary cost have remained in place (for example, Egypt and Pakistan have kept some tax relief measures in place).
- *Monetary and macro-financial.* Although policy interest rates remain low for many countries, some countries in the Caucasus and Central

Asia (CCA) region and Pakistan have begun to tighten monetary policy (Figure 1.3). Some of the macro-financial measures introduced in 2020 have expired (for example, the loan guarantee program and waivers for electronic transaction fees in Saudi Arabia). Other measures have been extended (for example, delayed recognition of loan impairments and reduced capital buffer and risk weights in Kazakhstan, and credit subsidies, credit guarantees and loan repayment deferrals in Gulf Cooperation Council (GCC) countries), and some have introduced new policies (for example, the government guarantee program for bank loans and small and medium enterprises in Kuwait).

Figure 1.3. ME&CA: Monetary Policy Rates
(Percent)



Source: Haver analytics.
Note: Yellow bars represent Middle East and North Africa countries, and green bars represent Caucasus and Central Asia countries. Country abbreviations are International Organization for Standardization country codes. ME&CA = Middle East and Central Asia.

Uneven Recovery and Rising Inflation

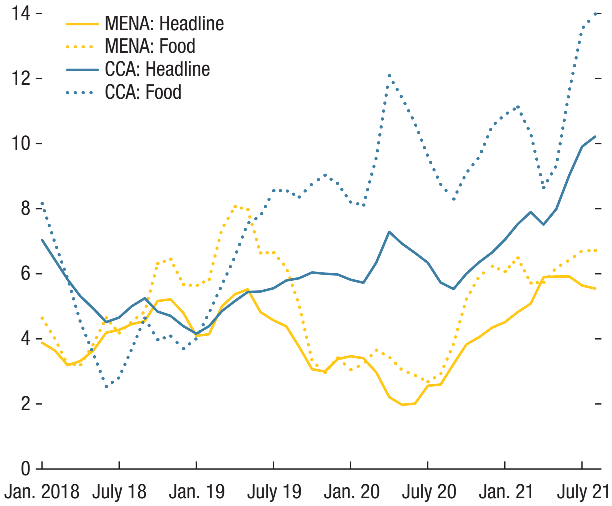
The recovery is ongoing, but it is uneven and incomplete, with new waves of the virus emerging. GDP growth in the first half of 2021 has increased and purchasing managers' indices point to a continued recovery in business activity but at a somewhat moderated pace since July.

Pickup in trade. Consistent with global trends, merchandise trade has recovered to its pre-pandemic level. Hotel demand has also been increasing, but it has remained below pre-pandemic levels in almost all countries. Remittances continue to provide crucial support for some countries (for example, Georgia, Kyrgyz Republic, and Tajikistan). Overall, the current account balances of oil exporters have started to recover with higher oil prices and global recovery, after most countries moved sharply into deficit in 2020.

Supportive global financial conditions. Emerging and developing economies experienced a brief episode of capital outflows in early 2021 due to inflation concerns in the United States, but these flows reversed in May as these fears subsided. The region has experienced cumulative net capital inflows of $2.9 billion up to the end of August. Sovereign bond spreads have declined since 2020, and countries in the region continued to tap international markets, benefiting from these favorable financing conditions, with 19 Eurobond issuances totaling $19.8 billion since the beginning of this year. Relative to the same period in 2020, the total value of issuances has been reduced by half due to reduced issuances in Qatar, Saudi Arabia, and the UAE (reflecting lower financing needs with higher oil prices and ongoing recovery) more than offsetting increases in Armenia, Georgia, and Oman.

Rising inflation (Figure 1.4). Meanwhile, headline inflation has been increasing, reflecting both international and domestic factors, such as higher global food and energy prices and shipping costs, pass-through from earlier depreciations, the ongoing domestic recovery in some countries, and monetary financing in others. Food inflation is feeding into headline inflation, particularly in *LICs* (for example, Kyrgyz Republic and Tajikistan) and in countries with high shares of imported food in their consumption items (for example, Algeria and Armenia). Excluding food and energy prices, core

Figure 1.4. Rising Inflation
(Year-over-year percent change; simple average)



Sources: Haver Analytics; National Authorities; IMF, *CPI database*; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENA = Middle East and North Africa. MENA includes ALG, BHR, EGY, IRN, IRQ, JOR, KWT, MAR, OMN, QAT, SAU, SOM, TUN, UAE, and WBG. CCA includes ARM, AZE, GEO, KAZ, KGZ, TJK, and UZB. Latest data are as of Aug. 2021 except for TUN (Mar. 2021) KWT (Apr. 2021), ALG (Jun. 2021), BHR, OMN, TJK, and UAE (Jul. 2021). Data were extrapolated based on latest available inflation growth rates as indicated.

inflation has been picking up in Jordan, Morocco, Qatar (from a low base), Iraq, and Pakistan.

Weak employment. Employment in most countries remains below pre-pandemic levels (for example, Armenia, Bahrain, Iran, Saudi Arabia, and Tunisia). The sensitivity of labor markets to broader economic conditions in many countries in the region appears to be weak, on average, particularly during upswings, reflecting the high prevalence of informality, other structural bottlenecks, and lower employment prospects after prolonged unemployment periods (Chapter 2). This suggests employment losses experienced during the pandemic may take some time to unwind.

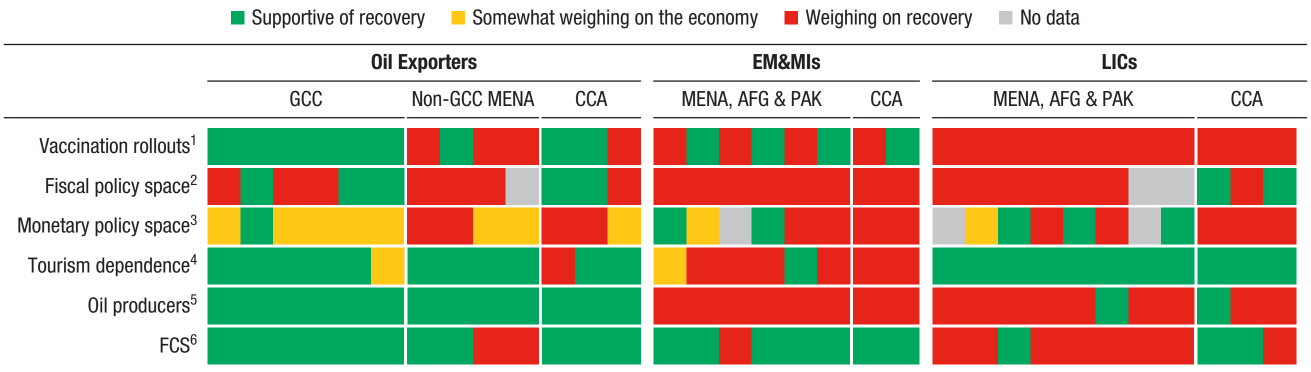
Increasing inequities. The impact of the pandemic has been uneven across groups. The low-skilled, the young, women, and migrant workers were affected the most, with the employment of women and youth declining in 2020 by 6 and 10 percent, respectively, which is more than for men and total adults (about 4 percent each). Unlike in previous crises, informal workers were not spared. Similarly, many workers in high contact-sensitive service sectors (such as travel and tourism) face the prospect of slower and more uneven recoveries until the pandemic is contained (Chapter 2). In addition, smaller firms, those in high contact-intensive sectors and with preexisting vulnerabilities have fared worse than others (Chapter 3). On the positive side, firms with greater digital connectivity have been able to partly mitigate the pandemic's impact.

Banking systems have been resilient so far, but risks are building unevenly. Although profitability has declined, nonperforming loans have remained broadly stable, and banks have increased buffers against credit and liquidity risks, partly reflecting supportive macro-financial policies. However, banks with higher exposure to the corporate sector have lower capital adequacy ratios, lower liquidity, and higher nonperforming loans; and those exposed to the hard-hit high contact-sensitive sectors have seen an increase in nonperforming loans. Higher loan-loss provisions, partly due to regulatory requirements, suggest that banks perceive risks in advance and are building buffers against a potential deterioration in asset quality when policy support is withdrawn (Chapter 3).

Outlook: Subdued and Fragile Recovery

After contracting by 3.2 percent in 2020, real GDP in the **Middle East and North Africa (MENA)** region is projected to expand by 4.1 percent in both 2021 and 2022, upward revisions of 0.1 and 0.4 percentage points since April, respectively. Meanwhile, inflation in the region is projected to increase to 12.9 percent in 2021 with higher food and energy prices and monetary accommodation in some countries, before subsiding to 8.8 percent in 2022. The increase in government gross debt for MENA oil importers (projected at more than 100 percent of GDP in 2021) led to a close to 50-percent rise in gross financing needs during 2021–22 (to $390 billion) compared to 2018–19.

Figure 1.5. Headwinds and Tailwinds: Diverse Set of Factors Affecting 2022 Outlook



Sources: Country authorities; IMF World Economic Outlook database; and IMF staff calculations.
[1]Vaccination rollouts: green represents 40 percent population coverage by end-2021; otherwise, red.
[2]Fiscal policy space: red represents no market access and/or debt-to GDP at or above the median; otherwise, green.
[3]Monetary policy space: red is whether IMF World Economic Outlook inflation projections for 2021 are at or above median or inflation target; green represents below median and target; orange represents peggers and currency boards.
[4]Tourism dependence: red is if both, the tourism share of GDP and the tourism share of total employment, are greater than 10 percent; orange if either one of these criteria is met; otherwise, green.
[5]Oil producers: green represents oil exporters; otherwise, red.
[6]FCS = Fragile states and conflict-affected countries: red represents FCS; otherwise, green.

Economic activity in the **CCA** region is also recovering, with real GDP projected to expand by 4.3 percent in 2021 (an upward revision of 0.7 percentage points) and 4.1 percent in 2022, following a contraction of 2.2 percent in 2020. Inflation is expected to accelerate to 8.5 percent in 2021 (an upward revision of 1.6 percentage points), reflecting the pass-through from higher global food and commodity prices and past depreciations, and ongoing recovery in demand, before gradually declining below the target bands from 2022 onwards, with dissipating temporary factors and higher policy interest rates.

Forces Shaping the Outlook

2021 is still being shaped by the ongoing COVID-19 pandemic and OPEC+ production curbs for oil exporters. Going forward, the recovery in the region will be defined by the confluence of five factors (Figure 1.5). First, **vaccination rollouts**: countries that have made more progress toward vaccinating their populations (GCC countries and some EM&MIs) will be more resilient to the emergence of new virus variants. Second, **policy space**: only a handful countries in the region have macro policy space with low debt and inflation to support the recovery (some oil exporting countries and a few countries in the CCA region with low debt levels). Third, **tourism dependence**: countries that rely more on tourism will continue to face headwinds. Fourth, **oil market developments**: higher oil prices and declining OPEC+ production curbs will support the economic activity of oil exporters, with spillover effects to the rest of the region; on the other hand, higher oil prices represent a drag on growth and will put pressure on inflation in oil-importing countries. Lastly, **political and humanitarian challenges**: growth in fragile and conflict-affected countries will hinge on the resolution of existing conflicts, political uncertainty, and other humanitarian challenges.

Oil Exporters

Oil exporters, particularly GCC countries, will benefit from the recovery in global demand, higher oil prices, and wider vaccine coverage than most other countries (Figure 1.2). Vaccination rates for all GCC countries have already reached 40 percent of their populations and are expected to cover 70 percent by the end of 2021. Nevertheless, many countries still have economic and social

restrictions in place, which will continue to weigh on the outlook until the pandemic is contained. Real GDP is projected to expand by 4.5 percent in 2021 (2.8 percent excluding Libya) and 4.0 percent in 2022, reflecting a rebound in both oil and non-oil GDP. Oil activity is expected to expand by 5.3 percent and 4.4 percent in 2021 and 2022, respectively, reflecting a surge in oil production in Libya and a gradual expansion in supply among OPEC+ countries after August 2021. Vaccine rollouts and higher oil prices will also support confidence and activity in the non-oil sector, which is set to expand by 3.9 and 3.4 percent in 2021 and 2022, respectively. Over the medium term, real GDP losses are expected to be more contained for oil exporters than other groups (Figure 1.6).

Inflation is projected to rise to 10.5 percent in 2021 and moderate to 8.0 percent in 2022 (an upward revision of 0.3 percentage points in both years). High inflation is mainly driven by non-GCC oil exporters, with inflation in the GCC countries peaking at 2.8 percent in 2021.

Higher oil prices and exports are expected to strengthen oil exporters' external positions, with their current account balance projected to move from a deficit of 1.9 percent of GDP in 2020 to a surplus of 3.6 percent of GDP in 2021 (above the pre-pandemic level). This surplus is expected to decline gradually over the medium term in line with the projected stabilization in oil prices. Gross official reserves are expected to increase by $95 billion to almost $1 trillion in 2021, an upward revision of more than $100 billion since April.

Fiscal deficits are projected to decline, starting from 2021, reflecting the ongoing recovery, higher oil prices, expiring measures, and consolidation efforts. Nonetheless, government debt as a share of GDP, while declining relative to peaks reached during the crisis, will likely remain higher than its precrisis level over the medium term. As a result, public gross financing needs are projected to remain elevated at $473 billion overall during 2021–22, compared to $310 billion during 2018–19.

Emerging Market and Middle-Income Countries

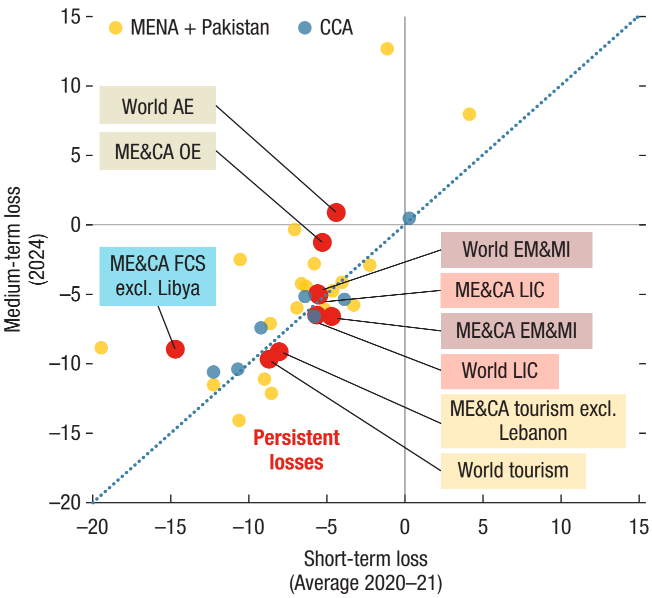
The recovery in EM&MIs will be uneven. Some countries have made notable progress toward increasing vaccination rates since April (for example, Jordan, Morocco, and Tunisia), while others have fallen behind (Figure 1.2). At the current pace of inoculations, vaccination coverage on average is expected to reach about 40 percent of populations by mid-2022 and 70 percent by the end of 2022. Countries that rely more on travel and tourism will benefit less from the ongoing global recovery. Real GDP is projected to expand by 3.6 percent in 2021 and rise further by 4.2 percent in 2022, remaining below growth rates projected for global EM&MIs in 2021 and 2022 (6.7 percent and 5.1 percent, respectively). Over the medium term, real GDP is expected to remain below precrisis projections by about 6.6 percent, broadly in line with global peers (Figure 1.6).

Inflation is projected to increase in all EM&MIs, except in Pakistan. Overall, inflation for this group is expected to remain above 7.5 percent in 2021–22, before gradually declining to 6.0 percent over the medium term. In addition to international food prices, the evolution of exchange rates and oil prices will be important factors behind inflation dynamics in countries with flexible exchange rates, since, on average, they explain about a quarter of inflation volatility historically.

As the recovery proceeds, fiscal balances are expected to gradually improve due to a cyclical recovery in revenues, the expiration of pandemic-related measures, and the prospect for medium-term fiscal adjustment in countries with elevated debt burdens (for example, Egypt and Pakistan). Aggregate debt is projected to rise from 86.8 percent of GDP in 2020 to 91.7 percent of GDP in 2021 and gradually decline between 2022 and 2026, returning to the precrisis level in 2023. However, this decline masks divergent dynamics across countries over the medium term, with debt ratios projected to be higher than pre-pandemic levels in Armenia, Georgia, and Tunisia and lower in Egypt, Jordan, and Pakistan (Figure 1.7).

Figure 1.6. Output Losses Expected to Persist for Some Countries

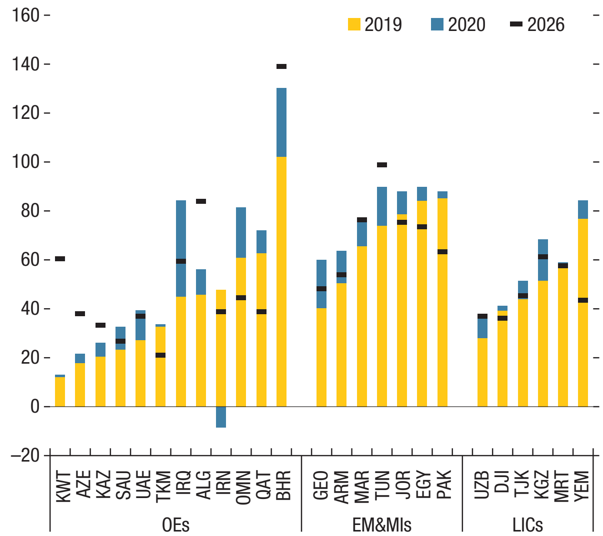
(Percent difference from precrisis projections)



Sources: National authorities; and IMF staff calculations.
Note: AE = advanced economy; CCA = Caucasus and Central Asia; EM&MI = emerging market and middle-income economy; FCS = fragile and conflict-affected state; LIC = low-income country; ME&CA = Middle East and Central Asia; and OE = oil exporter.

Figure 1.7. ME&CA: Public Debt

(Percent of GDP)



Sources: IMF World Economic Outlook database; and IMF staff calculations.
Note: Sudan is excluded from the LIC group. Country abbreviations are International Organization for Standardization country codes. EMMI = emerging market and middle-income economies; LIC = low-income economies; ME&CA = Middle East and Central Asia; OE = oil exporter.

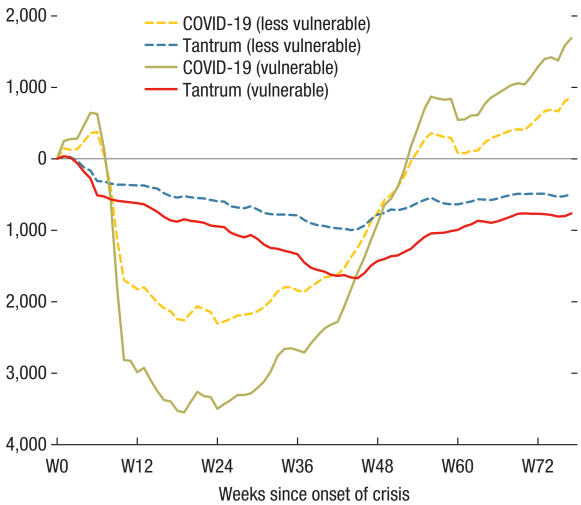
The debt buildup in 2020 led to a significant rise in public gross financing needs, projected to hit $564 billion overall during 2021–22, about a 20-percent increase compared to 2018–19. In addition, the increase in debt and contingent liabilities (stemming from off-budget measures like the provision of loans or guarantees, as well as many other forms of quasi-fiscal operations, including through state-owned enterprises) has weakened government balance sheets, threatening debt stabilization prospects (Box 1.1).

After shrinking due to the collapse in domestic demand and oil prices in 2020, the aggregate current account deficit is projected to widen from its 2020 level of 3.4 percent of GDP to 3.9 percent of GDP in 2022. This reflects the balance between a positive impact from the global recovery on merchandise exports, the impact of higher oil prices and domestic demand recovery on imports, and a slower recovery of travel and tourism (for example, Armenia, Azerbaijan, Georgia, Lebanon, and Morocco).

Low-Income Countries and Fragile and Conflict-Affected States

LICs—many of which are also fragile and conflict-affected states (FCS)—have relatively low vaccination rates and a heavy reliance on the multilateral initiatives for vaccine procurement. These countries, particularly FCS, also have limited health care and testing capacity, making it very difficult to track key pandemic trends. Absent strengthened multilateral action to bolster vaccine supplies, vaccination rates are not expected to reach 70 percent until 2024, exacerbating existing economic and social challenges. Activity is projected to expand by 3.4 percent in 2021 and 4.4 percent in 2022, with growth gradually rising over the medium term in tandem with rising vaccination rates. Consistent with global trends, the pandemic is expected to have lasting effects, with real GDP expected to remain below already

Figure 1.8. ME&CA: Cumulative Capital Flows
(Millions of dollars)



Sources: EPFR database; and IMF staff calculations.
Note: At time *t*, if the country is below the median value (of foreign exchange reserves), then it is characterized as "vulnerable". W1 for Tantrum is May 22, 2013, and W1 for COVID-19 is January 22, 2020. ME&CA = Middle East and Central Asia.

low precrisis projections by 4.8 percent over the medium term (Figure 1.6).

Beyond COVID-19 developments, a more sustained recovery in fragile and conflict-affected countries continues to be marred by conflict (Libya, Syria, West Bank and Gaza, Yemen), humanitarian emergencies (Afghanistan, Somalia, Syria, Yemen), and risks of continued economic and political instability (Afghanistan, Lebanon, Libya, Sudan). The outlook for Djibouti is also clouded by conflict in neighboring Ethiopia. Lebanon is in a very severe economic crisis, aggravated by the pandemic, and urgently needs to deal with a wide array of complex economic and social challenges. Similarly, the turmoil in Afghanistan has pushed its fragile economy, already reeling from the pandemic and drought, into an acute economic crisis with a falling output, paralyzed banks, and rising poverty (Box 1.2).

On the positive side, Sudan, with the help of the international community and the IMF, took bold actions to move to a market-determined exchange rate, raise revenue and reduce subsidies, and start to address deep-rooted governance deficiencies, improving its longer-term prospects and social conditions. As a result, Sudan became the 38th country to reach the Heavily Indebted Poor Countries (HIPC) Decision Point with an immediate reduction in external public debt of $28 billion that will eventually decrease to $6 billion (14 percent of GDP) at the HIPC Completion Point.

Rising Risks and Vulnerabilities

The pandemic and vaccine rollout. The rapid spread of the Delta variant and the threat of more virulent variants have increased uncertainty about how quickly the pandemic can be overcome. Faster progress toward vaccinations would save lives and expedite the recovery, but vaccine delays and further outbreaks represent important downside risks that could delay the recovery and threaten debt sustainability.

Tighter global financial conditions and financing risks. Given large financing needs, EM&MI countries remain vulnerable to a rise in global bond yields if global inflationary pressures persist longer than expected. A tightening in global financial conditions could lead to capital outflows and higher sovereign spreads, exposing particularly those with lower reserves and weaker external accounts (Figure 1.8). This would lead to a rise in interest rates across the region and reduce demand support; pose challenges for highly leveraged firms; increase financing, rollover, debt non-stabilization risks, and worsen bank-sovereign linkages, which, in turn, could further weigh on credit to the private sector and threaten the recovery and financial stability (Box 1.1 and April 2021 *Regional Economic Outlook: Middle East and Central Asia*).

A persistent rise in inflation. This could be due to continued global supply constraints, food price increases, and de-anchoring inflation expectations in countries with weak monetary frameworks. Rising inflation would both hurt the poorer segments of society more, aggravating existing inequalities, and trigger further increases

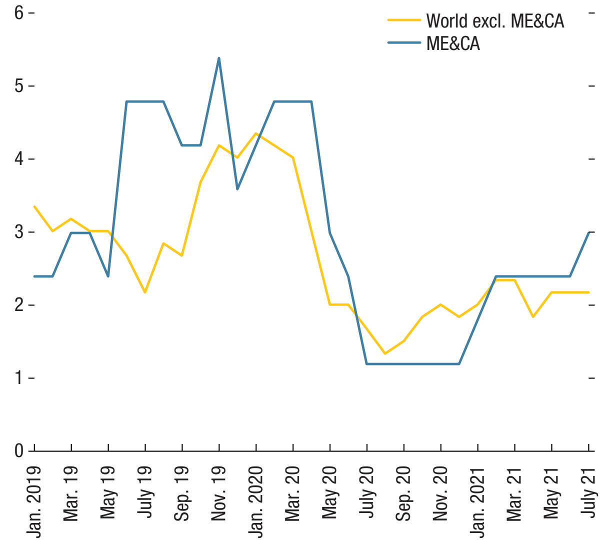
in policy rates, reducing policy support for the fragile recovery.

Premature withdrawal of policy support. More broadly, high debt levels and inflation raise the risk of premature withdrawal of policy support. This, together with low vaccination rates, would leave economies vulnerable to the emergence of new variants, impacting firms in the hardest-hit sectors and vulnerable households. This in turn could increase bankruptcies, defaults and nonperforming loans, leading to the materialization of corporate and banking sector risks (Chapter 3). In addition, such outcomes would increase unemployment and exacerbate inequities (Chapter 2).

A rise in social unrest, geopolitical, and security risks. While lower than in 2019, social unrest has increased in 2021 and could pick up further, due to repeated infection waves, dire economic conditions, high unemployment and food prices, particularly for LICs and FCS (Figure 1.9). This risk is exacerbated by heightened political uncertainty and geopolitical tensions in some countries (for example, in Iraq, Lebanon, Libya, Tunisia, and Yemen). The crisis in Afghanistan is impoverishing millions, especially women and vulnerable groups and has already displaced thousands of Afghans internally. This can set off a wave of refugees, the main channel of outward spillovers to the region (Box 1.2).

Crisis legacies, increased inequality, poverty, and scarring. A longer-term risk for the region is that an uneven recovery from the pandemic leads to a permanent widening of existing wealth, income, and social gaps and, ultimately, weaker growth and less inclusive societies. In addition, about 7 million more people are estimated to have entered extreme poverty during 2020–21 in the region compared to pre-crisis projections. Overall, crisis legacies and preexisting vulnerabilities—such as debt overhang, high structural unemployment, prevalence of inefficient state-owned enterprises that limit private sector innovation and pose fiscal risks, and commodity dependence—could weigh on the region's growth prospects in the post-COVID-19 world if left unaddressed.

Figure 1.9. Recent Trends in Social Unrest
(Fraction of countries, percent, six-month moving average)



Source: Barrett and others, 2020.
Note: Social unrest events are inferred from exceptionally large increases in country media coverage of key terms related to protests, riots, and other forms of civil disorder. ME&CA = Middle East and Central Asia.

Climate shocks. Climate change, a principal driver of more frequent and intense weather-related disasters, poses significant challenges to the ME&CA region, particularly given the region's large adaptation needs and its dependence on hydrocarbons (Box 1.3).

Starker Policy Trade-offs on the Way to a Transformational Recovery

As the COVID-19 pandemic continues, difficult policy trade-offs lay ahead. Many countries in the region are facing the prospect of a protracted recovery. Moreover, in addition to the limited fiscal policy space, countries now face the added burden of diminishing monetary space, given rising inflation. As such, countries face multiple challenges: striking the right balance between protecting lives and livelihoods, fostering a self-sustaining, inclusive, and greener recovery, preserving fiscal sustainability and financial stability, and investing in the future. To prepare

economies for the post-pandemic world, national policies need to be comprehensive to exploit synergies. Regional cooperation could support these efforts through vaccine deployment and by leveraging accelerating global trends.

Accelerated vaccine deployment is needed to save lives, support recovery, and reduce divergences. The strength and duration of the global and regional recovery rests on how well the virus is contained everywhere in the world. In the absence of coordinated action, unequal vaccine deployment will leave the region exposed to further threats to lives and livelihoods, particularly for LICs, FCS, and middle-income countries with limited policy space. Swift vaccination of populations is, therefore, the main short-term policy priority. This entails stepping up efforts to procure and deliver doses while ensuring that health systems are adequately resourced. Strong global and regional cooperation is needed to achieve the goal of vaccinating at least 40 percent of the population by the end of this year and 70 percent by the first half of 2022. So far, the region has secured 576 million vaccines (52 percent of which has been committed by the COVID-19 Vaccines Global Access initiative and African Union's African Vaccine Acquisition Trust), implying that it is short by about 66 million vaccines (24 million for the MENA region, 7 million for Afghanistan, 21 million for Pakistan, and 14 million for the CCA region).[1]

Fiscal policy requires a careful balancing act to preserve debt sustainability while supporting the recovery. Countries where vaccine deployment is slow and infection rates are rising should continue to support lives and livelihoods. Any additional fiscal support should be well targeted toward the most vulnerable and consider available fiscal space. In countries with fiscal space, the eventual withdrawal of policy support should be clearly communicated and gradual to avoid any unnecessarily sharp adjustments that could threaten the recovery. Countries without fiscal space would need to adjust despite the fragile recovery, highlighting the importance of quality and composition of the adjustment. To make the adjustment growth friendly, measures could rely on reallocating spending and increasing its efficiency, eliminating subsidies that benefit the rich, containing high wage bills, and mobilizing revenue (October 2021 *Fiscal Monitor*). Risks to debt stabilization should be carefully managed, including by closely monitoring contingent liabilities accumulated during the pandemic (Box 1.1). Oil exporters should use the opportunity provided by higher oil revenues to rebuild policy space, aim to avoid procyclical spending if the recovery is on hold, and focus any additional spending toward addressing longer-term transformational challenges.

Difficult trade-offs for monetary policy. Central banks have the difficult task of curbing rising inflation without chocking the fragile recovery. If inflation expectations remain anchored, central banks could afford to look through transitory inflation pressures and avoid tightening policy until the recovery takes hold. However, anchoring of inflation expectations might be difficult and hard to judge in real time. Therefore, if inflation proves more persistent, central banks may need to raise interest rates (as was done in some countries) to prevent de-anchoring of inflation expectations. In countries with pegged exchange rates, monetary accommodation is expected to decline as advanced country monetary policies normalize.

Improving policy frameworks to ease trade-offs. The amount of policy space available depends on overall policy frameworks, and credible steps toward improving them can ease some of the trade-offs. First, fiscal adjustments should be anchored in a medium-term fiscal plan that clearly illustrates debt sustainability over the medium term, which in turn could increase trust and reduce adjustment needs (October 2021 *Fiscal Monitor*, Chapter 2). Second, countries with weaker monetary frameworks are more

[1]Vaccines secured come from bilateral deals, donations received, and committed vaccines through global and regional initiatives. They do not represent doses delivered. The estimated shortfalls represent the number of additional doses (beyond those secured) needed to ensure the original target of 60 percent population coverage and were estimated before the recent revision of the target to 70 percent in response to the risk of surging new variants.

limited in the monetary accommodation they can provide without risking destabilizing inflation. Improvements in monetary frameworks (including by avoiding monetary financing of budgets) and clear communication strategies would help relax this trade-off. Third, because debt and financing risks have risen, countries should bolster their debt management strategies, including by taking advantage of current favorable conditions to reprofile debt, expanding the investor base, and developing domestic capital markets (April 2021 *Regional Economic Outlook: Middle East and Central Asia*).

Careful calibration of financial policies. Depending on the strength of the economic recovery and the scope of policy support, 15 to 25 percent of firms in the region may need to be either restructured or liquidated (Chapter 3). Therefore, a gradual withdrawal of financial sector support remains key to preventing defaults that would harm private sector recovery, employment, and financial stability. Given limited fiscal space, emergency measures should increasingly target distressed but viable firms and sectors. Appropriate financial safety nets—including bank resolution and deposit insurance frameworks—will help guard against financial stability risks. Support for private sector credit should be maintained, and banks' exposures to sovereigns should be monitored (April 2021 *Regional Economic Outlook: Middle East and Central Asia*). Over the longer term, enhancing insolvency frameworks and developing domestic capital and debt markets would support corporate sector adjustment.

Labor market policies focused on the future. Improved education and training opportunities and hiring incentives would help facilitate the mobility of workers toward sectors where job opportunities are expanding and support the transition to a post-COVID-19 economy (Chapter 2). Countries that implemented labor retention schemes (for example, Azerbaijan, Egypt, and Jordan) helped prevent sharper rises in unemployment while the crisis was unfolding; as the recovery gains momentum, these countries should unwind these schemes, promote a return to active job searches, and re-engage those who have become displaced. In countries with fiscal space, measures to support job creation, such as carefully designed, temporary, and targeted hiring subsidies, could be used. Countries also need to implement structural reforms to incentivize formal, youth, and women employment and to enhance mobility for migrant workers.

IMF support and Special Drawing Rights (SDR) allocation. The IMF, which has already supported its members in the region with $20 billion in financing since the pandemic began, continues to coordinate with other regional and international institutions to help countries successfully plot a course toward a stronger and more durable recovery. Moreover, in parallel with the World Bank, the IMF has helped in facilitating the Debt Service Suspension Initiative by G20 and Paris Club creditors, and has supported the Common Framework for debt treatment, which helps to address acute sovereign debt challenges. The IMF is currently revamping its broader strategy for FCS, which will articulate how the IMF's core competencies, mandate, and instruments can be leveraged to help across the fragility and conflict spectrum. It will also clarify how modalities of engagement can be better customized to the special characteristics of FCS and spell out how the IMF can contribute and cooperate with other partners.

The IMF's 2021 general allocation of SDR—the largest in the history of the IMF—became effective in August, increasing the region's reserve assets by $49.3 billion. At a time when many countries face difficult choices between meeting essential health and social spending needs, supporting their economies more broadly, and fulfilling obligations on external borrowing, the SDR allocation is set to ease some of the constraints and help them better manage the trade-offs. For SDRs to have maximum benefit, decisions on how to best use them should be prudent, well-informed, and consistent with macroeconomic sustainability and transparency.

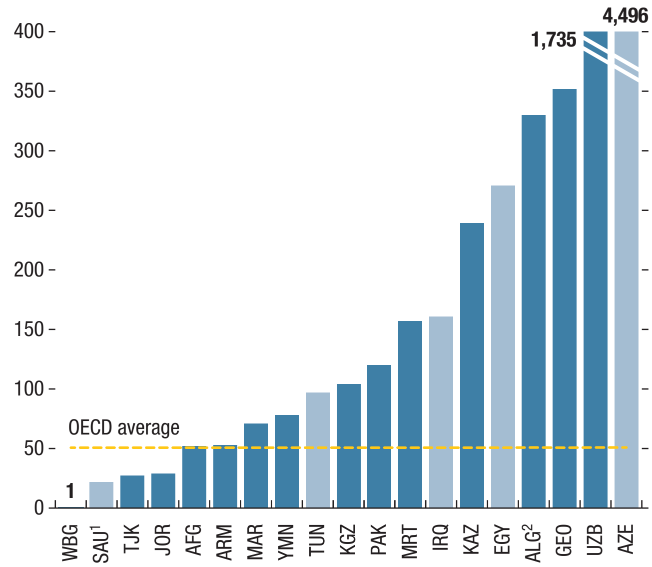
Investing in the Future to Emerge Stronger

The region faces long-standing structural issues, and these came into sharp focus at the onset of the pandemic. If left unaddressed, these challenges will remain vulnerabilities in the post-pandemic world. However, the crisis also provided silver linings for a transformational recovery that would lead to a new development model, one that contributes to enhanced growth and puts the region on a more sustainable and inclusive economic path.

Rethink the role of the state, foster a dynamic private sector, and enhance social protection. State interventions during the pandemic have helped mitigate the health and social impact of the crisis. This would be an opportune moment to build on this and revisit social contracts to reorient them toward health and education, expand the quality and coverage of safety nets, and reexamine the role and efficiency of existing subsidies. In parallel, a thorough revaluation of the ultimate objectives of state-owned enterprises—which have a large footprint in the region (Figure 1.10)—and their governance, together with competition-enhancing regulatory reform, is critical to identify and reduce fiscal risks while promoting private sector innovation and growth (see Rigo and others 2021). Labor market reforms could support this process by reducing excessive protection of public sector jobs and supporting the creation of good-quality jobs in the private sector (see Chapter 2). Improving anti-corruption frameworks would also help lay the foundation for stronger growth (see Jarvis and others 2021).

Leverage emerging global trends. It is important to ensure the region does not fall behind important global trends and leverages emerging growth opportunities. Many countries in the region used the crisis as an opportunity to accelerate these trends. For example, Morocco set up a centralized digital registration system for vaccinated people and introduced a unified internet portal to better tailor the delivery of public services to citizens' needs, improve transparency, and facilitate efficiency gains. Digital

Figure 1.10. ME&CA: State-Owned Enterprises
(Number, 2019 or latest available)



Source: OECD; National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization country codes. OECD = Organisation for Economic Co-operation and Development. Light shaded bars show data from alternative data sources.
[1]Saudi Arabia reporting is limited to the portfolio of entities under the remit of the reporting institution and therefore cannot be considered wholly representative of the national SOE portfolio.
[2]Number of SOEs in Algeria is representative of SOEs with 90 to 100 percent government ownership.

solutions have also been used to reach informal workers in Egypt. The Central Bank of Tunisia conducted an experiment with the Banque de France in July for a cross-border transfer of wholesale central bank digital currency, while the central banks of UAE and Saudi Arabia have undertaken a similar joint initiative through Project Aber. Such alternative cross-border transfer channels have the potential to enhance transparency, increase speed, and lower costs for cross-border transactions, with knock-on effects on economic activity, further expanding the participation of diasporas in domestic economies. Building on the crisis response, countries should invest in digital technologies and infrastructure to better identify vulnerable groups, deliver support, promote financial inclusion, and catalyze new growth and employment opportunities.

Adapt to climate change, mitigate emissions, and diversify economies. While several countries

have national climate strategies (for example, Egypt, Saudi Arabia, and the UAE), many countries in the region are in the early stages of drawing up national adaptation plans, and these efforts need to be accelerated. Regional cooperation could support national efforts to adapt to climate change, mitigate emissions, and manage transition risks, creating opportunities for green investments and job creation (Box 1.3).

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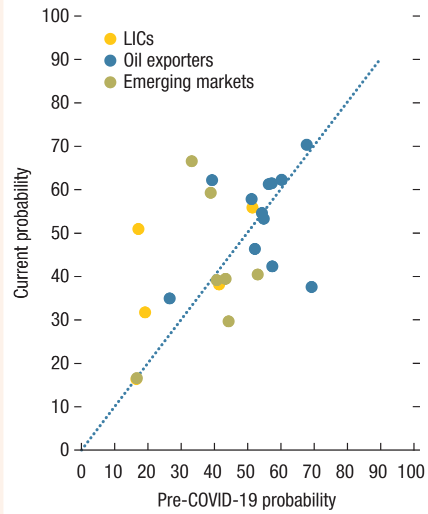
Box 1.1. ME&CA: Medium-term Debt Stabilization Risks

The COVID-19 shock has raised fiscal deficits and public debt-to-GDP ratios across the ME&CA region, worsening debt stabilization prospects in several countries.[1] Importantly, most ME&CA countries face a higher probability (than they did pre-COVID-19) that debt would not stabilize over a three-year horizon, based on an analysis using the IMF's new Sovereign Risk and Debt Sustainability Framework debt fan-chart toolkit (Box Figure 1.1.1). Notably, for some emerging market countries (EMs), particularly those under IMF-supported programs, the probability of debt non-stabilization is expected to decrease, benefiting from the medium-term frameworks provided under these programs.

These projections underscore the need for fiscal prudence and urgency. Even before COVID-19, the probability of debt non-stabilization was high (44 percent on average across ME&CA countries in our sample), and this probability increased further post-COVID-19, leaving countries without the fiscal space needed to absorb additional shocks. A decomposition of projected medium-term debt flows shows that reducing debt to pre-COVID-19 levels would require much stronger fiscal adjustment (than envisaged pre-COVID-19) for over a decade (see October 2021 *Fiscal Monitor*, Chapter 2). However, even these projections may be optimistic, as they rest on several favorable baseline assumptions (Box Figure 1.1.2). In particular,

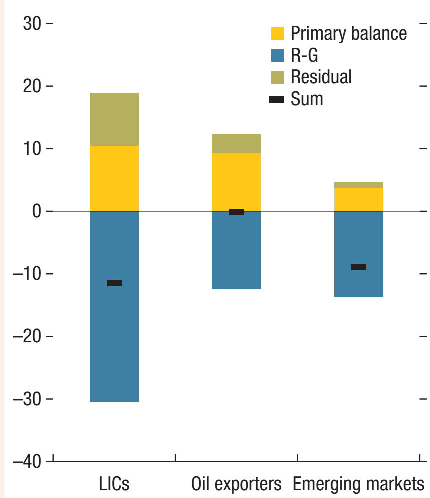
1. Under the baseline, ME&CA countries are projected to benefit from significantly negative interest rate-growth differentials, similar to, and in some cases exceeding, their pre-COVID-19 average (Box Figure 1.1.3). Clearly, though, risks of lower growth are now more elevated due to new COVID-19 waves and medium-term scarring, as well as of a sudden rise in global interest rates and the ensuing large financing needs.
2. The material debt reductions targeted for EMs hinge on relatively strong fiscal adjustment efforts over the medium term. However, the socio-political feasibility of these efforts may be tested in the context of fragile and high unemployment-ridden recoveries (Box Figure 1.1.2).
3. Many countries have provided extraordinary financial support during the pandemic through off-budget measures and quasi-fiscal operations, including through state-owned enterprises (see Rigo and others 2021). A materialization of these contingent liabilities may add to the above factors.

Box Figure 1.1.1. Probability of Debt Nonstabilization [Debt(2024) > Debt(2023)]



Sources: National authorities; and IMF staff calculations.
Note: LIC = low-income country.

Box Figure 1.1.2. Decomposition of Cumulative Debt Changes between End-2020 and End-2026



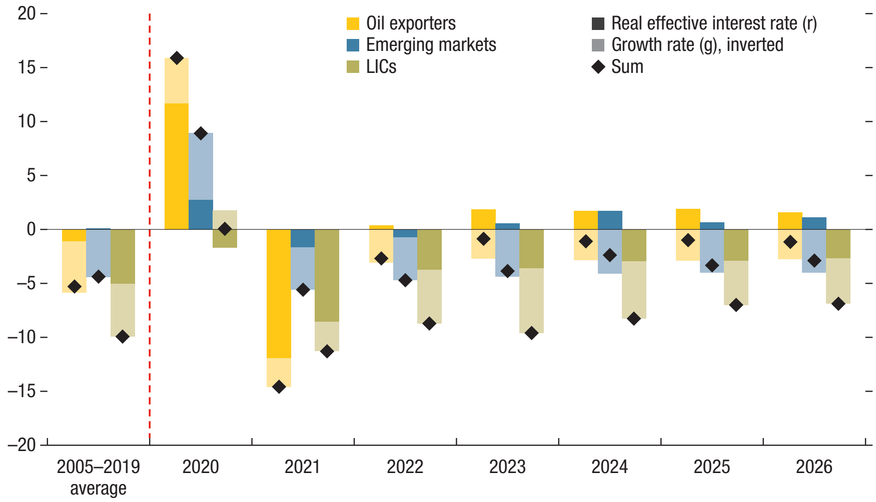
Sources: National authorities; and IMF staff calculations.
Note: LIC = low-income country; R-G = Real interest rate on debt minus real growth rate of the economy.

Prepared by Tannous Kass-Hanna, Lawrence Norton, Sidra Rehman, and Suchanan Tambunlertchai, with research assistance from Kate Nguyen, Jonathan Saalfield, Ahmad Jawed Sakhi. The project was led by Ali Abbas.

[1]This box excludes Afghanistan, Lebanon, Libya, Somalia, Sudan, Syria, Uzbekistan, and the West Bank and Gaza.

Box 1.1 *(continued)*

Box Figure 1.1.3. ME&CA: Real Effective Interest Rates and Real Growth Differential over the Period 2005–2026
(Median country, percentage points)

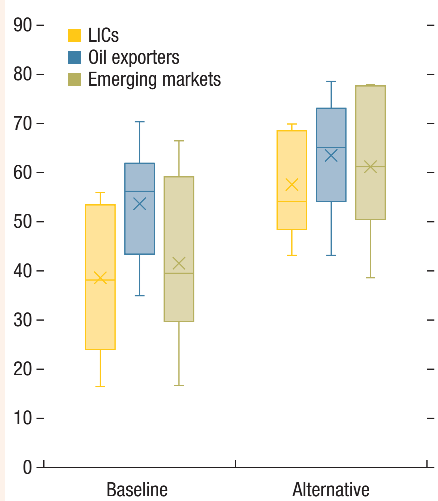


Sources: National authorities; and IMF staff calculations.
Note: LIC = low-income country; ME&CA = Middle East and Central Asia.

An adverse scenario, where these baseline assumptions are "tested," increases further the probability of debt non-stabilization. The alternative scenario assumes (during 2022–26): (i) higher real effective interest rates by 150 basis points; (ii) a cap on yearly projected growth for each country at the average real growth during the period 2001–19; (iii) lower primary balances by 1 percent of GDP for EMs and oil exporters, and 0.5 percent of GDP for low-income countries (LICs), to account for possible optimism in medium-term fiscal frameworks; and (iv) an additional 1 percent of GDP in contingent liability materializations every year, to account for implicit and explicit government guarantees of private sector or state-owned enterprises' (SOE) debt. The probability of debt non-stabilization increases markedly under the alternative scenarios, particularly for EMs and LICs (Figure 1.1.4).

This calls for continued vigilance and consideration of fiscal adjustment measures once the recovery is underway, anchored in a credible medium-term fiscal plan. Steps toward stronger institutions would enhance the credibility of medium-term adjustment, which would help anchor expectations and signal a commitment to fiscal prudence, including careful budgeting of likely risks to the public balance sheet from SOEs and other contingent liabilities. Given high debt levels, maintaining policy space for critical spending will also require expedited structural reforms to boost growth, debt management strategies to reduce confidence risks arising from near-term financing pressures, and additional grant and concessional financing from development partners.

Box Figure 1.1.4. Baseline versus Alternative Scenario Probabilities of Debt Nonstabilization



Sources: National authorities; and IMF staff calculations.
Note: LIC = low-income country.

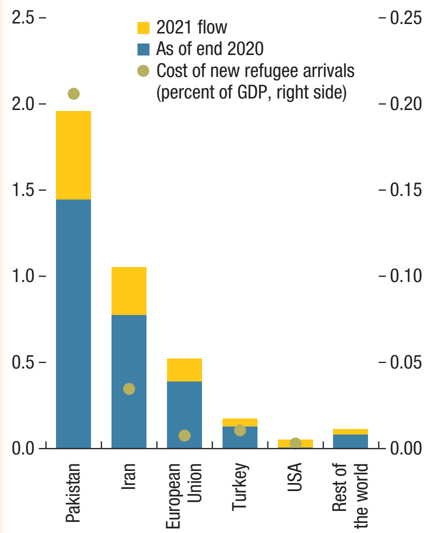
Box. 1.2. Turmoil in Afghanistan—Outward Spillovers

The turmoil in Afghanistan is expected to generate important economic and security spillovers to the region and beyond. It has fueled internal displacement and could trigger a surge in refugees to neighboring countries, Turkey, and Europe. While financial spillovers have been limited, "cash" trade across borders is likely to grow. The disruption of exports to Afghanistan could have a macroeconomic and social impact on some neighbors. Beyond economic spillovers, concerns about adverse security implications for the region could weigh on risk sentiment and growth prospects.

Afghanistan has sustained multiple shocks in the aftermath of the Taliban's return to power. With nonhumanitarian aid halted and foreign assets largely frozen, Afghanistan's aid-dependent economy faces severe fiscal and balance-of-payments crises. Cash shortages and the loss of correspondent banking relationships have crippled Afghan banks. These shocks could cause up to a 30 percent output contraction, with falling imports, a depreciating Afghani, and accelerating inflation. The resulting drop in living standards threatens to push millions into poverty and could lead to a humanitarian crisis.

The turmoil is fueling a surge in Afghan refugees. By the end of 2020, there were 3.5 million people displaced inside Afghanistan and nearly 3 million Afghan refugees around the world, half of them in Pakistan. Assuming that 1 million Afghans flee their country and settle in other countries in proportion to the existing stock of Afghan refugees, the annual cost of hosting new refugees would vary from $100 million in Tajikistan (1.3 percent of GDP) to about $300 million in Iran (0.03 percent of GDP) and more than half a billion dollars in Pakistan (0.2 percent of GDP).[1] A large influx of refugees could put a burden on public resources in refugee-hosting countries, fuel labor market pressures, and lead to social tensions, underscoring the need for assistance from the international community.

Box Figure 1.2.1. Afghan Refugees and Asylum-Seekers
(Millions of people)



Sources: UNHCR; country news; and IMF staff calculations.
Note: IMF staff projections based on UNHCR data and country news. For illustrative purposes, the projections assume one million new refugees from Afghanistan and allocate them in host countries in proportion to the existing stock of Afghan refugees.

Exports to Afghanistan are macroeconomically and socially relevant for Iran, Pakistan, Turkmenistan, and Uzbekistan. They make up 4–8 percent of these countries' exports, although their share in domestic economies is rather small. While the macroeconomic impact of a drop in exports to Afghanistan appears manageable, there will likely be important sectoral and social implications. Exports are concentrated in agricultural and basic consumer goods, fuel, and raw materials, production and distribution of which employ vulnerable populations, such as farmers and small traders.

Although financial spillovers have been limited given the negligible exposure of foreign financial institutions to Afghanistan's small banking sector, cross-border "cash" flows could increase. With Afghanistan receiving large donor funds, there has been a substantial "cash" flow across the borders in recent years, with US dollar banknotes exported from Afghanistan as part of legitimate trade and possibly illicit flows. This cross-border flow of cash will likely grow, raising new anti–money laundering/combating the financing of terrorism concerns, but its net balance could reverse now that Afghanistan itself is experiencing shortages of foreign currency. Furthermore, trade in border regions could shift to the Pakistani rupee and Iranian rial.

Prepared by Armine Khachatryan (EUR-lead), Mohamed Jaber, Jesus Sanchez (both MCD) with guidance from Azim Sadikov.
[1]See Camarota (2015) and Richwine and others (2020).

Box 1.3. Climate Change Challenges in the Middle East and Central Asia

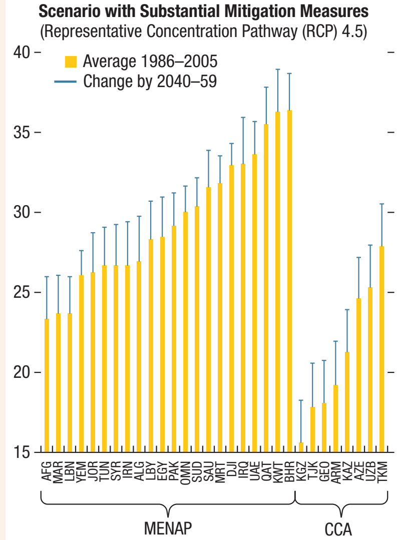
Climate Change. Average temperatures are expected to increase in all ME&CA countries by 2050 (Box Figure 1.3.1), even with significant cuts in global emissions. Lower and more erratic precipitation will aggravate the challenges from water scarcity. In addition, rising sea levels, and more frequent weather-related disasters will be felt unevenly, with communities dependent on agriculture especially exposed. Fragile and conflict-affected states are at risk due to low institutional capacity, inadequate infrastructure, limited social safety nets, and other factors.

Adaptation. Most countries have not yet estimated adaptation costs or prioritized adaptation policies. Securing financing for adaptation will require countries to fill data gaps on the costs and benefits of investment, mobilize internal resources, and seek support from bilateral and multilateral funding sources. Green bonds, which are earmarked for specific climate and environmental projects, could help attract resources for adaptation goals.

Mitigation. The region accounts for a small but growing share of global greenhouse gas emissions (about 10 percent), with large contributions from just a few countries. Many countries have communicated mitigation targets as part of the 2015 Paris Agreement, with significant emission reductions often conditional on external support. Achieving these targets by 2030 requires action and regional cooperation today. High-quality investment in green infrastructure will also support green jobs and provide other local co-benefits for air quality and health.

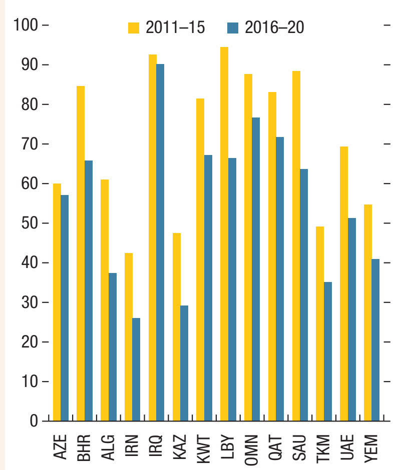
Transition. Global mitigation efforts will affect energy markets, impacting countries that rely on hydrocarbon revenues. While these countries' share of non-oil revenues has increased (Box Figure 1.3.2), reforms to accelerate economic diversification and rationalize government expenditures will be required to navigate the transition (Mirzoev and others, 2020). Strengthening climate-risk disclosure frameworks will help ensure companies and financial institutions are well-positioned to manage transition risks.

Box Figure 1.3.1. Average Summer Temperatures, 1986–2059
(Degrees Celsius)



Sources: Climate Impact Lab; and IMF staff calculations.
Note: RCP 4.5 is one of four scenarios considered by the IPCC for the trajectory of greenhouse gas concentration. The yellow bars reflect historical outcomes of average summer temperatures over the period 1986–2005. The blue bars are projections for the change in temperature for the period 2040–59, based on the median output of an ensemble of the most advanced climate models (CMI P5).

Box Figure 1.3.2. Hydrocarbon Revenues as a Share of Total Revenue, Oil-Exporters
(Percent)



Sources: Country authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization country codes. Revenues are of the general government except for Algeria, Azerbaijan, and Bahrain, which are of the central government.

Prepared by Gareth Anderson, drawing on a forthcoming paper "Feeling the Heat—Adapting to Climate Change in the Middle East and Central Asia."