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Middle East and North Africa: Economic Outlook and Key Challenges

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I. Regional Economic Outlook and Key Challenges

Historic transitions in the Arab Spring countries are coming under increasing strain from macroeconomic pressures and unmet social demands. Domestic uncertainty over the countries' future course, compounded by the global slowdown and rising oil prices, took a toll on growth during 2011. The outlook for 2012 and 2013 is equally challenging. The protracted political transition, lower global growth, and euro zone weakness are likely to result in a slow and drawn-out economic recovery, with unemployment at best stabilizing at high levels. Maintaining macroeconomic stability in this environment will be challenging, not least since policy buffers were reduced during 2011. Indeed, gross external and fiscal financing needs of MENA oil-importers are projected at about $93 and $103 billion, respectively, in 2012-13. With capital markets expected to provide only a small part of these funds, official financial support will be essential to allow countries to continue on their path toward economic transformation. But at the same time, countries need to make tangible progress on that path. This requires bold reform and modernization agendas that command broad consensus and are embedded in a sustainable medium-term macroeconomic policy framework to build confidence, anchor expectations, and pave the way for sustained and inclusive growth.

Background. Domestic and external factors have negatively affected the economic performance of MENA oil-importing countries in 2011. The uncertainty and turmoil generated by political transitions—which have been more drawn out than earlier anticipated—has dampened growth. In addition, countries were faced with higher commodity prices, lower global growth, and spillovers from the euro zone. As a result, with the exception of Morocco and Jordan, growth declined sharply and unemployment increased in many countries. Fiscal positions also deteriorated in 2011. Governments responded to surging global commodity prices by increasing spending, including on wages and food and fuel subsidies. In parallel, revenues declined in many countries as economic activity slowed and tax breaks were granted. In some countries, liquidity conditions tightened somewhat. External positions also deteriorated, driven by higher food and commodity prices, and declines in tourism and capital inflows. These factors, as well as the desire to limit exchange rate movements in many countries, put pressure on external reserves, which declined very sharply in Egypt, and to a lesser extent in Jordan, Morocco, and Tunisia. On the other hand, remittances and exports were stable, or increased, and provided some relief. Weakening economic fundamentals and higher risk aversion have translated into declining stock markets, higher borrowing costs, more nonperforming loans, and credit rating downgrades. For oil exporters, political unrest affected oil production in some countries and so affected the distribution of gains from high oil prices in 2011.

Short-term outlook. 2012 and 2013 will remain difficult years for most oil importers. Protracted policy uncertainty and social pressures in many countries, lower global growth, and euro zone weakness are expected to result in a slow and drawn-out economic recovery. At the same time, the policy space to maneuver is much reduced, and some countries will require external financial assistance. The outlook for oil exporters is better with growth expected to accelerate, on the back of higher oil export receipts and non-oil growth.

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Growth, inflation, and unemployment. Forecasts of economic activity in 2012 have been revised down compared with previous projections, due to both policy uncertainty and a weaker global economy. The Maghreb countries are most exposed to the euro zone recession, while Jordan and Lebanon are affected by spillovers from the conflict in Syria. In addition, higher international fuel prices and lower minerals prices will be a drag on growth. Inflation pressures are projected to pick up in Egypt, Jordan, Morocco, and Tunisia, as reductions in subsidies cause consumer prices to rise. Unemployment is also likely to rise further in many countries. For oil exporters, the growth outlook is broadly positive and, non-oil GDP, which is more employment intensive, will be a growth driver.

- *Fiscal balances*. Although fiscal consolidation is planned in some countries, fiscal deficits in 2012 are set to increase in others, and overall fiscal financing needs are projected to remain elevated because of weak economic activity, higher international fuel prices, and the impact of earlier measures to increase subsidies and wages, in response to social pressures. In some countries there are plans to embark on subsidy reform that will begin to rationalize subsidy outlays and support fiscal consolidation. Projections of fiscal financing needs in MENA oil importers amount to about $50 billion (see text table). In light of the difficult access to international capital markets, MENA governments are relying more on credit from domestic banks and risk crowding out the already weakened private sector. For oil exporters, moderating spending and higher oil prices will reduce most fiscal deficits, but fiscal sustainability concerns remain. Libya also has financing needs in 2012, but can meet them by drawing down its external assets.

Financing Needs, Middle Income MENA Oil Importers 1/
(in billions of U.S. dollars)

	Est.	Projections		
	2011	2012	2013	2012-13
Current account deficit (excl. official transfers)	27.4	27.6	25.0	52.6
External amortization	20.3	19.6	20.3	39.9
External gross financing needs 2/	47.8	47.2	45.4	92.6
Budget deficit (excl. grants)	36.7	36.9	35.6	72.5
Public external amortization	13.5	15.1	15.5	30.6
Fiscal financing needs 3/	50.1	52.0	51.1	103.1
Public short-term domestic debt 4/	87.5	103.6	102.8	

Sources: National authorities, and IMF staff estimates and projections.

1/ Comprises Egypt, Jordan, Lebanon, Morocco, and Tunisia. No data available for Syria.
2/ Current account deficit, excluding official grants, plus amortization.
3/ Budget deficit, excluding official grants, plus public external amortization. Assumes full domestic rollover.
4/ Remaining maturity basis.

- *External positions*. Tourism (an important source of jobs and foreign exchange receipts) and investment are likely to recover only slowly in 2012. Rising energy prices are expected to increase import bills, especially in the most oil-import-dependent countries, which include Jordan and Morocco. External financing needs in 2012 are currently projected to amount to $48 billion.

Downside risks predominate. Risks (domestic and external) remain tilted to the downside for oil importing countries. Regional spillovers from prolonged conflict in Syria would adversely affect countries in the region. Other external risks have increased recently, reflecting the recession in Europe, lower global growth, and rising fuel prices. Problems in the political transitions of some countries and/or prolonged conflicts in others, as well as

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further delays in defining a comprehensive medium-term macroeconomic policy framework could adversely affect investor sentiment. However, early conflict resolution in Syria along with timely political transitions in Egypt and Libya would create positive spillovers in the region, especially for neighboring countries.

Short-term policy issues. Resolute action is needed to maintain macroeconomic stability. Policy uncertainty is weighing on investment in most countries, in addition to higher global risk aversion. Governments will continue to face social pressures and maintaining investor confidence will be facilitated by a smooth and reasonably quick political transition and measures to assure and maintain macroeconomic stability, e.g., reining in expenditure through better targeting of subsidies while enhancing the effectiveness of social safety nets to protect the poor and vulnerable. Continued regional spillovers, including from the conflict in Syria, may adversely affect investor confidence. Monetary management should contain inflationary second round effects from subsidy reform and maintaining external stability may require more flexible exchange rates in some cases to mitigate external vulnerability. Large recourse to domestic banking sectors risks crowding out private-sector lending. In addition to implementing measures to contain fiscal and external deficits, mobilizing external support is important to help finance the fiscal deficit, stabilize reserves, and restore investor confidence now that policy buffers have been reduced.

Medium-term challenges and key reforms. In a nutshell, MENA countries need to create jobs. Unemployment rates rank among the highest in the world, and populations will continue to grow over the coming decade. A piecemeal approach will not suffice to meet this challenge. Rather, countries need to develop and start implementing medium-term economic transformation agendas that can generate high and inclusive growth. These agendas need to go to the heart of the economic problems of the past that have also fed into the Arab Spring. First, reforms need to ensure equal access to economic opportunities, promote transparency, improve access to credit by strengthening financial market infrastructures, and, more generally, enhance the business environment by cutting red tape and streamlining rules and procedures. Second, reforms need to replace wasteful subsidy regimes that benefit mostly the wealthy by targeted social safety nets. The fiscal resources freed up by this should be used for investment in infrastructure, education, and health. Third, reforms need to tackle problems in the education system and labor market and strengthen skill formation to prepare graduates for successful careers in the private sector. Transformation and modernization is a multi-year project, with each country following the path and priorities that best suit its own needs and realities. But the level of ambition and the urgency of action are common themes that will run across the transition countries of the region.

Role of the international community. While the main responsibility for this economic transformation lies with the countries themselves, the international community has a responsibility to support them with all available means. Immediately, this means that the

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international community needs to provide the necessary financing to help governments and central banks manage the difficult months ahead. In parallel, the international community can assist in devising and implementing transformation and modernization agendas by in addition to financing, providing the shared experience of countries elsewhere who have dealt with similar problems. Enhanced market access will be a key dimension of a sustained support package, not least because of its incentive effect in fostering the development of a competitive and vibrant private sector. For its part, the IMF is engaged in financing discussions with a number of the transition economies and committed to adapting its policy advice, capacity building and analytical work to respond effectively to the evolving needs of the region.

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II. EGYPT

One year after the revolution, a broad recovery of the economy has yet to set in. Growth has been held back by prolonged insecurity, political uncertainty, and the global slowdown. International reserves have declined by more than 60 percent in the past year, the fiscal deficit has risen, and domestic t-bill rates have soared, increasing financial vulnerabilities. While Egypt's medium-term prospects remain positive, a clear policy framework is needed to address fiscal and external imbalances and remove structural impediments to growth.

Background. During the second half of the past decade, Egypt experienced a period of accelerated growth following reforms to stimulate investment. However, social outcomes were unsatisfactory as unemployment remained high—particularly among the young—double-digit inflation eroded household incomes, and privatization was perceived to have benefited only a few. Moreover, progress in fiscal consolidation was interrupted with the 2008 surge in commodity prices and subsequent global economic crisis, leaving public debt above 70 percent of GDP.

Recent developments. Economic and financial vulnerabilities have increased since the revolution in early 2011. The country has suffered a sharp reversal of capital flows, an abrupt decline in tourist arrivals, and an investment standstill, although exports have continued to grow. Real GDP growth remains anemic, and is projected to reach only 1.5 percent for FY2011/12 (July-June), while the unemployment rate has increased to 12.4 percent from about 9 percent a year earlier. Lower revenue collection and higher spending led to a widening budget deficit, now expected to reach just under 10 percent of GDP for FY2011/12, which has contributed to a 500bps increase in domestic t-bill rates to almost 16 percent. The balance of payments has worsened with portfolio capital outflows and the sharp drop in tourism revenues and FDI. As a result, international reserves (including the central bank's foreign currency deposits in domestic institutions) have declined to $15.1 billion at end-March (about 3 months of imports), from $43 billion at end-December 2010. The banking sector has remained relatively stable through this period, but liquidity conditions have tightened, private sector credit has contracted in real terms, and deposit growth has slowed. Discussions between IMF staff and the authorities are ongoing to facilitate a homegrown program that enjoys broad political support, contains measures to maintain macroeconomic stability, restore confidence, and protect the vulnerable population, and is fully financed by IFIs and bilateral donors.

Short-term outlook. The outlook for FY2012/13 portends a slow recovery of economic activity and continued balance of payments pressures. Real GDP growth is expected to pick up only gradually, reaching 3¼ percent given a challenging external environment and the negative fiscal impulse from the needed consolidation in the FY2012/13 budget. Sectors most hit by the unrest (tourism, manufacturing, construction) are expected to contribute to the recovery. Despite the modest growth prospects, inflation is likely to increase, driven by higher global commodity prices. Unemployment is expected to remain elevated, with job

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Egypt: Selected Economic Indicators, 2009/10 – 12/13

		Est.	Proj.	
	2009/10	2010/11	2011/12	2012/13
GDP growth, percent	5.1	1.8	1.5	3.3
CPI inflation, percent	10.7	11.8	10.8	12.4
Fiscal balance, percent of GDP, excl. grants	-8.2	-10.1	-10.8	-8.1
Current account, percent of GDP, excl. grants	-2.4	-2.3	-3.1	-2.2
Fiscal financing needs, US$ billion, excl. grants 1/	18.5	24.7	24.9	23.7
External financing needs, US$ billion, excl. grants 2/	7.1	10.4	12.8	10.8
Public debt, percent of GDP	73.2	76.4	79.2	77.6
External debt, percent of GDP	15.5	14.8	14.6	17.1
Reserves to short-term debt, percent 3/	353.5	296.7	286.3	288.9
Reserves in months of imports of goods and services 3/	8.1	5.0	2.7	3.0

Sources: Egyptian authorities; and IMF staff estimates.

1/ Budget deficit, excluding official grants, plus public external amortization. Assumes full domestic rollover.
2/ Current account deficit, excluding official grants, plus amortization.
3/ Official reserves including central bank foreign currency deposits held at banks.

creation still weak and with a structurally large number of labor market entrants. However, the public debt-to-GDP ratio would decline somewhat, reflecting strong nominal GDP growth and a lower fiscal deficit. The forecast for FY2012/13 and beyond is contingent upon a smooth transfer of power to civilian rule now expected after presidential elections in May/June, which is critical to restore confidence.

Downside risks. While the weak global environment weighs negatively on Egypt's recovery prospects, the main risks to the outlook are domestic in nature. In particular, prolonged political uncertainty and/or a worsening of the security situation would dent confidence further. This would delay the recovery of the economy and could trigger dollarization and deposit outflows, increasing pressure on the pound and international reserves. Fiscal risks would also rise in such a scenario, as revenues would remain depressed and social spending needs increase, while banks would find it difficult to finance a continued large budget deficit and debt rollovers

Short-term policy issues. Against elevated crisis risks, the immediate challenge is to maintain macroeconomic stability while setting the stage for a gradual recovery. A priority will be to implement upfront measures to begin reducing the fiscal deficit and ensure a credible, sustainable medium-term fiscal trajectory. In addition, foreign financing would be critical to help bridge financing gaps. Allowing the pound to move more in line with market forces—while avoiding excessive short-term volatility—would help limit the international reserves drain and maintain external sustainability going forward.

Medium-term challenges. Sustaining rapid and more socially inclusive growth will require policies to leverage Egypt's large economic potential. This can be achieved by creating a more transparent and competitive business environment, especially for small enterprises, and providing more equal access to job and business opportunities for all sections of society, including through more investment in human capital and infrastructure, and improved access to financing. Maintaining a stable macroeconomic environment will be a necessary condition to achieve high growth that benefits the population at large. For this, fiscal consolidation to reduce government debt and create space for countercyclical policy will be central. This requires raising tax revenues, including through a transition to a modern value-added tax (VAT), and improving the quality of public spending by replacing the inefficient and inequitable system of generalized subsidies (costing more than 8 percent of GDP in FY2011/12) with a better-targeted social safety net.

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III. JORDAN

While economic activity remains subdued, unexpected additional fiscal and external pressures have arisen from high energy prices and instability in neighboring countries. Uncertainties related to regional economic and political developments will continue to pose significant challenges to Jordan in 2012-13.

Background. Following a period of robust growth during 2000–09 (averaging about 6½ percent), regional and domestic unrest, high imported food and fuel prices, and rising sovereign financing costs have adversely affected the economy. The Jordanian economy is among the most open in the Middle East, and remains highly dependent on commodity imports (oil and grains), tourism receipts, remittances, FDI flows, and external grants. While the authorities have implemented structural reforms to develop the private sector, Jordan has a chronic unemployment problem, with overall unemployment averaging around 13 percent during 2000–11. Unemployment is particularly high among the young and graduates (estimated at around 31 percent at end-2011).

Recent developments. Following a downturn in 2010, real GDP rose by about 2½ percent in 2011, mainly due to growth in mining, finance, and government services sectors. Inflation fell to 4½ percent in 2011, due in part to the absence (since January 2011) of pass through of international oil prices. Because of a larger import bill, declining remittances, sharply-lower tourism receipts, and lower FDI inflows, international reserves dropped to $10.7 billion (equivalent to 6⅔ months of imports) at end-December 2011.[1] Budgetary grants of $1.4 billion (about 5 percent of GDP) were provided by Saudi Arabia during 2011, which helped Jordan meet the high cost of food and fuel subsidies and rising social demands in 2011.

Short-term outlook. Modest economic growth, around 2¾ percent, is expected in 2012, led by the mining and financial sectors. Based on the latest developments and macroeconomic assumptions, the 2012 fiscal deficit (excluding grants) is expected to narrow by about 3 percent of GDP relative to the 2011 outturn. Nevertheless, the debt-to-GDP ratio is expected to rise to 65½ percent by end-2012, due to

Jordan: Selected Economic Indicators, 2010–13

		Est.	Proj.	
	2010	2011	2012	2013
GDP growth, percent	2.3	2.5	2.8	3.0
CPI inflation, percent	5.0	4.4	4.9	5.6
Fiscal balance, percent of GDP	-5.6	-6.0	-5.2	-4.9
Fiscal balance, percent of GDP, excl. grants	-7.7	-11.9	-9.1	-8.2
Current account, percent of GDP	-5.6	-9.5	-8.3	-6.8
Current account, percent of GDP, excl. grants	-10.1	-16.5	-13.4	-10.7
Fiscal financing needs, US$ billion, excl. grants 1/	2.6	3.8	3.6	3.2
External financing needs, US$ billion, excl. grants 2/	3.2	5.1	4.9	4.1
Public debt, percent of GDP 3/	61.1	64.6	65.2	65.2
External debt, percent of GDP	24.6	21.6	21.0	19.8
Short term debt, percent of international reserves	5.3	7.5	8.9	7.7

Sources: Jordanian authorities; and IMF staff estimates.
1/ Budget deficit, excluding official grants, plus public external amortization. Assumes full domestic rollover.
2/ Current account deficit, excluding official grants, plus amortization.
3/ Net debt.

[1] The value of energy imports increased in part due to higher oil prices, but also because of the need to substitute more expensive refined fuel products for natural gas. In effect, since the most recent sabotage of the Arab Gas Pipeline on the Sinai Peninsula on February 5, 2012—the thirteenth time since January 2011—there has been no flow of natural gas from Egypt to Jordan.

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increased borrowing on behalf of Jordan's National Electric Power Company. Despite regional uncertainties, the external current account deficit (excluding grants) is projected to narrow to about 13½ percent of GDP due to a moderation of energy imports and buoyant mining exports.

For the remainder of 2012, fiscal financing needs (excluding grants) are estimated to reach $3.6 billion (11½ percent of GDP), and external gross financing needs (again excluding official transfers) to reach $4.9 billion (15½ percent of GDP). For 2013, gross fiscal financing needs are estimated to decline to $3.2 billion (9½ percent of GDP), while external financing needs would decline to around $4.1 billion (12¼ percent of GDP).

Downside risks. An outturn of higher commodity-import prices (particularly oil imports) would generate lower economic growth and higher fiscal and external deficits. Regional political events with possible spillovers to Jordan—including unrest in neighboring countries—could adversely affect economic activity through lower tourism receipts and FDI, and more costly access to capital markets.

Short-term policy issues. For 2012, fiscal financing needs are expected to be met by borrowing from domestic banks; external financing needs can be met by drawing down foreign reserves (which are expected to decline to about 5⅔ months of imports at end-2012). For such a financing strategy to be sustainable over the medium term, additional external support or an enhanced pace of fiscal consolidation will be needed. Moreover, to the extent that Jordan continues to face external pressures (particularly continued disruptions to natural gas supplies from Egypt in 2012), then Jordan is likely to need external financing to limit the further drawdown of international reserves. Further tightening of the monetary stance is appropriate to sustain the attractiveness of Jordanian dinar-denominated assets and contain inflationary expectations.

Medium-term challenges. Key medium-term policy challenges are to reduce Jordan's vulnerabilities by reining in its large fiscal and current account deficits and dependence on external grants; and creating jobs and providing social protection by achieving faster and more inclusive growth. The latter will require: maintaining a stable macroeconomic environment; improving the business climate and governance; reducing generalized subsidies and building targeted transfers and social safety nets; enhanced trade openness; poverty reduction efforts; and modernizing labor market reforms to reduce unemployment while retaining reasonable labor protection.

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IV. LIBYA

After a dramatic decline in 2011, the Libyan economy is expected to rebound in 2012, underpinned by restoration of hydrocarbon production. Delays in normalizing the security situation pose risks to the outlook. In the near term, security must be established, hydrocarbon production restored to pre-2011 levels, fiscal discipline exercised, the banking system revived, and macroeconomic stability maintained. Medium-term efforts should focus on infrastructure renewal, private-sector development, job creation, improving education and health services, and putting in place an effective social safety net, within a framework of transparent and accountable governance.

Background. During 2004–10, average growth was approximately 5 percent, annual consumer price inflation averaged less than 4 percent, and foreign assets increased from $20 billion at end-2003 to $170 billion at end-2010. Although the non-hydrocarbon sectors grew rapidly, led by an ambitious public investment program, the country remained dependent on hydrocarbons, which accounted for over 70 percent of GDP, more than 95 percent of exports, and approximately 90 percent of government revenue. Development of the nascent private sector was constrained by the dominance of the state and by institutional weaknesses. As of end-2010, the authorities estimated unemployment at 26 percent.

Recent developments. The prolonged fighting had a far-reaching impact on standards of living, provision of basic services, and employment. The conflict caused a sharp contraction in economic activity in 2011 and consumer prices increased, primarily due to international sanctions and supply constraints. The current account surplus decreased due to the conflict-induced reduction in hydrocarbon output. Government revenue declined precipitously and expenditure was reduced in light of limited financing and due to constraints on implementing capital spending. The resulting budget deficit was financed by arrears and drawing down of government deposits at the Central Bank. During the conflict commercial banks suffered from a systemic liquidity shortage linked to the slow normalization of the foreign exchange market. The bulk of Libya's foreign assets were unfrozen on December 16, 2011, clearing the way for normalization of the foreign exchange market and commercial banking operations.

Short-term outlook. Real GDP is expected to rebound in 2012, underpinned by higher hydrocarbon output, while consumer price inflation will ease significantly. The current account surplus will increase and the fiscal

Libya: Selected Economic Indicators, 2010–13

		Est.	Proj.	
	2010	2011	2012	2013
GDP growth, percent 1/	2.9	-60.0	69.7	20.5
CPI Inflation, percent	2.5	14.1	1.9	-2.3
Fiscal balance, percent of GDP	5.0	…	…	…
Current account, percent of GDP	20.9	4.4	15.4	23.7
Fiscal financing needs, US$ billion, excl. grants 2/	—	16.0	1.5	—
External financing needs, US$ billion, excl. grants 3/	—	—	—	—
Public debt, percent of GDP	0.0	0.0	0.0	0.0
External debt, percent of GDP	6.9	15.1	7.0	5.8
Foreign assets, percent of GDP	213.4	477.7	225.1	207.0
Foreign assets, US$ billion	171.7	176.2	179.4	198.8

Source: Libyan authorities; and IMF staff estimates.

1/ GDP at factor cost.

2/ Budget deficit, excluding official grants, plus public external amortization. Assumes full domestic rollover.

3/ The absence of a financing need is indicated by "—".

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deficit will fall, with the deficit financed by a further drawdown in foreign assets. Current spending will increase from 24 percent of GDP in 2010 to 48 percent in 2012, while capital spending, constrained in the short-term by limited absorptive capacity, will decline from 27 percent of GDP in 2010 to 17 percent in 2012. In light of the recovery in hydrocarbon revenues, the budget deficit is expected to narrow significantly in 2012.

Downside risks. Risks to the outlook include delays in normalizing the security situation and lower international prices for oil and gas. Uncertainties in the security environment would constrain private-sector economic recovery and could impede the return of expatriate workers that are needed to alleviate workforce bottlenecks. Intensifying strains in the euro area and fragilities elsewhere have resulted in deteriorating financial conditions and escalated downside risks to global growth. Although hydrocarbon prices remain high, the economy remains vulnerable to a decline in oil prices.

Short-term policy issues. Libya must restore security, bring hydrocarbon production fully online, resuscitate the banking system, exercise fiscal discipline, resuscitate the banking system, and maintain macroeconomic stability. While the government needs to respond to short-term pressures to finance post-conflict economic recovery and social cohesion, increased current spending will weigh on fiscal sustainability and incentives for private sector development. Wage increases implemented by the previous regime will raise the wage bill from 9 percent of GDP in 2010 to 19 percent of GDP in 2012. Similarly, an increase in subsidies will raise their cost from 12 percent of GDP in 2010 to 15 percent in 2012. Although Libya can afford elevated current spending in the short term, the level of recurrent expenditure, if continued, is likely to be inconsistent with appropriate budgetary prioritization and fiscal sustainability and would exert upward pressure on the real exchange rate. It will also be important for the Central Bank, as banking supervisor, to verify that the commercial banks have as clear a picture as possible of the impact of the recent conflict on their balance sheets, and to ensure that they have sufficient capital to cover losses and to continue lending during the reconstruction period.

Medium-term challenges. There is a need for a new vision for the Libyan economy. The main challenges are to promote inclusive growth by advancing private sector led economic diversification, generating productive employment, enhancing competitiveness, improving governance, and strengthening social protection. On the macro-policy front, there is a need to enhance the public financial management (PFM) framework with a consistent fiscal rule that reflects economic objectives and volatility in hydrocarbon-based revenues. The sovereign wealth fund should be fully integrated into this framework. As a part of the PFM reform agenda, there is a need to enhance fiscal policy formulation over the medium term and help make the budget a strategic policy tool linking national policy objectives to economic performance.

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V. Morocco

The short-term economic outlook remains positive, supported by strong non-agricultural growth. While sufficient fiscal space in 2011 has allowed for spending in support of the political reform process and address social demands, beginning in 2012, Morocco intends to start addressing the fiscal impact of high international oil prices to help maintain long-term macroeconomic sustainability. The government is committed to improve the targeting of subsidies and to bring the deficit back to about 3 percent of GDP over the medium term. The authorities are deepening structural reforms to boost potential growth and competitiveness, enhance inclusiveness and reduce unemployment.

Background. The political transition appears to be proceeding smoothly. Recent domestic social and political tensions were largely diffused by the adoption of a new constitution which yields more independence to the Head of the Government and to the judiciary. The Justice and Development Party (JPD), a moderate Islamist party, won the largest number of seats in the November parliamentary elections. The head of the JPD formed a new coalition government in January.

Recent developments. GDP growth accelerated in 2011 (4.9 percent compared to 3.7 percent in 2010), owing to good agricultural production and the strong performance of the nonagricultural sector. In response to social demands, the Moroccan government has increased spending on subsidies, wages and pensions. Inflation remains below 1 percent and unemployment has declined to about 9 percent, but youth unemployment remains high at about 17 percent. Export growth remains robust, and tourism receipts and remittances have shown resilience to the slowdown in Europe, while import growth has accelerated, mainly on account of higher energy prices. Bank credit to the economy expanded by 10.3 percent in 2011.

Short-term outlook. While poor rainfall is expected to result in a decline in agricultural GDP, non-agricultural GDP growth is expected to remain strong at 4.7 percent, despite a deterioration of the economic situation in Europe. Unemployment is projected to remain broadly stable (about 9 percent) and average inflation is expected to be about 2.2 percent in 2012.

Morocco. Selected Economic Indicators, 2010–13 1/

		Est.	Proj.	
	2010	2011	2012	2013
GDP growth, percent	3.7	4.9	2.9	5.1
CPI inflation, percent 2/	1.0	0.9	2.2	2.5
Fiscal balance, percent of GDP	-4.4	-6.8	-5.4	-5.1
Current account, percent of GDP	-4.2	-7.9	-6.1	-5.8
Fiscal financing needs, US$ billion, excl. grants 3/	13.4	14.3	14.6	15.6
External financing needs, US$ billion, excl. grants 4/	5.2	9.4	7.8	7.9
Public debt, percent of GDP	51.3	54.5	56.1	57.2
External debt, percent of GDP 5/	24.7	24.6	25.3	24.9
Short term debt, percent of international reserves	0.02	0.02	0.02	0.02

Source: Moroccan authorities; and IMF staff estimates.

1/ Data for 2011 and projection period have been revised since the April 2012 WEO.

2/ Period average.

3/ Budget deficit, excluding official grants, plus public external amortization. Assumes full domestic rollover.

4/ Current account deficit, excluding official grants, plus amortization.

5/ Includes external publicly guaranteed debt.

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Due to social demands and a sharp increase in government expenditures (subsidies and public wages), the fiscal deficit is estimated to have widened to about 6.9 percent of GDP in 2011. The draft 2012 budget (currently being discussed by the Parliament) envisages reducing the budget deficit by 1½ percent of GDP in 2012. Despite optimistic assumptions on overall real GDP growth in the first draft of the budget law, staff does not expect any substantial change in the deficit target as the downward revisions of real GDP growth projections are driven by the agricultural sector, which has little impact on the fiscal accounts. The authorities plan to further reduce the deficit to 3 percent of GDP over the medium term, through a moderation of the wage bill, restraints in non-wage recurrent outlays, and lower subsidy spending through a better targeted social protection system.

The current account deficit is expected to remain large as a result of high oil prices and sluggish import demand from Europe. Despite an expected robust export growth in phosphates and derivatives, and notwithstanding continued growth in tourism and remittances, the current account deficit is projected to remain at about 6 percent of GDP in 2012. The financial account is, however, projected to improve in 2012, as a result of ongoing large foreign direct investment, reflecting Morocco's favorable FDI environment. External financing gross requirements are projected to decline in 2012. Gross international reserves are projected to decline slightly, but remain comfortable at about 4.8 months of prospective imports.

Downside risks. Risks to the outlook are mostly skewed to the downside as unfavorable weather conditions could result in a larger decline in agricultural production and spillovers from sluggish growth in Europe could further deteriorate non-agricultural GDP growth. In the absence of corrective measures, higher oil prices could potentially result in much higher subsidy outlays than currently budgeted, and a worsening of the current account deficit.

Short-term policy issues. Following the fiscal expansion in 2011, a firm consolidation plan is required to ensure fiscal sustainability. In line with Article 77 of the new constitution and the draft organic budget law–which lays down the principle of safeguarding fiscal stability–and the budgeted deficit reduction in 2012, authorities intend to bring the deficit back to about 3 percent of GDP over the medium term. This would be consistent with a debt-to-GDP ratio converging to about 50 percent of GDP in the medium term.

Medium-term challenges. The favorable economic performance recorded over the past decade can be largely attributed to a sound fiscal stance, reforms in key economic sectors (e.g., the financial sector and public enterprises) and efforts to improve the business climate. Nonetheless, accelerating structural reforms is needed for inclusive growth and improved social indicators. The authorities have established a committee to enhance the business environment to improve productivity and increase job creation. In addition, fiscal policies need to be reoriented to provide space for higher health and education spending. Moreover, strengthening the ongoing active labor market programs and reduce hiring costs are critical to reducing labor-mismatches and youth unemployment.

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VI. TUNISIA

Following a recession in 2011, the 2012 economic outlook remains difficult owing to deterioration of the external environment, investor caution due to social tensions, and the slow and uncertain recovery in Libya. Financing permitting, a well-targeted countercyclical fiscal expansion will support short-term growth and job creation. Moreover, a broad set of reforms and prudent macroeconomic policies will be needed to boost private investment and put Tunisia on a higher growth path over the medium term. Addressing pressing issues in the banking sector is an important priority.

Background. The democratic political transition is moving forward but social tensions remain. Following successful democratic elections on October 23, 2011, a Constituent Assembly is preparing laws that will define the post-revolution regime. Legislative and presidential elections are scheduled for the first half of 2013. Social demands, high unemployment and regional inequalities may continue to feed social tensions, resulting in strikes and sit-ins that have hampered economic activity.

Recent developments. Economic activity in 2011 was severely affected by domestic events and the conflict in Libya. Real GDP is estimated to have contracted by 2.2 percent, as the fiscal expansion only partly mitigated lower investment and tourism. With lower output and returning Tunisian workers from Libya, unemployment increased to 19 percent in 2011, with youth unemployment at 42 percent. The overall fiscal deficit widened to 3.6 percent of GDP, reflecting higher spending of 4 percent of GDP partly offset by resilient tax revenues and exceptional non-tax revenues. Declines in tourism receipts and FDI contributed to a widening of the current account deficit and a 20 percent fall in external reserves to US$7.5 billion (equivalent to 3.8 months of imports). Inflationary pressures started building up at end-2011, with inflation reaching 5.7 percent (y-o-y) in February 2012. Poor governance, regulatory forbearance, and insufficient supervision under the previous regime undermined banks' soundness. Banks' portfolio deteriorated further in 2011 due to the economic downturn and banks' liquidity became very tight. The Central Bank of Tunisia supported banks' liquidity via lower reserve requirements and more refinancing of banks; it reduced its reference interest rate and allowed banks to reschedule loan payments falling due in 2011.

Short-term outlook. The 2012 economic outlook remains difficult, with a weak external environment, particularly in Europe, the uncertain pace of recovery in Libya and a wait-and-see attitude of domestic and foreign investors because of social tensions. Real growth could nevertheless reach about 2 percent, with a gradual rebound in tourism and FDI inflows, as well as the sizable fiscal stimulus envisaged in the 2012 revised budget. A strong pick-up in capital expenditure to support economic growth and job-creation, particularly in disadvantaged regions, is envisaged as well as an increase in the wage bill. Even so, unemployment would remain high, with new jobs only partially absorbing new labor market

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entrants. Credit to the economy will likely decelerate as banks strive to improve their liquidity position. Tunisia faces substantial short-term financing needs. With the fiscal deficit projected at about 6½ percent of GDP, fiscal financing needs would be about $3.6 billion, which are not yet fully secured. Similarly, with a large current account deficit, external financing of $5.2 billion will be needed to avoid a further decline in external reserves. Public debt would remain at a sustainable level of about 44 percent of GDP in 2012.

Tunisia: Selected Economic Indicators, 2010–13

		Est.	Proj.	
	2010	2011	2012	2013
GDP growth, percent 1/	3.0	-2.2	2.2	3.5
CPI inflation, percent	4.4	3.5	5.0	4.0
Fiscal balance, percent of GDP, excl. grants 2/	-1.3	-3.6	-6.6	-5.1
Current account, percent of GDP, excl. grants	-4.8	-7.3	-7.0	-7.0
Fiscal financing needs, US$ billion, excl. grants 3/	1.6	2.8	3.6	3.5
External financing needs, US$ billion, excl. grants 4/	4.1	5.7	5.2	5.3
Public debt, percent of GDP	40.4	42.5	43.8	49.2
External debt, percent of GDP	48.8	51.1	53.1	55.3
Short term debt, percent of international reserves	53.6	68.4	68.9	69.6

Source: Tunisian authorities; and IMF staff estimates.

1/ Real growth for 2011 was revised after the cut-off date for the April 2012 WEO.

2/ Overall fiscal deficit of the central government, excluding grants and privatization.

3/ Budget deficit, excluding official grants, plus public external amortization. Assumes full domestic rollover.

4/ Current account deficit, excluding official grants, plus amortization.

Risks are still tilted to the downside. A worsening of the recession in Europe would hurt sharply Tunisia's short-term growth prospects, depressing exports, and limiting the rebound in tourism and FDI inflows. An escalation of domestic social tensions could impede foreign and domestic investment. Capacity and financing constraints could significantly curb the impact of the fiscal stimulus. On the upside, a rapid stabilization of the domestic social situation and in Libya could bolster investors' confidence.

Short-term policy issues. Macroeconomic management will face difficult challenges this year. A well-targeted countercyclical fiscal expansion will be key to support economic growth and job creation in the short-term, if external financing is mobilized. Monetary policy should address inflationary pressures while unwinding the CBT's liquidity support to banks gradually to avoid an abrupt deceleration in credit to the economy. A gradual monetary tightening and a more flexible exchange rate would help to stabilize official foreign reserves. In the banking sector, selective restructuring of the loans rescheduled in 2011 and possibly additional measures will be necessary to limit the rise in non-performing loans. Public debt would increase to 49 percent of GDP in 2013, mostly reflecting the anticipated recapitalization of public banks.

Medium-term challenges. The key medium-term challenge is to address high structural unemployment, especially among the youth. Tunisia has to formulate a more concrete medium-term strategy to foster private investment and more dynamic job creation through higher and more inclusive growth. Real GDP growth could reach about 7 percent by 2017 if a broad set of structural reforms is implemented together with appropriate macroeconomic policies, including preserving fiscal sustainability. Needed structural reforms include improving governance and the business environment, reforming the labor market and the education system, and a comprehensive financial sector reform–including restructuring and recapitalization and improving banks' governance.

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