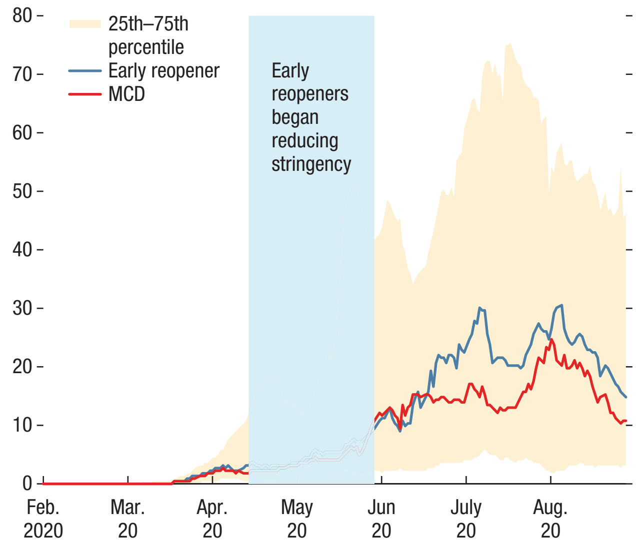
1. Regional Developments and Outlook

The coronavirus disease (COVID-19) pandemic continues to sweep across the region, though countries are cautiously proceeding with reopening. The necessary public health response to the pandemic has greatly decreased mobility and has come at a steep economic cost. As a result, real GDP in the region is projected to fall by 4.1 percent in 2020. This contraction is 1.3 percentage points larger than projected in April 2020. With global recovery subdued, downside risks continue to dominate the outlook as the pandemic continues to test countries. Ensuring adequate resources for health systems and correctly targeting support programs are still immediate priorities. In the near future, governments and policymakers need to continue to act decisively to secure jobs, provide liquidity to businesses and households, protect the poor, and put in place a carefully designed economic road map to recovery. Further actions will be necessary to address pressing vulnerabilities in countries with limited fiscal space to ensure a smooth recovery while maintaining macroeconomic sustainability.

Figure 1.1. New COVID-19 Cases: MCD
(Number of cases per million, seven-day moving average)



Sources: National authorities; and IMF staff calculations.
Note: MCD = Middle East and Central Asia countries. An MCD country is classified as an early reopener if its Oxford Stringency Index value at the end of May is lower than its highest, or most stringent, index value before the end of May. A country is classified as a late reopener if its index value at the end of May is its highest index value to date.

Necessary Lockdowns Came at an Economic Cost

The Middle East and Central Asia (MCD) region responded to the pandemic with swift measures to mitigate and contain the virus. Countries introduced a range of policies to restrict foreign and countrywide travel, close businesses and schools, trace and quarantine individuals at risk of contracting the virus, and require mandatory masks and gloves. The region's ability to treat those infected by the virus and protect health care workers varied significantly among countries, given respective differences in health care capacity. For example, the number of doctors per 100,000 people ranges from about 2.3 (Somalia 2014) to 712 (Georgia).

As of September 8, countries reported between 61 and 48,038 COVID-19 cases per million people and fatality rates between 2 and 304 people per million, with Armenia, Iran, Iraq, Oman, and the Kyrgyz Republic hit the hardest. With an average of 70 individuals per million, COVID-19-related deaths in the MCD region are higher than in sub-Saharan Africa and the Asia Pacific region, but well below those in Europe and the Western Hemisphere.

Since the first round of reductions in stringency, several countries saw growth in cases, which was more pronounced for many of the early reopeners (Algeria, Azerbaijan, Djibouti, Iran, Jordan, Kuwait, Kyrgyz Republic, Lebanon, Syria, United Arab Emirates, Uzbekistan, West Bank and Gaza). These countries, prior to reopening, also had higher infection rates (Figure 1.1).

Prepared by Joyce Wong, Yang Yang, and Gohar Abajyan.

©International Monetary Fund. Not for Redistribution

The necessary public health response to the pandemic has greatly decreased mobility and brought a steep economic cost (Figure 1.2).

As a result, activity took a hit, and real GDP in the MCD region is projected to fall by 4.1 percent in 2020, after growing by 1.4 percent in 2019. The projected contraction for 2020 is 1.3 percentage points larger than in the April 2020 *Regional Economic Outlook: Middle East and Central Asia* (REO), in line with revisions to global growth over this period. The MCD countries' top 10 trading partners are also projected to contract by 1.5 percentage points more relative to the April 2020 REO. Despite supportive policies, growth revisions also appear to be reflecting a deeper-than-expected impact of lockdowns on mobility, in addition to weak global growth. Compared with other regions, the contraction in the MCD region is broadly in line with oil exporters and middle-income countries in sub-Saharan Africa, but nearly half that of Latin America and the Caribbean, reflecting the lower impact from COVID-19.

Early Signs of Improvement in a Difficult Environment

Virus containment measures since the onset of the pandemic in 2020 have had a severe adverse effect on economic activity beginning in March as shown, for example, by purchasing managers' indices across several countries (Figures 1.3 and 1.4). Partly reflecting these measures, first quarter real GDP for the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) contracted by 5 percent year over year and, while remaining positive, growth for the Caucasus and Central Asia (CCA) declined to 3 percent year over year. Although purchasing managers' indices have shown somewhat of a rebound in recent months, indicators remain subdued broadly around the expansion threshold.

Consumer demand took a hit on the back of weak tourism and remittance inflows, which are key income sources for the region. International flights have all but stopped in many countries (Figure 1.5). Remittances saw declines ranging from 6 percent year over year in Uzbekistan to more than 25 percent in the Kyrgyz Republic during the first half of 2020 (Figure 1.6). Remittances in Pakistan have so far bucked the trend on the back of strong flows from the United States and increased usage of formal remittance channels. Recent data are not available for fragile states, but the impact will likely be sizable for countries such as Yemen and Syria, which depend highly on Gulf Cooperation Council (GCC) remittances. These declines, in turn, could have a sizable impact on poverty and inequality (Chapter 2).

Oil-exporting countries were hit hardest by a double-whammy of the pandemic and the resulting sharp decline in oil demand and prices. After dropping to 20-year lows between March and April, the Organization of the Petroleum Exporting Countries and other major oil producers (OPEC+) agreement in April and extension in June (which entailed oil production curtailment) succeeded at stabilizing oil prices, which have recovered more than 50 percent of the losses suffered since the end of 2019 but still currently trade at 40 percent below pre-COVID-19 levels (Figure 1.7). With the plunge in oil prices and output, available data point to a collapse in oil revenues during the first half of 2020, approaching a maximum of 50 percent (for Iraq). In the near and medium term, oversupply and large inventories remain concerns, while demand continues to be dampened by low air traffic volume (despite recovering road traffic). Oil futures curves indicate that prices are expected to increase toward $48 a barrel in the medium term (from $41 for 2020), remaining some 25 percent below the 2019 average.

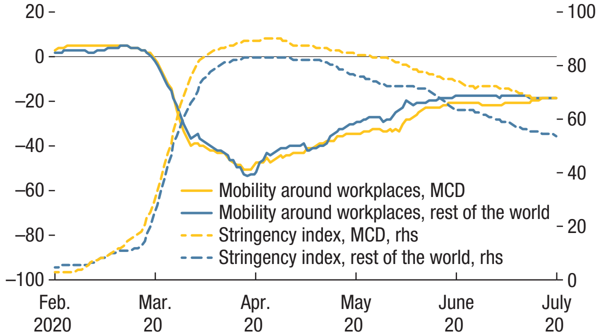
Mirroring measures taken to tackle COVID-19 (Box 1.1) and the oil price shifts, fiscal accounts in several countries deteriorated during the first half of 2020 (Figure 1.8), although less so than in other regions, reflecting smaller packages and expenditure reallocation (Chapter 3). For

©International Monetary Fund. Not for Redistribution

Figure 1.2. Lockdowns Took a Toll on Activity

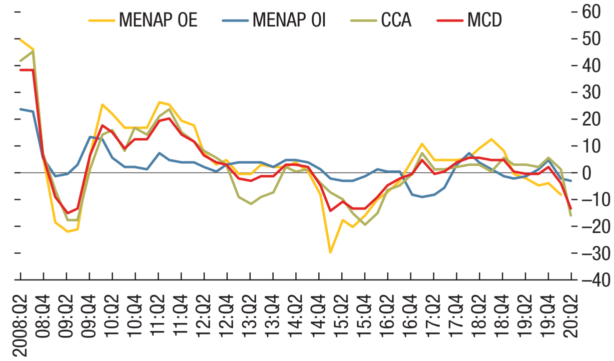
Mobility collapsed as countries locked down to fight the pandemic ...

1. MCD: Mobility and Stringency Index
(Seven-day moving average)



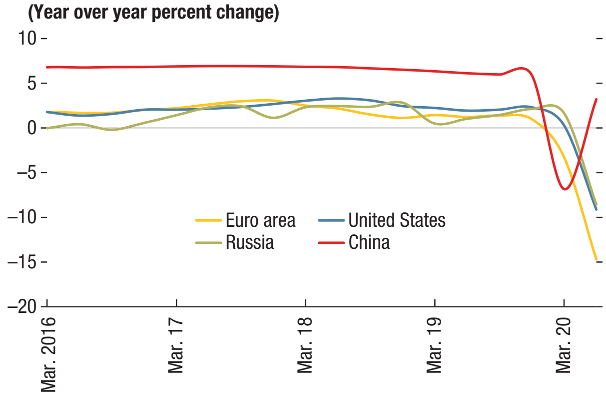
... leading to a collapse in economic activity in the second quarter of 2020 ...

2. Real GDP Growth
(Year over year, percent change)



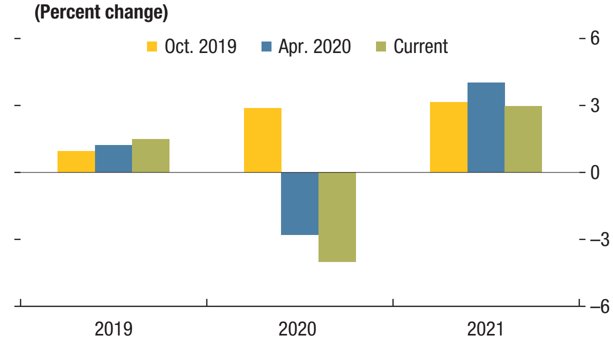
... in line with global trends.

3. Global Growth
(Year over year percent change)



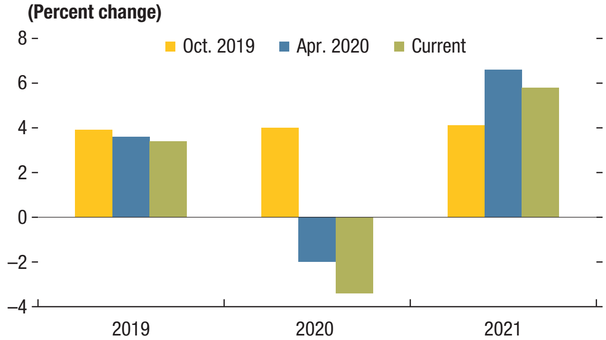
Consequently, GDP growth has been revised further down ...

4. MCD: Real GDP Projections
(Percent change)



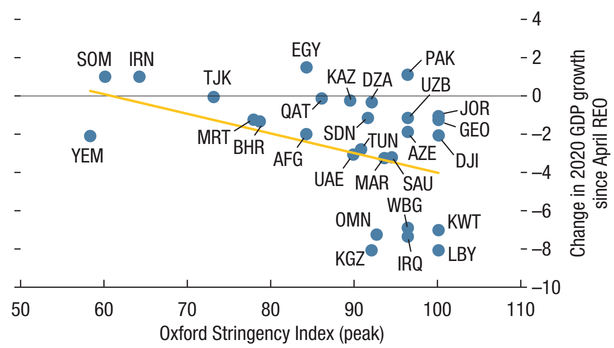
... in line with trading partners' revisions ...

5. MCD: Top 10 Trading Partners' Real GDP Growth
(Percent change)



... and partly linked to lockdown stringency.

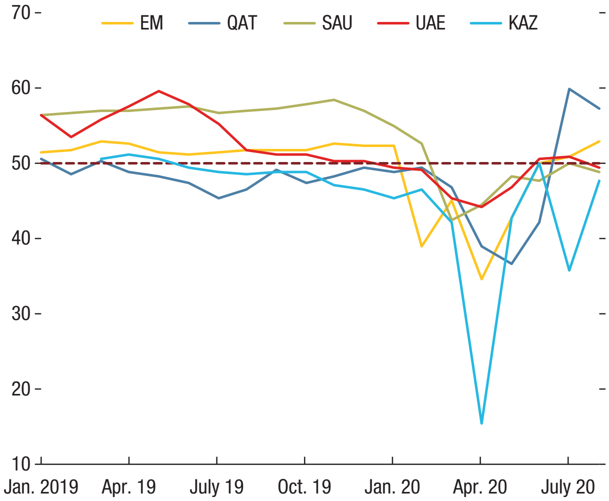
6. Revisions in 2020 GDP Growth since April 2020 and Stringency of COVID-19 Measures



Sources: Oxford Coronavirus Government Response Tracker; Google Mobility Trends; national authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; lhs = left-hand scale; MCD = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers; rhs = right-hand scale. Country abbreviations are International Organization for Standardization (ISO) country codes.

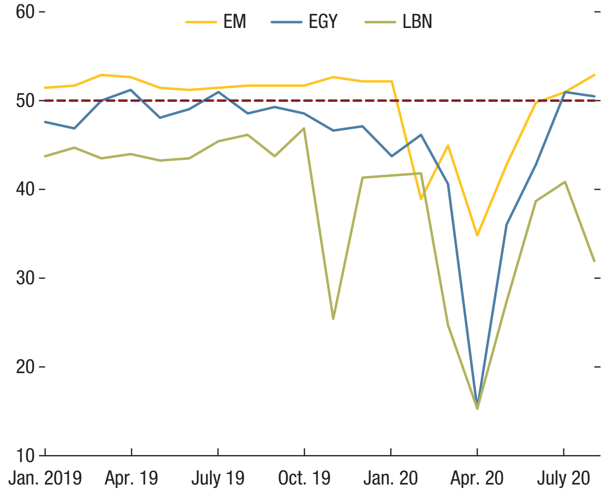
©International Monetary Fund. Not for Redistribution

Figure 1.3. PMI: Oil Exporters
(Seasonally adjusted, 50+ = expansion)



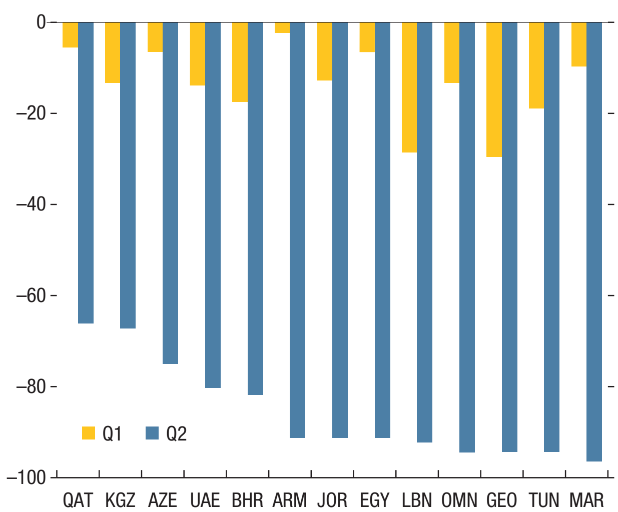
Sources: Haver Analytics; Thomson Reuters Datastream; and IMF staff calculations.
Note: PMI = purchasing managers' index. Country abbreviations are International Organization for Standardization (ISO) country codes. EM = emerging market economies.

Figure 1.4. PMI: Oil Importers
(Seasonally adjusted, 50+ = expansion)



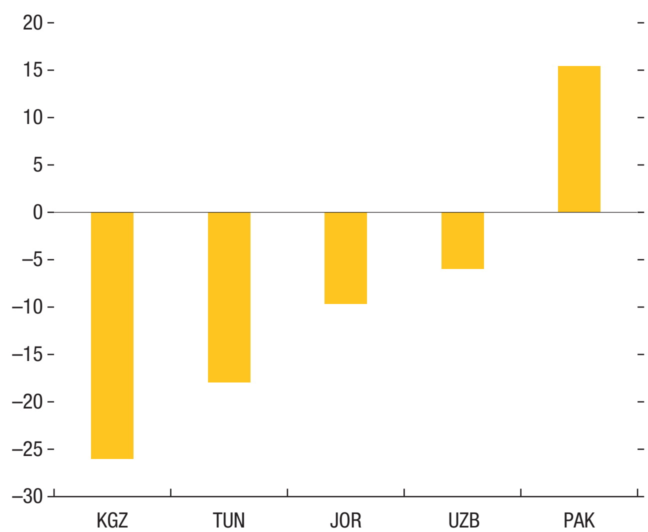
Sources: Haver Analytics; Thomson Reuters Datastream; and IMF staff calculations.
Note: PMI = purchasing managers' index. Country abbreviations are International Organization for Standardization (ISO) country codes. EM = emerging market economies.

Figure 1.5. Change in International Flight Arrivals
(Percent, year-over-year change)



Sources: FlightRadar24; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan. Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 1.6. Remittances
(Percentage difference between 2020:H1 and 2019:H1)

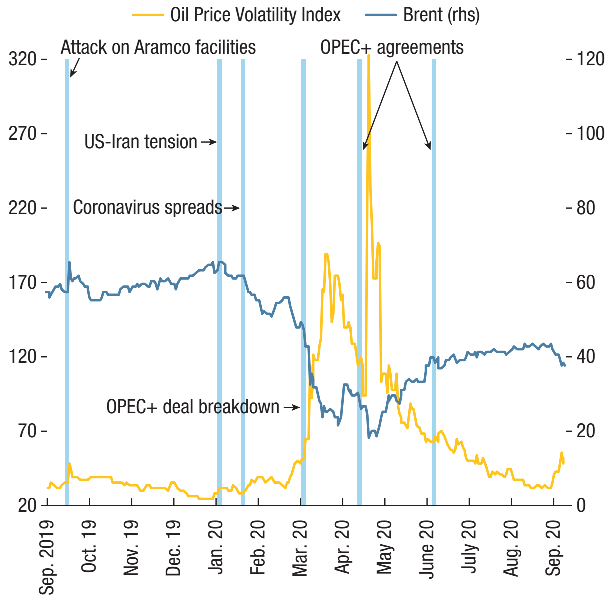


Sources: National authorities; and IMF staff calculations.
Note: For KGZ, the difference is between the first five months of each year. Country abbreviations are International Organization for Standardization (ISO) country codes.

countries for which such data are available, fiscal deficits ranged from about 0.8 percent of GDP in Azerbaijan to 4 percent of GDP for Jordan and Tunisia, implying sizable deterioration compared with the same period last year.

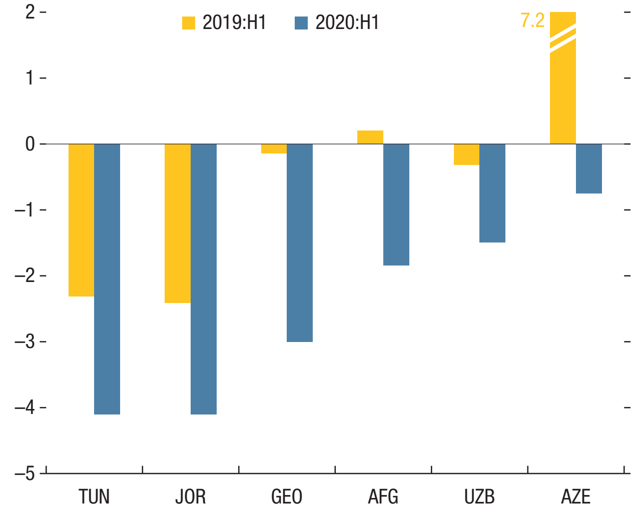
©International Monetary Fund. Not for Redistribution

Figure 1.7. Oil Prices and Oil Volatility
(Index, US dollars a barrel)



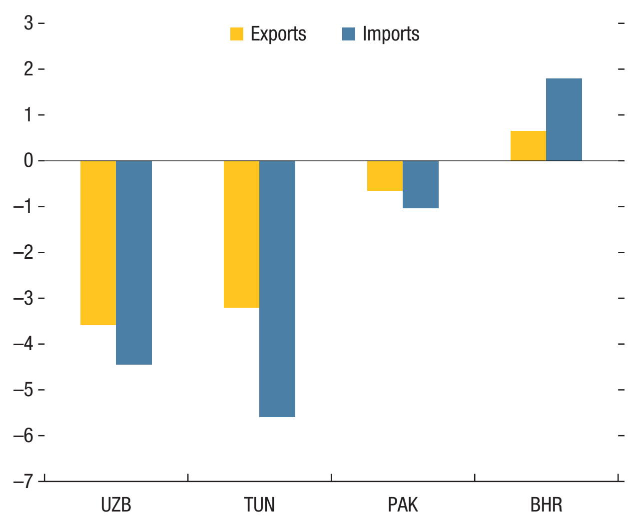
Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: OPEC+ = Organization of the Petroleum Exporting Countries and other major oil producers; rhs = right-hand scale.

Figure 1.8. Fiscal Balances
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 1.9. Change in Trade
(Difference between 2020:H1 and 2019:H1, percent of GDP)



Sources: National authorities; and IMF staff calculations.

With the exception of Bahrain, trade balances for several countries improved (Pakistan, Tunisia, Uzbekistan), as activity collapsed and imports were compressed (Figure 1.9). Although export declines during the first half of 2020 were sizable and ranged from 1 percent of GDP in Pakistan to nearly 4 percent of GDP in Uzbekistan, import compression was of the same or even larger magnitude.

Capital flows were highly volatile in March and April, with the MCD region seeing estimated outflows of $6 billion to $8 billion during this time. They have since stabilized, and MCD countries have accounted for more than 40 percent of sovereign issuances by all emerging markets since the end of March. Nonetheless, cumulative outflows from the region since the start of the crisis remain negative and total more than $5 billion.

Amid COVID-19 lockdown measures, social tensions and geopolitical risk appear to have de-escalated during the pandemic. Nonetheless, regional uncertainty remains high given ongoing conflicts in Afghanistan, Libya, Somalia, Syria, and Yemen, limiting policy reactions. The renewed hostilities in the Nagorno-Karabakh conflict zone add further risk. Lebanon, in particular, remains in a difficult situation, with a projected contraction of 25 percent for 2020. The country experienced

©International Monetary Fund. Not for Redistribution

political upheaval in October 2019, exacerbated by a sovereign debt default in March 2020, the first in the country's history. Deterioration of the local currency (whose parallel rate has lost 70 percent of its value since the end of 2019), imposition of informal capital controls by individual banks, and foreign exchange shortages caused a hyperinflationary spiral, resulting in food and electricity shortages and increasing poverty. In August, a massive explosion at the Beirut port caused sizable loss of life and physical damages. The event also led to the resignation of the government and renewed protests, exacerbating the country's difficulties and uncertainties.

Swift Support with Room for Enhancements

Most countries deployed an array of health, fiscal, monetary, and financial policies to mitigate the pandemic's immediate impact (Box 1.1, Figure 1.10).

Nearly all countries have boosted the health sector's capacity. Measures have included tax exemptions on food and medical supplies, increased spending on medical equipment and supplies, allowances for health care staff, and augmentation of hospital capacity and building quarantine facilities.

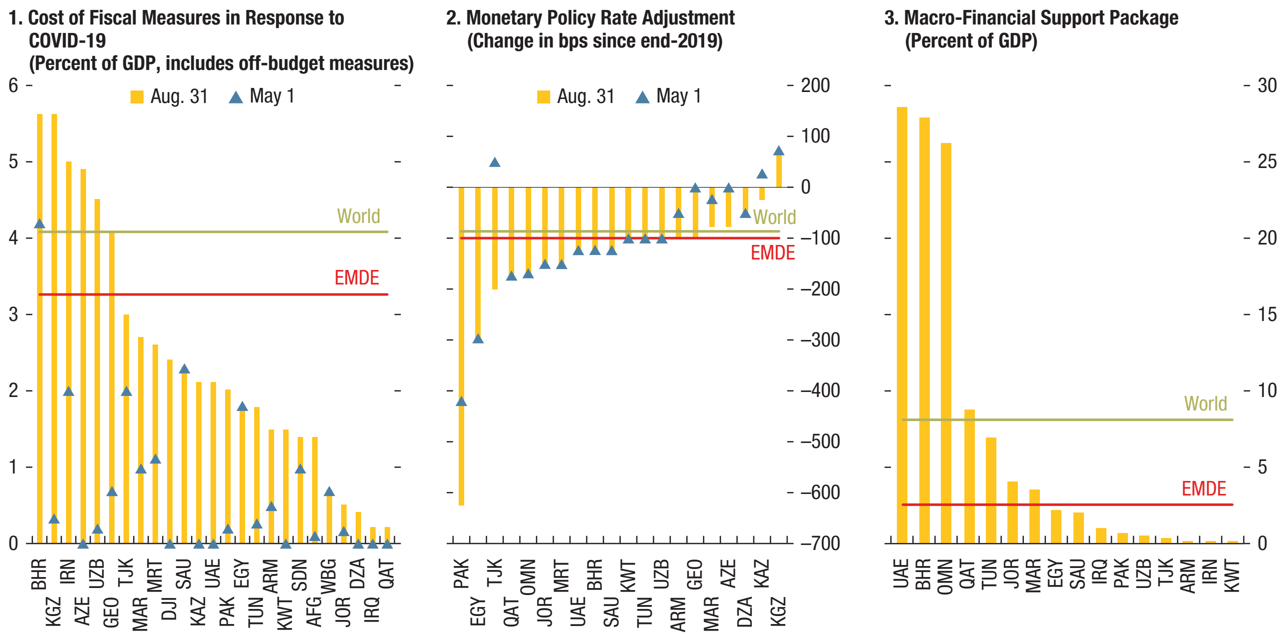
Fiscal policy has also been used to cushion the blow to households and businesses, and fiscal packages in the region, including off-budget measures, average about 2 percent of GDP, lower than the emerging market and developing economy average of about 3 percent of GDP. Revenue measures included exemption from rents and property and land taxes, deferrals or exemptions on declaration and payments of individual and corporate taxes, and suspension or reduction of various government fees and penalties. Spending measures focused on strengthening unemployment benefits, cash transfers to low-income households, subsidies to small and medium-sized enterprises (SMEs), and utility subsidies. Many governments also provided subsidized loans to SMEs (Box 4.2), businesses in hard-hit sectors, and low-income households. The fiscal support, in several cases, however, did not translate into a fiscal impulse, as countries also introduced offsetting revenue and expenditure measures.

Central banks in the region have also deployed monetary and financial policy, including unconventional tools. In countries with flexible currencies, the exchange rate was allowed to act as a buffer, with depreciations in mid-March, which have since partially reversed. Among pegged currencies, those of most GCC countries (with the exception of Oman) fared relatively well compared with during previous oil shocks, supported by bond issuances and the rebound in oil prices. By the end of August, most central banks had cut their policy rates. Those with pegs, managed floats, and crawls cut rates in line with the Federal Reserve. Cuts were especially deep in Egypt and Pakistan, by a cumulative 300 and 625 basis points, respectively, with Egypt reducing its rate by a further 50 basis points at the end of September. Half of the region's central banks supplied additional liquidity to the banking system, totaling more than $40 billion. Central banks also deployed many instruments to boost lending, including cutting the reserve requirement ratio, encouraging loan repayment moratoriums, introducing repo arrangements, providing liquidity support for lending and loan guarantees, and lowering the cost of refinancing. The Central Bank of Azerbaijan opened a bilateral swap line with the European Bank for Reconstruction and Development.

About half of the region's central banks have loosened their macro-financial stance (Box 1.1). Central banks have relaxed countercyclical capital requirements while also relaxing the liquidity ratio, capital adequacy requirements, and, in some countries, loan classification and provisioning rules (Chapter 4). In addition, direct central bank financing of the public sector has been used in Bahrain and Turkmenistan, in the latter partly reflecting underdeveloped financial markets.

©International Monetary Fund. Not for Redistribution

Figure 1.10. Policy Responses to COVID-19



Source: IMF staff calculations.
Note: EMDE = emerging market and developing economies. Country abbreviations are International Organization for Standardization (ISO) country codes.

Source: IMF staff calculations.
Note: bps = basis points; EMDE = emerging market and developing economies. Country abbreviations are International Organization for Standardization (ISO) country codes.

Sources: Elgin, Basbug, and Yalaman (2020); and IMF staff calculations.
Note: Macro-financial support is defined as the sum of liquidity injections into banks, change in reserve requirement, asset purchases, and funding for lending. EMDE = emerging market and developing economies. Country abbreviations are International Organization for Standardization (ISO) country codes.

The authorities have also implemented tools to influence goods and capital flows. Several countries with a flexible exchange rate implemented foreign exchange interventions to prevent disorderly market conditions and to counter excessive depreciation pressures (Egypt, Iran, Tajikistan, Turkmenistan). Many implemented some trade restrictions (Algeria, Iran, Jordan, Kazakhstan, Mauritania, Pakistan, Somalia, Sudan, Tajikistan, Turkmenistan) and price controls, mainly on essential and medical goods (Iran, Jordan, Kazakhstan, Kyrgyz Republic, Morocco, Pakistan, Qatar, Sudan, Tajikistan, Turkmenistan). Although some countries had strong capital flow controls in place before the pandemic, the use of additional capital flow management measures has so far been very limited.

Policies adopted across the region have been instrumental in dealing with the immediate impact of the crisis, but several areas demand policymakers' attention. The average size of fiscal support in the region is the smallest among regional groups, reflecting both existing fiscal constraints and those created by the crisis (Chapter 3). For GCC countries, this also reflects the already large public spending in the health sector. Some fiscal measures (tax increases) were necessary to shore up fiscal accounts in the short term but may pose a risk to the recovery. Land and property tax exemptions tend to be regressive, if not well targeted, and should be unwound. Income and consumption tax deferral and lending programs should be better targeted toward the neediest households or SMEs and, if necessary, distinguish recipients by income levels, sectors, or firms' preconditions. Effective communications and streamlined procedures will ensure that support reaches those who need it most. Policies such as regulatory forbearance may contribute

©International Monetary Fund. Not for Redistribution

to financial instability, and direct central bank financing of fiscal deficits should be removed because it could lead to inflation pressures and jeopardize institutional credibility. Banking supervision and financial inclusion should be strengthened (Chapter 4).

Examining the MENAP and CCA Outlooks

Countries in the MCD region face many shared challenges in coping with the crisis, but there are important distinctions in the outlooks for subregions:

Change in real GDP for MENAP oil exporters (MENAPOE) is projected at –6.6 percent in 2020. The weakness in 2020 follows a tepid year in 2019—which saw activity shrink marginally by 0.3 percent—and is manifested in both the oil and non-oil sectors. Oil GDP is expected to contract by 7.7 percent, reflecting the OPEC+ agreements on production cuts caused by sluggish external and internal oil demand and the US sanctions on Iran's exports. Non-oil GDP is expected to contract by 5.8 percent in 2020, mainly reflecting a collapse in the service sector caused by a decline in both domestic and external demand.

Hampered trade, tourism, and remittances are mostly offsetting the benefits from lower oil prices for MENAP oil importers (MENAPOI). These factors, along with confinement measures, continue to depress growth, which is now projected at –1 percent for 2020, after an expansion of 2.8 percent in 2019. All countries in the group except Egypt are expected to see negative growth in 2020, with a rebound to 2.2 percent growth in 2021. Sizable contractions are projected for Morocco and Jordan—7 percent and 5 percent, respectively—driven by severe impacts on tourism and manufacturing, as trading partners' growth continues to lag and travel remains disrupted (Chapter 2). For Egypt, weaknesses in growth during the second half of 2020 are reflected in lower projections for fiscal year 2020/21 (which started July 2020).

Projections for the CCA region point to a contraction of 2.1 percent in 2020. This is a sizable turnabout after a year of strong growth in 2019 (4.8 percent). Contrary to the trends in MENAP, the weakness in CCA is largely driven by oil importers (a contraction of 5 percent in 2020, after growth of 6.1 percent in 2019), reflecting the larger-than-expected economic impact from pandemic-related lockdowns, weak trade, a collapse in tourism activity (Armenia, Georgia, Tajikistan), and a sharp drop in remittances (Kyrgyz Republic), especially from Russia. The region's oil exporters are also projected to experience a downturn of 1.6 percent in 2020 but much less pronounced than that of the MENAPOE. This difference is due to the region's rapid and strong crisis response (Azerbaijan, Kazakhstan), smaller oil production cuts under the OPEC+ agreements, and more diversified economies. In addition, non-oil commodity producers benefited from the increase in gold prices (Kazakhstan, Uzbekistan), and favorable weather and price liberalization boosted agricultural output in Uzbekistan.

The crisis will also exacerbate economic and human challenges for fragile and conflict-affected states (Box 1.2). These countries are projected to contract by nearly 13 percent in 2020, after modest growth of 2.4 percent in 2019. This will imply a significant decline in GDP per capita—from \$2,900 in 2018–19 to under \$2,000 in 2020 (or about \$5 a day). Medium-term projections also suggest a more permanent loss and thus deeper scarring in relation to GDP.

In an environment of weaker demand, inflation is projected to remain low for most countries in the region. Two notable exceptions are Lebanon and Sudan, both affected by deep economic crises. The former is facing hyperinflation caused by food and electricity shortages, and a collapse in the exchange rate. For the latter, inflation, which accelerated starting in 2018, does not show any signs of abating. In general, risks from higher inflation because of looser monetary policies remain low, given subdued economic activity.

©International Monetary Fund. Not for Redistribution

The crisis will lead to a significant deterioration in external accounts for oil exporters in 2020, driven by dramatic drops in oil exports. For MENAPOE, the current account balance will turn into a deficit of 3.4 percent of GDP in 2020, relative to a surplus of 3.2 percent of GDP in 2019. Similarly, CCA oil exporters will see their current account deficit widen from 0.9 percent of GDP in 2019 to 3.3 percent of GDP in 2020. These are the largest deteriorations in current account balances across regional groups. For example, current account balances of sub-Saharan oil exporters are projected to deteriorate only by less than 2 percentage points of GDP, on average.

For oil importers, the picture on the external accounts is mixed, with modest improvements among MENAPOI (driven by import compression) but deterioration in CCA oil importers (driven by weak remittances).

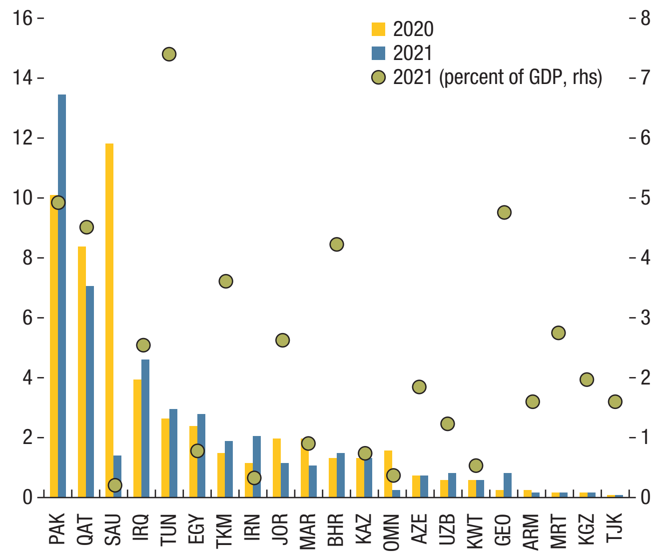
Projected reserve coverage remains generally adequate, at more than four months of imports for most countries, as lower imports compensate for reserve losses. However, attention is warranted for the few countries where reserve coverage is projected to be quite low (Bahrain, Djibouti, Pakistan, Sudan, Tunisia).

Fiscal deficits among oil importers are expected to worsen in 2020 compared with 2019. Although fiscal balances in MENAPOI are projected to decline by 0.6 percentage point of GDP (to –7.9 percent of GDP) in 2020, those among CCA importers are foreseen to deteriorate more significantly, by nearly 6 percentage points of GDP (to –7.1 percent of GDP in 2020), reflecting stronger policy responses to COVID-19 in Georgia, the Kyrgyz Republic, and Tajikistan. Risks to debt sustainability are high as debt levels in MENAPOI and CCA oil importers are expected to reach over 90 percent of GDP and nearly 60 percent of GDP, respectively, by the end of 2020.

For MENAPOE, the non-oil fiscal deficit in 2020 is projected at 33 percent of non-oil GDP, broadly the same as 2019 levels despite the policy responses. This is due to spending reallocation

Figure 1.11. External Debt Amortizations

(Billions of US dollars, and percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: rhs = right-hand scale. Country abbreviations are International Organization for Standardization (ISO) country codes.

and revenue measures being deployed to offset higher health and social spending. For CCA oil exporters the non-oil fiscal balance is projected to widen by over 2 percentage points (from 12.3 to 14.6 percent of non-oil GDP) in 2020 compared with 2019, partly because of their stronger policy responses. Nonetheless, for the group, debt-to-GDP levels among oil exporters remain relatively subdued (at 46 and 27 percent of GDP for MENAPOE and CCA oil exporters, respectively), but some oil exporters are facing much higher levels of gross debt (Algeria, Bahrain, Iraq, Oman, Qatar, Yemen), which, in some cases, are offset by substantial financial assets (Qatar).

The region will face external debt amortizations of about $45 billion in 2021, most of which correspond to sovereign debt service (Figure 1.11). In particular, Tunisia will face external amortizations of more than 7 percent of GDP, while Bahrain, Georgia, Pakistan, Qatar, and Turkmenistan, will each face external amortizations of about 4 percent of GDP. So far, countries have pursued different strategies to finance the larger needs, including external

©International Monetary Fund. Not for Redistribution

debt placements, tapping of domestic markets, monetary financing, and the reduction of buffers by using reserves, sovereign wealth funds, and deposits.

Beyond 2020, countries in the region will likely continue to face a challenging outlook. For 2021, all countries in the region except Lebanon and Oman are projected to see positive growth, albeit subdued. For MENAPOI and CCA, the rebound in 2021 will be enough to return real GDP to its 2019 level, but well below the precrisis trend. In contrast, real GDP levels in MENAPOE will be nearly 4 percent below the levels of 2019. Even these modest outcomes are subject to high uncertainty regarding the path of the pandemic. In the medium term, growth rates will not be enough to return GDP levels to precrisis trends as economic scarring from the crisis is expected to persist for the foreseeable future (Chapter 2).

Subdued prospects for global recovery will continue putting pressure on current accounts. For oil exporters, this will come from subdued oil prices, while for oil importers, this will be driven by weak remittances, tourism, and trade. For 2021, current account balances are expected to improve for oil exporters and CCA oil importers on the back of stronger oil exports and remittances, respectively, but widen somewhat for MENAPOI as export recovery lags. As the recovery progresses, imports are expected to recover more slowly than exports for most countries, leading to a modest improvement in current account balances and reserve coverage for the region.

While projections incorporate a gradual unwinding of COVID-19 fiscal support, medium-term prospects for debt remain risky. In 2021, fiscal balances are projected to improve for all regions (but especially for CCA oil importers) as COVID-19-related measures are unwound. Beyond 2021, for oil importers, a projected return to fiscal consolidation is expected to help close deficits by more than 4 percentage points of GDP, and debt is projected to modestly decline. It will, nonetheless, remain higher than precrisis levels for some countries. For oil exporters, medium-term prospects for both non-oil fiscal balances and debt remain risky, as the former is expected to remain broadly flat, with an increasing path for public debt.

Downside Risks Continue to Prevail

Considerable uncertainty continues to plague the outlook. On the upside, global recovery could proceed faster than expected supported by extensions in fiscal support and low infection rates. A safe and effective vaccine could be discovered and widely distributed, and new treatments and therapies for the disease could be created. Advances in digital technology could accelerate, leading to significant shifts in sectors with employees able to work from home.

Nonetheless, the crisis has exacerbated important vulnerabilities in the region, including excessive debt, elevated financing needs, exposure to oil market volatility, and high unemployment and informality, all of which may hinder the recovery and worsen scarring (Chapter 2).

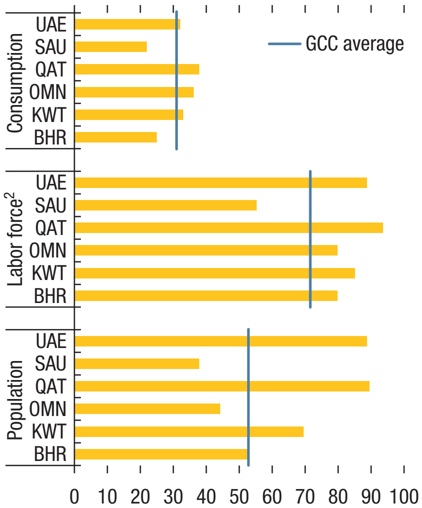
As a result, risks of a worse-than-projected scenario loom large. Given recent surges in COVID-19 infections in many countries around the world that have reopened, the possibility of stop-start containment measures would prolong uncertainty for firms and households and hinder long-term planning. Businesses that survived the first lockdown may not be able to survive a second one because the ongoing need for social distancing continues to weigh on contact-intensive sectors. The region's relatively low access to finance for SMEs (Box 4.2) could turn liquidity concerns into insolvencies. Stop-start containment would lead to continued declines in productivity as furloughs and reduced work hours translate into permanent job losses. This would exacerbate unemployment—which is already expected to remain high for a long time (Chapter 2)—and poverty.

Inequality will also likely widen as informal jobs are hit harder by the crisis and social safety nets

©International Monetary Fund. Not for Redistribution

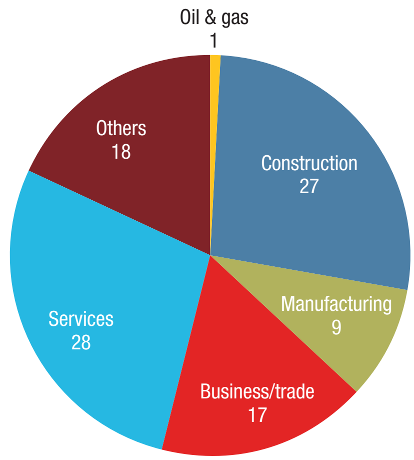
Figure 1.12. GCC Labor Market Indicators

1. GCC Share of Expatriates in Population, Labor Force, and Private Consumption[1] (Percent of total)



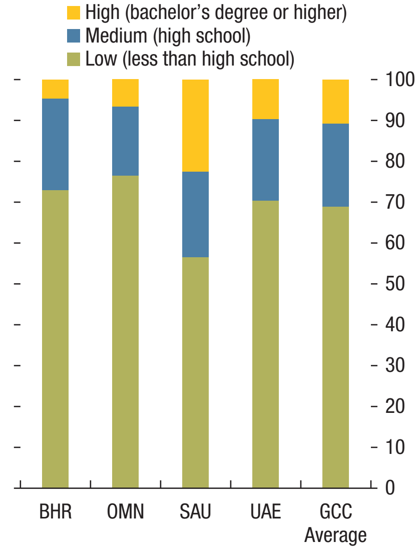
Sources: Country authorities; and IMF staff estimates and calculations.
Note: GCC = Gulf Cooperation Council. Country abbreviations are International Organization for Standardization (ISO) country codes.
[1]Data are latest available, unless indicated otherwise. Labor force, population, low-income expatriate, and remittance numbers include domestic workers.
[2]Due to data limitations, employment figures for Bahrain, Oman, and the United Arab Emirates are used.

2. GCC Total Expatriate Employment by Sector (Percent of total)



Sources: Country authorities; and IMF staff estimates and calculations.
Note: GCC = Gulf Cooperation Council.

3. Expatriates by Income Level (Percent)



Sources: Country authorities; and IMF staff estimates and calculations.
Note: GCC = Gulf Cooperation Council. Country abbreviations are International Organization for Standardization (ISO) country codes.

remain weak. In addition, school closures are more likely to impact youth in lower-income households, leading to long-term scars. All these factors will contribute to widening existing social gaps, potentially leading to widespread social discontent and political instability as restrictions on gatherings are lifted. The latter would worsen fiscal and debt concerns since governments would face difficult decisions around unwinding economic support. All of these risks will be amplified in fragile and conflict-affected states (Box 1.2).

On the external front, stop-start lockdowns could also lead to a weaker global recovery, with concurrent oversupply and volatility in the oil market. Remittances and tourism, key flows for the region, could face a more protracted recovery. As debt sustainability concerns rise in many countries, tighter financial conditions could restart capital outflows, accelerating financing risks and tipping vulnerable countries into debt and balance of payments crises.

Additional structural risks could come from intensifying geopolitical tensions and security concerns, which would constrain trade, and accelerating deglobalization and supply-chain breakdowns. Furthermore, the crisis has brought the region's dependence on expatriate labor into sharp focus, especially in GCC countries (Figure 1.12). According to the World Bank, since these groups enjoy limited social protection job loss often leads to immediate economic hardship, which then compounds the high risk of disease exposure from poor living and working conditions. The fact that expatriates are heavily

©International Monetary Fund. Not for Redistribution

employed in the hard-hit services sector poses further risks.

The financial sector remains stable but faces risks from weakening corporate balance sheets (Chapter 2), which increase credit risks, while declining oil prices affect banking system liquidity. Banks' operational risks have increased, including cyber and technology-related risks. The risk of bankruptcies and debt overhangs could have important implications for financial stability and the recovery if not addressed correctly (Chapter 4).

Near- and Medium-Term Policy Recommendations

Policies should be based on the evolution of the pandemic and countries' policy space and buffers.

In terms of the pandemic, in countries where cases are rising again, containing the health crisis will be the first and foremost priority. For countries that reopened and have infection rates under control, the health care sector's capacity should continue to be strengthened to ensure a safe return to work through timely testing, tracing, isolation, safe distancing practices, and localized lockdowns. For all countries, it will be key to develop a strategy for securing vaccine supplies once one is available.

Fiscal policy should remain supportive and flexible until a safe and durable exit from the crisis is secured. Continuation of the most critical support measures increases fiscal costs and public debt, but premature and rapid retrenchment could derail a nascent recovery, with even larger fiscal costs in the future. For countries with limited fiscal space, expenditure reallocation will be key for creating space in the short term. The type of fiscal support should also change as the recovery progresses. Different sectors will recover to different degrees, and the distinction between illiquidity and insolvency should become more prominent in designing support measures. Any further support should be complemented by governance reforms to ensure that financing is used efficiently.

In the short term, cushioning income losses (to the extent possible) will minimize damage to the economy and ensure activity can normalize quickly once the restrictions are lifted. Social spending should be expanded to protect the most vulnerable. Where gaps exist and as needed, authorities could enhance social protection and assistance measures such as paid and family sick leave, expanded eligibility for unemployment insurance, and strengthened health benefit coverage.[1]

For countries with limited fiscal space—most oil importers, except Armenia and Georgia, and several oil exporters (Algeria, Bahrain, Iran, Iraq, Oman)—it will be paramount to pursue a well-targeted approach, effective reorientation of spending, and further efforts to rebuild fiscal buffers (Chapter 3). These countries will need to rely on reorienting non-priority spending to the health, education, and social sectors and providing critical liquidity support measures rather than additional spending.

For low-income countries and fragile states, international and donor support will be crucial to avoid abrupt adjustments.

As the recovery materializes, the policy focus should gradually move to incentivizing worker reallocation, as needed, through hiring subsidies, additional spending on active labor policies, and measures to reduce labor market rigidities that deter firms from hiring. These support measures should be designed to enable a smooth shift of resources away from sectors that could emerge smaller after the pandemic (for instance, contact-intensive sectors). This will be key for countries with high dependence on travel and tourism (Armenia, Azerbaijan, Georgia, Jordan, Lebanon, Morocco).

Once the economy is on sound footing, fiscal adjustments will need to begin with a credible medium-term fiscal plan that focuses on improving revenue mobilization, minimizing tax avoidance, greater tax progressivity in some cases, and higher efficiency in spending. For countries

[1]For an in-depth discussion, see Mathai and others (2020).

©International Monetary Fund. Not for Redistribution

with limited fiscal space, urgent adjustments may be needed to restore fiscal and external sustainability. Oil exporters in both MENAP and CCA should avoid repeating procyclical fiscal policy as the new cycle begins—spending should be contained even if oil revenues rebound.

Many sovereigns will face higher financing needs. Oil importers, many of which have debt sustainability concerns but still enjoy market confidence, should seek maturity extensions and reduce rollover risk. Countries with very high spreads may need to resort to more difficult options that likely will require private sector participation, such as restructuring with interest and principal reductions. Low-income countries and fragile states should seek support in the form of concessional financing, grants, and debt relief.

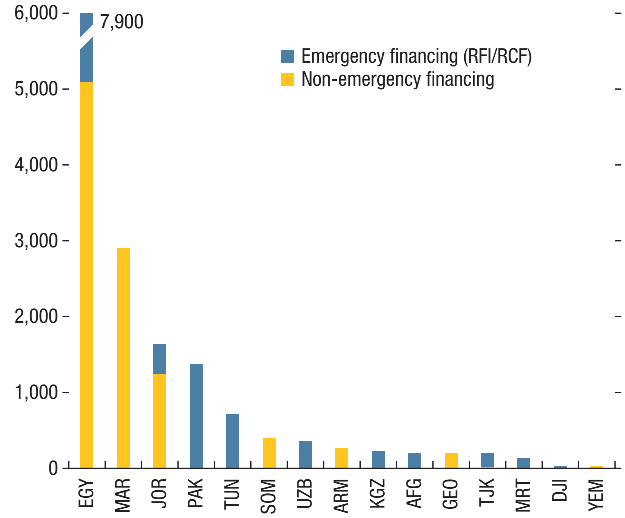
Monetary and financial stances should remain accommodative, with central bank interventions focused on keeping borrowing costs low and credit conditions supportive. Firms in certain sectors may shift from liquidity to solvency pressures. Timely recognition of credit losses will be key. Capital injections in some banks and systemic nonfinancial firms may become necessary for maintaining financial stability, but care should be taken that central banks' balance sheets are not excessively impacted.

For countries that entered the crisis with limited loss-absorbing buffers, namely MENAPOI (Chapter 4), banking sector resilience has yet to be tested but may emerge as a stress point later. For these countries, enhanced surveillance of financial systems is needed to facilitate timely policy responses, and liquidity management should be strengthened to prevent liquidity challenges from morphing into insolvency.

International Support and Rebuilding Sustainably Stronger

As the crisis progresses, countries in the region may require further support from the international community through debt relief, grants, and concessional financing so that these countries

Figure 1.13. New IMF Financing to MCD Countries
(January–July 2020, millions of US dollars)



Source: IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes. RCF = Rapid Credit Facility; RFI = Rapid Financing Instrument.

can conserve international liquidity and direct resources to priority health spending and relief measures.

The IMF and the international community will continue supporting MCD countries through financing, policy advice, and global and regional coordination. During the first seven months of 2020, the IMF approved nearly $17 billion in new financing for the region (Figure 1.13). Support has been in the form of emergency financing and augmented programs, in addition to debt relief, and catalyzing funding from other official creditors. Support to low-income and fragile states, while smaller in nominal terms, has been significant in relative terms. Access limits to IMF emergency financing facilities have been temporarily increased, and the institution has improved its ability to provide grant-based debt service relief. In addition, the IMF continues to provide policy support and technical advice to countries, including through remote capacity development, which has increased for MCD fragile states since the crisis began.

©International Monetary Fund. Not for Redistribution

Beyond the recovery, structural reforms should aim at expanding access to opportunities for all by permanently strengthening social safety nets, investing in strong and climate-friendly infrastructure, enhancing the reach of digital technology, and boosting human capital accumulation.

Inequality and poverty will become an even more pressing issue after the crisis, particularly for low-income countries and fragile states. Among this group and oil importers, social safety nets should be permanently strengthened, with social assistance and social insurance systems featuring wider coverage and better targeting.

As countries free fiscal resources from targeted support, some should be redeployed to public investment in renewable energy, improvements in the efficiency of power transmission, and retrofitting buildings to reduce their carbon footprint. Countries should also redouble efforts toward diversification to lower the region's heavy dependence on oil (MENAPOE), tourism (Georgia, Jordan, Lebanon, Morocco), and remittances (Egypt, Kyrgyz Republic, Pakistan, Tajikistan).

In addition, governments should invest in digital infrastructure to support the accelerated shift to e-commerce and increased digitalization of the economy. This should be complemented by labor market reforms that focus on creating jobs for young people and women in the private sector along with ensuring technological skills and literacy for the growing digital economy. Policies directed at informality and expatriate labor, especially in MENAPOE, should be reexamined to improve productivity and tax revenues.

To undo some of the damage caused by the loss in learning during the pandemic, countries should consider direct policies to make up this loss, including adjustments to the length of the school year, training teachers on remedial approaches, and broadening tutoring programs. Educational programs should also be retooled toward skills that are likely to be in high demand (health sector skills and digital literacy more broadly) so that increasing numbers can take advantage of teleworking opportunities.

©International Monetary Fund. Not for Redistribution

Box 1.1. Policy Responses to the Pandemic

Most countries have not enacted additional major policy measures since the July 2020 *Regional Economic Outlook Update: Middle East and Central Asia*. Instead, countries have focused on implementing already announced measures and, in some cases, extending measures deemed crucial for the economy. Major policies adopted by countries in the MCD region to mitigate the pandemic's impact are as follows:

Fiscal policy

- Exempting or postponing rent payments or property and land taxes (Bahrain, Egypt, Georgia, Kyrgyz Republic, Lebanon, Oman, Qatar, Tajikistan, United Arab Emirates)
- Deferring or exempting tax declarations and payments (Afghanistan, Algeria, Egypt, Lebanon, Saudi Arabia, Turkmenistan, West Bank and Gaza)
- Suspending or reducing various government fees and penalties (Algeria, Bahrain, Iran, Kuwait, Lebanon, Oman, Saudi Arabia, Tunisia)
- Strengthening and/or broadening unemployment benefits (Algeria, Azerbaijan, Bahrain, Iran, Jordan, Morocco, Qatar, Saudi Arabia, Sudan, United Arab Emirates, Uzbekistan, West Bank and Gaza)
- Expanding cash transfers to low-income households (nearly all countries in the region)
- Expanding energy subsidies for small and medium-sized enterprises (SMEs) and households (Bahrain, Djibouti, Georgia, Iran, Kazakhstan, Oman, Pakistan, Qatar, Turkmenistan, United Arab Emirates)
- Providing subsidized loans to SMEs, businesses in hard-hit sectors, and low-income households (Armenia, Bahrain, Egypt, Iran, Kuwait, Qatar, Saudi Arabia, Tunisia, United Arab Emirates, Uzbekistan)

Monetary policy

- Cutting policy interest rate (Algeria, Armenia, Bahrain, Egypt, Georgia, Jordan, Kazakhstan, Kuwait, Mauritania, Morocco, Oman, Pakistan, Qatar, Saudi Arabia, Tajikistan, Tunisia, United Arab Emirates, Uzbekistan)
- Injecting liquidity into the banking system (Armenia, Georgia, Jordan, Morocco, Qatar, Saudi Arabia, Tajikistan, Tunisia, United Arab Emirates, Uzbekistan)
- Expanding lending tools, including cutting the reserve requirement ratio and extending the maturity of loans (Algeria, Bahrain, Iraq, Jordan, Lebanon, Morocco, Qatar, Saudi Arabia, Tajikistan)
- Introducing repo arrangements, providing liquidity support for lending and loan guarantees, and lowering the cost of refinancing (Armenia, Bahrain, Georgia, Iran, Kazakhstan, Qatar)
- Opening bilateral swap lines with the central banks of their major trading partners (Azerbaijan)

Macro-financial policy (see also Chapter 4)

- Easing countercyclical buffers or the liquidity ratio (Kazakhstan, Kyrgyz Republic, West Bank and Gaza)
- Lowering capital adequacy requirements (Iran, Kazakhstan, Morocco, Sudan, United Arab Emirates)
- Relaxing loan classification and provisioning (Afghanistan, Iran, Kazakhstan, Kyrgyz Republic, Morocco, Oman, Pakistan, United Arab Emirates, West Bank and Gaza)
- Providing direct central bank financing to the public sector (Bahrain, Turkmenistan)

Overall, the policies adopted by MCD countries have covered the key areas where support to deal with the pandemic is most needed. Nonetheless, there is some room for improvement for the next phase.

©International Monetary Fund. Not for Redistribution

Box 1.1 *(continued)*

- A few countries implemented measures to raise revenues (Afghanistan, Egypt, Saudi Arabia, Tunisia) and cut or postponed spending elsewhere (Afghanistan, Jordan, Oman, Saudi Arabia) to compensate for either lower oil revenues or pandemic-related spending. Notable examples are Saudi Arabia (which tripled its value-added tax rate and increased customs duties substantially) and Egypt (which introduced a temporary 1 percent tax deduction on all salaries and 0.5 percent on pensions, applicable to all public and private sector employees for 12 months; very low-income workers are exempt from the tax increase). Although some of the tax measures may be desirable medium-term reforms, in general, tax increases would be more effective after the crisis. These measures may improve the short-term fiscal situation somewhat, but they will likely be a drag on the recovery and invite larger fiscal costs in the future. Compensation measures are also needed to protect the most vulnerable groups from the tax increases.

- Monetary and financial policies need to balance the immediate need for market stabilization and the credibility of future policies. Further reduction of policy rates and liquidity injections should be carefully designed in countries where inflation is high or where potential financial instability due to capital outflows is still a risk. Some countries resorted to regulatory forbearance such as relaxing loan classification, which may negatively affect financial stability and market development in the future. Direct central bank financing of fiscal deficits may undermine the credibility of central banks, alter inflation expectations, and lead to difficulties in conducting monetary policy in the future.

- A well-targeted approach is crucial for pandemic-related policies. Some of the lending and subsidy programs target SMEs (Box 4.2), businesses in hard-hit sectors, or low-income households. Nonetheless, targeting could be improved further to maximize the efficiency in the use of government, as exemplified in Armenia, where the government provides subsidized loans only to firms with good credit history. Furthermore, many of the tax deferral and exemption programs are broad-based. Policymakers should consider tailoring such programs to distinguish among income levels, sectors, or firms' preconditions. Exemptions on land and property taxes, for example, tend to be highly regressive if implemented broadly. However, in general, most measures other than those related to health are not designed to benefit expatriates. Measures should extend health and basic financial support to all residents, including expatriates who are unable to leave the country, to help contain the spread of the virus, aid economic recovery, and enhance social cohesion.

- Effective communication and streamlined procedures are important to realize the full benefits of social spending and SME support (Box 4.2). Many poor households and SMEs do not have enough capacity to navigate the regulatory process to file applications and receive support. Capacity constraints may lead to underuse of some SME and social transfer programs that have lengthy bureaucratic procedures. Governments should make administrative processes as simple as possible by using digital technology and self-service wherever possible and communicate policies extensively through all channels to inform those who are eligible for the support programs (Box 2.2).

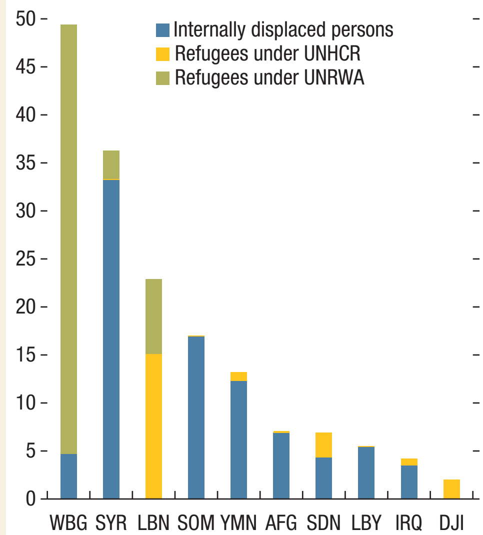
©International Monetary Fund. Not for Redistribution

Box 1.2. Impact of the Coronavirus Pandemic on Fragile States

The coronavirus pandemic presents a major humanitarian and economic challenge for fragile states in the MCD region.[1] It aggravates the underlying difficult challenges facing each fragile state: armed conflicts in Afghanistan, Iraq, Libya, Somalia, Syria, and Yemen; anti-government protests and fear of a humanitarian crisis in Lebanon; years of conflict and political uncertainty in West Bank and Gaza; and climate vulnerabilities in Afghanistan, Somalia, and Yemen. The region also hosts a large share of the world's refugees and internally displaced people (Figure 1.2.1).

Figure 1.2.1. Refugees and Internally Displaced Persons

(Percent of host population, 2019 or the latest available)



Sources: United Nations High Commissioner for Refugees, Internal Displacement Monitoring Centre; United Nations Relief and Works Agency for Palestine Refugees in the Near East; United Nations, Department of Economic and Social Affairs, Population Division; and IMF staff calculations.
Note: These numbers are based on registrations and thus are lower bound estimates. Country abbreviations are International Organization for Standardization (ISO) country codes.

The pandemic is likely to increase the risk of social unrest for this group of countries. The large informal sectors of fragile states have been hit particularly hard by coronavirus containment measures, with lack of digitalization and limited remote working. The effectiveness of monetary policy to support activity is constrained by weak monetary transmission amid shallow financial markets, dollarization, and explicit or implicit exchange rate pegs (or lack of a domestic currency altogether as in West Bank and Gaza). Although most governments have activated social safety nets, these remain weak because of poor design and insufficient information about recipients (especially given the presence of internally displaced people and refugees) or weak delivery mechanisms given cash dominance and difficult security circumstances. The decline in incomes will thus directly translate into higher unemployment and poverty. In addition, poor living conditions among refugees and internally displaced persons increase the risks of infection, and weak health systems raise concerns about their treatment; border closures are affecting asylum seekers, and risks of food insecurity loom large. A lack of timely support for those in need or an unequal distribution of human and economic losses across political factions and communities can fuel tensions, insecurity, and localized violence.

Policy space is extremely limited in the fragile states of the MCD region, underscoring the need for continued and timely support from the international community. Although external financing needs have increased and become more urgent, financing has become more constrained. This is because of the adverse impact that declines in growth and trade have on revenues and the extremely limited market access, given the risk of debt distress. The IMF has been helping by providing emergency financing and debt relief (Afghanistan, Djibouti, Tajikistan, Yemen; see Table 1.2.1), by offering policy advice and targeted technical assistance in crucial areas (spending efficiency, revenue collection, and debt management), and by reinforcing collaboration with other international financial institutions. Beyond financing, international support will also be key to ensure that fragile states have access to vaccines, once one is available. All these efforts will need to continue to protect

[1]Fragile states in the Middle East and Central Asia region include Afghanistan, Djibouti, Iraq, Lebanon, Libya, Somalia, Sudan, Tajikistan, West Bank and Gaza, and Yemen. Syria is not covered given data limitations.

©International Monetary Fund. Not for Redistribution

Box 1.2 *(continued)*

hard-earned progress on reforms in some countries and avoid a new humanitarian crisis, reducing the twin risks of future demands for international aid and increased refugee flows, and ensuring that reinfections do not propagate after the virus comes under control.

Table 1.2.1. Fragile States: Policy Response to the Coronavirus Outbreak

	Fiscal	Monetary	Macroprudential Banking Supervision	IMF Emergency Support	Debt Relief
Afghanistan	✓		✓	RCF	✓
Djibouti	✓		✓	RCF	✓
Iraq	✓	✓	✓		
Lebanon	✓	✓			
Libya	✓				
Somalia	✓		✓		
Sudan	✓		✓		
Tajikistan	✓	✓	✓	RCF	✓
West Bank and Gaza	✓		✓		
Yemen					✓

Source: National authorities, as of July 6, 2020.
Note: RCF = Rapid Credit Facility.

©International Monetary Fund. Not for Redistribution

References

Ceyhun Elgin, Gokce Basbug, Abdullah Yalaman. 2020. "Economic policy responses to a pandemic: Developing the COVID-19 Economic Stimulus Index." A VoxEU.org eBook, CEPR Press.

©International Monetary Fund. Not for Redistribution