

INTERNATIONAL MONETARY FUND

# REGIONAL ECONOMIC OUTLOOK

MIDDLE EAST AND  
CENTRAL ASIA

Building Resilience and  
Fostering Sustainable Growth

**2023**  
OCT



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## MIDDLE EAST AND CENTRAL ASIA

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# Acknowledgments

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

The analysis in this *Regional Economic Outlook* was coordinated under the general supervision of Jihad Azour (MCD Director). The project was directed by Taline Koranchelian (Deputy Director, MCD), Lone Christiansen (Chief, MCD Regional Analytics and Strategy Division), Cesar Serra (Deputy Chief, MCD Regional Analytics and Strategy Division), and for Chapter two also Yasser Abdih (Advisor, MCD).

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## Country Groupings

The *October 2023 Regional Economic Outlook (REO): Middle East and Central Asia* covers countries and territories in the Middle East and Central Asia Department (MCD) of the International Monetary Fund (IMF) referred to as ME&CA countries and territories. It provides a broad overview of recent economic developments and prospects and policy issues for the medium term. To facilitate the analysis, the 32 ME&CA countries and territories covered in this report are divided into three (nonoverlapping) groups based on export earnings and level of development: (1) Oil Exporters (OE), (2) Emerging Market and Middle-Income Countries (EM&MI); and (3) Low-Income Developing Countries (LIC). Additional analytical and regional groups provide a more granular breakdown for analysis and continuity. The country and analytical group acronyms and abbreviations used in some tables and figures are included in parentheses.

**ME&CA OE:** Algeria (ALG), Azerbaijan (AZE), Bahrain (BHR), Islamic Republic of Iran (IRN), Iraq (IRQ), Kazakhstan (KAZ), Kuwait (KWT), Libya (LBY), Oman (OMN), Qatar (QAT), Saudi Arabia (SAU), Turkmenistan (TKM), United Arab Emirates (UAE).

**ME&CA EM&MI:** Armenia (ARM), Egypt (EGY), Georgia (GEO), Jordan (JOR), Lebanon (LBN), Morocco (MAR), Pakistan (PAK), Syrian Arab Republic (SYR), Tunisia (TUN), West Bank and Gaza (WBG).

**ME&CA LIC:** Afghanistan (AFG), Djibouti (DJI), Kyrgyz Republic (KGZ), Mauritania (MRT), Somalia (SOM), Sudan (SDN), Tajikistan (TJK), Uzbekistan (UZB), Yemen (YEM).

**Caucasus and Central Asia (CCA):** Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, Uzbekistan.

**CCA OE:** Azerbaijan, Kazakhstan, Turkmenistan.

**CCA OI:** Armenia, Georgia, Kyrgyz Republic, Tajikistan, Uzbekistan.

**CCA EM&MI:** Armenia, Georgia.

**CCA LIC:** Kyrgyz Republic, Tajikistan, Uzbekistan.

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

**MENA OE:** Algeria, Bahrain, Islamic Republic of Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, United Arab Emirates.

**MENA OI:** Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Somalia, Sudan, Syrian Arab Republic, Tunisia, West Bank and Gaza, Yemen.

**MENA EM&MI:** Egypt, Jordan, Lebanon, Morocco, Syrian Arab Republic, Tunisia, West Bank and Gaza.

**MENA LIC:** Djibouti, Mauritania, Somalia, Sudan, Yemen.

**MENAP:** MENA, Afghanistan, Pakistan.

**MENAP OI:** MENA OI, Afghanistan, Pakistan.

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

**Arab World OE:** Algeria, Bahrain, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, United Arab Emirates.

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

**Non-GCC oil-exporting countries:** Algeria, Islamic Republic of Iran, Iraq, Libya.

**North Africa:** Algeria, Djibouti, Egypt, Libya, Mauritania, Morocco, Sudan, Tunisia.

**Fragile and conflict-affected states (FCS):** Afghanistan, Iraq, Lebanon, Libya, Somalia, Sudan, Syrian Arab Republic, West Bank and Gaza, Yemen.

**Conflict-affected states:** Afghanistan, Iraq, Somalia, Sudan, Syrian Arab Republic, West Bank and Gaza, Yemen.



# Assumptions and Conventions

A number of assumptions have been adopted for the projections presented in the *October 2023 Regional Economic Outlook: Middle East and Central Asia*. It is assumed that the established policies of national authorities will be maintained, the price of oil<sup>1</sup> will average US\$80.49 a barrel in 2023 and US\$79.92 a barrel in 2024, and the three-month nominal yield on US Treasury bills will average 5.3 percent in 2023 and 5.4 percent in 2024. These are working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would, in any event, be involved in the projections. The 2023 and 2024 data in the figures and tables are projections. Unless otherwise noted, these projections are based on statistical information available through late September 2023.

The following conventions are used in this publication:

- In tables, ellipsis points (. . .) indicate “not available,” and 0 or 0.0 indicates “zero” or “negligible.”
- Minor discrepancies between sums of constituent figures and totals are due to rounding.
- An en dash (-) between years or months (for example, 2019-20 or January-June) indicates the years or months covered, including the beginning and ending years or months; a slash or virgule (/) between years or months (for example, 2019/20) indicates a fiscal or financial year, as does the abbreviation FY (for example, FY 2020).
- “Billion” means a thousand million; “trillion” means a thousand billion.
- “Basis points (bps)” refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to  $\frac{1}{4}$  of 1 percentage point).

As used in this publication, the term “country” does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

The boundaries, colors, denominations, and any other information shown on the maps do not imply, on the part of the International Monetary Fund, any judgment on the legal status of any territory or any endorsement or acceptance of such boundaries.

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<sup>1</sup> Simple average of prices of UK Brent, Dubai Fateh, and West Texas Intermediate crude oil.

# Executive Summary

Growth in the Middle East and Central Asia (ME&CA) is slowing, with growth for the region projected at 2.0 percent in 2023 (down from 5.6 percent last year) before increasing to 3.4 percent in 2024. The Middle East and North Africa (MENA) region is mainly driving this year's slowdown, reflecting oil production cuts, tight macroeconomic policies, and country-specific factors. Inflation is declining, but it remains high in some countries. The need to address recurrent shocks has reduced policy space to support economic activity in many economies, and slow progress in comprehensive reform implementation is holding back investment, job creation, and inclusion while undermining resilience to shocks. Rising climate challenges are adding to the urgency of action.

In the MENA region, economic growth is projected to slow markedly this year (to 2.0 percent from 5.6 percent last year) amid lower oil production in oil exporters, tight policy settings in emerging market and middle-income economies (EM&MIs), and country-specific headwinds. Moreover, the conflict in Sudan is affecting lives and livelihoods, causing displacement of people and severe economic disruption. Economic conditions are set to improve in 2024, with growth reaching 3.4 percent, as the contraction in Sudan subsides and other growth-dampening factors, including temporary oil production cuts, dissipate. However, public sector debt remains elevated in several countries, and medium-term growth is forecast to remain subdued. Although inflation is broadly easing, it remains elevated in some economies, with high food prices exacerbating food insecurity.

Growth in the Caucasus and Central Asia (CCA) is projected to remain robust this year (4.6 percent) and next (4.2 percent), despite some moderation as migration, trade, and financial flows from Russia gradually normalize. However, CCA countries face heightened uncertainty because of Russia's war in Ukraine and rising geoeconomic fragmentation, which is reshaping trade, financial, and migration patterns. In this context, medium-term growth is set to slow to below the historical average, held back by persistent structural challenges, including poor market-based resource allocation and subpar productivity. Inflation is diverging across countries but is projected to ease only gradually, also reflecting strong domestic demand and continued wage pressures in some countries.

Adverse risks to the outlook have receded since April, but the balance of risks remains to the downside. On the upside, a faster-than-anticipated global decline in inflation would reduce pressure on central banks to raise interest rates further, and stronger-than-projected global demand could boost growth in ME&CA. On the downside, a larger-than-expected slowdown in China or major advanced economies could depress external demand and worsen economic prospects. An escalation of Russia's war in Ukraine could reignite inflationary pressures and worsen food insecurity. Climate-related shocks could result in worsening drought conditions and floods, affecting infrastructure, agricultural output, and food prices. Other downside risks could also materialize, such as debt distress related to tighter-for-longer global financial conditions.

Amid these challenges, policymakers have a pressing yet complex task of maintaining tight policies to safeguard macroeconomic stability and debt sustainability, while bolstering growth prospects. This can be accomplished through wide-ranging structural reforms to support job creation for the more than 100 million people who are set to enter working age over the next decade. As discussed in Chapter 2, structural reforms could help spur near-term economic activity—thus easing current policy trade-offs—while also lifting longer-term potential growth. Reforms in governance, labor markets, and business regulations would be particularly beneficial, helping to strengthen resilience and ensure economic stability. The strategic sequencing and packaging of reforms can magnify dividends. In addition, persistent inflationary pressures and depleted fiscal and external buffers in several ME&CA countries call for continued tight macroeconomic policies to re-establish price stability and ensure fiscal and external sustainability. As explored in Chapter 3, addressing vulnerabilities from the sovereign-bank nexus and establishing emergency liquidity tools would help reduce potential risks to ME&CA financial systems from a prolonged period of higher interest rates.

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# 1. Regional Developments and Economic Outlook: Building Resilience and Fostering Sustainable Growth<sup>1</sup>

*Across the Middle East and Central Asia (ME&CA), the combined effects of global headwinds, domestic challenges, and geopolitical risks weigh on economic momentum, and the outlook is highly uncertain. Growth is set to slow this year in the Middle East and North Africa (MENA) region, driven by lower oil production, tight policy settings in emerging market and middle-income economies (EM&MIs), the conflict in Sudan, and other country-specific factors. In the Caucasus and Central Asia (CCA), although migration, trade, and financial inflows following Russia's war in Ukraine continue to support economic activity, growth is set to moderate slightly this year. Looking ahead, economic activity in the MENA region is expected to improve in 2024 and 2025 as some factors weighing on growth this year gradually dissipate, including the temporary oil production cuts. But growth is expected to remain subdued over the forecast horizon amid persistent structural hurdles. In the CCA, economic growth is projected to slow next year and over the medium term as the boost to activity from real and financial inflows from Russia gradually fades and deep-seated structural challenges remain unsolved. Inflation is broadly easing, in line with globally declining price pressures, although country-specific factors—including buoyant wage growth in some CCA countries—and climate-related events continue to make their mark. Despite some improvement since April, the balance of risks to the outlook remains on the downside. In this context, expediting structural reforms is crucial to boost growth and strengthen resilience, while tight monetary and fiscal policies remain essential in several economies to durably bring down inflation and ensure public debt sustainability.*

## 1.1. A Global Slowdown amid Higher-for-Longer Interest Rates

A global slowdown is setting in, following resilient economic activity in the first quarter of this year driven by the reopening of China's economy, strong consumption in the United States, and robust service sector activity. High-frequency indicators for the second quarter point to additional weakening in manufacturing, softening services activity, and declining global trade growth. However, China's post-pandemic rebound is fading amid continued weakness in the real estate sector and exports. Even though financial stability concerns have receded in advanced economies, lending standards have tightened, curtailing the supply of credit. In this context, the October 2023 *World Economic Outlook* projects global growth to fall from 3.5 percent in 2022 to 3.0 percent in 2023 and 2.9 percent in 2024, driven primarily by a marked slowdown in advanced economies as tight monetary policy continues to bite.

Global headline inflation is receding, reflecting a moderation in fuel and non-fuel commodity prices. Still, core inflation is declining more gradually and remains above most central bank targets. In response, major central banks are expected to keep monetary policy tighter for longer. Global interest rate assumptions have thus been revised upward from the April 2023 *World Economic Outlook*, with the federal funds rate projected to peak at 5.4 percent by the end of 2023 and stay at that level until late 2024 (about 100 basis points higher than expected in April), thus keeping pressure on global financing conditions for longer than previously anticipated. Average petroleum spot prices are expected to moderate steadily (at \$80.5 and \$79.9 per barrel in 2023 and 2024, respectively), though they have been revised up (from \$73.1 and \$68.9 in April) as slowing global demand has only partially offset OPEC+ production cuts and additional voluntary cuts, primarily by Saudi Arabia. The

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<sup>1</sup> Prepared by Azhin Abdulkarim, Vizhdan Boranova, Hasan Dudu, Filippo Gori (lead), and Gustavo Ramirez.

ongoing moderation in food commodity prices—projected to decline by 6.8 percent in 2023 and 1.9 percent in 2024—should help alleviate pressures on food prices worldwide (although international food prices remain about 40 percent above prepandemic levels).

## 1.2. MENA Region and Pakistan: A Complex Road Ahead

*Despite resilient domestic demand and strong tourism, several factors weigh on growth, including lower oil production in oil exporters, tight policy settings in EM&MIs, and the combination of lingering fragilities and new shocks in low-income countries (LICs)—such as the conflict in Sudan. Looking ahead, growth in the MENA region is expected to improve in 2024 as some of the factors weighing on current economic activity fade, but medium-term growth is projected at below its historical average amid persistent structural challenges. Headline inflation has started to come down in line with global trends, but country-specific factors—for example currency depreciations, import restrictions, and recurring droughts—continue to fuel inflationary pressures in some countries, lifting average inflation across the region.*

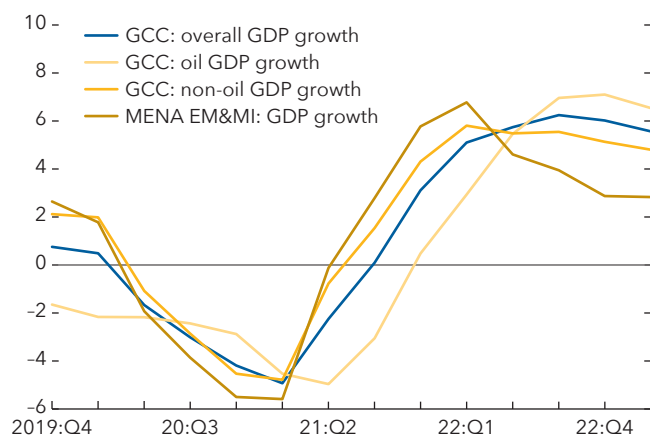
### Growth Is Easing amid Global Headwinds

Oil production cuts and country-specific factors have started to weigh on oil exporters. Oil GDP growth is slowing after three rounds of deep OPEC+ oil production cuts (October 2022, April 2023, June 2023) and additional temporary cuts by Saudi Arabia. For Gulf Cooperation Council (GCC) countries, crude oil production was cut considerably, driving a deceleration in oil GDP growth (Figure 1.1). Crucially, the slowdown of oil GDP has been

partially offset by continued strong non-oil GDP growth, driven by robust manufacturing activity (Oman, Qatar, Saudi Arabia, United Arab Emirates) and surging services (Bahrain, Oman, Saudi Arabia, United Arab Emirates). In Iraq, restrictions on foreign currency sales are constraining growth.

In the MENA region's EM&MIs and Pakistan, average growth is below that of oil exporters, held back by necessary tighter policy settings and several country-specific challenges. Notably, average real GDP growth remained lackluster at 3.1 percent in the first quarter of 2023 (below a historical average of 4 percent). Where growth strengthened in the first quarter, the uptick was supported by strong tourism flows (Morocco, Tunisia) and robust remittances (Morocco). In other countries, slowing growth reflects worsening macroeconomic conditions caused by the impact of foreign currency rationing (Egypt) and import restrictions (Egypt and Pakistan).

**Figure 1.1. MENA Region: Real GDP Growth**  
(Percent change, year-over-year; four-quarter moving simple averages)



Sources: Haver Analytics; and IMF staff calculations.

Note: Kuwait is excluded because of lack of recent data. EM&MI = emerging market and middle-income economy; GCC = Gulf Cooperation Council; and MENA = Middle East and North Africa.

Meanwhile, economic conditions in the MENA region's fragile LICs have deteriorated as conflicts and climate-related shocks amplify underlying fragilities. The ongoing conflict in Sudan is damaging the country's infrastructure and compromising the provision of basic services while causing large migration flows (Box 1.1). In Yemen, the United Nations-mediated truce expired in 2022, and the country lacks financing to ensure sufficient food imports to fulfill basic needs. In Somalia, conflict

and severe drought have left much of the population internally displaced. By contrast, economic performance in non-fragile LICs is generally positive, with increased trade (Djibouti, following the peace agreement in Ethiopia) and robust services activity (Mauritania) supporting growth.

### Inflationary Pressures Are Receding but Remain Elevated in Some Countries

Inflation is easing in most oil-exporting countries in line with global trends. After continued interest rate hikes, headline and core inflation, measured on a month-to-month annualized basis, have now returned to prepandemic historical averages in several economies, particularly GCC countries. By contrast, inflation remains high in other oil exporters (Algeria, Iraq, Islamic Republic of Iran), driven by food components in Algeria and reflecting the broad-based effect of currency depreciations on prices in the Islamic Republic of Iran.

Headline and core inflation in most EM&MIs have also returned to near prepandemic historical averages of between 3 and 4 percent—helped by monetary policy tightening and lower global commodity prices. However, some countries continue to face high inflationary pressures (Figure 1.2). Monthly inflation remains well above historical levels in Egypt, Pakistan, and Tunisia. Moreover, as of July, year-over-year food inflation remains above 10 percent in Morocco and Tunisia and above 35 percent in Egypt and Pakistan, because of droughts (Morocco and Tunisia) and the lagged impact of exchange rate devaluations on import prices (Egypt and Pakistan).

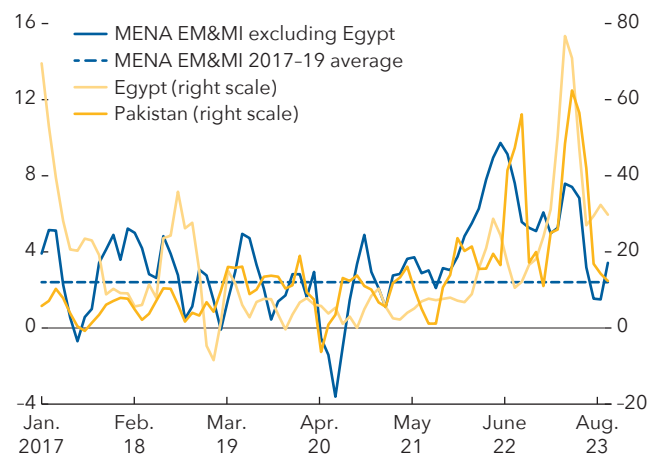
Though inflationary pressures vary markedly across LICs, food security remains a widespread concern. Inflation has eased in Djibouti and Mauritania since the beginning of 2023, reflecting favorable food price dynamics and the receding impact of past droughts (Mauritania). Nonetheless, inflation remains exceptionally high in Sudan because of the lingering effects of past climate-related shocks, low stocks of staples, and the ongoing conflict. Moreover, food insecurity remains pervasive despite some moderation in food prices in several LICs (Mauritania, Somalia, Yemen). As of July, more than 45 million people in Djibouti, Mauritania, Somalia, Sudan, and Yemen faced food insecurity—almost 50 percent of their combined populations.

### The Monetary Tightening Cycle Nears Its End, While Fiscal Positions Are Mixed

The pace of monetary policy tightening has slowed as price pressures have started to recede in several economies. Central banks in countries with currencies pegged to the US dollar (excluding Iraq) have followed the Federal Reserve, hiking policy rates by 100 basis points this year on average as of August 2023. Other central banks appear near the end of their monetary tightening cycle, with only some EM&MIs raising policy rates this year (Egypt, Morocco, Pakistan). Nevertheless, in a few economies, policy interest rates remain below model-based estimates of natural rates (Egypt, Pakistan, Tunisia; April 2023 *Regional Economic Outlook: Middle East and Central Asia*). Moreover, some oil exporters still face inflationary pressures (Algeria, Islamic Republic of Iran).

**Figure 1.2. MENA Region EM&MIs and Pakistan: Headline Inflation**

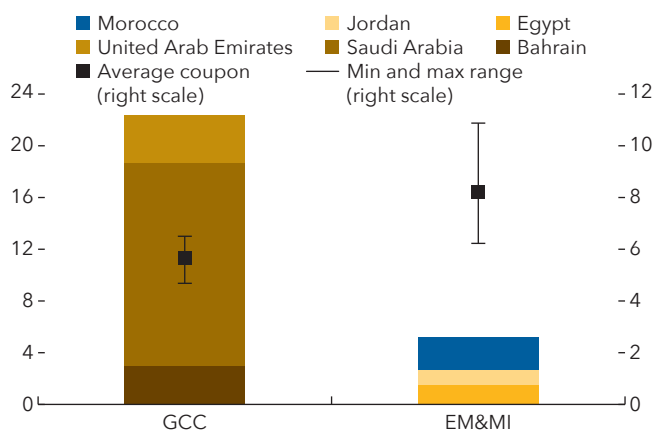
(Percent change, month-over-month, seasonally adjusted annualized rate)



Sources: Haver Analytics; IMF, Consumer Price Index database; national authorities; and IMF staff calculations.

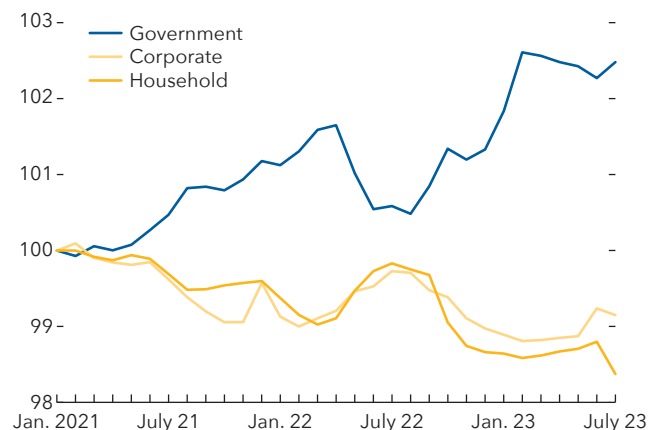
Note: EM&MI = emerging market and middle-income economy; MENA = Middle East and North Africa.

**Figure 1.3. International Bond Issuance in 2023**  
(Billions of US dollars, left scale; coupon rate for US dollar-denominated bonds, percent, right scale)



Sources: Bond Radar; and IMF staff calculations.  
Note: Issuances include Eurobonds and other international bond placements, such as sukuk. EM&MI = emerging market and middle-income economy; GCC = Gulf Cooperation Council.

**Figure 1.4. MENA Region EM&MIs and Pakistan: Share of Bank Credit by Sector**  
(Median index; January 2021 = 100)



Sources: IMF, Monetary and Financial Statistics database; and IMF staff calculations.  
Note: EM&MI = emerging market and middle-income economy; MENA = Middle East and North Africa.

To strengthen fiscal buffers further, non-oil primary balances (as a percentage of non-oil GDP) strengthened in most GCC countries last year (except for Saudi Arabia), while non-oil primary balances deteriorated in other oil exporters, reflecting higher public wages (Iraq, Libya) and subsidies (Algeria, Iraq, Libya). Most EM&MIs continued tightening their primary fiscal positions last year—amid high debt levels and elevated borrowing costs—despite the additional outlays associated with mitigating the cost-of-living crisis. For LICs, revenue mobilization has remained elusive, with fiscal revenues as a share of GDP at about 12 percent on average (about half the level of EM&MIs), down from about 18 percent 10 years ago, primarily because of revenue erosion in conflict-affected countries (Sudan, Yemen).

### Notable External Vulnerabilities Remain for Some EM&MIs

External funding conditions deteriorated for highly indebted countries. Following global financial turmoil in early March, foreign-currency sovereign bond spreads widened substantially in vulnerable EM&MIs (Egypt, Pakistan, Tunisia). By contrast, financing conditions moved broadly in line with global emerging markets for those with lower levels of debt (most GCC economies, Jordan, Morocco). While sovereign spreads have generally narrowed since last March's financial turmoil, as of August, they remain at distressed levels (more than 1,000 basis points) for Egypt, Pakistan, and Tunisia. In this context, some countries in the MENA region were able to access international financial markets during the first half of 2023 (Bahrain, Egypt, Jordan, Morocco, Saudi Arabia, United Arab Emirates) but at a relatively higher cost for more vulnerable emerging market economies (Figure 1.3). As such, amid limited external financing, EM&MIs continued to increase their reliance on domestic banks for public debt financing, further strengthening the already-elevated sovereign-bank nexus and reducing the pool of funding available to the private sector (Figure 1.4). In addition, after rebounding in the first two months of 2023, the global financial turmoil in March prompted a resurgence in capital outflows (in contrast to other emerging markets). But it was at a significantly slower pace than in 2022 (portfolio fund outflows from MENA and Pakistan totaled \$160 million in the second quarter of 2023, down from a record \$4.5 billion in outflows in 2022) (Figure 1.5).

Even so, external buffers improved for most EM&MIs during the first half of the year, partly because of strong tourism and remittance flows (Morocco, Tunisia) and support from bilateral and multilateral sources (Pakistan). Still, international reserve coverage is well below standard adequacy metrics, particularly for Egypt and Pakistan.

## MENA Region and Pakistan Outlook: A Slowdown amid Growing Challenges

Growth in the MENA region and Pakistan is projected to slow this year, driven by a few key factors, including extended oil production cuts in oil exporters, tight macroeconomic policies to safeguard macroeconomic stability and debt sustainability in EM&MIs, and heightened fragility from ongoing conflicts in LICs, particularly in Sudan. Notably, all country groups (oil exporters, EM&MIs, LICs) are projected to perform below the emerging market and developing economy average in the rest of the world. In addition, the region was recently hit by new shocks, including a devastating earthquake in Morocco and severe flooding in Libya that caused thousands of deaths and damaged infrastructure.<sup>2</sup>

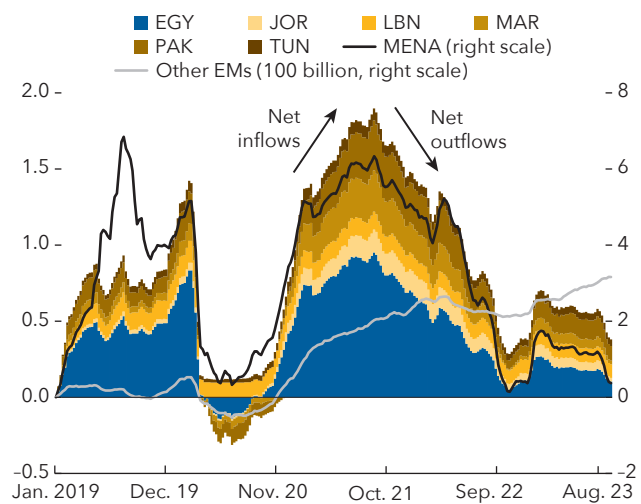
Looking ahead, as some of the factors weighing on growth in 2023 begin to dissipate, economic prospects are expected to rebound in 2024 and continue to improve in 2025. Yet persistent structural gaps and the decline in oil-related growth mean that for most countries, growth is projected to slow and remain modest and below its historical average over the medium term. In addition, large segments of the population face challenges finding jobs, including youth and women, while more than 100 million young people are expected to reach working age in the region in the next decade. Inflation is forecast to abate slowly with receding global price pressures, although large cross-country differences will persist.

### Oil Exporters: Growth is Slowing amid a Shift in Composition

Growth in oil exporters is projected to slow markedly this year to 2 percent (from 6.1 percent in 2022) before improving moderately to about 3.4 percent next year and setting at below 3 percent in the medium term—below its pre-pandemic historical average (Figure 1.6). Growth forecasts for 2023 are revised downward from April (by 1.1 percentage points), reflecting deeper than expected oil production cuts this year—including from unilateral cuts by Saudi Arabia—and the impact of foreign currency rationing on import-dependent sectors in Iraq. As such, non-oil activity is set to be the main growth driver in GCC countries in 2023 and subsequent years, supported by a moderate expansion in investment, while private consumption is set to remain subdued in relation to pre-pandemic historical trends. Nonetheless, despite ongoing efforts to diversify GCC economies away from oil, non-oil growth is projected to be insufficient to offset the decline in oil growth over the medium term, as productivity gaps in the non-oil sector persist (Chapter 2), posing challenges for job creation and inclusion (Figure 1.7).

Inflation dynamics are expected to continue easing, but price pressures will remain high in some non-GCC oil exporters. Across the MENA region's oil exporters, headline inflation is forecast to average 12.9 percent in 2023 (unchanged from 2022) and 9.4 percent in 2024. These elevated levels reflect persistent price pressures in some non-GCC countries because of ongoing fiscal expansions (Algeria) and the impact of sizable exchange rate depreciation (Islamic Republic of Iran).

**Figure 1.5. MENA Region EM&MIs and Pakistan: Net Cumulative Portfolio Inflows**  
(Billions of US dollars, cumulative flows since January 2019)



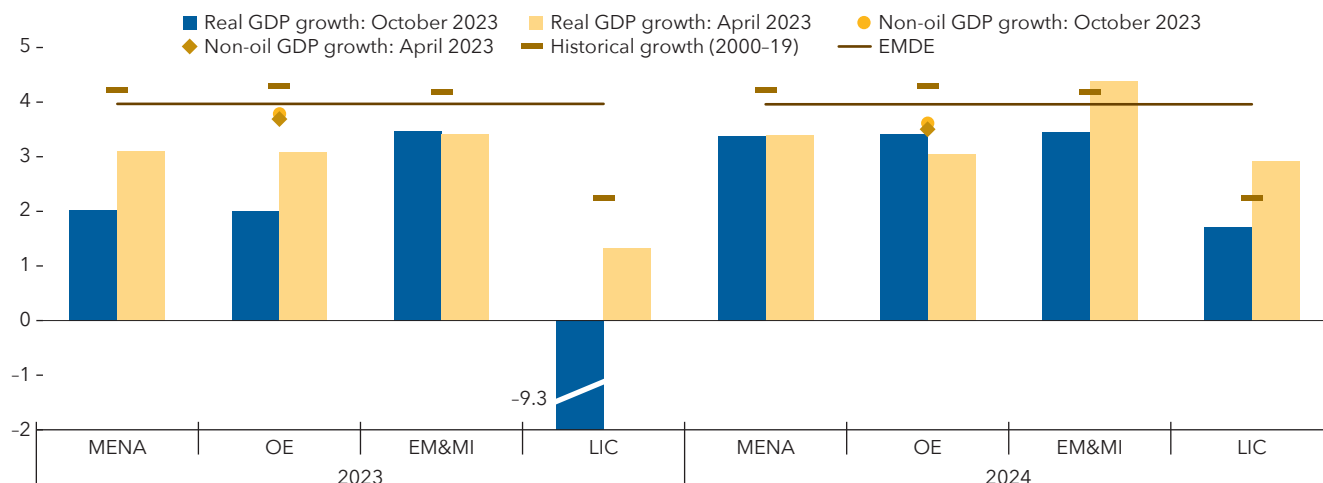
Sources: Haver Analytics; and IMF staff calculations.

Note: MENA includes flows to other MENA countries not displayed on the chart. Country abbreviations are International Organization for Standardization (ISO) country codes. EMs = emerging markets; EM&MI = emerging market and middle-income economy; MENA = Middle East and North Africa.

<sup>2</sup> Projections for Libya in this report do not include the impact of the disaster.



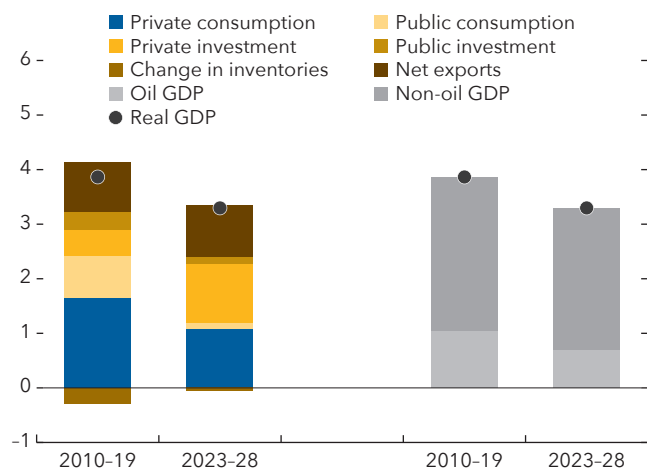
**Figure 1.6. Growth Projections**  
(Percent change, year-over-year)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Note: EM&MI = emerging market and middle-income economy; EMDE = emerging market and developing economy; LIC = low-income country; MENA = Middle East and North Africa; OE = oil exporter.

**Figure 1.7. GCC: Contributions to GDP Growth**  
(Percentage points, weighted averages)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Note: Data for Kuwait are available starting 2011. GCC = Gulf Cooperation Council.

Lower oil production and oil prices will not only weigh on growth but also drive a marked decline in oil exporters' external positions. Current account surpluses are projected to almost halve from 14.6 percent of GDP in 2022 to 7.5 percent in 2023 and contract further to 6.7 percent of GDP in 2024. But they will remain in comfortable positions over the medium term (except for Iraq).

In this context, several oil exporters are expected to continue consolidating their public finances to mitigate the fiscal impact of lower oil revenue and reduce budget sensitivity to oil price volatility. Planned consolidation efforts focus on rationalizing current expenditures to free up resources for priority spending, including on social safety nets and infrastructure (Bahrain, Oman, Qatar, Saudi Arabia), while also reducing the fiscal deficit in some (Bahrain, Qatar). As such non-oil fiscal balances (as a percentage of non-oil GDP) are expected on average to improve in 2023 by 5.5 percent and further to 1.8 percent in 2024. Conversely, an

increase in the wage bill (Kuwait, Iraq) and subsidies (United Arab Emirates) is expected to result in a worsening fiscal position in these economies this year.

### EM&MIs: Tighter Policies and Challenging External Conditions to Constrain Growth

Growth in the MENA region's EM&MIs is expected to slow to 3.5 percent this year (from 5.1 percent in 2022) amid tight macroeconomic policies, though with diverging trends across countries, reflecting country-specific factors. Developments in Jordan and Morocco are more favorable, with growth projected to remain stable (Jordan) or

accelerate (Morocco) because of strong tourism and exports (though subdued by historical standards) and the normalization of agricultural activity in Morocco as the impact of last year's drought fades. Conversely, growth in Egypt has decelerated in fiscal year 2023, reflecting the impact of foreign currency rationing on imports, production, and inflation, and the impact of elevated inflation on consumers' purchasing power. In the case of Pakistan, growth is estimated to have contracted during fiscal year 2023 because of severe damage from widespread flooding in the second half of 2022, broad-based inflationary pressures, and import curbs.

Further ahead, continued tight macroeconomic policies and persistent structural challenges are expected to hold back economic activity in several economies. Notably, while announced policy efforts, including on the structural reform agenda, are projected to gradually support growth, there are several challenges ahead. For example, gaps in economic opportunities for women and youth, fragmented social protection systems, and underdeveloped private sectors are expected to continue to put a damper on job creation.

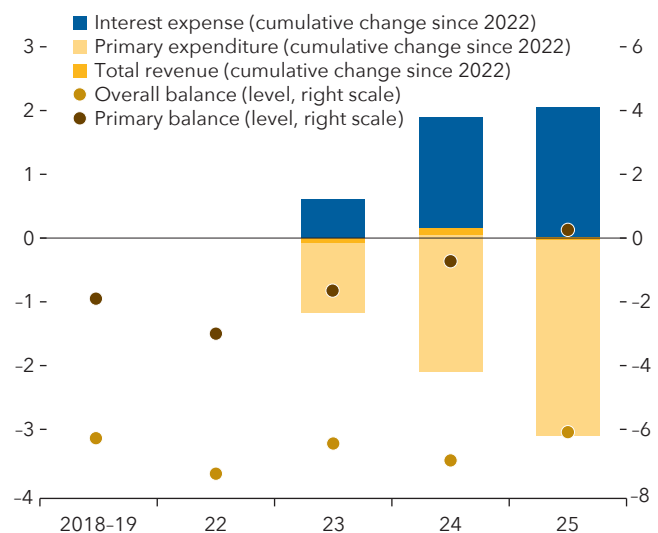
Inflationary pressures are poised to continue easing in most EM&MIs as the impact of monetary tightening takes hold. In Egypt, the lagged impact from exchange rate depreciations is set to keep pressuring domestic prices, with headline inflation peaking at 32.2 percent in 2024 but remaining in double digits through 2027. Inflation is forecast to peak in Pakistan in 2023, but it is foreseen to remain elevated in 2024. By contrast, price pressures in Jordan and Morocco are projected to continue declining, with inflation nearing prepandemic levels this year (Jordan) or next (Morocco).

Easing commodity prices and strong tourism activity are projected to benefit external balances in some EM&MIs. Overall, the current account deficit for EM&MIs is set to narrow from 5.2 percent of GDP in 2022 to 3.7 percent in 2023, reflecting robust tourism and resilient remittances, fiscal consolidation, and a partial reversal of the 2022 terms-of-trade shock. However, external financing needs will remain large, and reserve coverage is forecast to remain precarious in several countries, averaging about 70 percent of short-term external debt in Egypt, Pakistan, and Tunisia.

Primary fiscal balances are expected to improve in the MENA region's EM&MIs and Pakistan, reaching prepandemic levels this year, helped by expenditure rationalization (mostly on the back of lower subsidies and transfers). However, the overall fiscal balance is set to improve only by about 1 percent of GDP over 2023–24, reflecting a 2 percent of GDP increase in interest expenses, as higher interest rates put pressure on government debt-servicing costs (Figure 1.8). In this context, public debt-to-GDP ratios are projected to ease only gradually, from a peak of 90 percent in 2023 to 80 percent in 2025, primarily reflecting the erosion of the real value of public debt from still-elevated inflation in Egypt and Pakistan.

Elevated public sector gross financing needs are still a significant challenge for most MENA EM&MIs and Pakistan. Total financing needs over 2023–24 are projected at \$487 billion—an increase of about \$8 billion or 16 percentage points of fiscal revenues since April—reaching up to 38 and 21 percent of GDP by 2024 for Egypt and Pakistan, respectively (Figure 1.9).

**Figure 1.8. MENA Region EM&MIs and Pakistan: Overall and Primary Fiscal Balances**  
(Percent of GDP, simple averages)

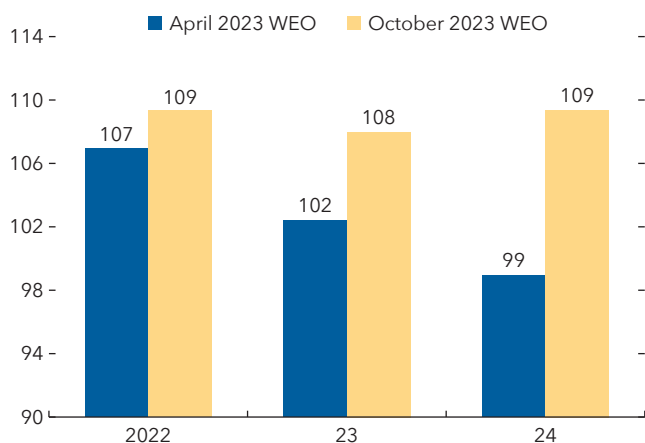


Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Note: Overall and primary balances and total revenues exclude grants. EM&MI = emerging market and middle-income economy; MENA = Middle East and North Africa.

**Figure 1.9. MENA EM&MI and Pakistan: Public Gross Financing Needs**

(Percent of fiscal revenue, simple average)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Note: EM&MI = emerging market and middle-income economies; MENA = Middle East and North Africa; WEO = *World Economic Outlook*.

These would require domestic and external debt issuance of about \$175 billion and \$6 billion in excess of domestic and external debt amortization, respectively, over 2023-24, and thus would likely exacerbate further the sovereign-bank nexus in the region's EM&MIs.

### LICs: Difficulties Mount amid Crises and Depleted Policy Space

Economic activity in the MENA region's LICs is forecast to contract sharply this year (9.3 percent), following a mild contraction in 2022, greatly amplifying existing domestic challenges. However, these figures mask considerable heterogeneity across countries, as economic activity remains driven by country-specific, idiosyncratic factors that weigh particularly on fragile and conflict-affected LICs. The worsening crisis in Sudan will have a considerable impact on people and livelihoods—the conflict's impact on the economy is large, with GDP growth forecast to contract by more than 18 percent in 2023. Similarly, Yemen's economy

is projected to contract by 0.5 percent this year after the truce agreed to in 2022 expired without delivering tangible macroeconomic improvements for the country. Somalia's economy is forecast to grow by a moderate 2.8 percent in 2023 as drought conditions continue to weigh on the economy. Economic activity in other LICs is projected to remain robust. In Djibouti, GDP growth is forecast at 5 percent in 2023, boosted by the peace agreement in Ethiopia that has spurred port and border traffic. In Mauritania, economic growth is projected to decelerate as activity in the extractive and agriculture sectors moderates but remains at a healthy 4.5 percent.

LICs face multiple economic challenges over the medium term, particularly relating to their external positions. Financing needs will remain high because export revenues and remittances are insufficient to offset large import bills, resulting in current account deficits of more than 5 percent of GDP over 2027-28. In most countries, aid flows constitute a critical source of external and public financing, but LICs face declining official grants over the medium term and considerable gross financing needs amounting to about \$12 billion cumulative until 2028.

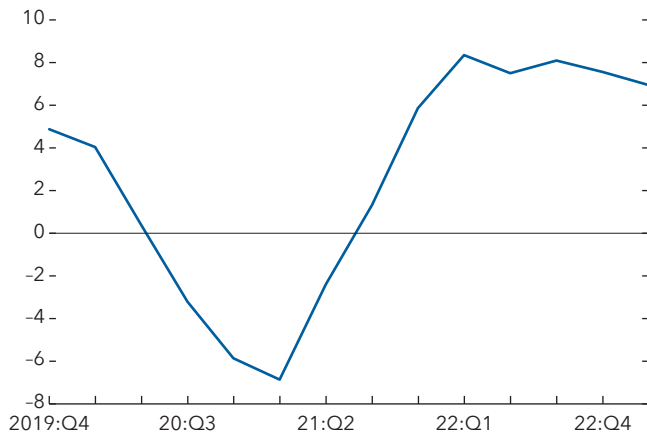
## 1.3. Caucasus and Central Asia: Growth Momentum Remains

*Economic growth in the CCA is expected to decelerate moderately in 2023 and next year, as migration, financial inflows, and trade with Russia gradually normalize. Over the medium term, economic activity is projected to grow at a slower pace and remain well below its prepandemic historical average as long-standing structural challenges continue to hold back growth. While price dynamics are diverging across countries, inflation is projected to ease more quickly than previously expected in 2023 but remain persistent in 2024 in some countries, reflecting continued wage pressures.*

### Economic Activity Remains Strong in Several Countries

Strong transit trade, inward migration, and tourism continue to support growth in the region, even amid some moderation in a few economies. Migrant flows, net money transfers, and nonresident deposits—though abating from 2022 peaks—have remained well above pre-war levels in most countries, and continued transit trade has supported a strong expansion of exports. Tourism growth has also remained robust, and in some countries,

**Figure 1.10. CCA: Real GDP Growth**  
(Percent change, year-over-year; simple average)



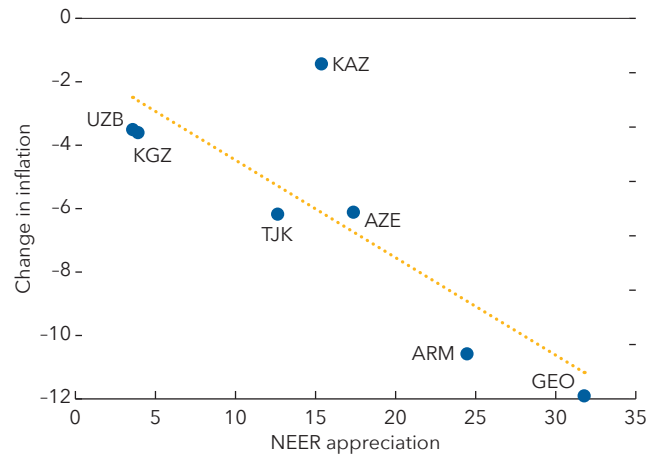
Sources: Haver Analytics; national authorities; and IMF staff calculations.  
Note: Simple average for Armenia, Azerbaijan, Georgia, Kazakhstan, and Kyrgyz Republic. CCA = Caucasus and Central Asia.

tourist arrivals have surpassed prepandemic levels (Armenia, Georgia). Moreover, expansions in retail sales and communication services—industries with growth above prepandemic levels—have resulted in robust domestic demand (Armenia, Georgia, Kazakhstan). Economic activity still showed signs of slowing in some CCA countries in the first quarter of 2023, as production constraints in extractive industries held back growth in Azerbaijan, and an easing of remittance flows and weaker gold and agricultural production weighed on activity in the Kyrgyz Republic (Figure 1.10).

However, external buffers have improved in most CCA countries thanks to high international oil and gas prices for oil exporters, large trade surpluses in services (Armenia, Georgia), continued private transfers from Russia, and strong remittance flows. Consequently, reserve accumulation has continued in 2023, and domestic currencies have appreciated (especially in Armenia and Georgia) because of sizable inflows relative to the size of the domestic economy.

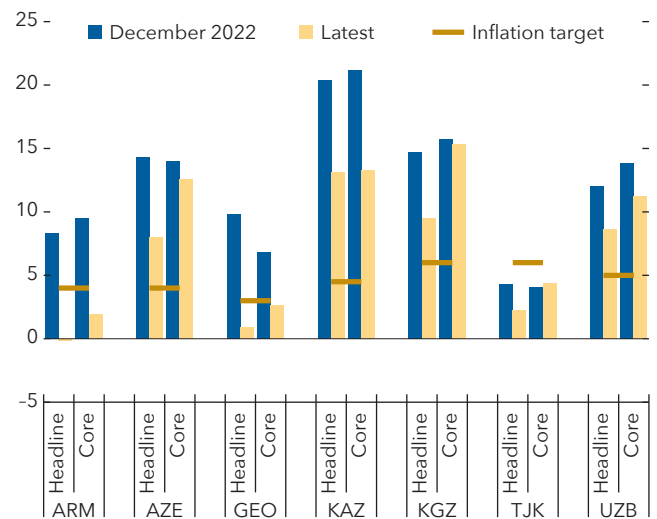
Despite still-robust growth, headline and core inflation have eased, helped by base effects, declines in international food and energy prices, earlier monetary policy tightening, and tighter fiscal positions in some countries. The disinflation process has been particularly fast where currencies appreciated strongly vis-à-vis trading partners (Armenia, Georgia), highlighting the exchange rate channel’s importance in domestic price dynamics (Figure 1.11). Notably, inflation has fallen below central bank targets in Armenia and Georgia and administered prices have contained inflation in Tajikistan (Figure 1.12).

**Figure 1.11. Inflation Changes and Currency Appreciation since June 2022**  
(Percent)



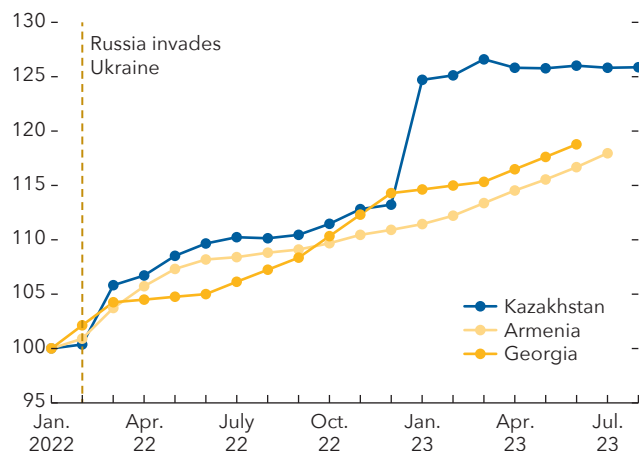
Sources: Haver Analytics; national authorities; and IMF staff calculations.  
Note: Country abbreviations are International Organization for Standardization (ISO) country codes. NEER = nominal effective exchange rate.

**Figure 1.12. CCA: Inflation**  
(Percent change, year-over-year)



Sources: Haver Analytics; national authorities; and IMF staff calculations.  
Note: Country abbreviations are International Organization for Standardization (ISO) country codes. CCA = Caucasus and Central Asia.

**Figure 1.13. House Prices**  
(Index, January 2022 = 100)



Source: Haver Analytics; national authorities; and IMF staff calculations.

Note: House prices in Armenia are proxied by the average price per square meter of multiapartment buildings in Yerevan. House prices in Georgia are interpolated from quarterly data. House prices in Kazakhstan are proxied by a price index for existing new housing.

However, inflation remains elevated in several countries and core inflation has proved stickier than headline. Strong demand in the services sector and strong wage growth in some countries has prevented a faster disinflation process in Azerbaijan, Kazakhstan, the Kyrgyz Republic, and Uzbekistan.

Slowing inflation has prompted some CCA central banks to begin loosening monetary policy, supporting an easing of financial conditions. Armenia, Georgia, Kazakhstan, and Tajikistan have reduced their policy rates by 50, 75, 25, and 300 basis points, respectively, since the beginning of the year. Combined with an expansion in monetary aggregates (Armenia, Georgia, Kyrgyz Republic) and local currency appreciation, the resulting easing of financial conditions has supported a steady (though small in magnitude) increase in credit to the private sector (Azerbaijan, Kyrgyz Republic, Tajikistan). At the same time, housing prices have risen in Armenia, Georgia, and Kazakhstan since the first quarter of 2022 (Figure 1.13).

### CCA Outlook: Moderating but Still Robust Growth

Near-term prospects in the CCA are broadly positive. Overall, GDP growth in the CCA is projected to moderate to 4.6 percent in 2023 and decline further to 4.2 percent in 2024. This reflects an upward revision of 0.3 percentage point for 2023 relative to April amid a more persistent positive impact on growth from real and financial flows to the region (Armenia, Georgia, Tajikistan, Uzbekistan). However, country-specific factors and challenges are expected to result in divergent growth trends across countries this year. For example, growth in Armenia and Georgia is set to decelerate from last year's double-digit surge in activity, and economic activity in CCA LICs is softening on a continued decline in remittance flows and weaker gold and agricultural production (Kyrgyz Republic, Tajikistan, Uzbekistan).

Among oil and gas exporters, economic momentum is projected to decelerate in Azerbaijan and remain subdued in Turkmenistan, reflecting persistent capacity constraints in hydrocarbon production and deep-seated structural challenges. By contrast, growth in Kazakhstan is expected to rebound this year, supported by strong domestic demand and increased oil production (because of easing operational constraints affecting the Caspian Pipeline Consortium and the Tengiz oil field expansion).

Economic activity in the CCA is generally forecast to decelerate over the medium term as inflows from Russia dissipate, growth in extractive sectors slows, and structural gaps persist, holding back productivity, including related to limited diversification of economic structures and international trade patterns (Box 1.2), governance challenges, and lack of competition (Gigineishvili and others 2023). In this context, average medium-term growth in the region is projected to decline below its pre-pandemic historical average (Figure 1.14).

External positions are projected to weaken as private transfers and trade from Russia gradually normalize. Azerbaijan and Kazakhstan are forecast to experience sharp current account deteriorations, reflecting lower export revenues and strong imports. Moreover, Azerbaijan is expected to continue to experience production constraints related to structural (oil) and capacity (gas) challenges.

Meanwhile, disinflation is projected to continue. Reflecting sharp declines in inflation in Armenia and Georgia, inflation is projected to ease to 11 percent on average in 2023 (0.8 percentage point faster than projected in April). Although strong wage growth in Kazakhstan, the Kyrgyz Republic, and Uzbekistan underpins more persistent price pressures, headline inflation in the CCA is still projected to moderate to 8.3 percent in 2024.

Public-sector debt is at manageable levels. Still, overall fiscal positions are forecast to worsen by 1.5 percent of GDP on average across the CCA in 2023 and remain broadly unchanged in 2024. Notably, expenditure increases are projected in Kazakhstan (though these will be largely offset by strong non-oil revenues), the Kyrgyz Republic (subsidies and the wage bill), and Azerbaijan and Tajikistan (capital expenditure). By contrast, Georgia is set to maintain a gradual consolidation path, supported by strong revenue and fiscal restraint.

## 1.4. Risks to the ME&CA Outlook

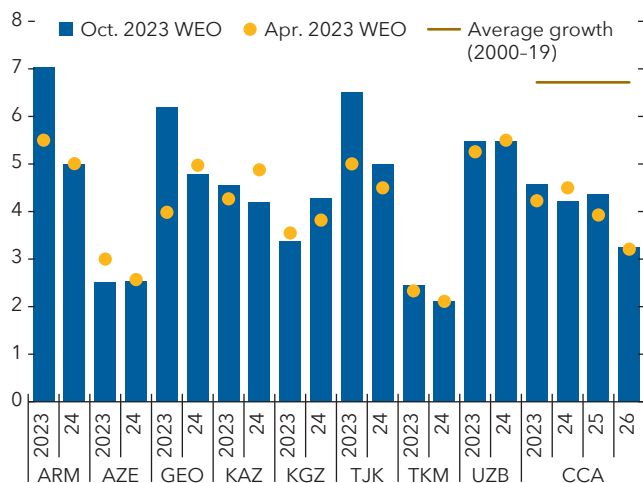
*The balance of risks to the outlook in ME&CA has improved since the April 2023 World Economic Outlook, but it remains tilted to the downside.*

The materialization of several upside risks could help lift growth prospects in ME&CA. A faster-than-anticipated global decline in inflation would reduce the extent of central banks' necessary interest rate hikes, allowing for an easing of global financing conditions and an attendant decline in borrowing costs in ME&CA. Moreover, lower-than-expected food prices would help reduce fiscal costs, alleviating food insecurity especially in LICs. Stronger-than-projected global growth (for example, because of additional stimulus measures in China), would reignite global trade and help strengthen external demand for ME&CA exports. A continued influx of migrants and foreign exchange to the CCA could boost demand.

Yet, several downside risks cloud the outlook. A larger-than-expected slowdown in China or advanced economies would depress external demand and worsen the region's economic prospects, reducing tourism and curtailing exports, including amid China's importance in global commodity demand. Moreover, an escalation of the war in Ukraine could put renewed pressure on food (for example, because of the suspension of the Black Sea Grain Initiative), fuel, and fertilizer prices, thus reigniting inflationary pressures and worsening food insecurity, with the potential differential effect on inflation across countries determined by their import or export dependence. The realization of climate-related shocks—especially amid changing El Niño patterns—could result in local or regional persistent drought conditions and floods, affecting physical infrastructure, agriculture output, and food prices.

Region-specific downside risks could also materialize:

**Figure 1.14. Real GDP Growth**  
(Percent change, year-over-year)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Note: Country abbreviations are International Organization for Standardization (ISO) country codes. CCA = Caucasus and Central Asia; WEO = World Economic Outlook.

- Tighter global financial conditions and deeper spillovers from regional conflicts could pose risks amid challenging financing conditions for MENA region EM&MIs. Tighter-for-longer global financial conditions could prompt investors to reassess lending to highly indebted EM&MIs, worsening debt dynamics and heightening risks of debt distress. Attendant fiscal tensions could spill over to the private sector through sovereign-bank link (Chapter 3). Separately, a deterioration of the crisis in Sudan could accelerate migration flows and add to social and economic costs in Egypt (Box 1.1).
- A possible worsening of geoeconomic conditions related to Russia's war in Ukraine could adversely impact financial flows, remittances, trade, and economic activity, and lead to the introduction of secondary sanctions. In addition, a conflict escalation could cause new disruptions to regional trade infrastructure and linkages, including maritime routes and oil pipelines, thereby hampering trade and economic activity for oil and gas exporters and importers alike.

Limited progress in implementing structural reforms, including under IMF-supported programs, would weigh on medium-term prospects further and undermine the region's resilience to shocks given long-standing structural gaps (Chapter 2). Chronically limited job creation, high unemployment rates, and a heavy reliance on volatile commodity markets expose ME&CA to downside risks. These structural deficiencies hinder the region's ability to attract foreign investment, foster innovation, and create the competitive and dynamic business environment necessary to increase the economy's resilience to shocks.

## 1.5. Policies: Building Resilience while Safeguarding Macro Stability

*In the context of subdued growth prospects, accelerating efforts to foster structural economic change is essential to enhancing potential growth and inclusion, hastening economic diversification, and increasing resilience to shocks. This is all the more important as persistent inflationary pressures and depleted fiscal and external buffers in several ME&CA countries call for continued tight macroeconomic policies to re-establish price stability and ensure fiscal and external sustainability.*

### Structural Policies: Transforming the Economy to Be Ready for Tomorrow

Expediting the implementation of comprehensive structural reforms is critical to solving the deep-seated economic challenges holding back growth in ME&CA, especially when many countries will need to maintain tight macroeconomic policies (Chapter 2).

- Strengthening governance would be instrumental to fostering an economic environment that promotes private investment. Reforms to improve government effectiveness and the rule of law can be particularly impactful by strengthening efficiency and predictability for private sector participants. This is particularly relevant as most ME&CA countries fall far behind the global frontier on multiple governance indicators. Moreover, countries need to ensure a level playing field between public and private firms to develop the private sector. This requires reducing the dominant role of state-owned enterprises, streamlining or eliminating burdensome government regulations, enhancing financial inclusion (especially of small and medium-sized enterprises), and improving general governance.
- ME&CA countries would benefit from fostering financial development (for example, by strengthening regulatory and supervisory frameworks, enforcing property rights and creditor rights, and enhancing banking competition, transparency, and information sharing; Gigineishvili and others 2023) and improving productivity by investing in infrastructure, including transportation and information and communication technologies.
- Promoting digitalization would be essential as it is a tool to improve both inclusion and efficiency. Notably, increased digitalization can help provide the young and women with new job opportunities associated with remote working, online learning, digital finance, and e-commerce.

- Amid low female labor force participation in the MENA region, several countries would also need to reduce barriers to women's participation in economic life, including by removing the legal and policy barriers that weaken the link between women's education and employment outcomes (Cardarelli, Vera-Martín, and Lall 2022).

However, identifying an appropriate set of structural reforms is not enough to maximize growth. Sequencing and packaging structural reforms matter for their overall economic growth dividend (Chapter 2). For example, “first-generation” reforms—governance, regulatory quality, and external sector reforms—can have a positive impact on the returns from subsequent reforms. Similarly, credit market and labor market reforms can have a substantial effect on output once countries implement first-generation reforms.

Critically, climate change-related shocks threaten growth prospects across ME&CA and represent a key source of socioeconomic risk. Effective climate change adaptation requires including climate risks and policies in all relevant policy frameworks and structural reform agendas; adopting measures that help boost climate resilience—notably social measures (such as social protection, health care, and education) and infrastructure investments (Duenwald and others 2022)—and promoting a balanced policy mix to support climate mitigation and more sustainable growth (April 2023 *Fiscal Monitor*). In addition, oil exporters should make the transition toward more diverse and greener sources of energy generation. Eliminating energy subsidies is an important first step. The geographic location and dependence on agriculture of many LICs and fragile and conflict-affected states (FCS) expose them to climate change disproportionately. Notably, droughts increase hunger from already elevated levels, calling for scaling up climate-resilient infrastructure investment (Jaramillo and others 2023).

### Monetary and Financial Policies: Bringing Inflation Down Durably While Maintaining Financial Stability

Monetary policy should remain focused on price stability. Consistent with prevailing policy frameworks, exchange rate flexibility can help cushion the impact of shocks. In all economies, clearly communicating policy intentions is essential to support stability. As such, countries in the region could benefit from strengthening monetary policy frameworks and increasing the transparency of monetary policy operations. Ensuring central bank independence is critical for the monetary policy effectiveness (April 2023 *Regional Economic Outlook: Middle East and Central Asia*).

- In countries with a flexible exchange rate and persistent inflationary pressures, monetary policy should remain tight and follow a data-dependent approach. Most EM&MIs would need to maintain a tight policy stance and remain vigilant until signals of sustained disinflation are well-established. In some economies where inflation is high, this may require more monetary policy tightening (Egypt, Pakistan, Tunisia).
- In countries where inflation has returned to or is near inflation targets and underlying inflationary pressures have abated, monetary easing can proceed in countries where growth is lackluster. But in countries where demand is still strong, it should be done cautiously to prevent re-igniting price pressures. This is particularly relevant in some CCA economies (Armenia, Georgia). Paying due attention to any risks of a reversal of inflation developments will be essential.
- In countries with a fixed exchange rate (GCC, Jordan), any policy interest rate change should be made in accordance with their frameworks.

Additionally, reforms to deepen the financial sector would strengthen liquidity conditions and help spur investment and growth. In some GCC countries, policies to guard against unexpected liquidity stress related to foreign liabilities would help ensure financial sector stability, while countries in the CCA would benefit from macroprudential policies and tools that incentivize de-dollarization and enhance corporate and bank risk management. All ME&CA countries should step up efforts to foster a deep and diversified investor base and improve the



management of state-owned banks—particularly in countries where these entities dominate the marketplace (MENA region, Pakistan)—by building adequate buffers, providing clear and well-defined mandates, and aligning supervisory tools such as stress tests (Chapter 3).

### Fiscal Policy: Strengthening Resilience and Rebuilding Buffers

Amid marked differences in fiscal space and varying dependence on global developments across ME&CA, carefully tailoring policy actions to local conditions will be essential. In all economies, it is essential to ensure that social protection systems have sufficient reach and provide equal access to basic services. Additionally, social spending should be targeted toward the most vulnerable segments of the population, avoiding generalized increases in wages, subsidies, and transfers.

MENA oil exporters would benefit from avoiding procyclical spending. Amid volatile oil prices and a high dependence on global economic developments, boosting fiscal buffers further would help ensure resilience. Moreover, oil exporters would benefit from diversifying away from their current dependence on oil fiscal revenue, strengthening fiscal risk management, and implementing credible medium-term fiscal frameworks. To support longer-term economic resilience, public investments should target the development of non-oil sectors and address the challenges associated with climate change.

In the MENA region's EM&MIs, policymakers will need to strengthen fiscal balances further and bring down public-sector debt levels decisively. Given elevated debt-to-GDP ratios and related debt-servicing costs, EM&MIs should continue consolidating their public finances, mainly by containing current spending on wages and subsidies, and in some cases through additional revenue mobilization (including by removing tax exemptions). Moreover, credible medium-term fiscal frameworks would reinforce these efforts and build a track record of fiscal discipline. For example, the publication by Moroccan authorities of a three-year budget plan as part of the annual budget starting from 2023 represents an important step toward a stronger institutional fiscal framework, as publishing a credible, realistic, and consistent medium-term fiscal plan could reassure markets about the authorities' commitment to fiscal discipline. In addition, for all economies, considering ways to mitigate fiscal risks from state-owned enterprises will be important.

In the MENA region's LICs and FCS, ensuring stability while easing food insecurity remains a priority. Where present, resolving ongoing conflicts is a prerequisite for improving living standards and growth. Where financing constraints prevent progress toward the Sustainable Development Goals, strong efforts are needed to mobilize domestic fiscal revenues. Amid persistent droughts and devastating food insecurity, any spending aimed at supporting livelihoods should target the most pressing social needs (such as acute food insecurity). Support from the international community is essential in this regard because it would help mitigate ongoing humanitarian crises.

Fiscal risks are prevalent in low- and middle-income countries in the MENA region and include those associated with macroeconomic shocks (commodity price volatility), public-sector guarantees (including to state-owned enterprises), and natural disasters, among other shocks (Boukezia and others 2023). To mitigate these risks, country authorities would benefit from developing fiscal risk management frameworks, including building the capacity to identify and assess sources of fiscal risks and their budgetary impact. To this end, countries should collect regular, timely, and comprehensive fiscal data covering the entire public sector, along with other macroeconomic data to facilitate the adoption of fiscal risk mitigation measures.

Amid the uncertainty surrounding the medium-term outlook, CCA countries should maintain a prudent fiscal stance to build buffers and reduce vulnerabilities. Fiscal structural reforms—such as increasing budget transparency and adopting credible medium-term fiscal frameworks anchored in fiscal rules—will reinforce these efforts and help facilitate access to external financing.

## IMF Support Has Expanded

The IMF remains dedicated to supporting the region by offering policy advice, fostering capacity development, and providing financial assistance. The World Bank-IMF Annual Meetings in Marrakech, Morocco, provide a platform for wide-ranging policy discussions on challenges facing the region and the global economy. Since the onset of the pandemic, the IMF has provided \$34 billion in new financing to 15 countries in ME&CA. Over the last year, IMF programs were approved for Armenia (Stand-By Arrangement), Egypt (Extended Fund Facility), Mauritania (Extended Credit Facility and Extended Fund Facility), Morocco (Flexible Credit Line, Resilience and Sustainability Facility), and Pakistan (Stand-By Arrangement). Since 2020, the IMF has also provided about \$6 billion in emergency financing and enhanced its emergency financing facilities to address the pressing food crisis confronting the Fund's most vulnerable members. This includes establishing a Food Shock Window that allows easier access to financial assistance for countries facing balance-of-payments pressures related to food and fertilizers. Moreover, the IMF created the Resilience and Sustainability Trust to support low-income and vulnerable middle-income countries in addressing longer-term challenges, including climate change. The recent approval of a Resilience and Sustainability Facility with Morocco amounting to about \$1.3 billion is the first in ME&CA. The IMF has also increased its local presence in the region by expanding Resident Representative offices, reopening its Middle East Regional Technical Assistance Center, opening its Caucasus, Central Asia, and Mongolia Regional Capacity Development Center, and setting up a new regional office in Riyadh, Saudi Arabia, which will strengthen the IMF's partnership with the region.

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### Box 1.1. The Conflict in Sudan: Migration Consequences for North Africa

The conflict in Sudan is rapidly worsening the country's humanitarian crisis, which has been ongoing for more than two decades. Economic and social conditions have deteriorated since 2021, with currency depreciation driving a dramatic rise in inflation and worsening food insecurity. At the start of 2023, almost 16 million people—one-third of the population—needed humanitarian assistance, and 11 million people were acutely food insecure. However, since the conflict intensified in April, the United Nations estimates that the number of people in Sudan needing humanitarian assistance has increased by a staggering 10 million. This jump partly reflects a 20 percent increase in food prices between March and June, reducing access to sufficient and safe food, and pushing more than 20.3 million (42 percent of country's population) to high levels of acute food insecurity, according to the Food and Agriculture Organization.

The crisis in Sudan is expected to generate large flows of displaced persons in Africa. The United Nations High Commissioner for Refugees (UNHCR) reported that more than 5.3 million had been displaced as of September. Of these, about 1.2 million have left the country. Chad and Egypt have received the most internationally displaced refugees (412,000 and 317,000, respectively); other neighboring countries

received around 70,000 refugees. Additionally, about 250,000 refugees from South Sudan are expected to leave Sudan to return to their home country.

The economic costs for countries impacted by this displacement are substantial. The UNHCR estimates the total cost of the response across the five countries receiving refugees at \$1 billion through December 2023. By September, \$266 million had been funded (Box Figure 1.1.1).

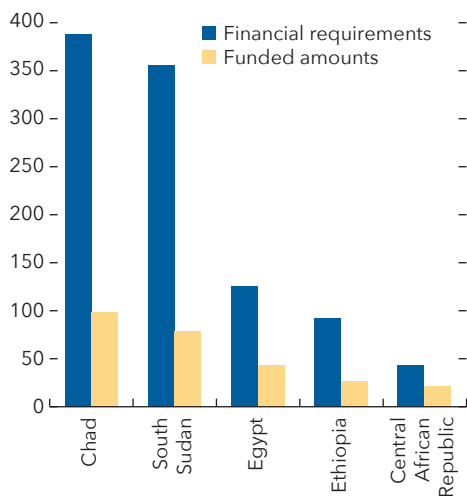
According to the United Nations Office for the Coordination of Humanitarian Affairs, the current crisis has also increased the cost of Sudan's overall humanitarian response plan by an estimated \$750 million, raising it to \$2.6 billion. As of September, donors had funded about \$900 million, about one-third of the response funds needed.

The impact of the conflict in Sudan could be long-lasting. Sudan's infrastructure and human capital are incurring significant losses, that could take years to rebuild. A weakened Sudanese economy would negatively affect neighboring countries and North Africa more broadly over the medium term. To prevent these

consequences, donor countries, both internationally and in the region, should contribute to relief efforts for refugees and continue to use all their capacity to end the conflict as soon as possible.

**Box Figure 1.1.1. Refugee Response: Financial Requirements and Funded Amounts**

(Millions of US dollars)



Sources: UNHCR (2023); and IMF staff calculations.

Prepared by Hasan Dudu.

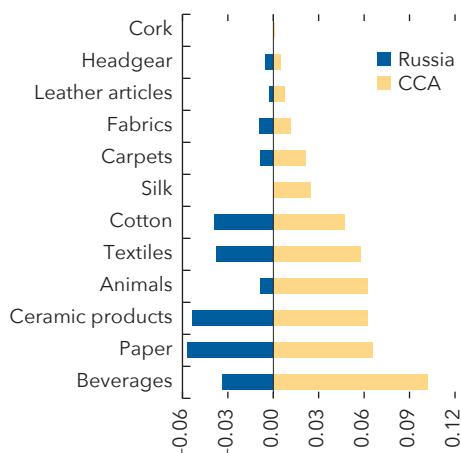
## Box 1.2. Changing Trade Patterns in the Caucasus and Central Asia

Since the start of the war in Ukraine, trade patterns in the Caucasus and Central Asia (CCA) have changed. Despite possible errors and omissions in trade statistics,<sup>1</sup> the data show that trade flows between Russia and several CCA countries have increased for product categories including iron and steel, machinery, chemicals, agriculture products, and energy. Overall, the Kyrgyz Republic's share of exports to Russia has tripled (increasing from 14 percent of total exports in 2021 to 44 percent in 2022), while Armenia's exports to Russia almost doubled (from 27 percent in 2021 to 45 percent in 2022). The increase in Uzbekistan's exports to Russia was significantly smaller—only 5 percentage points (from 12 percent in 2021 to 17 percent in 2022)—as exports to the European Union and the rest of the world increased significantly. By contrast, the share of exports to Russia from Azerbaijan, Georgia, and Kazakhstan declined slightly.

In parallel, most CCA countries have stepped up their exports to the rest of the world, expanding the region's overall footprint in global trade. In relative terms, most countries in the CCA (excluding Armenia and the Kyrgyz Republic) increased their non-energy export share to trading partners other than Russia in 2022. This rise was primarily in agriculture products, food, and raw materials (especially metals), and corresponds to the product categories in which Russian exports have declined the most since the war started (Box Figure 1.2.1). From a geographical standpoint, exports to the European Union, the United States, China, and the rest of the world surged, suggesting a broad-based geographical widening of CCA trade links (Box Figure 1.2.2).

### Box Figure 1.2.1. CCA Exports to the Rest of the World

(Change in billions of US dollars, 2022 versus 2019–21 average)

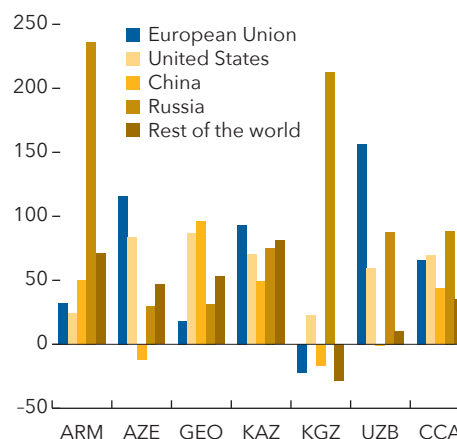


Sources: United Nations Comtrade; and IMF staff calculations.

Note: Includes all CCA countries except Tajikistan and Turkmenistan because of lack of data. CCA = Caucasus and Central Asia.

### Box Figure 1.2.2. CCA Exports by Trading Partner

(Percentage change, 2022 versus 2019–21 average)



Sources: United Nations Comtrade; and IMF staff calculations.

Note: All CCA countries except for Tajikistan and Turkmenistan because of lack of data. Data for the Kyrgyz Republic do not include gold exports, which declined sharply because of non-war-related reasons. Country abbreviations are International Organization for Standardization (ISO) country codes. CCA = Caucasus and Central Asia.

Prepared by Hasan Dudu.

<sup>1</sup> Official trade statistics may not accurately reflect trade within the Eurasian Customs Union and, therefore, among Armenia, Kazakhstan, the Kyrgyz Republic, and Russia. For example, available data for the Kyrgyz Republic are based on sporadic surveys of exporters and vehicles crossing the border.

## 2. From Setbacks to Comebacks: Reforms to Build Resilience and Prosperity<sup>1</sup>

*Policy space in many countries in the Middle East and Central Asia (ME&CA) region has diminished following an extended period of shocks, particularly among the region's emerging market and middle-income countries (EM&MIs). Amid high public debt and inflation, fiscal consolidation and tight monetary policy are needed in many countries in the region. In this context, structural reforms offer a way to not only increase potential growth, but also accrue near-term growth benefits. In addition, reforms can be instrumental in accelerating economic diversification among oil exporters. In a novel analysis for the region, this chapter shows that most structural reforms help lift output, with the impact growing over time. Governance reforms—particularly, enhancing the rule of law and government effectiveness—are especially important and can also generate positive output effects during periods of weak growth or relatively limited policy space. Improving the government's ability to implement policies and regulations to promote private sector development also contributes to fostering growth through improved investment and productivity. Moreover, prioritizing governance reforms before other reforms can magnify their overall growth dividends, and the strategic packaging of reforms—for example, by combining external sector and credit market reforms—can amplify positive output effects. Importantly, the design of structural reforms will need to include political considerations and distributional impacts.*

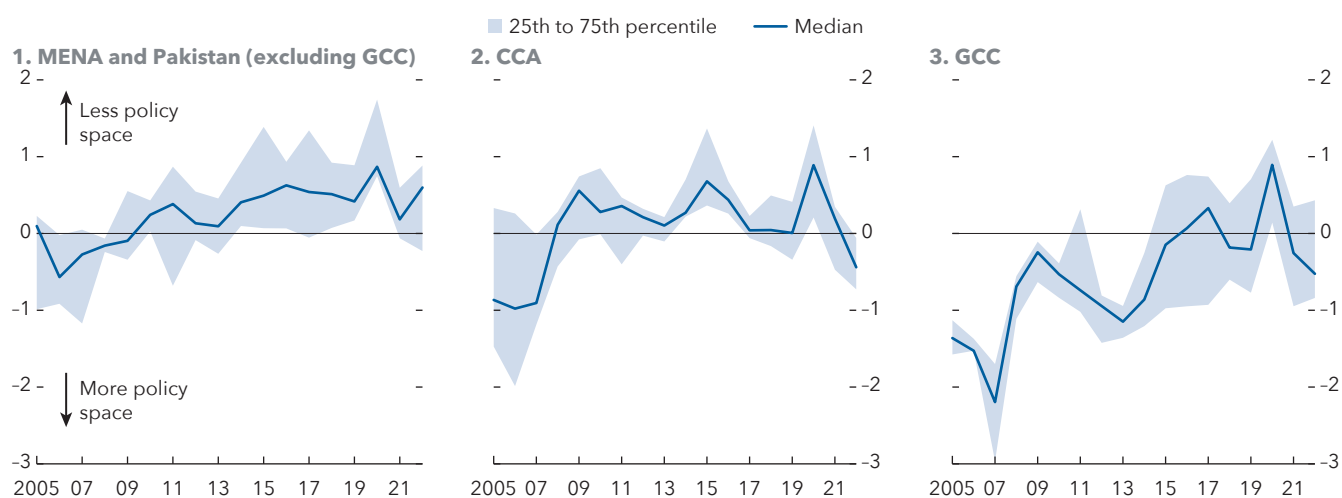
### 2.1. Narrowing Policy Space Amplifies the Urgency of Implementing Reforms

Recent global shocks have triggered a concerning rise in debt levels and inflation in many ME&CA countries, significantly limiting policy options, especially for EM&MIs. Notably, public debt in ME&CA EM&MIs rose to an average of 83.5 percent of GDP in 2022 (from 79 percent of GDP before the pandemic), and medium-term growth is projected to remain below historical trends. Concurrently, average headline inflation in EM&MIs jumped to double digits in 2022, and monetary policy tightening in major advanced economies to bring down inflation led to tighter financial conditions in emerging market and developing economies (EMDEs) and higher borrowing costs. Amid these challenges, striking a delicate balance between implementing tighter monetary and fiscal policies to safeguard macroeconomic stability and debt sustainability while promoting economic growth has become a complex and pressing task.

Policy challenges have intensified in several economies over the last few years. Notably, many economies in the Middle East and North Africa (MENA) region (excluding Gulf Cooperation Council [GCC] countries) and Pakistan face limited policy space.<sup>2</sup> Meanwhile, several GCC and Caucasus and Central Asia (CCA) economies have seen some recent improvements because of higher oil prices in 2022 and financial flows to the CCA from Russia (Figure 2.1; see Chapter 1 and Online Annex 2.1 for more details).

<sup>1</sup> Prepared by Nadia Ali, Anja Baum, Rodrigo Garcia-Verdu, Troy Matheson (co-lead), Karmen Naidoo, Roy Randen, Sahra Sakha (co-lead), Subi Velkumar, and Weining Xin.

<sup>2</sup> Building on an IMF Staff Discussion Note (Budina and others 2023), this chapter constructs a policy tradeoff index (capturing multiple dimensions of policy constraints) (see Online Annex 2.1 for details).

**Figure 2.1. Policy Space Index in ME&CA Countries, 2005–22**

Source: IMF staff calculations.

Note: The higher the policy space index score, the more policy space is constrained. Lower values indicate more policy space. While the approach is common across countries, some country-specific aspects remain, which cautions comparisons across countries that are structurally very different (for example, oil exporters versus oil importers). CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENA = Middle East and North Africa.

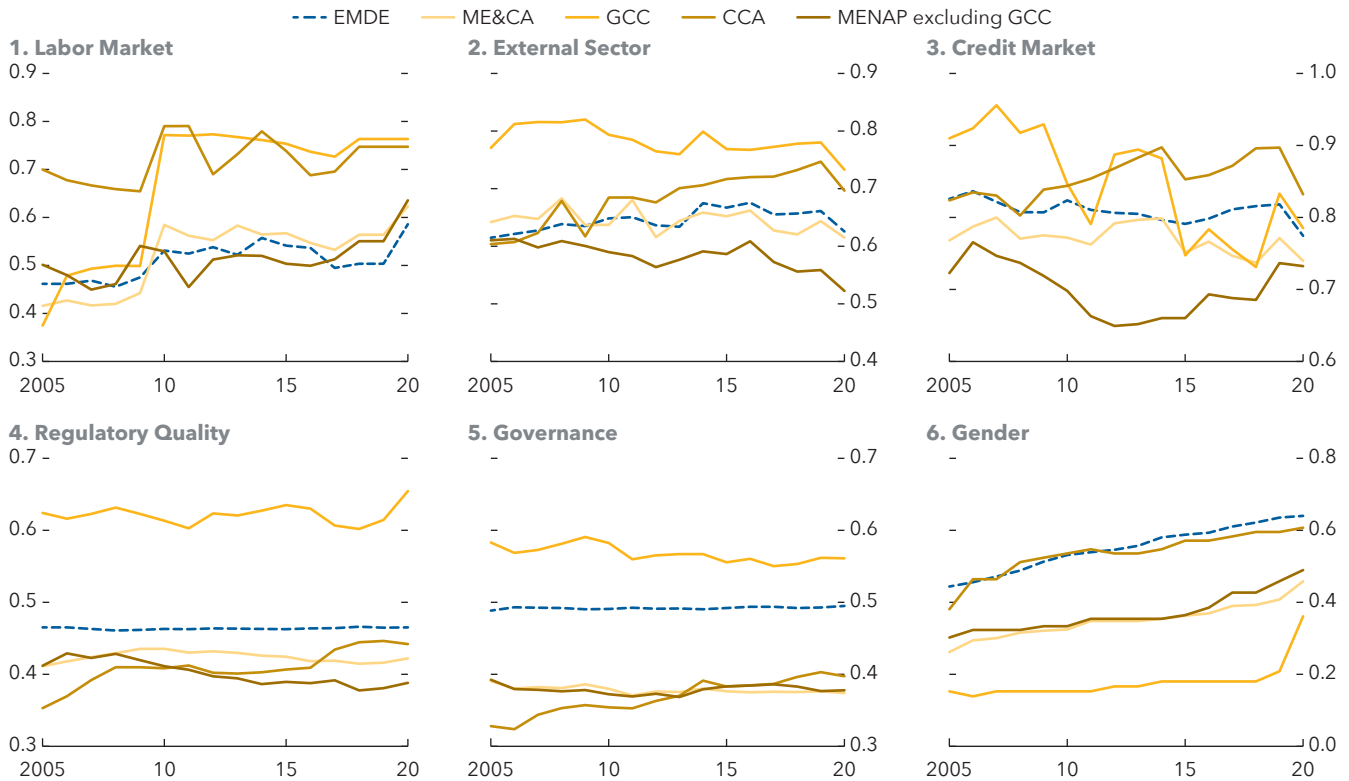
Structural reforms emerge as a promising avenue to help address current macroeconomic challenges. In this respect, the ME&CA region is politically, socially, and economically diverse, and these factors will affect the design and implementation of reforms across countries. For EM&MIs and low-income countries (LICs) in need of fiscal consolidation, structural reforms offer one of the few policy approaches that can be implemented to offset the negative impact of fiscal adjustment by generating an enabling environment for new investments and jobs.

More broadly, reinvigorating structural reforms and supply-side policies can be instrumental in building much-needed, stronger foundations for growth. For oil exporters, reforms can help lift growth in the non-oil sector, thus contributing to economic diversification. In addition, structural reforms can play a crucial role in unlocking and enhancing a country's potential growth and productivity. For example, strong institutions (including secure property rights, the rule of law, and accountable governments) contribute to stability, predictability, and investor confidence, ultimately attracting investments and supporting sustainable development (Budina and others 2023; Gigineishvili and others 2023; Rodrik 2000; October 2019 *World Economic Outlook*). As such, implementing reforms would not only help accelerate income convergence toward advanced economies but also facilitate an improvement in human development, social outcomes, and medium-term growth (Cardarelli, Vera-Martín, and Lall 2022).

### Sizable Reform Gaps Persist in the ME&CA Region

Progress in implementing structural reforms has been limited, and many countries in the ME&CA region fall well behind the frontier (leading emerging market economies) across several indicators. Although GCC countries score relatively well on labor market, external sector, and credit market flexibility indicators compared with other EMDEs, they lag on gender-related regulations (Figure 2.2). Governance reforms are trailing in a number of ME&CA countries, with relatively poor performance across several dimensions (including voice and accountability, political stability, government effectiveness, the rule of law, and control of corruption; see Online Annex 2.2 for details). Weakness is particularly prevalent for indicators on the rule of law, corruption, and political stability in the region's LICs and fragile and conflict-affected states (FCS) such as Afghanistan, Libya, Sudan, and Yemen. Governance shortcomings in voice and accountability are also evident in Algeria, the Islamic Republic of Iran, and Turkmenistan, and in several GCC countries (for example, Qatar and Saudi Arabia).

**Figure 2.2. Evolution of Structural Reforms**  
(Index, 0–1)

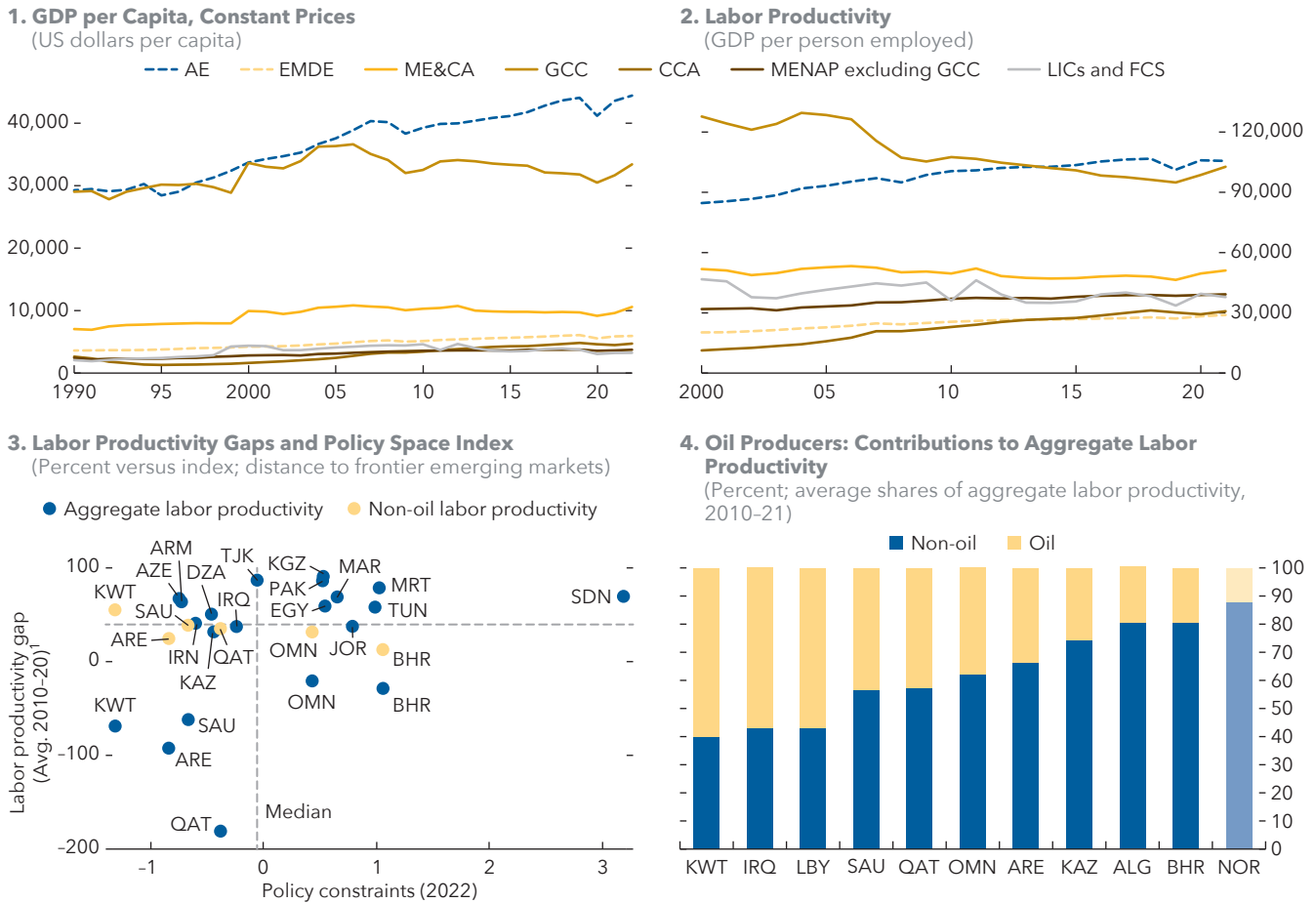


Sources: Cardarelli, Vera-Martín, and Lall (2022); Fraser Institute, Economic Freedom database; UN Educational, Scientific, and Cultural Organization Institute for Statistics; World Bank, Women, Business, and the Law database; World Bank, World Governance Indicators database; and IMF staff calculations.

Note: Each indicator is a simple average of normalized index values of subindicators. The labor market regulations indicator is a simple average of two components: hiring and firing regulations and centralized collective bargaining. The external sector reforms index is computed as the simple average of four subindicators: (1) tariffs, which aim to measure to what extent tariffs can be a barrier to trade freely internationally (tariff revenues, tariff rate, and volatility of tariffs); (2) nontariff trade barriers; (3) black market exchange rate, which aims to capture the disparity between the official and the parallel (black market) exchange rate; and (4) control of the movement of capital and people, which encompasses a country's degree of financial openness, restrictions to visitors, and whether capital controls are in place. The credit market indicator consists of ownership of banks, private sector credit, and interest rate controls. The governance indicator consists of voice and accountability, political stability and absence of violence and terrorism, government effectiveness, the rule of law, and control of corruption. The indicator for regulatory quality from the World Bank Governance Indicators is used as a proxy for business regulations. The gender regulation index covers legislation that restricts women's mobility (including the right to travel outside their home and country, choose where to live, and obtain a passport) and their position within the household (including whether a woman can legally be the head of her household and legislation on domestic violence, divorce, and the right to remarry). CCA = Caucasus and Central Asia; EMDE = emerging market and developing economy; GCC = Gulf Cooperation Council; ME&CA = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, Pakistan.

Slow progress in implementing structural reforms has been accompanied by less-than-favorable outcomes in income convergence and productivity. Convergence toward advanced economy per capita income levels remains stalled overall, particularly in subregions such as the MENA (excluding the GCC) and Pakistan (Figure 2.3, panel 1). Moreover, during the past two decades, labor productivity in ME&CA has stagnated, in contrast to the upward trend observed in advanced economies and other emerging market economies (Figure 2.3, panel 2). Countries in the GCC (and partially LICs and FCS), where non-oil labor productivity has declined, have mainly driven these developments (Figure 2.3, panel 2; Online Annex 2.4), because of the overreliance on the public sector, underdevelopment of the private sector, and lack of economic diversification (Callen and others 2014). Notably, even though GCC countries have substantial policy space, they continue to exhibit labor productivity

**Figure 2.3. Real GDP per Capita and Average Labor Productivity**



Sources: ILOSTAT database; International Labour Organization; IMF, World Economic Outlook database; World Bank, World Development Indicators; and IMF staff calculations.

Note: Country abbreviations are International Organization for Standardization (ISO) country codes. AE = advanced economy; CCA = Caucasus and Central Asia; EMDE = emerging market and developing economy; FCS = fragile and conflict-affected state; GCC = Gulf Cooperation Council; LIC = low-income country; ME&CA = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, Pakistan.

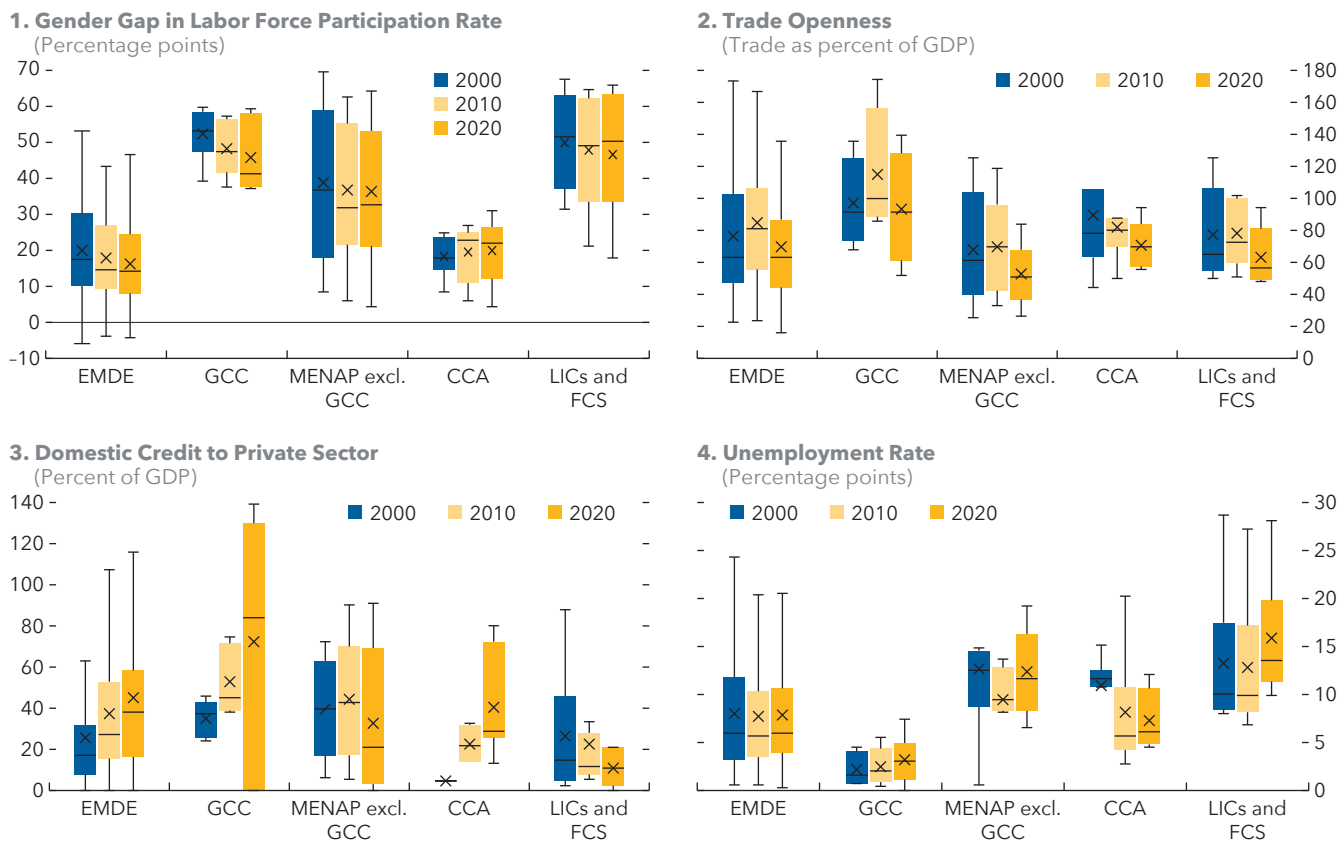
<sup>1</sup>Gap is defined as the distance to the most productive emerging market economies outside the ME&CA regions (top quartile) each year.

gaps in the non-oil sector relative to frontier emerging markets (Figure 2.3, panel 3).<sup>3</sup> Furthermore, the non-oil sector contributes less to aggregate labor productivity than in other oil-exporting countries such as Norway (Figure 2.3, panel 4).

Moreover, the region faces labor market challenges and persistently high unemployment rates, particularly for women and youth (Figure 2.4). Despite improvements in education levels, gender disparities in the labor market are alarming (October 2021 *Regional Economic Outlook: Middle East and Central Asia*; Cardarelli, Vera-Martin, and Lall 2022). Gender gaps in the CCA are on par with those in other EMDEs, supported by relatively low disparities in gender legislation, but female labor force participation rates in the MENA region are among the lowest globally (at 44.5 percent in the GCC and 18.2 percent in the MENA region—excluding the GCC—and Pakistan in 2022). By contrast, the region appears to align with the EMDE average in terms of the size of the financial sector and trade openness.

<sup>3</sup> In Figure 2.3, panel 3, comparing aggregate labor productivity (blue markers) to non-oil labor productivity (yellow markers) for six GCC countries shows that non-oil labor productivity lags frontier emerging markets.



**Figure 2.4. Comparing Outcomes: ME&CA versus Other EMDEs**

Sources: Fraser Institute, Economic Freedom database; International Labour Organization-modeled estimates; World Bank, Gender Statistics; World Bank, World Development Indicators; and IMF staff calculations.

Note: The gender gap is defined as the male labor force participation rate minus the corresponding rate for females. CCA = Caucasus and Central Asia; EMDE = emerging market and developing economy; FCS = fragile and conflict-affected state; GCC = Gulf Cooperation Council; LIC = low-income country; ME&CA = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, Pakistan.

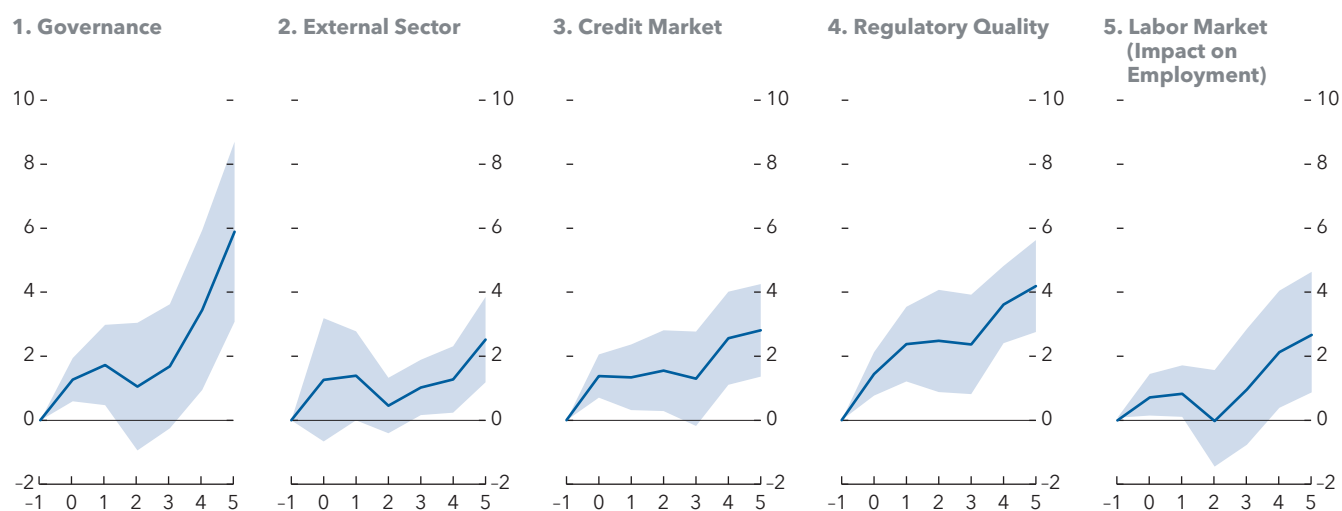
The degree of resistance to structural reforms and prospects for success across countries will vary depending on their nature and scope. In this respect, political economy considerations and ownership among policymakers are often important factors impacting the reform impetus. That said, some countries have showcased the feasibility of successful and comprehensive structural reforms (Box 2.1 and Online Annex 2.5). For example, some CCA economies have shown that rapid improvements in governance—particularly anticorruption efforts—can support economic growth (Armenia, Georgia) and protect against external shocks (Kazakhstan). Additionally, as Jordan has shown, trade liberalization and privatization efforts can effectively spur private sector participation in economic activity.

## 2.2. Implementing Structural Reforms Can Lift Growth Significantly

This section presents the analysis of the output gains from structural reforms, building on previous IMF work (October 2019 *World Economic Outlook*; Budina and others 2023) adapted to the ME&CA region.<sup>4</sup> The impact of major structural reforms on key macroeconomic outcomes—output, investment, employment, and labor

<sup>4</sup> The sample consists of 27 countries in the ME&CA regions and spans the period from 2000 to 2021 at annual frequency. In addition, Budina and others (2023) has been adapted to tailor the analysis to ME&CA. Specifically, oil prices as a regressor (as a percent change) are included and examine the impact on non-oil GDP growth and average labor productivity of the non-oil sector for oil exporters are examined.

**Figure 2.5. Average Effects of Reforms under the Baseline**  
(Percent; effect on output unless otherwise specified)



Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.

Note: The scale of the x-axis is years, where  $t = 0$  is the first year of the reform is implemented. The lines denote the response to a major historical reform—defined as two standard deviations of the annual change in the structural index—and the shaded areas denote 90 percent confidence bands.

productivity—was estimated using the local projection method developed by Jordà (2005).<sup>5</sup> Reform areas in the analysis include governance, external sector reforms, credit market, labor market, and regulatory quality reforms (see Online Annex 2.6). The precise impact of reforms is difficult to estimate (especially amid the broad impact across different sectors) and thus results are inevitably subject to uncertainty, but the analysis provides a meaningful assessment of the direction, relative size, and importance of reforms.<sup>6</sup> Moreover, although the analysis does not cover structural reforms related to gender due to a lack of variation in the reform series,<sup>7</sup> Budina and others (2023) suggest that adopting strategies to reduce gender disparities in other EMDEs could provide a substantial boost to GDP. Generally, structural reforms can provide a boost to output over time, but their design and implementation is complex and will require policies that are tailored carefully to country circumstances (political, social, and economic) to maximize their prospects for success.

### Governance Reforms Can Yield Significant Output Gains

The empirical evidence shows that major reforms can have sizable output effects. Consistent with estimates from the literature (October 2019 *World Economic Outlook*; Budina and others 2023; Gigineishvili and others 2023), major reforms are associated with higher economic output, with magnitudes that increase over time (Figure 2.5). Five years after implementation, governance reforms reap the largest output gains (about 6 percent), followed by regulatory quality reforms. This result is consistent with reform gaps in both areas being relatively large in the ME&CA region, rendering the marginal return from reform relatively high compared with countries with smaller gaps (such as the global EMDEs sample in Budina and others 2023; for more detailed results, see Online Annex 2.6). This estimate implies that closing the governance gap with EMDEs could lead to an average

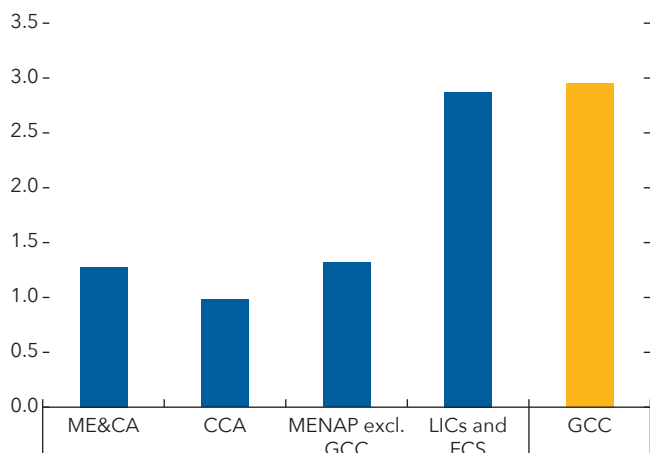
<sup>5</sup> Following the October 2019 *World Economic Outlook* and Budina and others (2023), major reforms are defined as episodes for which an annual change in the relevant indicator is at least two standard deviations of the distribution (of annual changes in the relevant indicator across the whole sample). Such major reforms would improve a country's structural quality from the median to the top 5 percent in the sample. Countries that have experienced at least two standard deviation improvements in the aggregate governance indicator include Georgia (2003), Jordan (2003), Kazakhstan (2014), and Armenia (2018). Box 2.1 and Online Annex 2.5 provide case studies of these episodes.

<sup>6</sup> In addition to uncertainty, the literature also finds that the local projection method may yield biased estimates with small sample sizes on the time dimension (Herbst and Johansen 2020).

<sup>7</sup> Ninety percent of observations are unchanged over time.

### Figure 2.6. Output Gains from Closing the Governance Gap

(Percent; benchmark is EMDEs except GCC for which it is advanced economies)



Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.

Note: The bars show the output effects after five years from closing the governance gaps in relation to EMDEs (as of 2020) and advanced economies in the case of GCC. The estimates assume linear average effects, calculated by multiplying the reform gaps by the point estimates of the output effects after five years. CCA = Caucasus and Central Asia; EMDEs = emerging market and developing economies; FCS = fragile and conflict-affected state; GCC = Gulf Cooperation Council; LIC = low-income country; ME&CA = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

regional output gain of about 1.3 percent in the medium term, ranging from 1 percent in the CCA to almost 3 percent for LICs and FCS (Figure 2.6).<sup>8</sup> Similarly, output gains in the GCC could be about 3 percent when closing governance gaps relative to advanced economies.<sup>9</sup> Moreover, positive effects on employment and labor productivity in the medium term suggest that governance reforms have a widespread enabling impact to strengthen potential growth.

The findings also underscore the importance of individual governance-related indicators in shaping long-term output (Figure 2.7). For example, enhancing government effectiveness has a strong positive effect in the short and medium terms. Similarly, strengthening the rule of law has the potential to increase output by about 6 percent after five years.<sup>10</sup> Moreover, the effects of comprehensive governance reforms are larger than those from narrower governance reforms, highlighting the enhanced effects of implementing governance reforms as a package and improving overall governance. Examples of such governance reforms include the implementation of online procurement in Georgia and Saudi Arabia (see Box 2.1) and Uzbekistan (Online Annex 2.5).

The benefits of reforms are evident beyond governance. Notably, regulatory quality reforms have a positive impact on output, contributing to a 4 percent increase after five years. This boost to activity is driven by the enabling impact on investment, as regulatory quality reforms are associated with a positive impact on investment in the same year as the reform implementation and they yield increasing returns in the subsequent year. Significant labor productivity improvements (by about 5.5 percent) are observed five years after regulatory quality reforms (for more details, see Annex Figure 2.6.1 in Online Annex 2.6). Like governance reforms, the impact of credit market and labor market reforms are larger than those estimated from the global EMDEs sample in Budina and others (2023), mainly because of the structural gaps of the ME&CA region relative to EMDEs.

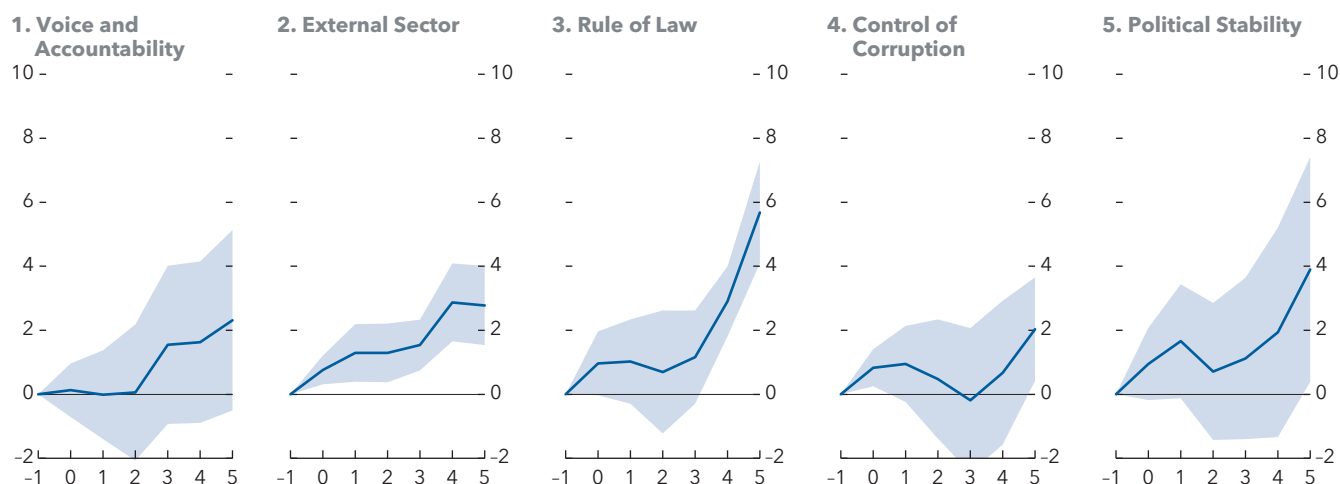
More broadly, as reforms tend to spur investment, reforms in areas where the region performs relatively well can also help boost growth. For example, external sector and credit market reforms gradually lift investment and output, contributing to about 2.5 percent output gains after five years and significant improvements in labor productivity over the medium term. Even though the short-term impact of labor market reforms may be limited, their positive effects on employment and output materialize over time.

<sup>8</sup> In a similar vein, lower initial governance levels amplify positive output gains more than the baseline (Annex Figure 2.6.2, Online Annex 2.6).

<sup>9</sup> The benchmark for the GCC are advanced economies because the GCC does well relative to the rest of the world in all governance indicators except “voice and accountability” (Online Annex 2.2).

<sup>10</sup> Other governance indicators are not statistically significant using a 90 percent confidence interval.

**Figure 2.7. Average Effects of Individual Governance Reforms under the Baseline**  
(Percent; effect on output unless specified)



Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.

Note: The scale of the x-axis is years, where  $t = 0$  is the first year of the reform is implemented. The lines denote the response to a major historical reform—defined as two standard deviations of the annual change in the structural index—and the shaded areas denote 90 percent confidence bands.

### Some Reforms Can Have a Strong Impact during Periods of Weak Growth

Reforms can be politically costly when enacted in periods of weak economic activity. However, certain reforms can be beneficial for economic activity also during downturns, which is especially relevant during the current period of tight policies that will inevitably weigh on growth. This analysis explored this issue by considering how the baseline results differ during periods of weak economic activity.<sup>11</sup> As such, the findings indicate that increasing the flexibility of the domestic credit market and improving regulatory quality during weak growth can lead to significantly higher medium-term growth (1.7 percent and 1.2 percent higher, respectively, than the baseline after five years) (Figure 2.8).<sup>12</sup> Output effects occur as increasing credit market flexibility leads to more significant gains in investment and labor productivity (11 and 4 percentage points, respectively, in addition to the baseline effects after five years) (Annex Figure 2.6.3 in Online Annex 2.6). Kuwait and the Islamic Republic of Iran highlight the potentially significant effects of credit market reforms during periods of weak growth. In the early 2000s, both countries improved credit market flexibility.

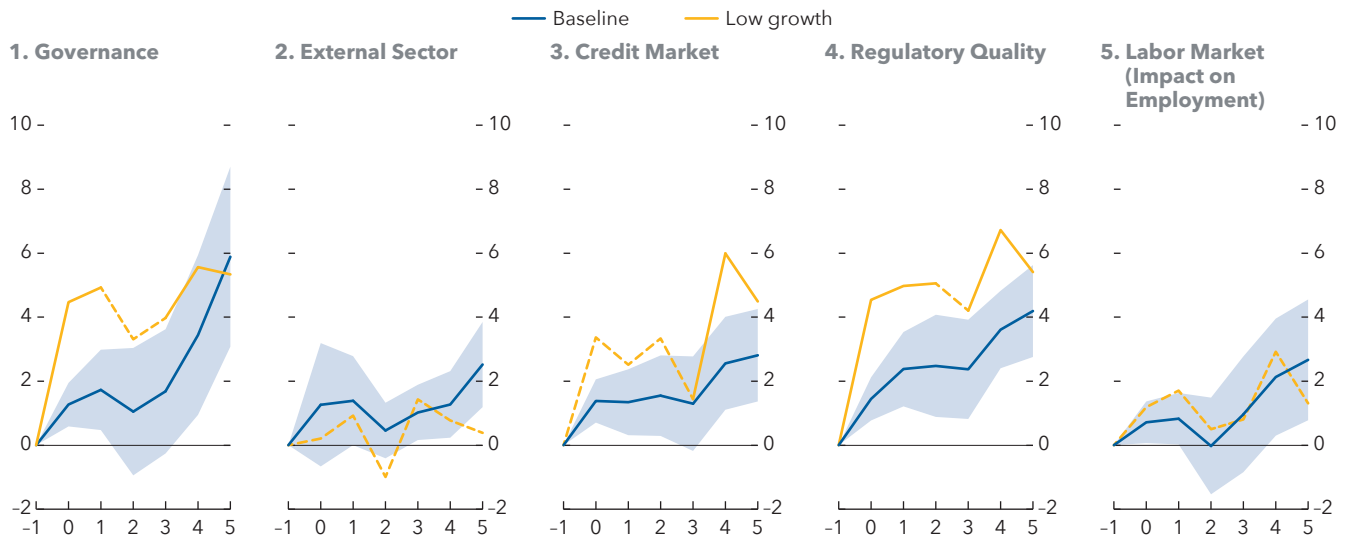
Kuwait, for example, enhanced the capital market by expanding cross-listing agreements and operationalized a credit bureau. The Islamic Republic of Iran allowed more flexibility in setting interest rates, licensing of private banks, and authorizing private insurance companies. These reforms added to strong economic growth in subsequent years (during 2004–07, Kuwait and the Islamic Republic of Iran’s non-oil growth averaged above 10 and 6 percent, respectively).<sup>13</sup> Yet it appears that external sector reforms have a more pronounced effect on output (Figure 2.8) and investment (see Online Annex 2.6) when implemented during expansionary cycles. Though positive, the baseline effect of labor market reforms (on employment) appears to be statistically insignificant, possibly muted by the high level of informality across EMDEs (October 2021 *Regional Economic Outlook: Middle East and Central Asia*).

<sup>11</sup> For the empirical analysis, a country is considered to have weak economic activity or low growth for a specific year when it experiences below-median growth during that period.

<sup>12</sup> Although the point estimates of the output effects of credit market reform under low growth are larger than those under the baseline in the near term, they are not statistically significant.

<sup>13</sup> The sample includes 12 country examples with major credit market reforms, of which five countries under weak growth.

**Figure 2.8. Average Effects of Reforms: Low Growth Scenario versus the Baseline**  
(Percent; effect on output unless otherwise specified)



Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.

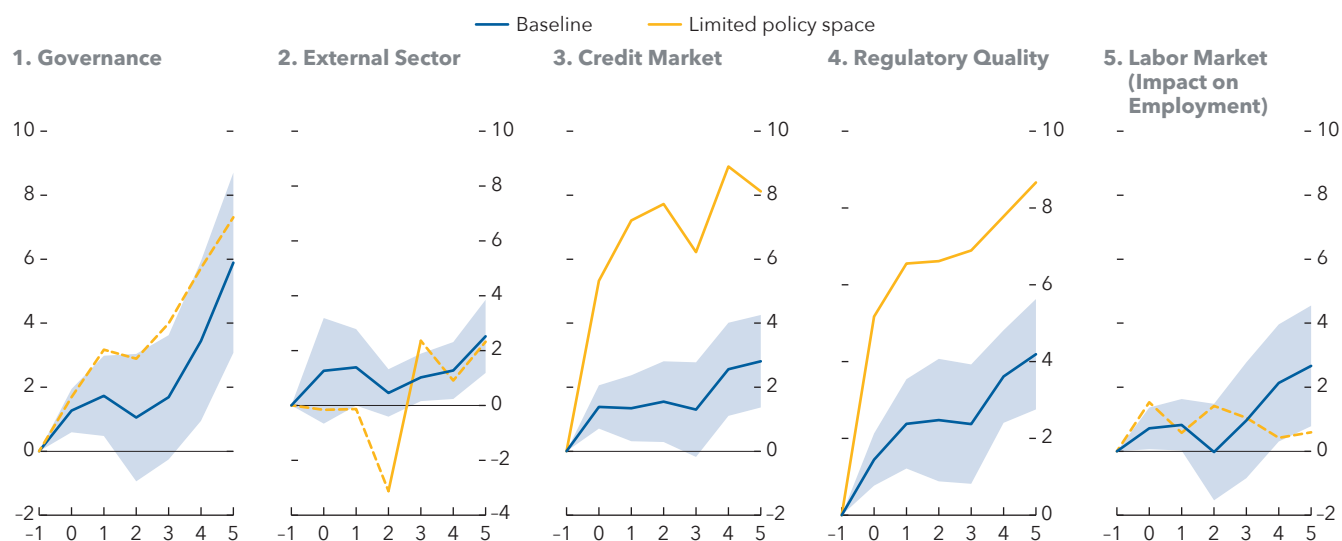
Note: The scale of the x-axis is years, where  $t = 0$  is the first year of the reform is implemented. The blue lines denote the baseline (that is, sample average) responses to a major historical reform—defined as two standard deviations of the annual change in the structural index—with the shaded areas denoting 90 percent confidence bands for the responses. The yellow lines denote the responses when growth is low where the solid (dashed) segments denote statistically significant (insignificant) responses at the 90 percent level.

## Sizable Reform Impact May Also Occur during Periods of More Limited Policy Space

Point estimates suggest that some reforms may have larger positive effects on economic activity when the policy space is relatively tighter.<sup>14</sup> Credit market and regulatory quality reforms have a significantly higher positive impact on output when policy space is relatively lower than in the baseline. For instance, increasing flexibility of credit markets when policy space is more limited is expected to raise output by 8 percent after five years, compared with just below 3 percent in the baseline (Figure 2.9). Under limited policy space, the larger positive output effects of credit market reforms are achieved primarily through significant increases in investment and substantial boosts in labor productivity (Annex Figure 2.6.4, Online Annex 2.6). These results may stem from the fact that credit market reforms enhance the private sector's access to credit, which could support private sector adjustment. Simultaneously, improving regulatory quality could lead to increased confidence and investment when growth is sluggish, or policy space is limited.

<sup>14</sup> Countries have limited policy space in a specific year if their policy space score is below the median across all countries in that year. More results on policy space can be found in Online Annex 2.6.

**Figure 2.9. Average Effects of Reforms under a Limited Policy Space Scenario versus under the Baseline**  
(Percent; effect on output unless otherwise specified)



Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.

Note: The scale of the x-axis is years, where  $t = 0$  is the first year of the reform is implemented. The blue lines denote the baseline (that is, sample average) responses to a major historical reform—defined as two standard deviations of the annual change in the structural index—with the shaded areas denoting 90 percent confidence bands for the responses. The yellow lines denote the responses when growth is low where the solid (dashed) segments denote statistically significant (insignificant) responses at the 90 percent level.

## 2.3 Attention to Sequencing and Packaging Reforms Is Valuable

### Strategically Sequencing and Packaging Reforms Can Amplify Their Impact

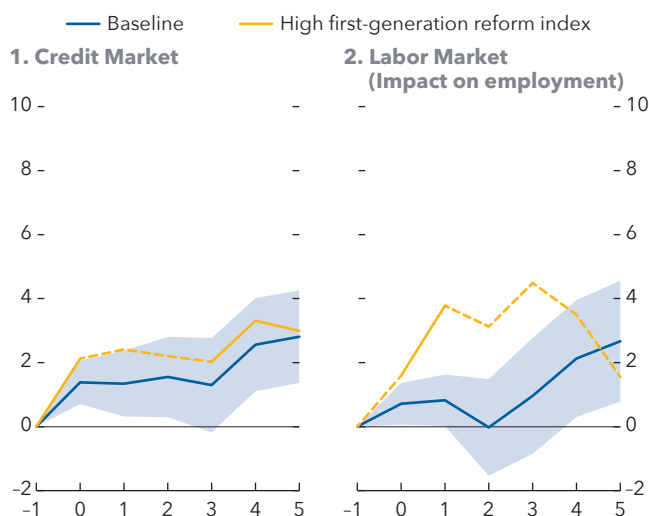
The specific sequence in which reforms are implemented can play a crucial role in affecting macroeconomic outcomes.

- First, reforms in areas of relative weakness, such as governance, would yield the largest gains. Reform efforts in Georgia and Kazakhstan demonstrate how prioritizing governance reforms and bolstering the rule of law can be pivotal for implementing other reforms (Box 2.1; see also Online Annex 2.5). Improved governance generally plays a crucial role in driving other reforms by fostering trust and confidence in public institutions and creating a favorable business climate.
- Second, a “first-generation” reform package—governance, regulatory quality, and external sector reforms—has a positive impact on the returns from subsequent reforms. For example, Jordan’s large-scale trade liberalization and privatization in the early 2000s led to a jump in private sector participation. The share of credit to the private sector increased from 72 percent in 2000 to 88 percent in 2005 (Online Annex 2.6). Moreover, the results indicate that credit market reforms would have a substantial effect on output once countries implement first-generation reforms. The estimated increase in output is about 2 percent when credit market reform is implemented after first-generation reforms, surpassing the baseline of 1.4 percent, and the gains persist for several years after the reform (Figure 2.10). These results are consistent with earlier findings drawn from a global sample of emerging market economies and low-income countries (October 2019 *World Economic Outlook*; Budina and others 2023). Similarly, labor market reforms after first-generation reforms also produce positive outcomes, though with a more pronounced impact in the near term.

In addition, when certain reforms are implemented together, they can amplify each other’s positive effects, resulting in more substantial gains than when the reforms are implemented separately. The empirical evidence shows that the gross effect of the first-generation reform package is larger than the sum of the effects of its

**Figure 2.10. Average Effects of Reforms under High First-Generation Reform Index versus the Baseline**

(Percent; effect on output unless otherwise specified)



Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.

Note: The blue lines denote the baseline (that is, sample average) responses to a major historical reform, defined as two standard deviations of the annual change in the structural index, and the shaded areas denote 90 percent confidence bands for the responses. The yellow lines denote the responses when first-generation reform index is high, that is, above the sample median, where the solid (dashed) segments denote statistically significant (insignificant) responses at the 90 percent level.

components when they are implemented individually (Figure 2.11). The first-generation reform package could raise output by about 3 percent in the year of its implementation, accumulating to more than 9 percent after five years, more than doubling the total output gains compared with implementing its components individually.

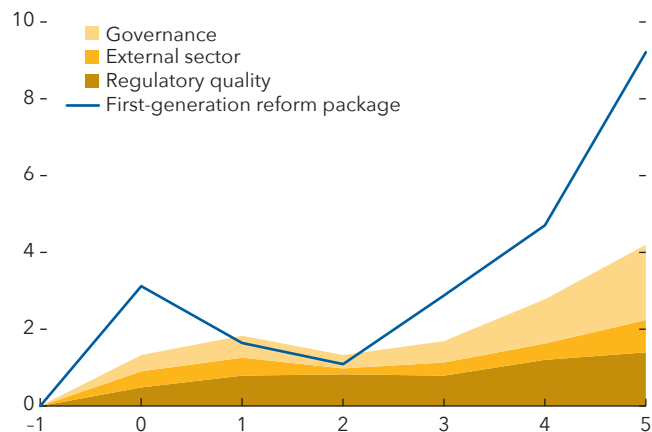
Several country examples highlight the benefits of comprehensive reforms. For example, Morocco implemented a package of multiple reforms—including trade liberalization and the monetary policy framework—to improve social and economic outcomes. Saudi Arabia also stands out as an example of a successful bundled reform approach. Through its ambitious Vision 2030 plan launched in 2016, the country achieved greater government efficiency, upgraded trade infrastructure, and better labor market outcomes (including raising the female labor force participation rate from 23 percent in 2016 to 28 percent in 2022, nearing the 2025 target of 30 percent). Moreover, access to credit improved for small and medium enterprises, with bank loans increasing almost fourfold, from 2 percent to 7.7 percent (see Box 2.1).

## 2.4. Where Macro Policies Need to Tighten, Reforms Provide Growth-Enhancing Options

Overcoming the political economy challenges of implementing reforms can be a complex and delicate task because reforms often face resistance from stakeholders with vested interests. The extent of resistance can also vary depending on the nature and scope of the reforms. A multifaceted approach is therefore required (see Box 2.1 for insights on Georgia, Morocco, and Saudi Arabia). Strong leadership and effective communication

**Figure 2.11. Output Effects of First-Generation Reform Package**

(Percent)



Sources: Fraser Institute, Economic Freedom database; IMF, World Economic Outlook database; World Bank, World Governance Indicators database; and IMF staff calculations.

Note: The scale of the x-axis is years, where  $t = 0$  is the first year of the reforms are implemented. The blue line denotes the response to a major historical first-generation reform package—defined as the sum of one-third of a major historical reform (two standard deviations) on its three components. The stacked areas denote the responses to one-third of a major historical reform (two standard deviations) on the three components of the first-generation reform package, namely governance, external sector, and regulatory quality, when implemented individually.

are essential to build support and trust in the reform agenda. Building coalitions and seeking consensus among diverse stakeholders can help navigate political resistance, and transparency in the reform process helps build trust and attract support. Involving the public in the reform process through consultations and participatory mechanisms can help legitimize the reforms and ensure that they align with the population's needs and aspirations. Studying successful reform experiences in other countries and benchmarking against best practices can provide valuable insights and improve the design and implementation of reforms. For countries with capacity constraints to implementing reforms and limited fiscal space, external actors (international organizations and donor countries) can provide technical assistance and financial support. Overall, persistence in the face of obstacles and a commitment to the reform agenda are essential.

The sizable macroeconomic impact of structural reforms calls for increased attention to their swift implementation, especially where fiscal and monetary policies need to remain tight:

- Governance reforms (among all the outcomes) demonstrate a robust and substantial positive effect on economic growth and other macroeconomic indicators and should be prioritized. Government effectiveness and the rule of law are shown to be particularly influential. By reducing both political and economic uncertainty, governance reforms can create an environment that fosters increased investment, leading to higher economic growth (Acemoglu and others 2019; Afzali, Çolak, and Fu 2021). Moreover, these reforms can play a pivotal role during downturns or periods with limited monetary or fiscal policy options.
- Targeting regulatory quality and credit market reforms also affect output positively by stimulating investment. This underscores the significance of reducing the state's intervention in nonessential sectors, streamlining bureaucratic processes, and fostering an environment where younger and more innovative firms can thrive (Rigo and others 2021). This principle applies equally to oil-exporting countries, where non-oil productivity growth has been declining in recent years, and economic diversification away from overreliance on oil and gas exports is essential.
- Policymakers can amplify the impact on output by strategically sequencing and packaging reforms. First-generation reforms such as governance, external sector liberalization, and regulatory quality reforms can yield significant upfront gains. When these first-generation reforms are implemented together, their combined gross effect tends to be larger than when they are implemented individually. Therefore, policymakers should concurrently focus on improving governance, enhancing regulatory quality, and reducing external sector barriers.

Addressing the distributional effects of reforms and ensuring the protection of vulnerable groups is crucial and especially pertinent in the context of external sector liberalization as empirical evidence has demonstrated its negative effect on employment (Autor, Dorn, and Hanson 2013; Engel and others 2021). In this respect, some reforms, undertaken simultaneously, could have an offsetting distributional effect. For example, implementing active labor market policies (such as training and reskilling possibilities) along with external sector liberalization can help address potential distributional consequences and facilitate the smooth reallocation of labor (Engel and others 2021). Enhancing social safety nets for the vulnerable will also be important. By balancing these aspects carefully, policymakers can create a more inclusive and effective reform strategy that leads to sustainable economic growth and development.

A number of other actions can help support growth and render it more resilient. Enhancing labor market flexibility in good times can elevate workforce productivity and open more employment opportunities, but efficiency considerations need to be balanced against the need to protect workers and their income (October 2019 *World Economic Outlook*). Engaging in regional and international trade allows countries to access larger markets, tap into new technologies and knowledge, and benefit from economies of scale. Ensuring access to finance for all segments of society is crucial for stimulating investment and driving economic growth. Finally, investing in gender-specific reforms (such as promoting equal access to education and vocational training for women, implementing policies that support work-life balance and parental leave, and encouraging women's participation in entrepreneurship and leadership roles) can significantly contribute to economic progress and better social outcomes.



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## Box 2.1. Transformative Tales: Structural Reforms in Georgia, Morocco, and Saudi Arabia

**Georgia: Anticorruption efforts as a gateway for structural transformation.**<sup>1</sup> Following the Rose Revolution of 2003, the Georgian government enacted a zero-tolerance policy toward corruption. Political commitment at the highest level, coupled with strict compliance, was crucial. In this respect, increased credibility following high-profile corruption cases and arrests aided the shift in attitude about corruption. Institutional reforms ensued in key public institutions: judiciary, tax, customs, electricity distribution, land and property rights registration, and higher education. Public sector salaries increased in the reformed institutions, and graduates who succeeded in those institutions' qualification exams filled new vacancies. Standardized university tests were administered in a unified manner that addressed widespread problems in the university entrance process. The strategy also prompted a reduction in red tape that helped improve the business environment. In 2005, Georgia enacted a new tax code that streamlined the system, lowered tax rates, and significantly broadened the tax base by rescinding most tax benefits. In addition, a comprehensive customs reform in 2006 eliminated the 16 customs bands, replacing them with a zero rate for 86 percent of imports. The expanded tax base, enhanced compliance, and rigorous enforcement offset the revenue loss caused by lowered tax rates. The result was meaningful: indicators on corruption, government effectiveness, and regulatory quality jumped from lower worldwide ranks to the top 30th percentiles over five years. Moreover, early successes fostered the population's buy-in and increased trust in public institutions, and structural reform efforts continued unabated for several years. That said, governance reforms have been partially reversed in more recent years, demonstrating the importance of sustained, strong political will.

**Morocco: Multiple reform packages and the New Model of Development.**<sup>2</sup> Morocco launched a new wave of structural reforms in the wake of the pandemic to address lower growth since the mid-2000s, still-high informality, elevated youth unemployment, and low female labor market participation. The country's New Model of Development aims to boost private sector investment, strengthen human capital accumulation, enhance women's participation in economic life, improve the social protection system, and reinforce the governance of public institutions (Cardarelli, Koranchelian, and Queyranne 2023). Reforms are being made to the health care system by expanding health insurance to all Moroccans and conducting a comprehensive overhaul. Social protection system reform targets support better by gradually reducing existing subsidies and extending conditional cash transfers based on the new Unified Social Registry. Education system reform aims to reduce the primary school dropout rate, increase primary school students' skills acquisition, and expand access to extracurricular activities. Morocco is also implementing a series of reforms to support private sector development by reforming state-owned enterprises, introducing a new charter of investment, establishing the new Mohammed VI Fund to finance large infrastructure projects and provide firms with equity or quasi-equity, and strengthening competition.

**Saudi Arabia: Vision 2030 is underway.**<sup>3</sup> Saudi Arabia's economic transformation is progressing swiftly. Even with the slowdown caused by the COVID-19 pandemic, Saudi Arabia has made strides on several fronts since the 2016 launch of Vision 2030, notably by diversifying across the external and real sectors, boosting female workforce participation, and enhancing digitalization. Improvements to the regulatory and business environment (along with a new set of laws to promote entrepreneurship, reduce the cost of

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Prepared by Anja Baum, Rodrigo Garcia-Verdu, and Karmen Naidoo, with inputs from country teams.

<sup>1</sup> IMF (2003, 2004, 2006, 2007, 2008); Torosyan and Filer (2012); World Bank (2012).

<sup>2</sup> Cardarelli, Koranchelian, and Queyranne (2023).

<sup>3</sup> World Bank, World Development Indicators; IMF (2023).

**Box 2.1. (continued)**

doing business, and streamline numerous fees for small and medium enterprises) have contributed to higher private sector investment and boosted the non-oil sector's economic contribution. The authorities are also enhancing the non-oil industrial base by attracting investment, boosting competitiveness, facilitating trade, and supporting climate policies under the Saudi Green Initiative. Efforts to enhance competitiveness and develop a robust logistics infrastructure to support trade have resulted in a substantial increase in the number of licenses issued in strategic industries and improved Saudi Arabia's score on the World Bank Logistics Performance Index. Labor market and human capital reforms have yielded positive outcomes, including an improved World Bank Human Capital Index rank since 2016. In 2022, female workforce participation was already close to meeting the Vision 2030 target of 30 percent because of transformative legal and labor market reforms, which gender budgeting will support further. Additionally, the share of Saudis in high-skilled jobs increased markedly (from 32 percent in 2016 to 42 percent in 2022, surpassing the 40 percent midterm target for 2025). Since the launch of the information and communication technology sector strategy in 2019, Saudi Arabia's digital economy has outperformed the primary targets set for 2023. Saudi Arabia's improvement in the World Bank's government effectiveness rankings and the United Nations E-Government Development Index since 2016, along with the expansion of cashless operations from 18 percent in 2016 to 62 percent in 2022, underscore the country's high global ranking for digital infrastructure and the maturity of digital government transformation. Robust digital development in Saudi Arabia has bolstered financial inclusion, strengthened the financial sector's resilience, and enhanced government efficacy. Overall, Saudi Arabia's non-oil growth has accelerated since 2021, averaging 5.3 percent in 2022 spurred by strong domestic demand. Non-oil growth is expected to remain robust and above 4 percent in the medium term, supported by Saudi Arabia's sound macroeconomics policies and strong reform momentum.

### 3. Higher for Longer: What Are the Macrofinancial Risks?<sup>1</sup>

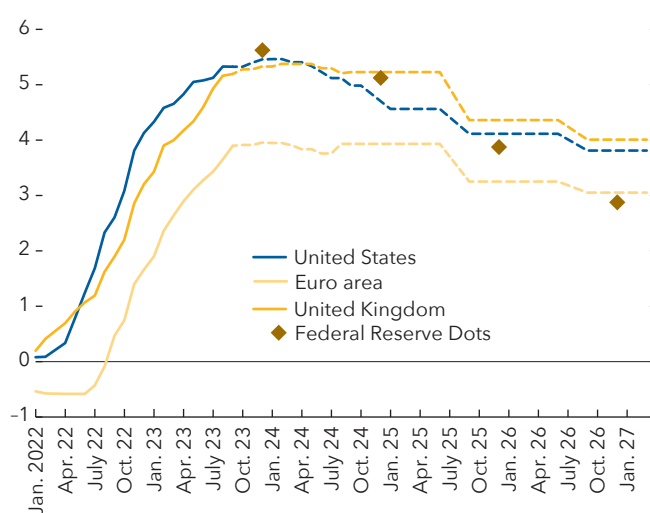
Central banks in the Middle East and Central Asia (ME&CA) face difficult trade-offs and policy challenges at a time when core inflation, though gradually declining, remains above central bank targets in many countries. In this context, a prolonged period of tighter monetary policy to reduce inflation could have unintended consequences for financial systems in the region. This chapter assesses the state and resilience of banking sectors in ME&CA to credit and liquidity risks that could emerge in a “higher-for-longer” interest rate environment. The results suggest that banking systems would be resilient in an adverse scenario of higher interest rates, corporate sector stress, and rising liquidity pressures. However, pockets of vulnerability exist in some countries, particularly among state-owned banks, and capital losses could emerge that, while manageable, could limit lending and add to downside risks to output. Policies to mitigate downside risks center on strengthening macroprudential frameworks, containing the vulnerabilities stemming from the sovereign-bank nexus, enhancing clear and timely communication, establishing emergency liquidity tools to stem systemic financial stress, and developing resolution regimes to reduce the buildup of zombie firms.

#### 3.1. Higher Global Interest Rates Could Expose Fault Lines among Banks

A fundamental question is confronting market participants and policymakers: Is the higher interest rate environment, which recently triggered banking sector stress in some advanced economies, a harbinger of more systemic risks that could test the resilience of ME&CA banking systems and the global financial system more broadly?

Despite some prospects for a moderation in monetary policy tightening ahead, financial market participants expect policy rates to remain elevated for a prolonged period (Figure 3.1). Subsequently, a higher-for-longer interest rate environment could affect financial conditions and trigger strains across financial institutions. This is particularly relevant as vulnerabilities may be hidden (accounting rules or regulatory treatments can temporarily mask exposures and losses) and some holdings are concentrated in certain asset classes, such as government bonds. Recent banking sector stress in some advanced economies provided a stark reminder that funding can evaporate rapidly, and a reliance on foreign funding sources is a key financial vulnerability. Banks could also face a deterioration in asset quality from interest-rate-sensitive

**Figure 3.1. Major Advanced Economies Central Bank Rates Expectations**  
(Percent)



Source: Bloomberg Finance L.P.

Note: Data as of September 21, 2023. Federal Reserve Dots represent the median for Federal Reserve Board members projection for the short term policy rate at selected periods.

<sup>1</sup> Prepared by Adrian Alter, Bashar Hlayhel, Thomas Kroen, Troy Matheson (co-lead), and Thomas Piontek (co-lead).

borrowers that suddenly face challenges in servicing their debt. An escalation in such stress could have significant repercussions for banking sector profitability and credit provision and materially affect economic growth and financial stability.

## 3.2. Certain Factors Could Exacerbate Financial Stability Risks

### Reliance on Foreign Funding Increases Vulnerabilities

A high reliance on external funding, such as nonresident deposits and other foreign liabilities, increases banking sector vulnerability to sudden shifts in investor sentiment. For example, nonresident deposits could suddenly reverse during periods of stress or broader global financial turbulence, making outflows of such funding a source of volatility for banks in ME&CA. This is particularly relevant in countries with a greater dependence on external funding sources, such as in the Gulf Cooperation Council (GCC; Bahrain, Qatar) and the Caucasus and Central Asia (CCA; Georgia) region (Figure 3.2, panel 1). Formal deposit insurance varies across the region and is lacking in some countries, leaving some banks vulnerable to large deposit withdrawals. However, the large share of government deposits in the total deposit base (a prevalent feature of bank funding profiles in some countries, such as Qatar and the United Arab Emirates) and government ownership of some major banks (Azerbaijan, Egypt, Saudi Arabia) could mitigate the risk of large deposit withdrawals, given their generally more stable trends.

### The Sovereign-Bank Nexus Can Trigger Adverse Feedback Loops

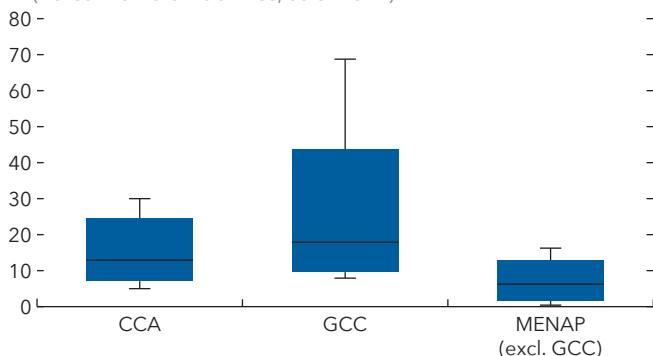
A prolonged period of higher interest rates could trigger adverse feedback loops between the sovereign and the banking sector. In banking systems with elevated bank holdings of domestic sovereign debt (Algeria, Egypt, Pakistan), high government exposure to interest rate risk and worsening sovereign credit conditions could spill over to banks. Subsequently, this would leave banks vulnerable to a further tightening in financial conditions that may erode capital and liquidity positions, particularly if marking-to-market and the sale of government debt is needed to combat funding stress. Moreover, the sovereign-bank nexus could also trigger negative spillovers through other channels. For example, with the Middle East and North Africa (MENA) region emerging market and middle-income countries (EM&MIs) and Pakistan already facing elevated gross financing needs, higher sovereign borrowing costs could fuel debt sustainability concerns and limit access to international financing sources. This may lead to domestic banks increasing their holdings of government debt, affecting bank balance sheets and funding conditions adversely. Ultimately, this would also affect the real economy by crowding out lending to firms and households. Credit to the private sector is often lower in countries where banks are more exposed to sovereign debt (Figure 3.2, panel 2).

### Weaker Corporate Credit Quality Could Test Ample Bank Buffers

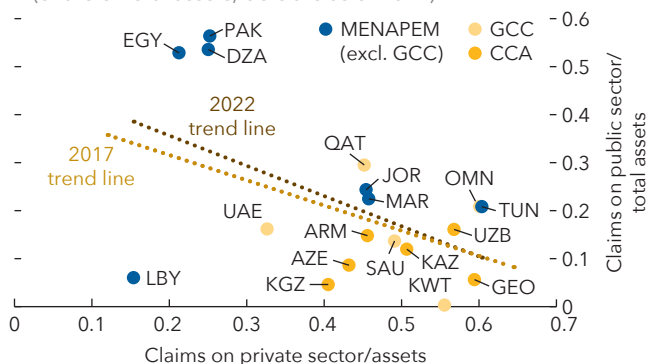
Bank profitability has generally recovered from pandemic lows. State-owned bank performance, however, remains well below prepandemic levels in MENA EM&MIs and Pakistan and, to a lesser extent, in the GCC (Figure 3.2, panel 3), reflecting subsidized loan programs that lend to state-owned enterprises or otherwise lend at preferential rates. By contrast, bank profitability in CCA countries has surged above prepandemic trends, partly because of sizable inflows from Russia amid Russia's war in Ukraine. Even as most pandemic-related forbearance measures have been removed, capital ratios across ME&CA remain well above regulatory minimums. Additionally, nonperforming loan ratios are mostly contained but are elevated for state-owned banks in MENA EM&MIs and Pakistan because of a higher concentration of loans to less profitable state-owned enterprises (Figure 3.2, panel 4). Banks in the region also have ample liquidity buffers, which have been bolstered by higher oil prices in oil-exporting countries.

**Figure 3.2. Banking Sector Funding, Sovereign Nexus, and Buffers****1. Banking Sector Foreign Liabilities**

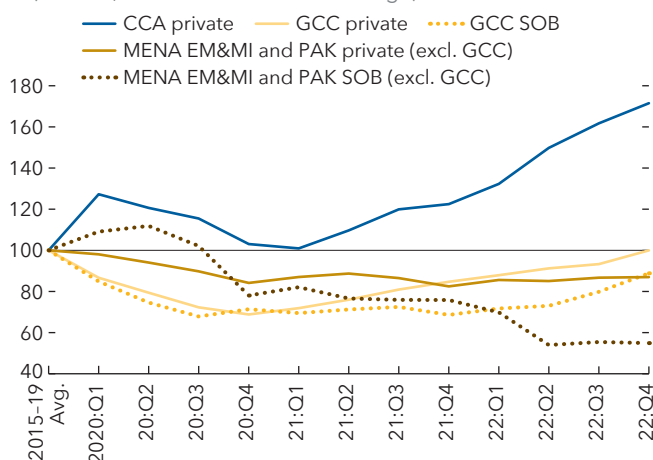
(Percent of total liabilities, as of 2022)

**2. Bank Exposure to Sovereign Debt and Private Sector Credit**

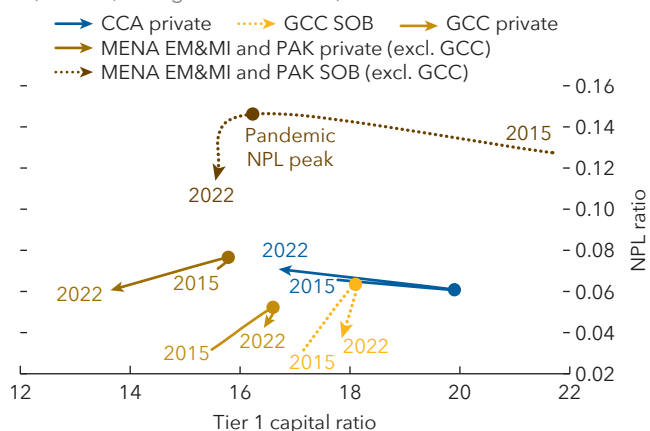
(Share of total assets; dots are as of 2022)

**3. Banking Sector Return on Assets**

(Median, index 100 = 2015–19 average)

**4. Banking Sector Tier 1 Capital and NPL Ratios**

(Median, change from 2015–22)



Sources: Fitch Connect; Haver Analytics; and IMF staff calculations.

Note: Panel 1 shows country-level data for the banking sectors' nonresident liabilities as a percent of total liabilities, with countries grouped by subregion. The line in the middle of the box is the median, the outer edges of the boxes are the 25th and 75th percentiles, and the ends of the lines are the maximum and minimums. In panel 2, some countries are excluded because of missing bank-level data; dots for 2017 are not shown (only the accompanying trend line). A steepening of the trend line over time indicates a strengthening of the sovereign-bank nexus. For panels 3 and 4, state-owned banks are defined as banks with government ownership greater than 50 percent. Data labels in the figure use International Organization for Standardization (ISO) country codes. CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENA EM&MI and PAK = Middle East and North Africa emerging market and middle-income countries and Pakistan; MENAPEM = Middle East and North Africa emerging markets and Pakistan; NPL = nonperforming loan; SOB = state-owned bank.

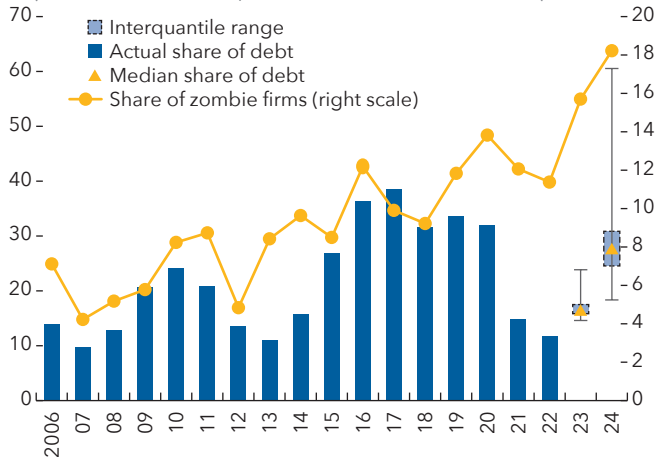
However, as many nonfinancial corporations have emerged from the pandemic with higher leverage and compressed profitability (partly because of rising input costs), the impact from higher-for-longer interest rates through pressures on debt-servicing capacity may not yet be reflected in nonperforming loans. The potential increase in problem loans would result in additional loan loss provisioning, which could negatively affect banks' capital and credit provision to the region.

### 3.3. Higher-for-Longer Could Hold Back Growth in an Adverse Scenario

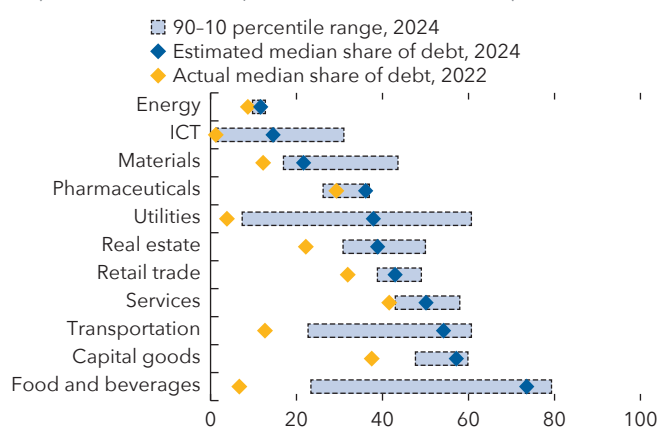
*Higher-for-longer interest rates could strain corporate balance sheets and banks in the region. Stress tests show that while some nonfinancial firms are vulnerable, banking systems would be resilient to individual stress scenarios. Still, vulnerabilities could emerge in certain segments, and some banks would experience capital losses that, although manageable, could limit lending and add to downside risks to output.*

**Figure 3.3. Corporate Stress****1. Corporate Debt Held by Zombie Firms**

(Percent of total debt; simulation results for 2023-24)

**2. Sectoral Share of Debt at Zombie Firms**

(Percent of total debt; simulation results for 2024)



Sources: S&amp;P Capital IQ; and IMF staff calculations.

Note: Country coverage: Azerbaijan, Bahrain, Egypt, Jordan, Kazakhstan, Kuwait, Kyrgyz Republic, Lebanon, Morocco, Oman, Pakistan, Qatar, Saudi Arabia, Sudan, Tunisia, and United Arab Emirates. ICT = information and communication technology.

**Corporate Sector Stress Test: Debt at Risk of Default Could Double**

The COVID-19 shock affected the corporate sector adversely, particularly contact-intensive industries, but strong policy support in ME&CA helped to mitigate the overall impact (October 2021 *Regional Economic Outlook: Middle East and Central Asia*). The corporate sector has broadly recovered since the start of the pandemic, but some nonfinancial firms could still become vulnerable in a higher-for-longer interest rate environment. In this context, stress scenarios were simulated over 2023-24 to estimate the share of corporate debt at risk of default.

The analysis focused on “zombie” firms—firms that are highly leveraged and at a greater risk of default.<sup>2</sup> The share of zombie firms in the region, which has been on an upward trend for more than a decade, stood at about 12 percent in 2022 (Figure 3.3, panel 1). Moreover, zombie firms’ median leverage (proxied by total liabilities to total assets) was twice that of other firms at the end of 2022 (40 percent versus 20 percent) and, while non-zombie firms’ median profitability (proxied by return on assets) recovered after the pandemic, zombie firms’ operating losses continued to deteriorate (see Online Annex 3.1). At the end of 2022, zombie firms held about 12 percent of corporate debt. This share is lower than prepandemic levels for a variety of reasons, including the bankruptcy of some firms and others receiving temporary support, but history suggests that the share of debt held by zombie firms typically peaks several years after a recession.<sup>3</sup>

The adverse scenario was calibrated to the higher-for-longer interest rate environment combined with a sector-specific profitability shock to simulate the impact of a global slowdown (see Online Annex 3.1). The effective interest rate was increased sequentially by 100 basis points per year, reaching an average of more than

<sup>2</sup> Following Acharya and others (2022), zombie firms are those whose average interest coverage ratio (ICR) over two years falls below 2.5 (the mean ICR for BB-rated firms) and simultaneously receive “subsidized” lending (that is, their effective interest rate is below that of top-rated firms). The rationale for the ICR threshold is to focus on firms at the investment grade frontier, which are more likely to default under stress conditions.

<sup>3</sup> Many firms received temporary support during the pandemic, including through various forms of loan relief and tax breaks. Together with lower interest rates over 2020-21, this contributed to temporarily higher ICRs for some zombie firms. While the total debt of firms in the sample declined between 2020 and 2021, the decline was more marked for zombie firms as some failed and went into bankruptcy and healthier firms were more able to access credit.



8 percent by the end of 2024, about 2 percentage points higher than prepandemic levels. The sector-specific profitability shocks were calibrated based on the evolution of earnings (before taxes and interest) in the first two years after the global financial crisis, with most sectors experiencing double-digit negative returns.

The results show that firm profitability could decline, on average, to about 3 percent in 2024, below the prepandemic level of 5 percent. The median interest coverage ratio was estimated to decline from 3.5 to 1.5 at the end of 2024, and the share of debt at risk of default more than doubled, increasing from about 12 percent of total debt in 2022 to almost 30 percent by 2024 (Figure 3.3, panel 1). Looking across sectors, firms in the transportation, capital goods, and food and beverage sectors would be most vulnerable, with the median share of zombie firm debt in the food and beverages sector increasing particularly sharply by 2024 (Figure 3.3, panel 2).

### Banking Sector Stress Test: Resilience Tested under Shocks and High Rates<sup>4</sup>

Four banking sector stress scenarios were simulated amid a higher-for-longer interest rate environment. The first scenario considered a liquidity shock through deposit outflows that could force some banks to realize capital losses on hold-to-maturity securities (see Online Annex 3.2 for the methodology following Copestake, Kirti, and Liu, forthcoming, and Jiang and others 2023).<sup>5</sup> This established a baseline for banks' vulnerability to liquidity shocks. The second scenario added a 200 basis point increase in interest rates to the first scenario.<sup>6</sup> The third scenario mapped the corporate sector stress test results from the previous section to banking sector pressures through higher provisioning requirements, consistent with higher probabilities of default in the corporate sector.<sup>7</sup> The fourth combined scenario features a confluence of shocks with higher interest rates, corporate sector stress, and a liquidity shock. Detailed country-level results are displayed in Online Annex 3.2 (Annex Figure 3.2.1).

The results point to banking sector resilience, though amid risks. Notably, banks in the GCC and in MENA EM&MIs and Pakistan would remain resilient to individual stress scenarios but could be tested by a combined shock (Figure 3.4, panel 1).<sup>8</sup> While banks in the CCA would remain resilient in the stress scenarios described, partly because of their relatively high cash buffers resulting from surging profitability, the CCA is more exposed to risks relating to foreign exchange than other countries in ME&CA (Box 3.1).<sup>9</sup> Regarding the individual stress scenarios, many banks in ME&CA can withstand liquidity or corporate sector stress without realizing capital losses because of generally high profitability among privately owned banks (Georgia, Kazakhstan, United Arab Emirates), ample cash buffers, and a significant share of already marked-to-market securities portfolios in some

<sup>4</sup> The stress tests used in this chapter are designed for cross-country comparability and thus are a useful complement to the more in-depth country-specific analyses conducted during Financial Sector Assessment Programs (FSAPs). For example, the chapter's stress tests used concepts of solvency and liquidity based on academic studies that differ from the related regulatory concepts and definitions that supervisors employ and the FSAPs use. Moreover, because of data limitations, the chapter does not cover the direct impact of higher interest rates on the household sector. For more information, see recently completed FSAPs for Georgia, Jordan, and Kuwait, and Chapter 2 of the October 2023 *Global Financial Stability Report*. The chapter abstracts from the implications of recent increases in sovereign rollover risks for banking sectors in countries whose governments have shortened maturities (see Online Annex 3.5).

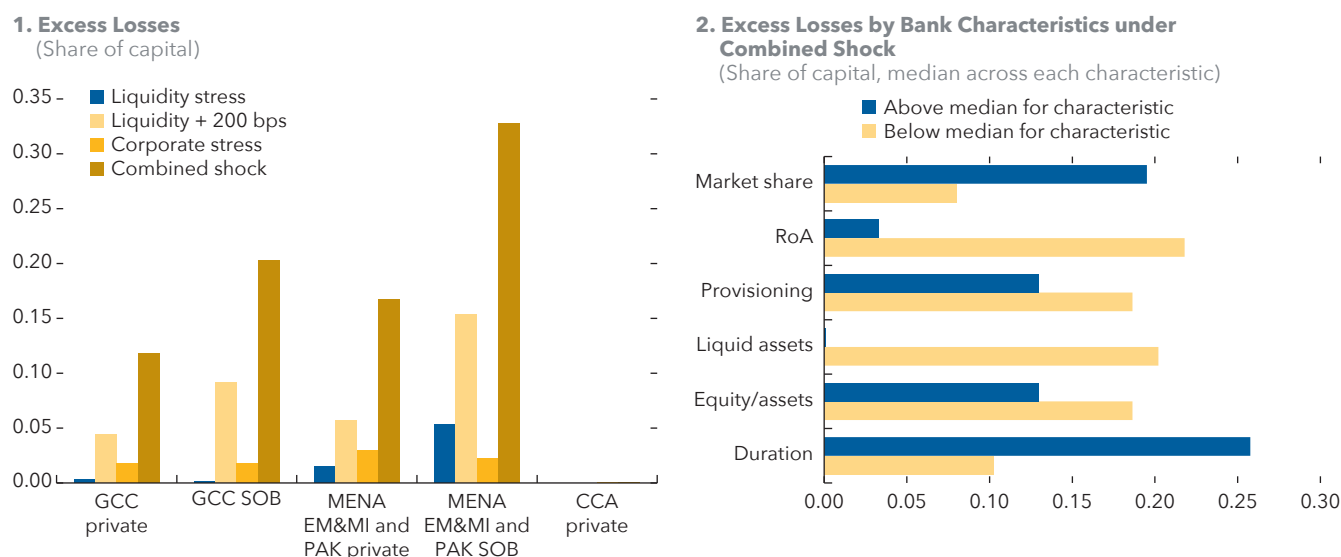
<sup>5</sup> Such a shock could be triggered by spillovers from global financial turbulence and exacerbated by uneven deposit insurance in the region. To capture the differences in the stickiness of funding sources, the liquidity shock imposes stronger withdrawals of foreign deposits and wholesale funding, with its simulated size (withdrawals of 20 percent of resident deposits and 30 percent for foreign deposits and wholesale funding) comparable to recent FSAPs in the region (see IMF 2023) and the worldwide liquidity stress tests of Copestake, Kirti, and Liu (forthcoming).

<sup>6</sup> The 200 basis point shock to the interest rate refers to the potential of further monetary policy tightening (domestic tightening for countries with floating exchange rates; from US monetary tightening for countries with pegged exchange rates), a potential further increase in sovereign spreads for Middle East and Central Asia countries relative to the United States, and an increase in risk premiums as banks' creditworthiness deteriorates.

<sup>7</sup> In the corporate sector stress test scenarios, ICRs deteriorate relative to the status quo. Annex Figure 3.1.2 shows the distribution of ICRs. The change in ICR was mapped into a corresponding change in default probabilities using Damodaran (2023). It was assumed that banks provision fully against these increases in nonperforming loans. Details are provided in the online appendix.

<sup>8</sup> Capital losses would be realized if overall losses are greater than net income.

<sup>9</sup> Strong inflows from Russia amid appreciating exchange rates have led to a large increase in net foreign exchange gains for Caucasus and Central Asia (CCA) banks, which has strengthened profitability.

**Figure 3.4. Capital Losses under Stress Scenarios**

Sources: Bloomberg Finance L.P.; Fitch Connect; and IMF staff calculations.

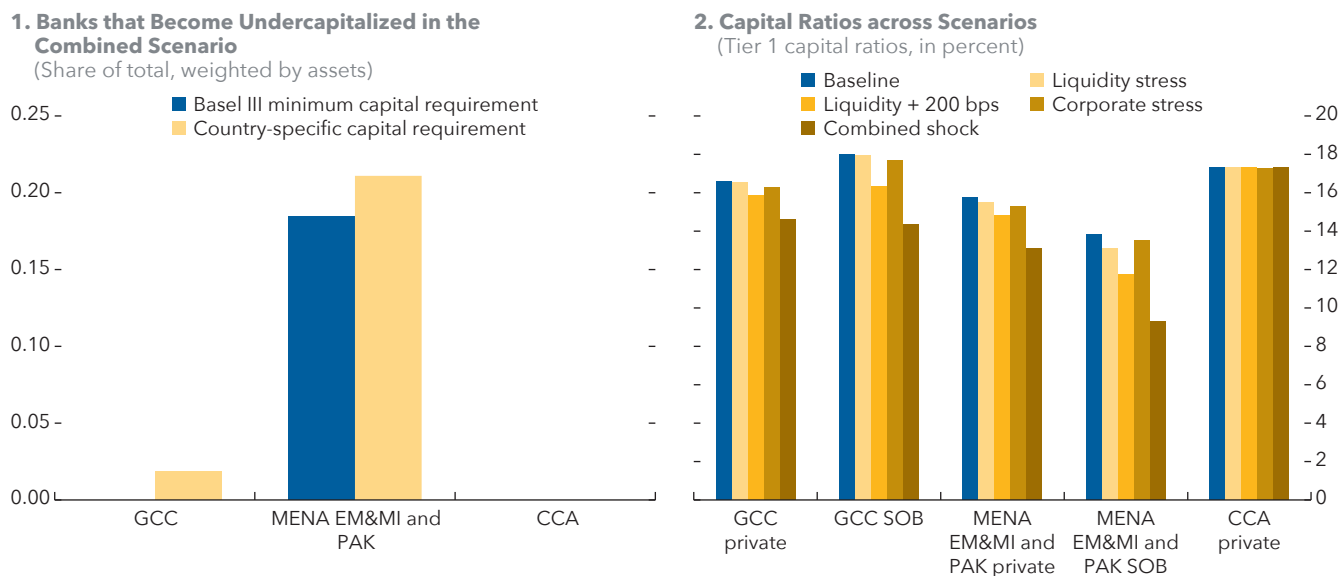
Note: Panel 1 shows losses, measured in excess of net income, as a fraction of Tier 1 regulatory capital. State-owned banks are defined as banks with at least 50 percent government ownership. Panel 2 shows median loss for banks above/below median of a particular characteristic. Market share is defined as within-country market share. Return on assets is defined as net income over total assets. Duration is measured at the country level as the weighted average duration of outstanding local currency government bonds. GCC countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. MENA EM&MI and PAK includes Egypt, Jordan, Morocco, and Pakistan. CCA includes Georgia and Kazakhstan. bps = basis points; CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENA EM&MI and PAK = Middle East and North Africa emerging market and middle-income countries and Pakistan; RoA = return on assets (defined as net income over total assets); SOB = state-owned bank.

countries (primarily in the GCC). However, across most scenarios, state-owned banks are more vulnerable than privately owned banks in MENA EM&MIs and Pakistan and to a lesser extent the GCC, reflecting their lower profitability and higher levels of securities holdings, which increases interest rate risk.<sup>10</sup> Specifically:

- Losses would be relatively small in the liquidity stress scenario. However, if liquidity stress is coupled with higher interest rates, losses would be much larger, particularly for state-owned banks. The main drivers of these losses are rising unrealized capital losses on banks' holdings of fixed-income securities, particularly long duration securities (Jordan, Morocco, Saudi Arabia). Countries with lower ex ante capital buffers are also more exposed (Egypt, Morocco).
- The corporate sector stress scenario suggests that banks have ample buffers, reflecting relatively high provisioning in the region (Kuwait) and low exposures to the private sector in countries with a strong bank-sovereign nexus (Egypt, Pakistan).
- The combined scenario leads to the largest capital losses. Privately owned banks in MENA EM&MIs and Pakistan and the GCC experience losses of 16.7 percent and 11.8 percent, respectively, with state-owned banks experiencing losses about twice as large as privately owned banks.
- Across all scenarios, losses in the CCA would be negligible because of large cash buffers and high profitability. Nevertheless, significant vulnerabilities could emerge following an external shock because of high levels of dollarization, risks from borrowers' unhedged foreign exchange exposures, and foreign exchange funding stress (Box 3.1).<sup>11</sup>

<sup>10</sup> In the corporate scenario, state-owned banks are slightly less vulnerable because they have a lower share of loans relative to total assets than privately owned banks. Thus, their additional provisioning needs are lower.

<sup>11</sup> Teodoru and Akepanidaworn (2022) show that the simultaneous realization of foreign exchange-induced credit risks and acute foreign exchange funding stress would have compounding effects, and the largest and state-owned banks seem to be the most vulnerable.

**Figure 3.5. Bank Undercapitalization and Impact on Capital Ratios**

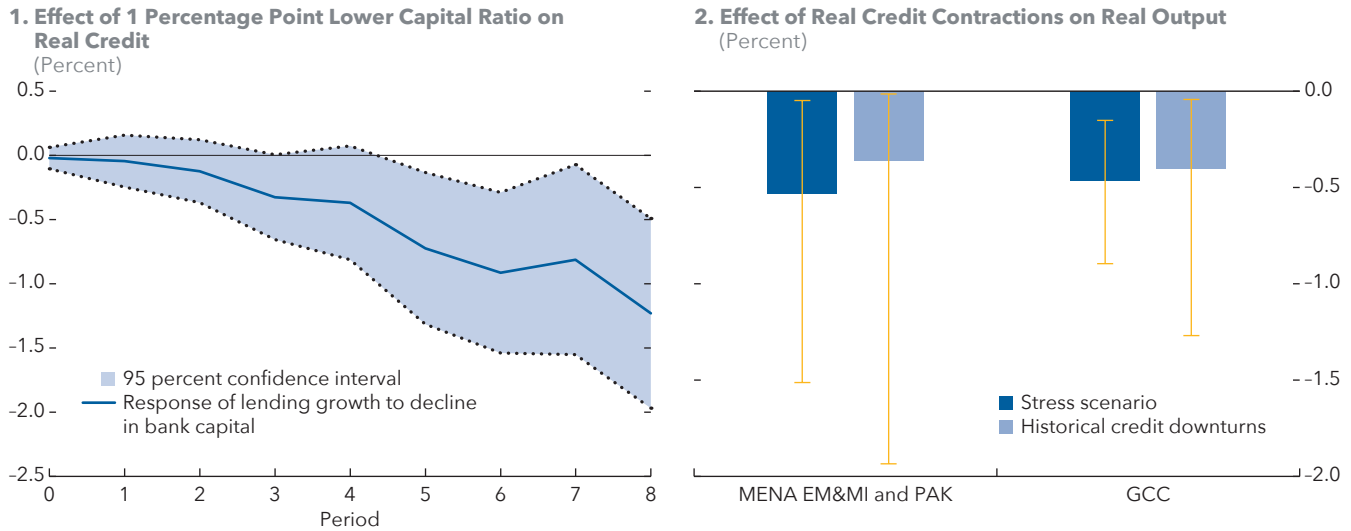
Sources: Bloomberg Finance L.P.; Fitch Connect; and IMF staff calculations.

Note: Panel 1 reports the share of banks weighted by total assets that become undercapitalized across regions. Basel III minimum capital requirements refers to 4.5 percent minimum common equity Tier 1 capital plus an extra 1.5 percent of additional Tier 1 capital plus a 2.5 percent capital conservation buffer, which most countries in the region have implemented. Country-specific capital requirement adds the country-specific Tier 1 capital requirement and capital conservation buffer. Panel 2 reports Tier 1 capital ratios for banks across current baseline and four stress scenarios. GCC countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. MENA EM&MI and PAK includes Egypt, Jordan, Morocco, and Pakistan. CCA includes Georgia and Kazakhstan. bps = basis points; CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENA EM&MI and PAK = Middle East and North Africa emerging market and middle-income countries and Pakistan, excluding the GCC; SOB = state-owned bank.

Excess losses vary across banks depending on their characteristics (see Figure 3.4, panel 2). Losses tend to be more concentrated in banks with relatively illiquid balance sheets, low profitability, low provisioning levels, and higher leverage, with larger losses concentrated in banks with higher market shares. Moreover, banks in countries with greater duration of outstanding sovereign bonds are more exposed because these banks face much higher sensitivity to interest rate increases.

While few banks would become undercapitalized in the combined scenario, capital buffers would be significantly eroded, especially in countries that begin with relatively low capital ratios (Egypt, Morocco, Pakistan). Relative to Basel III minimum capital requirements,<sup>12</sup> 18 percent of banks in MENA EM&MIs and Pakistan would become undercapitalized in the combined scenario (Figure 3.5, panel 1). By contrast, all banks in the GCC and the CCA would remain above minimum requirements. The share of undercapitalized banks would increase slightly in the GCC and MENA EM&MIs and Pakistan when country-specific minimum capital requirements are imposed. Aggregate Tier 1 capital ratios would decline by 2.6 and 4.5 percentage points for privately owned and state-owned banks in MENA EM&MIs and Pakistan, respectively. Similarly, state-owned banks are also more vulnerable than privately owned banks in the GCC, with ratios declining by 3.7 and 2.0 percentage points, respectively (Figure 3.5, panel 2).

<sup>12</sup> Estimated scenario-related losses are compared with Tier 1 capital. Basel III stipulates 4.5 percent common equity Tier 1 plus 1.5 percent additional Tier 1 capital and a 2.5 percent capital conservation buffer. Based on a desk survey, most countries included in the stress testing exercise require minimum Tier 1 capital higher than 8.5 percent. For the country-specific capital requirements, domestic systemically important banks' surcharges and other buffers are treated as buffers and not as capital requirements in line with IMF (2023).

**Figure 3.6. Impact on Credit and Output**

Sources: Fitch Connect; Haver Analytics; and IMF staff calculations.

Note: Panel 1 reports the estimated impulse response of real credit to lower bank capital ratios (see estimation details in Online Annex 3.3).

Standard errors are clustered by bank and time. Dotted lines display 95 percent confidence bands. Panel 2 reports distribution of output losses from credit contractions under stress scenarios (dark blue plot) and during historical credit downturns (light blue plot). The output losses displayed reflect the median and 95th percentile of losses across countries in each subregion. GCC = Gulf Cooperation Council; MENA EM&MI and PAK = Middle East and North Africa emerging market and middle-income countries and Pakistan, excluding the GCC.

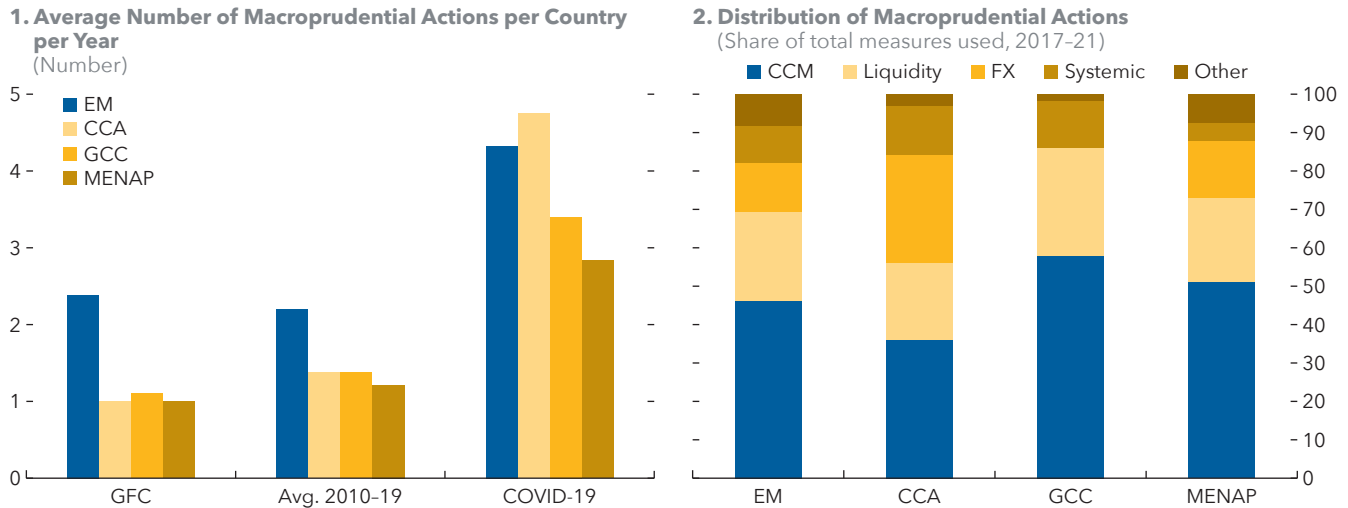
### Stress in the Banking Sector Could Weigh on Credit Provision and Growth

The erosion of bank capital under the stress scenarios is likely to result in a reduction in lending to the private sector as banks aim to rebuild buffers. Notably, a local projection approach (Jordà 2005) suggests that a 1 percentage point decline in capital ratios has been historically correlated with a contraction in real credit, reaching 1.2 percent after eight quarters (Figure 3.6, panel 1). Based on the combined scenario from the previous section, these estimates imply that real credit could contract by 4.3 percent in MENA EM&MIs and Pakistan and 3.2 percent in the GCC over a two-year horizon.<sup>13</sup>

Amid lower credit provision, which may affect financial inclusion as marginal borrowers lose access to credit, economic activity could also decline markedly. Results from a macroeconomic model show that the decline in bank lending in line with the combined scenario from the previous section could translate into output losses of a magnitude similar to those seen during past credit downturns in MENA EM&MIs and Pakistan, and the GCC (see Figure 3.6, panel 2).<sup>14</sup> In fact, the median output loss from the decline in lending is estimated to be about 0.5 percent in MENA EM&MIs and Pakistan, and in the GCC. That said, while the median output losses are comparable to those seen during credit downturns over the past two decades, there is significant statistical variation across these estimates, suggesting that the resulting downside risks from an adverse scenario could potentially

<sup>13</sup> The banking stress test does not explicitly model interbank linkages, due to lack of data, which could further amplify downward spirals in the case of banking sector stress. Hence, these estimates should be interpreted as lower bounds. Amplification could also occur through nonbank financial institutions, although this is expected to be limited because they have a low market share in most countries of the region.

<sup>14</sup> See Online Annex 3.4 for a description of the model and estimation details. In the combined scenario, average real credit losses estimated for banks across each subregion and their associated uncertainty bands are applied to all countries with available macroeconomic data in each subregion to estimate output losses for each country. A historical credit downturn is defined to be a sequence of at least one negative credit shock estimated using all available data since the fourth quarter of 2001. It is important to note that the estimated output losses from credit shocks would come on top of any other declines in output that might result from all other (noncredit) shocks that affect aggregate demand, such as tighter financial conditions and slowing global demand.

**Figure 3.7. Macprudential Frameworks**

Source: IMF staff calculations.

Note: CCA = Caucasus and Central Asia; CCM = credit and capital-related measures; EM = emerging market; FX = foreign exchange; GCC = Gulf Cooperation Council; GFC = global financial crisis; MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

be much larger. For example, at the 95th percentile of estimated output losses across countries following the credit contraction in the combined scenario, there could be a 1.5 percent output contraction in MENA EM&MIs and Pakistan and a 0.9 percent contraction in the GCC over two years.<sup>15</sup>

### Macprudential Frameworks in ME&CA: Where Do We Stand?

In the aftermath of the global financial crisis, central banks across the world ramped up efforts to deploy macroprudential tools to prevent the buildup of systemic risk and deal with financial stability concerns. However, the use of macroprudential policies in ME&CA has been generally slow. For example, almost all the countries in the region have some form of broad-based tool available that covers capital buffers such as the countercyclical capital buffer, but most countries have left the setting at zero since inception. Furthermore, while most countries have implemented some form of borrower-based tool for the household sector, such as a cap on debt-service-to-income ratios, tools to guard against pockets of vulnerabilities and elevated credit risk in the nonfinancial corporate sector have generally been less used. In addition, some countries in the GCC (for example, Saudi Arabia) have not used measures to reduce banks' foreign currency liquidity risks, and some MENA countries (Algeria, Lebanon, Morocco, Tunisia) have taken fewer actions to reduce risks from domestic systemically important financial institutions. Overall, progress on macroprudential actions in ME&CA has often lagged other regions and the range of tools deployed also varies across subregions (Figure 3.7). Such differences may reflect the nature of the risks faced by banks in each subregion but could also leave key gaps in addressing potential vulnerabilities.

### Policies to Safeguard Financial Stability

*Several region- and country-specific actions could help reduce downside risks in a higher-for-longer interest rate environment. Policy recommendations center on strengthening macroprudential frameworks, mitigating risks from the sovereign-bank nexus, enhancing clear and timely communication, establishing emergency liquidity tools to stem systemic financial stress, and developing resolution regimes to reduce the buildup of zombie firms.*

<sup>15</sup> In the most adverse scenario for the CCA discussed in Box 3.1, the decline in capital ratios would imply a 4.1 percent reduction in real credit. This could lead to a 0.4 percent decline in output, with significant downside risks; the 95th percentile of estimated output declines across CCA countries is 1.3 percent over two years.

Developing and strengthening **macroprudential frameworks** in the region remains a priority. These include the following:

- In the MENA region and Pakistan, ramping up the use of broad-based macroprudential tools, such as the countercyclical capital buffer (established across most of the GCC and CCA, but not yet deployed), would help to prevent a sharp credit contraction during downturns. Countries where corporate debt-at-risk is elevated, or zombie firms are prevalent (for example, Kuwait, Jordan, and United Arab Emirates) should consider using borrower-based tools such as caps on debt-service-to-income ratios and loan-to-value ratios.
- Implementing additional measures that target large, domestic systemically important institutions, such as increased capital surcharges (as is used across most GCC countries)—particularly in MENA EM&MIs where implementation of domestic systemically important institution frameworks is lagging—would help reduce concentration and interconnectedness risks.
- In the GCC, guarding against unexpected liquidity stress will be important, particularly related to foreign liabilities. For example, consideration could be given to tools that account for concentrated nonresident deposits bases in liquidity coverage and net stable funding ratios. More generally, most GCC countries are more integrated with the international financial system than other countries in the region and are more exposed to foreign flows, raising the importance of implementing enhanced macroprudential foreign exchange measures, such as reserve requirements.
- In the CCA, countries would benefit from continuing to pursue ongoing macroprudential measures to build up resilience across credit cycles, especially in the current context of large inflows from Russia, and incentivize de-dollarization to reduce foreign exchange mismatches and enhance corporate and bank risk management.<sup>16</sup>
- Furthermore, although still nascent across most ME&CA countries, links between the banking sector and nonbank financial institutions should be monitored, especially where regulators see signs of risks migrating toward the sector.

Policymakers should continue to address the vulnerabilities related to the elevated **sovereign-bank nexus**. Given the complicated and multifaceted nature of the nexus in some countries, the policy response to mitigate risks must be tailored to country-specific circumstances:

- In the near term: In countries where banking systems face elevated interest rate risk (for example, Jordan), preserving bank capital to absorb losses is critical. Conducting bank stress tests by considering the multiple channels of the nexus would help countries to understand the nature and severity of these risks. In the current environment of high interest rates, central banks will need to pay special attention to bank asset classification and provisions and to exposures to interest rate and liquidity risks. Where risks are elevated, restricting profit distribution plans could be the first line of defense.
- Over the medium term: In countries with limited fiscal space and tight borrowing constraints, macroeconomic policies that strengthen debt sustainability would help contain government financing needs and thus a worsening of the sovereign-bank nexus. In addition, in countries where bank holdings of sovereign bonds exceed certain concentration limits (for example, Egypt, Pakistan), authorities should consider ways to lessen the sovereign-bank nexus gradually, with a precondition that macroeconomic policies are also set appropriately. This could include imposing capital surcharges on banks' sovereign bond holdings above certain thresholds, which can moderate the nexus in a way that increases resilience if phased-in appropriately.<sup>17</sup>
- Over the medium term and across all countries in the region, efforts to foster a deep and diversified investor base to help reduce the sovereign-bank nexus and strengthen market resilience should continue, particularly in countries where state-owned entities dominate the marketplace (Egypt, Tunisia, but also the MENA region

<sup>16</sup> See Khandelwal and others (2022) for more details on macroprudential policy recommendations for CCA countries.

<sup>17</sup> See the April 2022 *Global Financial Stability Report* for a detailed discussion of capital surcharges on banks' sovereign bond holdings above certain thresholds, including how to minimize potential adverse impacts.

and Pakistan more broadly). Building adequate buffers at state-owned banks, providing clear and well-defined mandates, and aligning supervisory tools such as stress tests with banks' unique risk profiles would enhance resilience further.<sup>18</sup>

A rise in financial stability risks from persistently high core inflation and higher-for-longer interest rates would complicate the task of central banks, and it puts a premium on clear **communication**. Clearly communicating central bank objectives and policy functions will be crucial to avoiding unnecessary uncertainty. In this respect, some countries would benefit from improving their communication on macroprudential frameworks, for example, by issuing a financial stability report. Policymakers must also act swiftly to prevent systemic events that may adversely affect market confidence in the resilience of financial systems. If policymakers adjust the monetary policy stance for financial stability purposes, they should clearly communicate their resolve to bring inflation back to target as soon as possible once financial stress lessens.

In parallel, policymakers should stand prepared to deal with financial instability, if it occurs. If faced with systemic financial stress, crisis management measures, such as emergency liquidity support, may be needed. Furthermore:

- In countries where central banks lack explicit authority to provide emergency liquidity assistance (Algeria, Morocco, Oman), governments should prioritize establishing a clear framework for dealing with liquidity distress in the banking system.
- In countries where central bank laws allow for the provision of emergency liquidity but lack details on operational directives and requirements (Egypt and Jordan in the MENA region; Georgia and Tajikistan in the CCA), providing specific instructions to banks and having internal guidelines would help in building additional capacity on the use of emergency liquidity facilities, including foreign exchange liquidity.<sup>19</sup>

Across all countries, central banks' liquidity support measures should aim to address liquidity, not solvency issues, which are best left to the relevant fiscal (or resolution) authorities. A significant part of the risk needs to remain in the marketplace to minimize moral hazard, and each intervention should have a well-defined end date, allowing market forces to reassert themselves once acute strains subside. Interventions should also be parsimonious to avoid conflicting with the monetary policy stance, especially in a tightening cycle. This means that liquidity support should be appropriately priced to avoid attracting opportunistic demand not in need of support. Liquidity support and broader crisis management tools also need to comply with Islamic banking rules in the region (IMF 2019).

Ex post solvency concerns require robust **resolution frameworks**, and many countries across the region have made progress and enhanced insolvency procedures to deal with legacy nonperforming loans. If borrower defaults rise, domestic banks may face incentives to delay the recognition of loan losses by evergreening credit to firms at advantageous rates. This can lead to long-lasting buildups of nonperforming loans, which constrain bank lending, and the resulting emergence of zombie firms would weigh on aggregate productivity growth. Therefore, resolution regimes should be structured to enable a swift resolution of nonperforming loans to prevent banks from building up impaired legacy assets on their balance sheets.

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<sup>18</sup> See Adams and others (2022) for more details on policy proposals related to state-owned banks.

<sup>19</sup> The regional and country recommendations are based partially on data from the IMF's Monetary Operations and Instruments database.

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### Box 3.1. Banking Sector Stress Test for the Caucasus and Central Asia

The Caucasus and Central Asia (CCA) is facing different financial stability challenges compared with other banking sectors in the region, including relatively high levels of dollarization, associated exchange rate risks,<sup>1</sup> and strong recent inflows from Russia.<sup>2</sup> To better assess financial stability risks in the CCA, the following assumptions are added to the baseline banking sector stress test:<sup>3</sup>

- Inflows from Russia normalize, and profitability returns to its prepandemic average amid a normalization of net foreign currency gains.
- An adverse external shock triggers a rise by 150 percent in sovereign spreads.<sup>4</sup>
- Exchange rates depreciate by 30 percent, stressing unhedged corporate and household borrowers.

The results show that CCA banks are resilient in a liquidity stress scenario because of high profitability and cash buffers, with losses of between 4 and 7 percent of regulatory capital. Given significant unhedged foreign exchange exposures, a large currency depreciation would lead to a surge in nonperforming loans among corporations, requiring additional provisioning, with losses rising to 7.3 percent of regulatory capital (Box Figure 3.1.1, panel 1). Combined liquidity and corporate stress could lead to losses as large as 15.3 percent of regulatory capital. While only 1.8 percent of banks (weighted by assets) would become undercapitalized, capital ratios would decline by 2.6 percentage points in aggregate, from 17.4 percent to 14.8 percent (Box Figure 3.1.1, panel 2).

Vulnerabilities related to dollarization and unhedged foreign exchange borrowers are key drivers of the losses. In the corporate stress scenario, the aggregate Tier 1 capital ratio would drop by 1.2 percentage points. Without currency depreciation, the decline would be negligible as banks would have sufficient buffers to absorb higher provisioning needs, even if profitability returns to prepandemic averages (a 44 percent decline from current levels). Overall, CCA banks would remain resilient against small shocks, with their main vulnerabilities stemming from an adverse shock that triggers a surge in sovereign spreads and sizable currency depreciations.

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<sup>1</sup> See Teodoru and Akepanidaworn (2022) for a more detailed discussion of dollarization and exchange rate risks in the Caucasus and Central Asia.

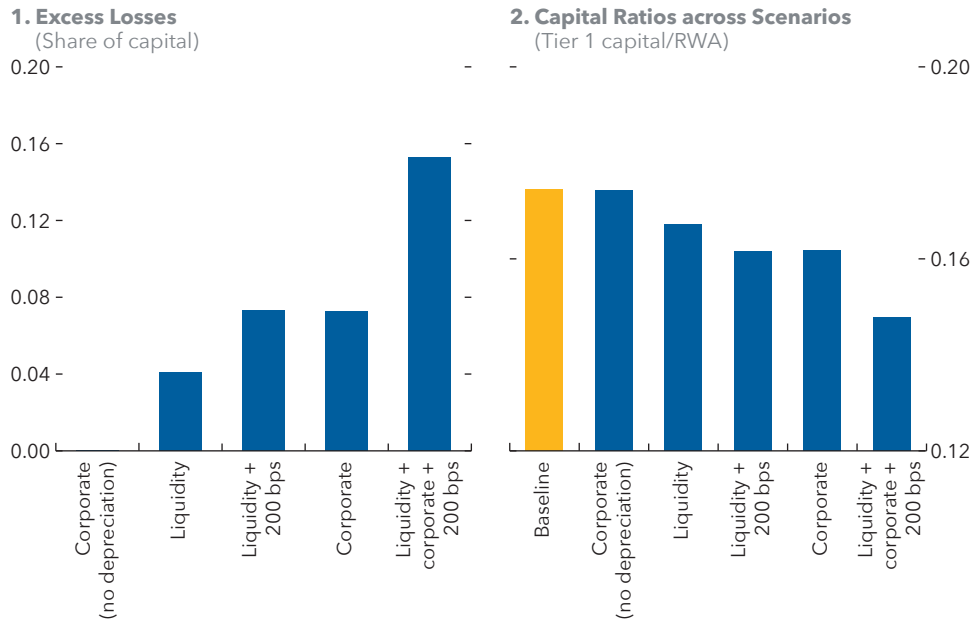
<sup>2</sup> Because of limitations in the availability of recent banking data, the analysis covers Georgia and Kazakhstan.

<sup>3</sup> Foreign exchange liquidity is a potential vulnerability that is not part of the stress test. The bank-level data used do not include a breakdown of liquid assets between local currency and foreign currency liquid assets. Thus, it is not possible to evaluate the extent to which banks have sufficient foreign exchange liquidity, especially in US dollars. See Online Annex 3.1 for further details. Teodoru and Akepanidaworn (2022) highlight that the simultaneous realization of foreign exchange credit and liquidity risks would have compounding effects on the banking sectors in the Caucasus and Central Asia, with the largest and state-owned banks being most vulnerable.

<sup>4</sup> The magnitude of the increase is consistent with the external shock scenario in the 2021 Financial Sector Assessment Program for Georgia (IMF 2021).

## Box 3.1. (continued)

Box Figure 3.1.1. Losses and Capital Ratios in the Caucasus and Central Asia



Sources: Fitch Connect; IMF, Financial Soundness Indicators database; and IMF staff calculations.  
 Note: Panel 1 reports estimated losses—in excess of banks' net income—across five scenarios. Losses are scaled as a share of Tier 1 regulatory capital. The corporate (no depreciation) scenario assumes a growth shock only to corporations. The full corporate scenario adds a further rise in nonperforming loans because of borrowers' unhedged foreign exchange exposures. Panel 2 reports current baseline Tier 1 capital ratio for Caucasus and Central Asia banks and counterfactual capital ratios across scenarios. Countries included are Georgia and Kazakhstan. bps = basis points; RWA = risk-weighted assets.

**ME&CA: Selected Economic Indicators, 2000-24***(Percent of GDP, unless otherwise indicated)*

	Average 2000-19	2020	2021	2022	Projections	
					2023	2024
<b>ME&amp;CA<sup>1,2</sup></b>						
Real GDP (percent change, year-over-year)	4.5	-2.6	4.3	5.6	2.0	3.4
<i>of which non-oil growth</i>	5.2	-2.2	4.6	4.7	2.9	3.4
Current Account Balance	5.7	-3.4	3.3	8.6	4.1	3.6
Overall Fiscal Balance	1.2	-7.9	-2.6	1.8	-1.1	-1.8
Inflation (percent change, year-over-year)	7.3	10.4	12.8	14.0	18.0	15.2
<b>ME&amp;CA oil exporters</b>						
Real GDP (percent change, year-over-year)	4.5	-3.7	4.3	5.7	2.2	3.4
<i>of which non-oil growth</i>	5.6	-2.9	4.7	4.4	3.8	3.6
Current Account Balance	8.9	-3.3	6.7	14.0	6.9	6.2
Overall Fiscal Balance	3.3	-8.5	-1.1	4.8	0.5	0.0
Inflation (percent change, year-over-year)	6.8	8.6	11.0	13.2	12.9	9.3
<b>ME&amp;CA emerging market and middle-income countries<sup>1</sup></b>						
Real GDP (percent change, year-over-year)	4.3	-0.8	4.6	5.7	2.1	3.2
Current Account Balance	-3.4	-3.2	-3.6	-4.9	-2.8	-3.2
Overall Fiscal Balance	-5.2	-7.3	-6.3	-6.2	-5.7	-7.6
Inflation (percent change, year-over-year)	7.1	8.2	7.8	11.5	23.9	24.0
<b>ME&amp;CA low-income developing countries<sup>2</sup></b>						
Real GDP (percent change, year-over-year)	4.4	-1.4	2.2	3.2	-0.5	3.9
Current Account Balance	1.1	-5.8	-7.2	-8.1	-7.2	-6.6
Overall Fiscal Balance	-2.0	-3.7	-2.6	-2.8	-4.0	-3.0
Inflation (percent change, year-over-year)	13.9	38.6	60.0	37.6	42.3	30.8

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

<sup>1</sup> 2011-24 data exclude Syrian Arab Republic.<sup>2</sup> Afghanistan is excluded from real GDP growth, overall fiscal balance, and inflation data for 2022-24, and current account balance data for 2021-24.

Note: Data refer to the fiscal year for the following countries: Afghanistan (March 21/March 20 until 2011, and December 21/December 20 thereafter), Islamic Republic of Iran (March 21/March 20), and Egypt and Pakistan (July/June).

The 32 ME&amp;CA countries and territories are divided into three (nonoverlapping) groups, based on export earnings and level of development: (1) Oil Exporters (ME&amp;CA OE), (2) Emerging Market and Middle-Income Countries (ME&amp;CA EM&amp;MI); and (3) Low-Income Developing Countries (ME&amp;CA LIC).

ME&amp;CA OE include Algeria, Azerbaijan, Bahrain, Islamic Republic of Iran, Iraq, Kazakhstan, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Turkmenistan, and United Arab Emirates.

ME&amp;CA EM&amp;MI include Armenia, Egypt, Georgia, Jordan, Lebanon, Morocco, Pakistan, Syrian Arab Republic, Tunisia, and West Bank and Gaza.

ME&amp;CA LIC include Afghanistan, Djibouti, Kyrgyz Republic, Mauritania, Somalia, Sudan, Tajikistan, Uzbekistan, and Yemen.

**MENA: Selected Economic Indicators, 2000-24**

(Percent of GDP, unless otherwise indicated)

	Average 2000-19	2020	2021	2022	Projections	
					2023	2024
<b>MENA<sup>1</sup></b>						
Real GDP (percent change, year-over-year)	4.2	-3.0	4.0	5.6	2.0	3.4
<i>of which non-oil growth</i>	5.2	-2.4	4.2	4.4	3.3	3.5
Current Account Balance	6.8	-3.6	4.1	10.2	5.2	4.6
Overall Fiscal Balance	1.6	-8.4	-2.1	3.0	-0.4	-1.3
Inflation (percent change, year-over-year)	7.2	10.8	14.0	14.4	17.5	15.0
<b>MENA oil exporters</b>						
Real GDP (percent change, year-over-year)	4.3	-3.8	4.3	6.1	2.0	3.4
<i>of which non-oil growth</i>	5.4	-3.0	4.6	4.3	3.8	3.6
Current Account Balance	9.6	-3.3	7.1	14.6	7.5	6.7
Overall Fiscal Balance	3.3	-8.8	-0.9	5.2	0.6	0.1
Inflation (percent change, year-over-year)	6.7	9.0	11.3	13.0	12.9	9.4
<b>MENA emerging market and middle-income countries<sup>1</sup></b>						
Real GDP (percent change, year-over-year)	4.2	-0.5	3.6	5.1	3.5	3.5
Current Account Balance	-4.0	-3.7	-4.8	-5.2	-3.7	-3.9
Overall Fiscal Balance	-5.8	-7.4	-6.6	-5.7	-4.8	-8.1
Inflation (percent change, year-over-year)	7.1	6.9	7.0	11.1	22.1	25.5
<b>MENA low-income developing countries</b>						
Real GDP (percent change, year-over-year)	2.2	-4.2	0.7	-0.3	-9.3	1.7
Current Account Balance	-3.4	-13.1	-9.0	-13.0	-9.1	-10.0
Overall Fiscal Balance	-3.1	-3.6	-0.3	-2.2	-2.9	-1.5
Inflation (percent change, year-over-year)	16.9	89.7	170.8	80.4	109.6	72.4
<b>MENA excl. conflict-affected states</b>						
Real GDP (percent change, year-over-year)	4.0	-2.3	4.3	5.8	2.7	3.5
<i>of which non-oil growth</i>	5.0	-1.7	4.3	4.8	3.7	3.5
Current Account Balance	7.6	-2.5	4.3	10.3	6.0	5.6
Overall Fiscal Balance	2.0	-8.1	-2.3	2.7	0.2	-0.8
Inflation (percent change, year-over-year)	6.8	8.9	10.4	13.0	15.9	14.1
<b>MENA excl. fragile and conflict-affected states</b>						
Real GDP (percent change, year-over-year)	4.0	-1.6	3.9	6.1	2.5	3.4
<i>of which non-oil growth</i>	5.0	-1.2	4.4	4.9	3.8	3.5
Current Account Balance	7.7	-2.2	4.6	10.3	6.0	5.5
Overall Fiscal Balance	1.9	-7.9	-2.5	2.6	0.1	-0.8
Inflation (percent change, year-over-year)	6.9	8.4	9.6	12.2	15.0	13.8

	Average 2000-19	2020	2021	2022	Projections	
					2023	2024
<b>MENAP<sup>1,2</sup></b>						
Real GDP (percent change, year-over-year)	4.3	-2.7	4.1	5.7	1.7	3.3
<i>of which non-oil growth</i>	5.1	-2.2	4.5	4.6	2.8	3.4
Current Account Balance	6.1	-3.3	3.7	8.9	4.7	4.0
Overall Fiscal Balance	1.1	-8.2	-2.5	2.0	-1.1	-1.8
Inflation (percent change, year-over-year)	7.2	10.8	13.2	14.1	19.0	16.2
<b>Gulf Cooperation Council</b>						
Real GDP (percent change, year-over-year)	4.2	-4.7	3.6	7.9	1.5	3.7
<i>of which non-oil growth</i>	5.9	-4.1	5.2	5.3	4.3	4.0
Current Account Balance	12.8	-1.1	8.9	16.0	9.6	8.8
Overall Fiscal Balance	6.0	-8.0	-0.2	6.8	3.5	3.3
Inflation (percent change, year-over-year)	2.2	1.3	2.2	3.3	2.6	2.3
<b>Arab World<sup>1</sup></b>						
Real GDP (percent change, year-over-year)	4.5	-4.3	3.8	6.0	1.8	3.6
<i>of which non-oil growth</i>	5.5	-3.7	4.3	4.6	3.4	3.7
Current Account Balance	7.4	-3.9	4.2	10.8	5.3	4.7
Overall Fiscal Balance	2.4	-8.6	-1.9	3.7	0.1	-0.8
Inflation (percent change, year-over-year)	4.8	6.1	9.1	8.9	12.1	11.7
<b>Arab World oil exporters</b>						
Real GDP (percent change, year-over-year)	4.7	-6.1	4.2	6.8	1.7	3.7
<i>of which non-oil growth</i>	6.0	-5.2	4.9	4.6	4.1	4.0
Current Account Balance	11.3	-3.6	7.6	15.9	8.1	7.1
Overall Fiscal Balance	4.7	-9.2	-0.5	6.4	1.5	1.0
Inflation (percent change, year-over-year)	3.0	1.3	3.2	4.2	3.6	2.9

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

<sup>1</sup> 2011-24 data exclude Syrian Arab Republic.

<sup>2</sup> Afghanistan is excluded from real GDP growth, overall fiscal balance, and inflation data for 2022-24, and current account balance data for 2021-24.

Note: Data refer to the fiscal year for the following countries: Afghanistan (March 21/March 20 until 2011, and December 21/December 20 thereafter), Islamic Republic of Iran (March 21/March 20), and Egypt and Pakistan (July/June).

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

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

MENA emerging market and middle-income countries: Egypt, Jordan, Lebanon, Morocco, Syrian Arab Republic, Tunisia, and West Bank and Gaza.

MENA low-income developing countries: Djibouti, Mauritania, Somalia, Sudan, and Yemen.

MENA excl. conflict-affected states: Algeria, Bahrain, Djibouti, Egypt, Islamic Republic of Iran, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Tunisia, and United Arab Emirates.

MENA excl. fragile states and conflict-affected states: Algeria, Bahrain, Djibouti, Egypt, Islamic Republic of Iran, Jordan, Kuwait, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Tunisia, and United Arab Emirates.

MENAP: MENA, Afghanistan, and Pakistan.

Gulf Cooperation Council: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.

Arab World: MENA excluding Islamic Republic of Iran.

Arab World oil exporters: Algeria, Bahrain, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and United Arab Emirates.

**CCA: Selected Economic Indicators, 2000-24***(Percent of GDP, unless otherwise indicated)*

	Average 2000-19	2020	2021	2022	Projections	
					2023	2024
<b>CCA</b>						
Real GDP (percent change, year-over-year)	6.7	-2.0	5.7	4.8	4.6	4.2
Current Account Balance	0.0	-3.9	0.6	6.0	0.4	0.6
Overall Fiscal Balance	2.0	-5.4	-3.0	0.5	-1.3	-1.4
Inflation (percent change, year-over-year)	8.9	7.3	9.6	13.0	11.0	8.3
<b>CCA oil and gas exporters</b>						
Real GDP (percent change, year-over-year)	7.0	-3.0	4.5	3.3	3.9	3.6
<i>of which non-oil growth</i>	7.0	-2.1	5.3	5.3	3.9	3.4
Current Account Balance	0.5	-3.7	3.1	9.6	2.7	2.7
Overall Fiscal Balance	2.6	-5.6	-2.3	1.8	-0.2	-0.7
Inflation (percent change, year-over-year)	7.8	5.9	9.2	14.2	12.9	8.5
<b>CCA emerging market and middle-income countries</b>						
Real GDP (percent change, year-over-year)	5.9	-6.9	8.5	11.1	6.5	4.9
Current Account Balance	-9.0	-8.7	-7.5	-1.9	-3.9	-4.2
Overall Fiscal Balance	-1.7	-6.9	-4.6	-1.9	-2.0	-1.9
Inflation (percent change, year-over-year)	4.3	3.5	8.6	10.5	2.9	3.3
<b>CCA low-income developing countries</b>						
Real GDP (percent change, year-over-year)	6.4	1.4	7.4	6.0	5.4	5.3
Current Account Balance	1.0	-3.0	-5.6	-4.3	-5.9	-4.5
Overall Fiscal Balance	0.0	-4.2	-4.9	-3.3	-4.8	-3.8
Inflation (percent change, year-over-year)	13.0	11.7	10.7	11.1	9.7	9.4

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

Note: CCA oil and gas exporters: Azerbaijan, Kazakhstan, and Turkmenistan.

CCA emerging market and middle-income countries: Armenia and Georgia.

CCA low-income developing countries: Kyrgyz Republic, Tajikistan, and Uzbekistan.