



**Deauville Partnership Ministerial Meeting
April 19, 2013
Washington DC**

**Arab Countries in Transition:
Economic Outlook and Key Challenges**

Prepared by Staff of the International Monetary Fund

INTERNATIONAL MONETARY FUND



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I. REGIONAL ECONOMIC OUTLOOK AND KEY CHALLENGES	3
II. EGYPT	9
III. JORDAN	12
IV. LIBYA	15
V. MOROCCO	18
VI. TUNISIA	20
VII. YEMEN	23
BOXES	
1. Tackling Subsidies While Protecting the Poor	7
2. The Middle East and North Africa (MENA) Transition Fund (TF)	8

I. REGIONAL ECONOMIC OUTLOOK AND KEY CHALLENGES

Arab Countries in Transition (ACTs) continue to face high political uncertainty and social pressures.¹ The uprisings and protests have generated the promise of a better life for 300 million people, but forthcoming elections and constitutional reform, as well as populations anxious for jobs and higher incomes, complicate policymaking for many governments. At the same time, fiscal and reserves buffers have diminished sharply, underscoring the urgent need to maintain macroeconomic stability in an environment of sluggish global growth, high commodity prices, and still impaired domestic confidence. Resolute policy action and support from the international community are required; particularly as last year's subdued growth in the ACTs (except Libya) is expected to improve only slightly in 2013 and is overshadowed by persistent external and regional risks. It will be equally important for policymakers to move quickly on designing and implementing effective structural reforms to build dynamic and inclusive economies that generate (many) more jobs than are available today. Promoting private-sector growth and international trade, as well as attracting foreign direct investment inflows, will be key components of success. Financial assistance and technical expertise from external partners, including Transition Fund projects, can make a big difference in this endeavor.

Background and recent developments. Most ACTs are still undergoing difficult political transitions. In many cases, political uncertainty is high as countries prepare for elections and work toward constitutional reforms. There is much social unrest that reflects these political uncertainties and populations' impatience for a transition dividend in the form of jobs, better incomes and social conditions, and equal access to economic opportunity. In fact, however, unemployment has continued to increase over the past two years from already elevated levels, particularly among women and youth. These problems are considerably aggravated by the tragic conflict in Syria, which has deteriorated into a major humanitarian crisis with growing economic and social spillovers to neighboring countries.

A weak global economic environment has added to the difficulties the ACTs are facing and has intensified pressure on international reserves. Recession in the euro area, sluggish economic activity in other trading partners, and elevated commodity prices have taken a toll on the region's current account balances. Exports have declined owing to soft external demand, while imports remained high in line with international food and fuel prices. Tourist arrivals have started to rebound but are still below 2010 levels; and remittances and Foreign Direct Investment (FDI) remain tepid. Last year's current account balances were further strained by a drought in Morocco (now over) and low gas supplies in Jordan. These dynamics, together with limited exchange rate flexibility, have been eroding reserves.

¹ The ACTs are Egypt, Jordan, Libya, Morocco, Tunisia, and Yemen.

Fiscal deficits and public debt have been increasing, even as capital investments have stagnated. Faced with high social pressures and a challenging external environment, policymakers substantially raised public wages, employment, and subsidies over the past two years. Meanwhile, weak economic activity weighed on tax revenues. As a consequence, large fiscal deficits have raised public debt and, in some cases, strained the capacity of banks to lend to the private sector.

Recent subsidy reforms are making inroads in reducing fiscal and reserves pressures. Substantial fuel price hikes in Jordan and Yemen have considerably reduced budgeted subsidy outlays. Egypt, Morocco, and Tunisia are also taking steps towards lower subsidies but, with only gradual tariff increases, their budgetary savings have been small, and further steps will be needed to better address the issue (Box 1). In most of the region, the impact of energy tariff increases on the poorest households has so far been mitigated through cash transfers and targeted price subsidies. The development of better means-testing systems has just started and will, over time, bring further improvement in the targeting of social spending.

Outlook. 2013 will be another difficult year for the ACTs. The expected moderate economic recovery—an average 2.9 percent excluding Libya—will not be enough to generate the jobs needed to tackle the region’s substantial unemployment, especially among women and youth. Despite the positive impact of the recovery on government revenues, fiscal deficits will only decline in countries that are acting early in the year to increase revenues and contain wage and subsidy expenditures. Continued high commodities prices will allow for only a gradual increase in reserves.

Risks. Persistent global, regional, and domestic risks could undermine this outlook:

- Lower global growth, particularly in Europe, or reintensification of global financial risk aversion, could thwart external inflows and growth.
- Higher global food and fuel prices could weaken oil importers’ already large fiscal and external deficits.
- The conflict in Syria already weighs heavily on neighboring countries. A regional escalation could result in a further decline in confidence and lower growth for the region, particularly in the Mashreq.
- Further setbacks in political transitions would add to uncertainty and further delay needed fiscal adjustment and recovery of economic confidence, hold back private investment and reduce output, and translate into greater pressure on already eroded international reserves.

On the positive side, external inflows and growth would benefit from a more benign global outlook, particularly if the recovery picks up momentum in Europe. Successful political transitions could boost investor confidence and accelerate implementation of reforms.

Short-term policy challenges and recommendations. Policymakers are pressed to satisfy peoples' high expectations for improved employment and socioeconomic conditions. But with low fiscal buffers and eroded reserves, governments will have to pay attention to large public-sector wage bills and reduce expensive subsidies while finding more efficient ways to protect the poor. In most countries, considerable fiscal consolidation and greater exchange rate flexibility along with structural reforms to raise productivity, are needed to maintain macroeconomic stability, improve competitiveness, and instill confidence. These would also help mobilize the external financing required to smooth the burden of adjustment, with external financing needs estimated at more than \$40 billion in 2013.

Governments should take steps to reorient the composition of expenditures and raise revenues in a way that is fair and encourages private-sector activity. The success of these policies will largely depend on policymakers building broad ownership through better communication of the benefits of reforms to the public and emphasizing protection of the most vulnerable.

Medium-term challenges and key economic reforms. Transitioning to dynamic and inclusive economies that create (many) more jobs requires that countries move quickly on designing and implementing effective structural reforms. Promoting private-sector growth and international trade, as well as attracting more foreign direct investment (FDI) inflows, will be key components of success. To guide this project and provide hope for their populations, governments should develop medium-term visions for their economies in a participatory approach that facilitates broad buy-in. These visions, which would establish the desired state of the economy 3–5 years out, would provide a guidepost for reforms across a multitude of areas that are common across the ACTs; but each will begin at a different starting point and implementation will vary across countries.

- Build capacity and enhance communications capabilities across the public sector as a basis for successful reform efforts, and strengthen inter-agency coordination to ensure focused implementation of priority measures.
- Deepen trade integration with the advanced economies, fast-growing emerging markets, and among countries within the region; and improve the ACTs' FDI environments. The World Bank's recent report on trade and FDI for the Deauville Partnership indicates potential avenues for reform in this area.²
- Improve the business climate. This is a multifaceted undertaking, but includes initiatives to remove impediments to entry and exit; streamline business regulations; promote rules-based and accountable institutions; and improve transparency, including provision of good statistical data and other relevant information.

² Jean-Pierre Chauffour, 2013, *From Political to Economic Awakening in the Arab World. The Path of Economic Integration*. Washington D.C.: World Bank,

- Encourage private firms to hire by reforming labor market regulations while maintaining adequate worker protection; and aligning the education system with employer needs.
- Expand access to finance, in particular for small- and medium-sized enterprises, through alternatives to bank financing including microfinance; improved financial infrastructure; and greater financial sector competition.
- Improve social safety nets, including, where feasible, the use of means-tested cash transfers.

Role of the international community. The ACTs are responsible for driving their own economic transition, but the international community can support positive change by providing better trade access for the region's products and services, financing, and policy advice. Providing better trade access and encouraging FDI inflows are the areas with the biggest potential for a positive impact on the ACTs' economic development and should be a priority for all of the region's trading partners.

While acknowledging the substantial financial contributions that have been provided so far from the international community and especially from within the region, external partners should provide more coordinated and medium-term funding commitments to support the countries'

transition once a path has been agreed. In this context, the use of credit guarantees could be a promising means to overcome fiscal constraints in the European Union and the United States. Technical expertise will be especially important in supporting countries' pursuit of medium-term reform agendas while maintaining macroeconomic stability. Here, the Transition Fund can play a useful role (Box 2). For its part, the IMF has already committed more than \$8 billion in financing arrangements with Jordan, Morocco, and Yemen, and is in discussions on possible arrangements with Egypt and Tunisia, and on a second program with Yemen. More generally, the IMF has been closely engaged with all ACTs, providing analysis, policy advice, and capacity building support.

Arab Countries in Transition: Financing Needs¹
(Billions of U.S. dollars)

	Est.		Projections	
	2011	2012	2013	2014
Current account deficit (excl. official transfers)	26.3	31.5	26.5	17.6
External amortization	14.4	13.8	14.1	20.2
External gross financing needs²	40.7	45.4	40.6	37.8
Budget deficit (excl. grants)	37.3	46.7	48.8	39.7
Public external amortization	4.8	5.5	5.8	8.0
Fiscal financing needs³	42.1	52.2	54.6	47.6

Sources: National authorities; and IMF staff calculations.

¹Comprises: Egypt, Jordan, Morocco, Tunisia, and Yemen. Libya does not face financing needs.

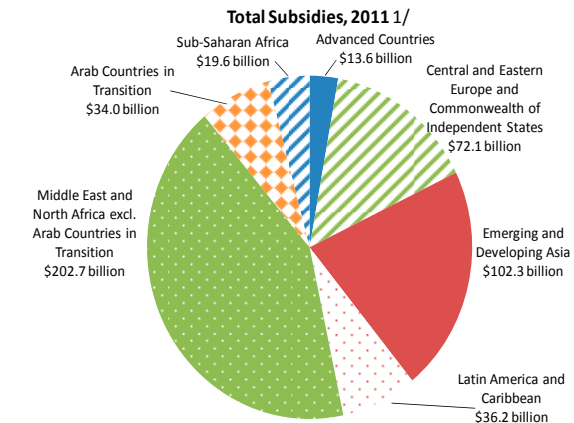
²Current account deficit, excluding grants, plus amortization.

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

Box 1. Tackling subsidies while protecting the poor

Energy subsidies are prevalent across the ACTs, accounting for 7 percent of the \$480 billion global bill spent on energy subsidies. While these subsidies provide some support to poor consumers, their benefits go mainly to the better-off, and they weigh on government budgets at the expense of growth-enhancing expenditures. Thus, subsidy reform can have big payoffs in higher growth and greater equity.

However, energy subsidy reforms are technically and politically complex, especially because consumers have grown accustomed to them. To succeed, subsidy reforms need to be planned carefully. Country experiences suggest the following six key ingredients for success:



Sources: IMF staff estimates, Organisation for Economic Cooperation and Development, International Energy Agency, Deutsche Gesellschaft für Internationale Zusammenarbeit, IMF World Economic Outlook, and World Bank.
1/Includes petroleum, electricity, natural gas, and coal subsidies before tax.

A comprehensive energy sector reform plan. The plan should include clear long-term objectives, an assessment of the impact, and consultation with those affected by it.

A good communications strategy. A strong communications campaign helps generate broad understanding and support for change, and should be undertaken throughout the reform process, emphasizing not just the cost of subsidies but also the benefits of reform.

Phased price increases. Phasing-in price increases and sequencing them differently across energy products can be helpful. Too sharp an increase in energy prices can generate intense opposition. A phased strategy will allow people and businesses to adjust and governments to strengthen social safety nets.

Improved efficiency of state-owned enterprises to reduce producer subsidies. State-owned companies—especially power generation companies—often receive substantial budgetary resources to compensate for inefficiencies in production, distribution, and revenue collection. Improving their operational efficiency can strengthen the financial position of these enterprises and reduce the need for subsidies.

Measures to compensate the poor. It is crucial that those who are hardest hit by the removal of subsidies be compensated from the beginning—for example through targeted cash transfers or coupon schemes.

Depoliticized price setting. Durable reforms require a depoliticized mechanism for setting energy prices and allow the transmission of changes in world prices to domestic prices. Automatic pricing mechanisms can reduce the chances of reform reversal, while price smoothing rules can help avoid large price changes.

Box 2. The Middle East and North Africa (MENA) Transition Fund (TF)

The MENA TF was established in 2012 by the Deauville Partnership as a joint venture among the G-8 countries, Gulf partner countries and Turkey, and international and regional financial organizations. Its objective is to support the ACTs in formulating policies and programs and implementing reforms that aim to bring about sustainable, inclusive growth over the medium term, while strengthening transparency and accountability in governance.

The TF's Steering Committee has so far approved 13 projects for all ACTs, except Libya. They cover such areas as support to micro, small, and medium enterprises (Egypt, Morocco), access to water (Jordan), targeted social assistance (Jordan), public-private partnerships (Tunisia), civil society dialogue (Yemen), and leadership development and governance (Morocco, Tunisia, Yemen).

Building on its early momentum, the TF could evolve over time into a key vehicle to support the ACTs' capacity-building efforts in the areas of structural reforms identified in the main text. It is particularly suited for this role: it was designed to be rapid, flexible, and responsive in providing grant support for technical cooperation; and it facilitates coordination and prioritization of work programs across donors and the ACTs governments. Perhaps most importantly, the TF can stay involved long enough to help with the implementation of reforms, not only with their design.

Future TF projects should focus in particular on the following priorities in response to the countries' key development needs:

- ***Building strong institutions to help establish improved accountability and governance.*** Specific efforts are expected to focus on reforms in the areas of public financial management (budgeting, budget execution and cash management, and reporting), public procurement (transparency in awards, increased competition, improved public service delivery and better public funds management), and financial sector strengthening (banking supervision and financial sector stability and capital market development). Strengthening the quality of statistics could become another key component of this work program.
- ***Promoting trade integration.*** Specific efforts could focus on measures that have the potential to show immediate effects, to bridge the time until the ACTs will reach or upgrade free trade agreements with their major trading partners.
- ***Helping policies become more equitable and inclusive.*** Specific efforts could concentrate on reducing untargeted subsidies to create room for targeted social safety nets and on putting in place a more efficient and fairer tax system to ease distortions, improve revenue administration, and thereby increase long-term growth prospects.
- ***Lowering the cost of doing business.*** This agenda would require focus, inter alia, on removing impediments to entry and exit and streamlining business regulations.

The impact of the TF on the ACTs' reform efforts will depend on the quality of its project pipeline, but also on its capacity to meet currently strong project demand with its financial resources. At present, the contributed \$50 million (out of a total envisaged volume of \$250 million) has already been committed within three months. There is clearly strong demand from the ACTs, which represents ample opportunity for donors to engage. Every effort should be made that the projects financed by the TF are demand- rather than supply-driven.

II. EGYPT

Egypt's economic outlook remains challenging. Heightened political uncertainty and delays in the implementation of corrective policies have held back the onset of a sustained recovery. Moreover, financial vulnerabilities have risen with a further decline in international reserves and an increase in the fiscal deficit. The economy's medium-term potential remains intact but consensus on the implementation of a comprehensive economic program is needed to address the fiscal and balance of payments deficits, including through subsidy reforms, and build the foundations for higher and more socially balanced growth. Discussions on possible financial support from the IMF are ongoing.

Background. More than two years after the revolution, the political transition remains a work in progress. While a new constitution was adopted in late December, the process was quite controversial and, as a result, the political climate is still highly polarized. Elections for the lower house of parliament, originally scheduled for late April, have been postponed by court order and are now likely to take place sometime in the second half of 2013.

Recent developments. Prolonged political and policy uncertainty, social unrest, and security problems have taken a toll on confidence. As a result, real GDP growth has remained sluggish, while the unemployment rate has increased further to 13 percent from about 9 percent before the revolution. Delays in implementing a comprehensive fiscal reform plan are weighing on the budget deficit, which is projected to register a further increase in FY2012/13. Reliance on the domestic banking system to finance the deficit remains high and is keeping domestic t-bill rates at elevated levels. In late December, following heightened pressure on the pound, the central bank implemented an auction system to provide foreign exchange to the market. These auctions, along with exceptional financing from the international community, have helped limit the drain on reserves, which stood at about 2½ months of imports in March. However, operational restrictions have limited price discovery in the auctions and have led to rationing of foreign exchange and the emergence of a parallel market, notwithstanding a depreciation against the dollar of about 12 percent so far. In early 2013, the authorities increased fuel prices for the industrial sector and electricity tariffs as part of a first phase of planned energy subsidy reforms. While welcome from a fiscal standpoint, these price increases—combined with the impact of fuel shortages, the weakening of the currency, and base effect—contributed to an acceleration of inflation from 4.7 percent in

Egypt: Selected Economic Indicators, 2010/11 - 2013/14¹
(Percent of GDP, unless otherwise indicated)

	Projections			
	2010/11	2011/12	2012/13	2013/14
GDP growth, percent	1.8	2.2	2.0	3.3
CPI inflation, period average, percent	11.1	8.6	8.2	13.7
General government balance, excl. grants	-10.0	-11.4	-11.6	-8.8
Current account balance, excl. grants	-2.9	-3.3	-2.4	-1.9
Fiscal financing needs, (excl. grants), US\$ billion	23.5	29.4	30.1	24.5
External financing needs (excl. grants), US\$ billion	11.9	13.4	11.7	10.4
Public debt	76.6	80.2	85.2	82.6
External debt	14.8	13.4	15.9	18.4
Reserves to short-term debt, percent	297.0	542.4	307.2	287.8
Reserves in months of imports	4.7	2.7	2.7	3.5

Sources: National authorities; and IMF staff calculations.

¹Data are consistent with the April 2013 WEO. Some figures may differ from those currently.

December 2012 to 8.2 percent in February 2013. In response, the central bank increased policy rates by 50 basis points in March.

Short-term outlook. The unsettled political situation will continue to weigh on the pace of economic recovery and the already significant fiscal and external imbalances are at risk of deteriorating further. The authorities have prepared a revised economic program that seeks to preserve macroeconomic stability, restore confidence, and protect the vulnerable population, but have not yet succeeded in achieving buy-in on the main objectives of this program from the broader population. As part of this program, tax reforms with a yield of about $\frac{3}{4}$ percent of GDP (annualized) have been submitted to the Shura council for approval. The authorities have requested financial assistance from the IMF and other partners to support program implementation. Discussions on such support are ongoing. Real GDP growth in FY 2012/13 is expected to remain subdued at about 2 percent. Growth could begin to recover in FY 2013/14 provided the political situation stabilizes and the authorities implement corrective policies that succeed in restoring confidence and investment. Inflation is likely to increase in the short term, due to persistent supply-side bottlenecks, exchange rate pass-through, and gradual phasing out of energy subsidies.

Risks. Risks to the outlook are mainly domestic. Prolonged political uncertainty and social unrest, a worsening of the security situation, and delays in putting in place corrective policies (including structural reforms in the areas of taxes and subsidies) would further dampen confidence and could lead to increased pressure on the pound and international reserves. Fiscal risks would also rise in such a scenario. On the other hand, the emergence of a broad domestic consensus on the remaining steps in the political transition and steadfast reform implementation would boost confidence and could trigger an upside surprise.

Short-term policy issues. The most immediate challenges are to put policies in place to contain the large fiscal and balance of payments deficits, support rapid economic recovery and job creation, and protect the most vulnerable segments of the population. Moreover, it will be important for the government and the credibility of the reform efforts to explain this agenda to the public and build broad support. On the fiscal front, bringing the budget balance back on a sustainable path requires better control of public expenditures, including by rationalizing the costly and ill-targeted energy subsidies (which exceeded 6 percent of GDP in FY 2011/12), and increasing tax revenues with fairness. At the same time, improving the quality of spending—by putting in place a targeted social safety net and shifting budgetary resources to infrastructure investment, education, and health—should improve growth prospects and social outcomes. Removing the restrictions to price discovery in the foreign exchange market will help the currency move in line with market forces and eliminate distortions from rationing. Finally, mobilizing foreign financing on favorable terms would allow undertaking these adjustments in a more gradual manner.

Medium-term challenges. The short-term policy agenda needs to be complemented with a structural reform program to support and sustain higher and more socially balanced growth, which will require leveraging Egypt's considerable economic potential and unleashing its private sector. Work should start immediately, as progress with macroeconomic stability will likely be short-lived without implementing this second leg of the economic reform package that could provide a positive anchor for expectations in the post-revolutionary environment. Creating a more transparent and competitive business environment, addressing in orderly and transparent manner business litigations (past privatizations and tax arrears), streamlining burdensome regulations, and improving access to financing, especially for small enterprises, would help boost economic activity and create jobs. Increasing public and private investment in human capital and infrastructure would help provide more equal access to job and business opportunities for all segments of society. Potential areas for further technical assistance from Egypt's external partners include public finance management; subsidies and social safety nets; civil service reform; Islamic finance; and access to finance for small- and- medium-scale enterprises (SMEs).

III. JORDAN

Jordan's economy has been suffering from exogenous shocks. These include high energy prices and regional unrest, especially the events in neighboring Syria. Real GDP growth increased to about 3 percent in 2012, while the current external account deficit further deteriorated from an already high level and the fiscal deficit remained in the double digits. The authorities are implementing a national reform program to correct domestic and external imbalances through fiscal and energy policies, while fostering high and inclusive growth. The Fund continues to support Jordan through a Stand-By Arrangement.

Background. Jordan experienced a period of robust growth during 2000–09 (averaging about 6½ percent). The economy is among the most open in the Middle East; tourism receipts, remittances, FDI flows, and external grants play an important role. Jordan imports most of the hydrocarbon products and grains that it needs. While the authorities have implemented structural reforms to develop the private sector, unemployment remains persistently high, averaging 13.7 percent during 2000–12. Unemployment is largely a youth phenomenon— young people (of ages 15 to 24) account for almost half of the unemployed, and their unemployment rate reached 29 percent in 2012.

Recent developments. Political uncertainties were lowered by the parliamentary elections and the formation of a new government in early 2013. In 2012, managing the economy was very challenging. Nonetheless, performance was broadly positive; growth is estimated to have accelerated slightly to 2.8 percent and inflation increased to 7.2 percent at year-end, following the full liberalization of fuel prices. Pressures on fiscal and external accounts intensified as

severely reduced gas inflows from Egypt had to be replaced over most of 2012 by expensive fuel imports for electricity generation and as the conflict in Syria created a large influx of refugees. As a result, the external current account widened to 18 percent of GDP in 2012 and the losses of the national electricity company (NEPCO) reached 5.2 percent of GDP. The situation

improved toward year-end as gas inflows from Egypt increased in November. The Central Bank of Jordan (CBJ) managed well the temporary pressures on reserves in late-2012, which, since then, have been rebuilt, helped by sizeable grants from GCC countries and a successful U.S. dollar-denominated domestic bond issuance. The central government budget was tightly managed, and the authorities eliminated the highly sensitive fuel subsidy while at the same time providing cash transfers to compensate low- and middle-income Jordanians.

Jordan: Selected Economic Indicators, 2011 - 2014
(Percent of GDP, unless otherwise indicated)

	Projections			
	2011	2012	2013	2014
GDP growth, percent	2.6	2.8	3.3	3.5
CPI inflation, period average, percent	4.4	4.8	5.9	3.2
General government balance, excl. grants ¹	-11.7	-10.3	-13.3	-11.3
Current account balance, excl. grants	-19.0	-22.8	-17.0	-14.3
Fiscal financing needs, (excl. grants), US\$ billion	5.9	6.4	8.8	9.3
External financing needs (excl. grants), US\$ billion	6.0	7.6	6.5	5.8
Public debt	70.7	79.6	83.8	87.0
External debt	21.9	23.4	25.4	25.6
Reserves to short-term debt, percent	178.7	111.4	144.6	139.3
Reserves in months of imports	5.9	2.9	4.0	4.9

Sources: National authorities; and IMF staff calculations.

¹Starting in 2013, the government balance includes direct transfers to NEPCO.

Short-term outlook. The outlook for 2013 is broadly favorable and the first review of the IMF's Stand-By Arrangement in support of the authorities' program was concluded in early April. Real GDP growth is expected to accelerate to above 3 percent reflecting an increase in government capital spending, higher domestic consumption, and a recovery in exports. Inflation is expected to decline to just over 3 percent at year-end. At the same time, the external current account deficit, while remaining sizable, is projected to improve significantly because of higher grant financing and lower energy imports (including from a doubling of gas flows from Egypt). In combination with a pickup in confidence and a stronger capital account, this will allow the CBJ to strengthen its reserve position. The 2013 central government deficit (excluding grants) is projected to narrow by about 2 percent of GDP relative to the 2012 outturn—helped by the elimination of virtually all fuel subsidies in late 2012, a roll-back of losses of NEPCO by about 1 percent of GDP, and expectations of continued higher gas inflows from Egypt. The public debt-to-GDP ratio would stand at slightly less than 84 percent by end-2013.

Risks. They remain sizable. Of particular concern is the accelerated inflow of Syrian refugees, though this could, to a large extent, be mitigated by international assistance. Other risks stem from lower growth, a weaker current account (in particular related to higher oil prices and a renewed disruption in gas supplies from Egypt), and a further delay in implementing the energy strategy designed to bring NEPCO back to cost recovery. These risks could trigger lower confidence, which could translate into considerable pressures on reserves. Based on recent experience, though, bilateral support might be forthcoming to replenish reserves. The authorities' reform program is designed to lower these risks. In addition, there are implementation risks to the program—most importantly, coordination between macro agencies and capacity constraints pose risks to program monitoring. On the upside, higher gas inflows from Egypt would ease pressures on NEPCO and the current account.

Short-term policy issues. The authorities are committed to continue their reforms to keep the fiscal and external balances on a sustainable path. On the fiscal front, consolidation will continue to be gradual so as to not jeopardize growth prospects and social cohesion. The envisaged measures in 2013 include an increase in government investment and cuts in less productive spending, as well as improvements in tax administration and public financial management. On the energy front, the authorities drafted a strategy to return NEPCO to cost recovery, on which they intend to consult with parliament. Implementation of this strategy, including tariff increases, will be critical for improving the fiscal and external positions. To help build up international reserve buffers, monetary policy will remain focused on maintaining the attractiveness of dinar-denominated assets.

Medium-term challenges. To strengthen debt sustainability, fiscal consolidation will continue in the medium term through expenditure and tax reforms. At the same time, the burden of reforms on vulnerable groups will need to be minimized through well-targeted assistance. To reduce public debt, NEPCO will be brought back to cost recovery, which to a large extent will hinge on the success of Jordan's strategy to establish transparent and sustainable energy prices

and diversify its energy sources. In parallel, the authorities' program envisages fostering high and more inclusive growth, and will include implementing structural reforms aimed at improving the business environment and enhancing access to finance, while improving labor market skills through education and training reform. This agenda offers opportunities for possible technical assistance, including in the areas of tax administration and public financial management.

IV. LIBYA

While the Libyan economy is recovering rapidly from the conflict-induced collapse in economic activity, the high degree of dependency on volatile hydrocarbon earnings makes economic performance vulnerable to oil shocks and complicates macroeconomic management. The short-term challenges are to normalize the security situation, manage the political transition, exercise budget discipline while maintaining macroeconomic stability, institute the timely compilation and dissemination of key statistics, and address severe institutional capacity constraints. The key economic challenge for Libya will be to build a vibrant nonoil economy and private sector. In addition, it will be important to strengthen public institutional capacity to manage and support a \$95 billion economy of 6.3 million people. The Fund is supporting Libya through policy advice and intensive technical assistance.

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 by end-2010. The nonhydrocarbon sectors grew rapidly—albeit from a low base—on the back of an ambitious public investment program, but 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, unemployment was estimated officially at 13.5 percent with youth unemployment at 25–30 percent.

Recent developments. The prolonged fighting had a far-reaching impact on standards of living, provision of basic services, and employment: economic activity contracted sharply in 2011 and consumer prices increased, primarily due to international sanctions and supply constraints. The restoration of hydrocarbon output

underpinned the recovery of economic activity in 2012, with a resulting doubling of real GDP. Consumer price inflation has been falling, with a year-on-year rate of -3.7 percent in December 2012. The overall budget balance moved to a surplus of 20.8 percent in 2012, from a deficit of 18.7 percent of GDP in 2011.

Similarly, the current account surplus widened to 36 percent, from 9 percent of GDP in 2011. Finally, broad money grew by 11.5 percent with a modest shift from currency into deposits, and credit to the private sector increased by some 24 percent.

Libya: Selected Economic Indicators, 2011 - 2014
(Percent of GDP, unless otherwise indicated)

	Projections			
	2011	2012	2013	2014
GDP growth, percent	-62.1	104.5	20.2	10.1
CPI inflation, period average, percent	15.9	6.1	2.0	5.2
General government balance, excl. grants	-18.9	20.8	18.4	12.1
Current account balance, excl. grants	9.1	35.9	25.8	17.7
Fiscal financing needs, (excl. grants), US\$ billion
External financing needs (excl. grants), US\$ billion
Public debt	0.0	0.0	0.0	0.0
External debt	16.1	6.8	5.8	5.5
Reserves to short-term debt, percent	81.2	90.7	103.5	112.5
Reserves in months of imports of imports	41.6	39.1	39.9	37.4

Sources: National authorities; and IMF staff calculations.

Short-term outlook. Real GDP will continue to rebound, underpinned by restoration of nonhydrocarbon output. Average inflation will be low in 2013 due to the base effect of high prices during the conflict. The current account surplus and the budget surplus will narrow with capital spending increasing to 11 percent in 2013, from 5.3 percent of GDP in 2012.

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 are constraining private sector economic recovery and impeding the return of expatriate workers that are needed to alleviate workforce bottlenecks. There are also security-related spillovers from neighboring countries and a potential for negative spillovers from Libya to the region via renewed conflict and to the world via disruptions in hydrocarbon production. A law banning interest in financial transactions has been passed by the legislature but is yet to come into effect; the implementation of this law would paralyze financial intermediation unless Sharia-compliant instruments and institutions are operational. Meanwhile, Libyan bankers do not know the status of implementation of the law and private banks will not lend until the situation is clarified. Public finances and the external current account remain susceptible to a sustained decline in oil prices.

Short-term policy issues. Libya must restore security, resuscitate the banking system, maintain macroeconomic stability including through improved fiscal discipline, and manage the sharply higher flow of reserves transparently and with good accountability. Current spending has increased from 29 percent of GDP in 2010 to almost 41 percent in 2013. The increase in recurrent expenditures poses risks to fiscal sustainability and is causing appreciation of the real exchange rate. In the absence of a curb on current spending, necessary reconstruction and development spending will eventually push the budget into deficit. Plans for subsidy reform are well-advanced with an inter-ministerial report due to Parliament by August. The system of budget management needs to address the challenge of budget fragmentation posed by separation of institutional responsibilities across the Ministry of Finance and the recently-created Ministry of Planning for the preparation and execution of the recurrent and investment budgets. Streamlining bank regulation while strengthening the supervisory framework remains key to promoting financial intermediation that would help underpin investment, growth, and macroeconomic stability.

Medium-term challenges. There is a need for a medium-term vision for the new Libyan economy. The main challenges are to promote inclusive growth by advancing private sector-led economic diversification outside the energy sector, generating productive employment, enhancing competitiveness, improving governance, and strengthening social protection. Creating more and better employment opportunities in the private sector, the lack of which was a key underlying cause of the revolution, remains a high priority. On the macropolicy 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 and help make the budget a strategic policy tool that links national policy objectives to economic performance. This agenda offers ample opportunities for further technical assistance from the international community, including the IMF.

V. MOROCCO

The authorities' overall sound macroeconomic policies over the last decade have helped the economy weather the crisis relatively well, but Morocco's economic performance has nonetheless been affected by the deteriorated external environment. Growth is estimated to have slowed to about 3 percent in 2012, from 5 percent in 2011. In addition, the fiscal and current account deficits widened, in a context of pressing social demands. The authorities' economic program aims at rebuilding external and fiscal buffers and promoting higher and more inclusive growth. The IMF supports this effort through an arrangement under the Precautionary and Liquidity Line (PLL) to provide insurance against exogenous shocks.

Background. The transition has so far proceeded smoothly. A political reform process was initiated in March 2011 following social protests. A new constitution, paving the way for broader reforms, was adopted in July 2011 and elections were held in November 2011. The head of the Justice and Development Party formed a new coalition government in January 2012. The challenge for the government is to sustain the delivery of difficult reforms, in a context of high expectations and an unfavorable global environment.

Recent developments. The crisis in Europe and a poor harvest caused growth to slow down to about 3 percent in 2012, from almost 5 percent in 2011. However, nonagricultural growth has remained robust at 4 ½ percent thanks to increased domestic consumption. Inflation remained low at 1.3 percent despite significant increases in the price of several subsidized energy products. Unemployment has

remained around 9 percent since 2012 and is particularly elevated among the youth (at about 18 percent). The fiscal deficit deteriorated in 2012, increasing to 7.5 percent of GDP (including grants) from 6.8 percent in 2011. The high deficit party reflects the cost of subsidies, which amounted to about 6.5 percent of GDP in

2012. The current account deficit is estimated to have increased to 9.6 percent of GDP in 2012 as import growth, pushed by energy-related imports, outpaced slow export growth. International reserves fell in 2011 and most of 2012, but have stabilized at around four month of imports.

Short-term outlook. Growth is expected to accelerate somewhat in 2013 to 4½ percent on account of a rebound in agriculture and continued robust nonagricultural growth. Inflation is expected to remain low at about 2½ percent. The current account deficit is projected to

Morocco: Selected Economic Indicators, 2011 - 2014
(Percent of GDP, unless otherwise indicated)

	2011	2012	Projections	
			2013	2014
GDP growth, percent	5.0	3.0	4.5	4.8
CPI inflation, period average, percent	0.9	1.3	2.5	2.5
General government balance, excl. grants	-7.0	-7.6	-6.7	-5.3
Current account balance, excl. grants	-8.4	-9.8	-8.3	-6.9
Fiscal financing needs, (excl. grants), US\$ billion	7.7	8.3	8.2	7.1
External financing needs (excl. grants), US\$ billion	9.8	11.2	10.8	9.8
Public debt	54.4	59.6	61.2	61.1
External debt ¹	23.8	27.3	27.6	27.2
Short-term debt, percent of international reserves	0.02	0.03	0.02	0.02

Sources: National authorities; and IMF staff calculations.

¹Includes external publicly guaranteed debt.

contract as a result of the planned reduction in the fiscal deficit, lower global energy prices, a recovery in agriculture, and recent investments in export-oriented sectors.

Risks. Morocco faces important external and domestic risks in a context of pressing social demands. A spike in international oil prices would add pressure to the already high fiscal and external deficits. In addition, a marked deterioration in economic activity in the advanced trading partners, especially in the euro area, could have sizeable real spillovers on growth and the balance of payments. The Fund's two-year PLL arrangement (\$6.2 billion), which was approved in August 2012 and whose first review was concluded in February 2013, will continue to support the authorities' policies by providing insurance against exogenous shocks. The authorities do not intend to draw upon resources available under the PLL unless Morocco experiences actual balance of payments needs resulting from a significant deterioration in external conditions. Pressing social demands may slow the pace of implementation of the necessary reforms.

Short-term policy issues. Rebuilding the eroded fiscal and external buffers by moving ahead with difficult but necessary reforms to ensure macroeconomic stability in a challenging environment remains crucial. In particular, the fiscal monitoring framework needs to be strengthened. The costly universal subsidies should be replaced by well-targeted social programs that benefit those most in need. In a context of political transition, high social demands, and regional tensions, effective communication will be important to be able to stick to the medium-term path, show citizens the benefits of the planned social and economic reforms, and thus ultimately protect policy credibility.

Medium-term challenges. Addressing other fiscal challenges, such as achieving the authorities' medium-term targets on the wage bill and reforming the pension system, and strengthening the tax system by broadening the base and reducing informality, are also necessary to ensure fiscal sustainability. To improve competitiveness and achieve more inclusive growth, the authorities need to accelerate structural reforms aimed at job creation, reduce high unemployment especially among the youth, and further improve the business climate and economic governance by enhancing transparency, accountability, and the rule of law. Morocco is also encouraged to move toward greater exchange rate flexibility to enhance external competitiveness and strengthen the economy's ability to absorb shocks. This agenda presents substantial needs for further technical assistance, particularly in the areas of taxation, the budget monitoring process, as well as on further strengthening the monetary policy framework and exchange rate management.

VI. TUNISIA

The Tunisian economy embarked on a moderate recovery in 2012, despite a challenging international environment and persistent domestic political and social tensions. The external current account deficit and the fiscal deficit further increased. The economic outlook will remain dependent on the unfolding of the political transition amidst a difficult external environment. Negotiations are ongoing on an IMF Stand-By Arrangement in support of the authorities' economic program, which aims at reducing financing sector vulnerabilities, restoring fiscal and external buffers, and fostering more inclusive growth. The IMF-supported program should help provide insurance against exogenous shocks and restore investor confidence.

Background. The political transition process was upset following the February 2013 assassination of a well-known opposition politician, which resulted in the resignation of the Prime Minister and accelerated plans for a new cabinet. The situation appears to have stabilized after the formation of a new coalition government—led by the moderate Islamic Ennahda party and with independents running key ministries. The new government's immediate priorities are to ensure a smooth transition to the elections, support the economic recovery, and improve security throughout the country. The Constituent Assembly's drafting of a new constitution has been delayed and is now expected in the next few months, followed by general elections in the last quarter of 2013. Delays in the political transition led to a further rating downgrade, with Moodys joining other agencies in downgrading Tunisia's debt rating below investment grade.

Recent developments. After a severe recession in 2011, real GDP growth picked up to about 3.6 percent in 2012, helped by base effects and rebounding tourism and FDI inflows. Unemployment declined to 16.7 percent due to significant recruitment activity by the public sector, but remains very high among the youth at close to 40 percent.

Headline inflation rose to 5.6 percent in 2012 (year-on-year) as a result of mostly higher food prices, wage increases, and demand pressures from Libya. In spite of recovering tourism and remittance receipts, the current account deficit continued to widen: exports weakened by the slowdown in

Europe while capital goods imports rose. Large official external financing and rebounding FDI inflows raised foreign exchange reserves to \$8.6 billion (about 3.8 months of imports) in 2012, up from \$7.5 billion at end-2011. A higher wage bill and rising subsidies contributed to a wider fiscal deficit in 2012, although lower than originally budgeted. Critical vulnerabilities in the

Tunisia: Selected Economic Indicators, 2011 - 2014¹
(Percent of GDP, unless otherwise indicated)

	Projections			
	2011	2012	2013	2014
GDP growth, percent	-1.9	3.6	4.0	4.5
CPI inflation, period average, percent	3.5	5.6	6.0	4.7
General government balance, excl. grants ²	-3.5	-5.4	-7.1	-6.4
Current account balance	-7.3	-8.1	-7.3	6.0
Fiscal financing needs, (excl. grants), US\$ billion	3.3	4.3	5.3	4.8
External financing needs (excl. grants), US\$ billion	10.6	9.2	10.0	9.6
Public debt	44.0	44.7	43.8	45.3
External debt	50.7	51.2	55.0	58.2
Reserves to short-term debt, percent	146.0	165.0	168.2	194.8

Sources: National authorities; and IMF staff calculations.

¹Figures may differ from WEO data as they reflect updates by recent missions.

²Central government.

banking sector remain, despite recent steps to improve banking supervision and strengthen regulation.

Short-term outlook. The unfolding of the political transition will continue to affect business confidence. Under a smooth transition, with elections organized later this year, economic growth in 2013 could reach 3½–4 percent, supported by sustained domestic demand, but held back by a challenging external environment. Inflation is likely to increase further in 2013, due to higher administered prices and despite a tighter monetary policy. The underlying fiscal stance for 2013—as measured by the structural fiscal balance—is expected to remain unchanged, although the overall fiscal deficit will widen to allow for public bank recapitalization, much-needed public investments in the marginalized regions of the interior, and increased social expenditures. Tunisia’s current account deficit would remain large at about 7 percent of GDP in 2013, financed mostly by sizable official external financing flows, thereby keeping foreign exchange reserves broadly stable at about 3.2 months of imports.

Risks. An escalation of domestic social tensions fueled by continuing high unemployment and rising political uncertainty could undermine the economic recovery and impede investment. A worse-than-anticipated recession in Europe would also hurt Tunisia’s short-term growth prospects by further impacting exports, tourism receipts, and FDI inflows. A shortfall in expected external financing or loss of market access would add to financing needs. On the upside, a reduction of social tensions and a smooth political transition could bolster domestic and foreign investors’ confidence.

Short-term policy issues. The most immediate challenge is to reduce the fragilities of the banking sector while restoring fiscal and external buffers. On the banking sector front, mobilizing resources for public banks’ recapitalization needs, strengthening public banks’ balance sheets and governance framework, tightening banking supervision, and improving prudential regulation are essential to restore investors’ confidence. Fiscal policy will have to strike the right balance between supporting the economic recovery and the need for consolidation to preserve fiscal sustainability. A prudent monetary policy will aim at containing inflationary pressures, while preserving the stability of the banking sector and adequate credit to the economy. Greater exchange rate flexibility would contribute to improving Tunisia’s external position and rebuild foreign exchange buffers. A two-year Stand-By Arrangement with the IMF—currently under negotiation—would help support the authorities’ home-grown program and provide Tunisia with a financing cushion in case of a shock.

Medium-term challenges. Generating higher and more inclusive growth to absorb high unemployment and reduce social and economic disparities across regions is the key challenge for Tunisia. In addition to strengthening the banking sector, reforms should focus on: (i) a more transparent and competitive environment for doing business—including through a new investment code, a new competition policy, and streamlined administrative and fiscal procedures; (ii) progress towards better-targeted social safety nets; and (iii) labor market

reforms, including through reducing existing rigidities and enhancing skills through education reform and new training programs. The reform of the investment code and the ongoing fiscal reform will help reduce regional disparities by creating a more level playing field for the on-shore and offshore sectors. This agenda offers opportunities for further technical assistance, including in the areas of banking, revenue administration, public financial management and expenditure policy.

VII. YEMEN

Since overcoming the political crisis of 2011, the coalition government has made progress in restoring macroeconomic stability. Nonetheless, GDP growth remains low and widespread poverty and high unemployment, which increased further after the 2011 political crisis, urgently need to be addressed. The political and economic situation remains fragile and fiscal and structural reforms are needed to achieve sustained high and inclusive growth. Substantial donor support is required to help close the large financing gaps. The Fund supported the authorities' stabilization program with a Rapid Credit Facility in 2012. There is good progress in the discussions on a successor IMF arrangement to address macroeconomic and structural issues.

Background. In 2011, Yemen experienced a serious political crisis that resulted in shortages of basic commodities. A political agreement was brokered by the Gulf Cooperation Council, leading to the formation of a national unity government in December 2011 and the election of a new president in February 2012. A national dialogue to prepare a new constitution started in March 2013 and elections are scheduled for February 2014.

Recent developments. The Fund supported the authorities' program with a Rapid Credit Facility (amounting to about \$100 million), which was fully disbursed in April 2012. The program and donor assistance, especially from Saudi Arabia, helped the authorities achieve macroeconomic stabilization. After contracting by more than 10 percent in the previous year, output resumed its growth in 2012, inflation decelerated sharply, foreign exchange reserves increased, and the exchange rate stabilized. However, the fiscal deficit (including grants) widened to 6.3 percent of GDP due to revenue loss caused by the frequent sabotage of the key oil pipeline. A mission met with the authorities in March 2013 to conduct the Article IV consultations and discuss a possible successor program. IMF technical assistance has been provided in the fiscal, banking supervision, and national accounts statistics areas.

Short-term outlook. Despite the progress made on the political front and in macroeconomic stabilization, Yemen continues to face serious political, security, and economic challenges. The political consensus and security situation remain fragile. Poverty, malnutrition, and unemployment are very high. This said, with further progress in the political and security situation, as well as with the planned reforms and donor disbursements (donors recently pledged about \$8 billion over the 2012–14 period, including a \$1 billion Saudi deposit at the Central Bank of Yemen), the recent macroeconomic gains are expected to be consolidated.

Yemen: Selected Economic Indicators, 2011 - 2014¹
(Percent of GDP, unless otherwise indicated)

	Projections			
	2011	2012	2013	2014
GDP growth, percent	-12.7	2.4	6.9	5.2
CPI inflation, period average, percent	19.5	9.9	7.5	8.7
General government balance, excl. grants	-5.7	-12.3	-7.1	-6.0
Current account balance, excl. grants	-6.5	-7.1	-4.6	-5.9
Fiscal financing needs, (excl. grants), US\$ billion	1.7	3.8	2.2	1.9
External financing needs (excl. grants), US\$ billion	2.3	3.9	1.6	2.2
Public debt	45.2	47.8	46.0	46.9
External debt	18.3	17.9	16.9	17.4
Reserves in months of imports	3.9	5.6	4.9	4.0

Sources: National authorities; and IMF staff calculations.

¹Figures may differ from WEO data as they reflect updates by recent missions.

Nonhydrocarbon growth is projected to pick up, reflecting increased utilization of idle capacity, donor-supported investment, and rekindling of private sector activity. Oil production, which had declined due to sabotage, is projected to gradually recover. Inflation is expected to be in the high single digits. Having benefitted from exceptional Saudi support in 2012, the current account and foreign exchange reserves positions are expected to decline in 2013.

Risks. The main downside risks are a deterioration in the political and security situation, heightened social unrest, and unraveling in the macroeconomic stance. There is, however, potential for an upside if further progress is made on the political front in terms of the national dialogue, and if at the same time there is an acceleration of donor disbursements, including budget support to buttress economic policies and reforms. Also, improved investment in the oil and gas sectors could eventually boost production above projected rates.

Short-term policy issues. The short-term policy priority is to strengthen macroeconomic stability and lay the foundation for fiscal and external sustainability, as well as sustained high and inclusive growth. This will entail a gradual fiscal consolidation and realigning the budget toward pro-growth and pro-poor expenditures, through increasing tax revenues, containing the wage bill, and reducing fuel subsidies, while increasing social transfers and infrastructure investment. There is also scope for continuing to reduce the policy interest rate while strengthening bank supervision to facilitate lending to the private sector. Increased exchange rate flexibility is also needed to protect foreign exchange reserves.

Medium-term challenges. The key medium-term challenges are to diversify the production and export structure from hydrocarbon exports and put public finances on a sustainable medium-term footing. This would help Yemen move to a virtuous cycle where macroeconomic stability and higher investment contribute to sustained high and inclusive growth. Sustained fiscal reforms will be needed to improve nonoil tax revenues, reduce generalized energy subsidies, contain the large public sector wage bill, improve financial management, and ensure a well-targeted social safety net to minimize the impact on the poor. There is also a need to address inefficiencies in oil refining, electricity generation, and state enterprises in general. Improvements in the environment for doing business, strengthened supervision, and continued prudent monetary policy will be critical in spurring private sector credit growth and job creation. Further improvements are also needed in governance and transparency in line with the Government's Transition Plan. This agenda requires further technical assistance by Yemen's external partners, including in the areas of public financial management, financial and capital market development, monetary operations, banking supervision, payment system, economic and financial statistics, and judicial reforms.