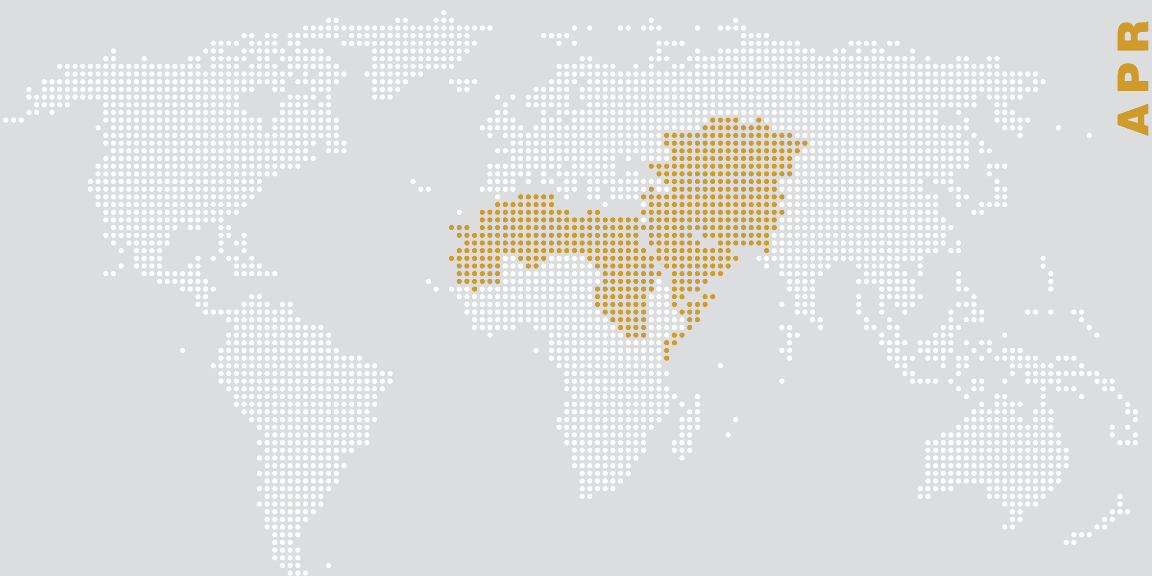
World Economic and Financial Surveys

Regional Economic Outlook

Update

Middle East and Central Asia

APR 16



INTERNATIONAL MONETARY FUND

Middle East, North Africa, Afghanistan, and Pakistan

Low oil prices and deepening conflicts continue to weigh on economic activity in the MENAP region.

The growth prospects for most oil exporters have been revised down markedly since last October, amid a continued rout in the global oil market. Oil exporters' growth is still projected to rise from 2 percent in 2015 to 3 percent this year; however, this is mainly due to increased oil production in Iraq and post-sanctions Iran. In the GCC, economic activity is projected to slow further. Ambitious fiscal consolidation measures are being implemented this year, but budget balances will deteriorate nonetheless given the sharp drop in oil prices. An additional and substantial deficit-reduction effort is required over the medium term to restore fiscal sustainability, and, in the GCC countries, to support the exchange rate pegs. An equally important priority is to ensure that the private sector can create enough jobs for a young and growing population at a time when public sector job creation will be constrained. This will require deep structural reforms to improve medium-term prospects and facilitate economic diversification. Policymakers in most countries are increasingly determined to be proactive in addressing the challenges posed by the oil price malaise.

After four years of stagnation, economic activity in MENAP oil importers is starting to strengthen, albeit gradually and unevenly. Growth increased from 3 percent in 2011–14 to 3¾ percent in 2015 and is projected to remain around that level in 2016–17. Lower oil prices, less fiscal drag, and improved confidence owing to progress with recent reforms are supporting this recovery. Yet security disruptions and social tensions persist, and adverse spillovers from regional conflicts—including economic pressures from hosting refugees—and, more recently, slowdowns in the GCC, strain the outlook. Reforms of generalized energy subsidies have helped stabilize public debt and preserve macroeconomic stability, and improved targeted safety nets have helped protect the vulnerable. However, additional fiscal consolidation is still needed to put public debt firmly on a sustainable path and rebuild policy buffers. In some cases, greater exchange rate flexibility would also help reduce vulnerabilities and improve competitiveness. Stepped-up structural reforms in business, labor and financial markets, and trade are critical for boosting economic prospects, improving living standards, and creating much-needed jobs.

Real GDP Growth, 2014-17

	MENAP Oil Exporters	GCC	Iran	Countries in Conflict[1]	MENAP Oil Importers
2014	2.7	3.5	4.3	-4.8	2.9
2015	1.9	3.3	0.0	-2.0	3.8
2016	2.9	1.8	4.0	5.4	3.5
2017	3.1	2.3	3.7	5.4	4.2

Sources: National authorities; and IMF staff calculations.
[1]Countries in conflict include Iraq, Libya, and Yemen. Data for Syria are not available.

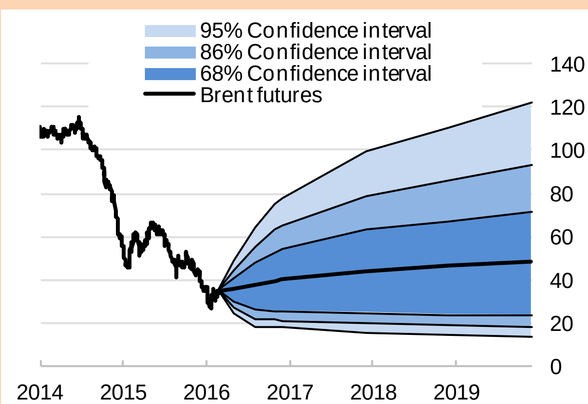
MENAP Oil-Exporting Countries: Adjusting to Cheaper Oil

New Oil Market Reality

Over the past decade, MENAP oil exporters enjoyed large external and fiscal surpluses and rapid economic expansion on the back of booming oil prices. However, with oil prices plunging in recent years, surpluses have turned into deficits and growth has slowed, raising concerns about unemployment and financial risks. How should the region adjust to the new oil reality?

The oil price drop since mid-2014 has been spectacular: prices have fallen nearly 70 percent to about $40 a barrel. Futures markets anticipate oil prices to recover only modestly to $50 a barrel by the end of this decade, though much uncertainty surrounds this forecast (Figure 1). The weak price prospects reflect the expectation that global oil supply growth will moderate only slowly as Iran boosts its exports and other MENAP oil exporters maintain high output, at a time of sluggish global growth.

Figure 1
Brent Crude Oil
(U.S. dollars a barrel)



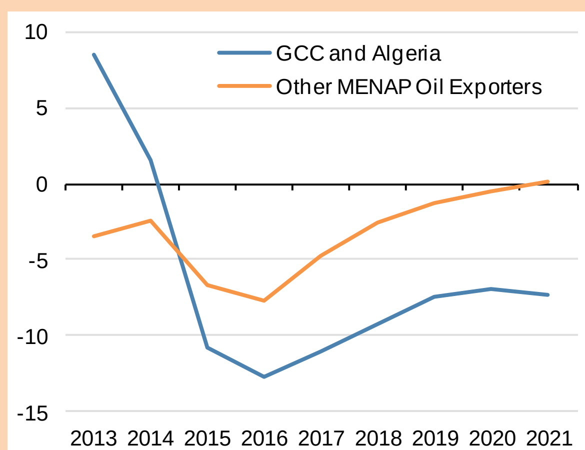
Sources: Bloomberg; and IMF staff calculations.
[1] Derived from prices of futures and options on March 2, 2016. The average price of oil in U.S. dollars a barrel was $50.79 in 2015; the assumed price based on futures markets is $34.75 in 2016 and $40.99 in 2017.

Large Revenue Losses

The outlook for lower oil prices implies weak oil revenues for years to come, dramatically reducing the capacity of governments to spend. Export receipts in MENAP oil exporters declined by $390 billion in 2015 (17½ percent of GDP). Despite a partial offset from reduced imports owing to subdued prices of non-oil commodities, the combined current account of the GCC and Algeria has reversed from a comfortable surplus to a projected deficit of about 8 percent of GDP in 2016. The deficit of other MENAP oil exporters is projected to be 4¾ percent of GDP this year. The current account is expected to improve only gradually over the medium term, as the oil price recovers somewhat and fiscal adjustment unfolds.

Mirroring the large loss in export receipts, fiscal balances have deteriorated considerably (Figure 2). The ample surpluses of the GCC countries and Algeria have turned into significant deficits, projected to average 12¾ percent of GDP in 2016 and remain at 7 percent over the medium term, despite the implementation of sizable deficit-reduction measures. For other MENAP oil exporters—those generally less reliant on oil but with smaller fiscal buffers—the combined deficit is projected to average 7¾ percent of GDP in 2016, and gradually close by the end of the decade as oil output increases and conflicts are assumed to ease.

Figure 2
Overall Fiscal Balance
(Percent of GDP)



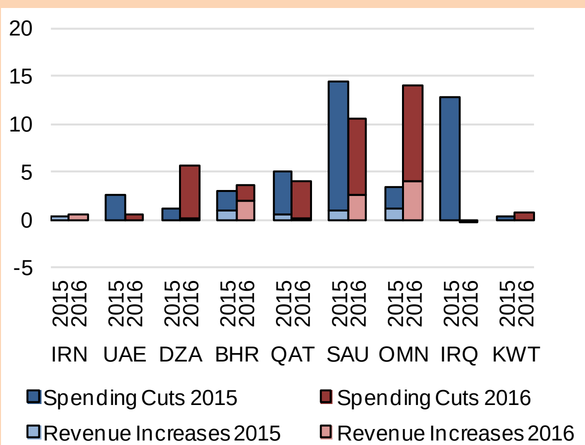
Sources: National authorities; and IMF staff calculations.
Note: Libya excluded from Other MENAP Oil Exporters.

Policy Adjustment Underway

For most MENAP oil exporters, the fiscal adjustment needed to absorb the oil price shock is unprecedented. Last year, many countries adopted significant deficit-reduction measures, while drawing down financial buffers, where available, or borrowing to smooth the adjustment to lower oil prices. This year's budgets suggest that policy effort will only intensify (Figure 3).

The bulk of this adjustment has so far comprised spending cuts; however, new sources of revenue are also being considered. Algeria, Iraq, the United Arab Emirates, Saudi Arabia, and, to a lesser extent, Oman have focused on capital spending cuts. Current spending reductions are an important part of the adjustment process in Bahrain, Oman, and Qatar. New revenue measures are being taken in Oman (an increase in the corporate income tax), Bahrain (tobacco and alcohol taxes), and Iran (reduced exemptions and better tax administration). The GCC is planning to introduce a VAT in the coming years.

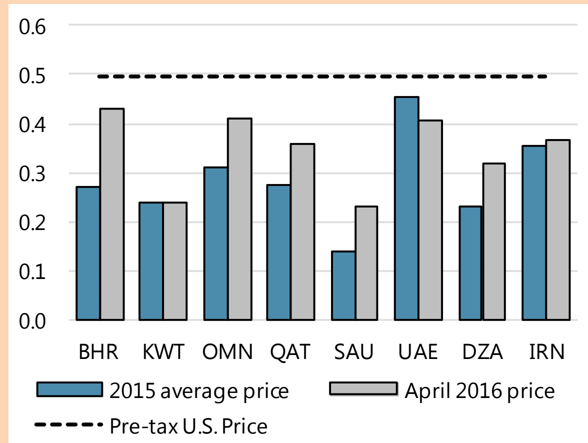
Figure 3
Fiscal Consolidation Measures, 2015–16
(Percent of non-oil GDP)



Sources: National authorities; and IMF staff estimates.
Note: DZA denotes Algeria. Fiscal consolidation measures as identified by IMF country teams.

Significantly, many MENAP oil exporters have initiated substantial energy price reforms in response to lower oil prices. In the GCC, most countries have raised fuel, water, and electricity charges, with some announcing further increases in the coming years. Oman and the United Arab Emirates have introduced automatic pricing mechanisms. Outside the GCC, Algeria recently hiked fuel, electricity, and natural gas prices, and Iran increased fuel prices. Still, local energy prices remain well below global benchmarks in most countries (Figure 4). To minimize the impact of these reforms on vulnerable income groups, targeted support schemes should be strengthened.

Figure 4
Premium Gasoline Prices
(U.S. dollars per liter)



Sources: National authorities; EIA; and IMF staff estimates.
Note: DZA denotes Algeria. Oman and the U.A.E. have introduced automatic fuel pricing formulas.

In tandem with the fiscal adjustment, Algeria and Iran have allowed their currencies to depreciate. This has boosted local currency budget revenues from oil exports, but the fiscal gains will only last if expenditures, particularly the public wage bill, do not rise in response to depreciation. The GCC countries have maintained their long-standing pegs, underpinned by substantial net foreign assets. Pressures on these pegs in forward currency markets have increased in recent months, although the forward markets are relatively illiquid and most GCC countries have significant buffers.

Further Fiscal Policy Action Needed

Despite the announced policy measures, medium-term fiscal positions remain challenging given the expectation of oil prices remaining low (Figure 2). The cumulative fiscal deficits of the GCC and Algeria are projected at almost $900 billion during 2016-21. Algeria, Bahrain, Oman, and Saudi Arabia will become significant debtors over this period as their financing needs are expected to exceed their current liquid financial buffers. The budgets of almost all non-GCC countries are also projected to remain in deficit by the end of the decade.

Further saving measures are needed over the medium term to restore fiscal sustainability, rebuild buffers, and save sufficiently for future generations. In the GCC, ambitious fiscal consolidation is also required to support the fixed exchange rate regimes. The timing and composition of these policy measures should be designed to minimize the short-term impact on growth, while enhancing equity and medium-term growth prospects. Structural policies (see below) can complement fiscal adjustment efforts.

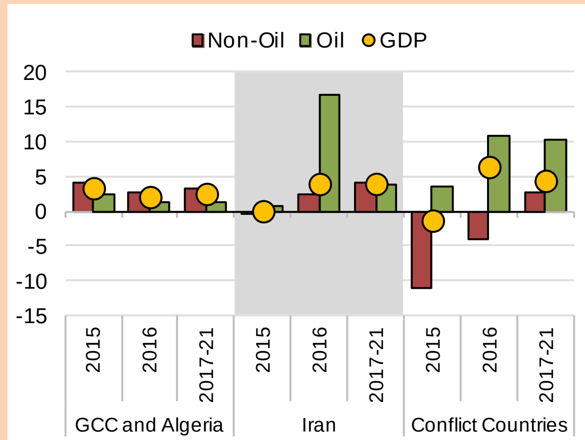
Large fiscal adjustment will inevitably entail difficult choices, including rethinking the role and size of the public sector and modifying the social contract. There is room to cut public spending, which ballooned during the oil price boom, and to raise new revenues. On average, the GCC countries spend twice as much on their public wage bills as other emerging market and developing countries, and almost 50 percent more on public investment as a share of GDP. Further energy price reforms could save some 2 percent of GDP. Revenue efforts should focus on designing broad-based tax systems. For example, introducing a 5 percent VAT could raise about 1½ percent of GDP.[1]

Deficits are being financed with asset drawdowns and debt issuance. After the significant withdrawals of financial savings last year, some countries may issue more debt this year. Policymakers need to strike a balance between drawing down buffers, issuing domestic debt—thus helping to develop domestic capital markets, but potentially crowding out private investment—and borrowing abroad. Yet with lower oil prices and rising U.S. interest rates, funding costs have risen. A number of sovereign credit ratings have been downgraded. CDS spreads have widened, but remain well below the peaks of the global financial crisis.

Sharp Worsening in Growth Prospects

The slump in oil prices is straining growth prospects of MENAP oil exporters. With oil prices lower and fiscal policy tighter, growth projections for almost all MENAP oil exporters have been revised down significantly since last October. In particular, in the GCC and Algeria, growth is now expected to slow more sharply because of tighter fiscal policy, weaker private sector confidence, and lower liquidity in the banking system (Figure 5).

Figure 5
Real GDP Growth
(Percent change)



Note: Conflict countries include Iraq and Yemen

Nonetheless, increased oil production and non-oil economic activity in postsanctions Iran,[2] and the projected bottoming out of activity in Libya and Yemen with the assumption of conflicts gradually easing, are projected to raise the aggregate growth rate of MENAP oil exporters to 2.9 percent in 2016 and 3.1 percent in 2017 from 1.9 percent last year.

With oil prices projected to remain low and fiscal tightening expected to weigh on economic activity, medium-term growth forecasts have been revised down in most countries. Non-oil growth in the GCC is

[1] See IMF (forthcoming) "*Learning to Live with Cheaper Oil*", and IMF (2015) "*Tax Policy Reforms in the GCC Countries: Now and How?*"

[2] For more details on the economic effects of easing sanctions on Iran, see the October 2015 REO, available at www.imf.org.

now projected at 3¼ percent over the next five years—well below the 7¾ percent in 2006–15.

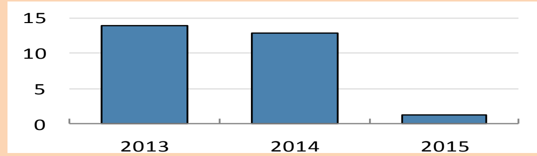
Risks Are Tilted to the Downside

Risks to this outlook are mainly to the downside. Planned fiscal deficit-reduction measures could exert a larger-than-expected drag on growth, especially given tightening financial conditions. In some countries, the fiscal consolidation implemented so far has not yet been sufficient to restore fiscal sustainability, potentially reducing confidence and increasing uncertainty. The recent increase in oil prices could result in some improvement. However, in view of the persistent excess in global oil supply over demand, a further drop in prices cannot be ruled out, especially in the case of a further slowdown in China's growth. Another risk relates to regional conflicts, which could become more protracted, disrupting economic activity. A faster-than-anticipated increase in U.S. interest rates would further raise external borrowing costs and feed into higher domestic interest rates.

Domestic financial risks are also on the rise. Amid worsening fiscal balances and slowing economic activity, public and private sector bank deposit growth has stalled, reducing liquidity in the financial system (Figure 6). Meanwhile, policymakers in Bahrain, Kuwait, Saudi Arabia, and the United Arab Emirates have hiked policy rates after the Fed's interest rate increase in December 2015. These developments will moderate private sector credit growth. Authorities have eased liquidity pressures by increasing loan-to-deposit ratios (Saudi Arabia), cancelling T-bill auctions (Qatar), and preparing to reactivate central bank lending facilities (Algeria). Bank asset quality may deteriorate as the non-oil economy slows, eroding bank profitability, although capital buffers generally remain strong.

Greater risks call for enhancing financial surveillance and policies. Priorities include the design and implementation of policies for effective monitoring and management of liquidity, operationalizing central bank lending facilities, developing appropriate collateral regimes, and enhancing public debt management strategies. Given the increased cross-border activities of banks, enhanced cooperation between home and host supervisors is needed.

Figure 6
Deposit Growth in GCC and Algeria
(Percentage change, y-o-y)



Sources: Authorities' data; and IMF staff estimates.
Note: Data weighted by PPP GDP.

Urgent Need to Reduce Oil Dependence

With medium-term growth prospects weakening significantly as a result of the slump in oil prices, the need to reduce oil dependence has become even more critical. The current growth model based on the redistribution of resources by the government is no longer sustainable, given the fiscal retrenchment and a rapidly growing labor force. In light of budget pressures, the public sector will not be able to absorb all the new labor market entrants.

Hence, a deepening of structural reforms is essential to promote diversification and non-oil sector growth in order to create jobs for the growing workforce.[3] Job creation and growth in the oil-exporting countries in the region will also have important positive spillovers for trading partners, who will benefit from higher trade and remittances. Reform priorities include further improvements in the business environment, a reduction in the public-private sector wage gap, and education and skills becoming more aligned to market needs. Privatization of state-owned enterprises would increase productivity and efficiency—Oman and Saudi Arabia, for example, have indicated plans to privatize selected state assets.

Iran's post-sanctions growth dividend, meanwhile, depends crucially on the implementation of much-needed domestic reforms. In conflict countries (Iraq, Libya, Yemen), improving security is a prerequisite for further development and diversification (Box 1).

[3] For more details on diversification in the GCC, see Cherif, R., F. Hasanov, and M. Zhu (2016) "*Breaking the Oil Spell: the Gulf Falcons' Path to Diversification*."

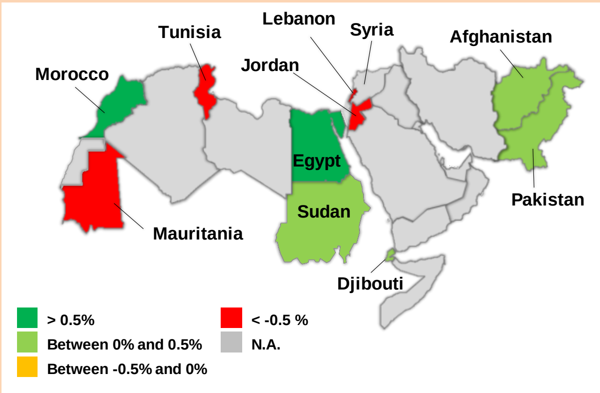
MENAP Oil-Importing Countries: Gradual but Uneven Economic Recovery

Economic Activity Trending Up

Since the onset of political transitions in 2011, MENAP oil importers have struggled to meet the public's demands for higher living standards and better access to business opportunities and jobs. Recent reforms have helped preserve macroeconomic stability. Yet, unemployment remains high at 10 percent, especially among the young (25 percent). Thus, strengthening economic growth and making it more inclusive remains a high priority.

The recent pick-up in economic activity in some countries is a start. Growth averaged 3¾ percent in 2015, compared to 3 percent over 2011–14 (Figure 7). Lower oil prices, less drag from fiscal consolidation, and improved confidence owing to progress with recent reforms—including reforms to reduce fiscal deficits and improve the business environment (Morocco, Pakistan)—supported the recovery, helping to counteract the negative impact of rising security risks and spillovers from regional conflicts—including large inflows of refugees (Box 1) and trade disruptions—as well as slower growth in the oil-exporting trading partners (the GCC).

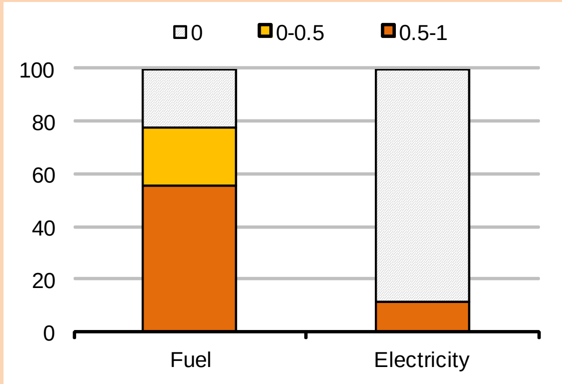
Figure 7
Gradual and Uneven Growth Improvements
(Percentage Point Change, 2015 vs. 2014)



Sources: National authorities; and IMF staff estimates.

In 2016–17, growth is expected to remain, on average, near 4 percent. Investment growth is gradually strengthening, mainly because recent subsidy reforms and lower oil prices have increased room for public infrastructure spending. Consumption is growing steadily, supported mainly by large public sector wage bills. Savings from lower oil prices—following energy subsidy reforms, most countries now pass through changes in global oil prices to domestic retail fuel prices (Figure 8)—are also supporting consumption, offsetting slowing remittances due to lower flows and currency appreciation against the euro. Continued security risks and spillovers from conflicts, meanwhile, still weigh on domestic demand.

Figure 8
Oil Price Pass Through Higher for Fuel than Electricity 1/
(Proportion of Total Sample, Expected end-June 2016)



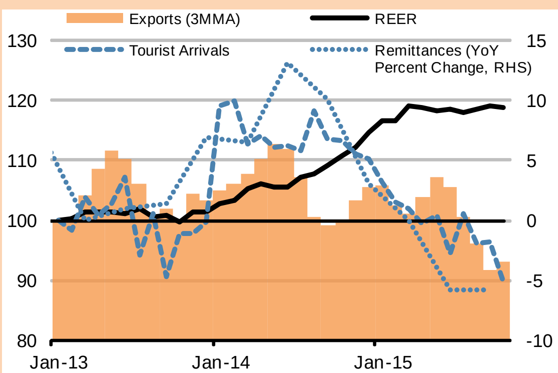
Sources: IMF staff estimates.
1/ Pass-through period is defined as the oil price drop since Sept 2014 to end-June 2016

The pick-up in economic activity is proceeding unevenly. In 2015, Mauritania's exports slowed due to lower iron ore prices and weaker demand from China. In Tunisia, heightened security threats hampered confidence and tourism. Spillovers from Syria's conflict hurt confidence in Jordan and exacerbated the difficulties in

Lebanon from the domestic political impasse and lack of structural reforms. In Egypt, growth is being held back by concerns over security and rising external vulnerabilities (see below). Economic activity is also expected to slow in Morocco, reflecting lower agricultural production.

External positions are weakening because of slowing exports and remittances but are being supported by lower energy import bills. Exports of goods are declining—mainly to the euro area and China (35 percent and 5 percent of the region's exports, respectively) (Figure 9). Against a backdrop of stable demand from the region's main export markets, this reflects an erosion of cost-competitiveness (evidenced by appreciating real exchange rates), which, along with heightened security concerns, has also reduced tourist receipts from the euro area. Declining remittances add to these pressures. In

Figure 9
Declining Exports, Tourism, and Remittances
(Index Values, Jan 2010 = 100)



Sources: National authorities; Bloomberg, LP; and IMF staff calculations.
Note: Exports and remittances are measured in U.S. dollars. Exports are expressed in constant January 2010 exchange rates.

2016, the region's current account deficit is projected to remain unchanged for a third straight year (at 4½ percent of GDP). Yet the drop in imports (mainly energy products), supported by stable financial flows, is set to raise reserve coverage by 1 month of imports to 6¼.

In some cases, international reserve coverage is very low. In Egypt, where the current account is worsening from near balance in 2014 to a projected 5¼ percent of GDP deficit in 2016, reserve coverage is at 3 months of imports. Against this backdrop, the depreciation of the currency, by 13 percent against the U.S. dollar in March 2016, is a welcome development. In Sudan, limited access to external financing and de-risking by international banks have complicated the policy adjustment and kept international reserves low.

Sharply Declining Inflation

Continuing a sharp decline that began in mid-2014, inflation is projected to fall to 6 percent this year—a 1 percentage point drop from last year and a 3½ percentage point decline since 2014. Among other factors, lower food and energy prices (where pass-through has been allowed) and currency appreciation against the main import partners—China and the euro area (15 and 25 percent of imports, respectively)—are the main drivers. Continued energy subsidy phase-outs (including in electricity), monetization of fiscal deficits, and, in some cases, exchange rate depreciation are preventing a faster decline in inflation.

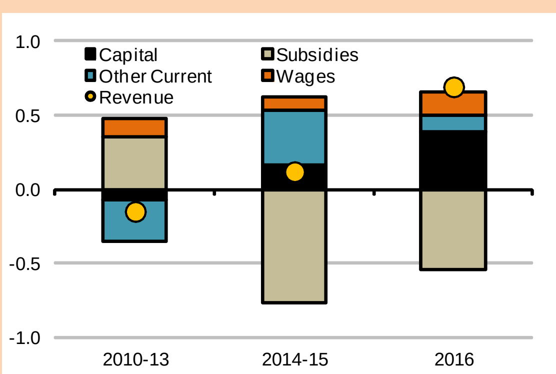
Downside Risks Dominate

The economic outlook is subject to significant downside risks**.** A worsening in security conditions or social tensions, reform fatigue, or increased spillovers from regional conflicts could derail policy implementation and weaken economic activity. Downside external risks have also risen since last October. Tighter and more volatile global financial conditions—arising from movement in the U.S. interest rate and recent turbulence in global financial markets—could raise external borrowing costs, feed into domestic interest rates, and slow capital inflows. Weaker growth in China could reduce infrastructure financing (Egypt, Pakistan) and put further pressures on commodity prices—weakening international reserves in commodity exporters (especially Mauritania). Weaker growth in the GCC could dampen remittances, tourism, exports, investment, and official financial support. Weaker growth in the euro area and/or emerging markets would have similar effects. On the upside, a faster improvement in domestic confidence in response to ongoing reforms may bolster growth.

Fiscal Positions Improving Yet Still Vulnerable

Concerted fiscal efforts, together with lower oil prices, have reduced fiscal deficits. The region's average deficit is expected to fall to 6½ percent of GDP in 2016 from a 2013 peak of 9½ percent. This improvement is mainly due to subsidy reforms (Figure 10). Where reforms are yet to be completed (Egypt, Sudan, Tunisia), low oil prices have reduced energy subsidy bills. In some cases, low oil prices have also improved the balance sheets of state-owned enterprises (SOEs)—especially in electricity (Jordan, Pakistan)—reducing their borrowing from the banking system and arrears. To lower the adverse impact of fiscal consolidation on growth and stimulate job creation, some savings from lower energy subsidies are being channeled toward infrastructure, health, and education spending, as well as targeted social assistance and wage bills (Egypt, Morocco, Pakistan, Tunisia).

Figure 10
Changes in Government Spending and Revenues
(Percent of GDP, Change from Prior Year)



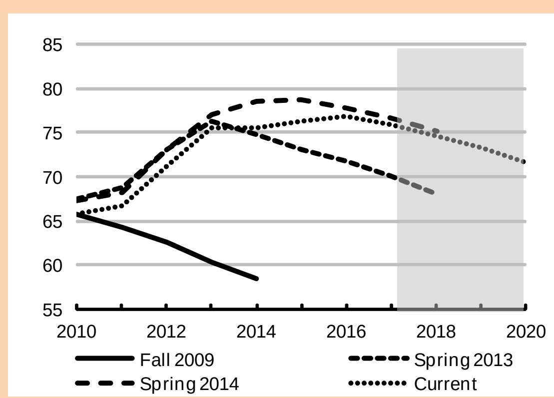
Sources: National authorities; and IMF staff estimates.

Against a backdrop of high spending pressures and downside risks to growth, maintaining progress with fiscal consolidation is a challenge. Spending pressures are mounting with the need to address social tensions and the rising costs of basic public services, in part owing to growing numbers of refugees (Jordan, Lebanon). Tax revenues are suffering from lower ad valorem fuel tax revenues (Jordan) and weak collection.

This year, revenues are expected to rise with the elimination of exemptions (Pakistan), a reduction in tax loopholes, income tax reforms (Jordan), higher excises, and strengthened administration. Many of these revenue reforms, however, are yet to be implemented and unexpected shocks or lower growth could undermine these efforts. Financial assistance from GCC countries is also expected to slow in line with their economies.

Despite recent stabilization, public debt ratios remain high, especially in Egypt, Jordan, and Lebanon where they range between 90 and 145 percent of GDP (Figure 11). These large ratios undermine investor confidence, particularly in a volatile global financial market environment, raising debt servicing costs and financing needs. High public sector loan concentrations, absent deeper financial markets, could pose risks to the stability of the banking sector, which has remained liquid, capitalized, and profitable, despite a recent rise in non-performing loans stemming from weak economic activity.

Figure 11
Public Debt: Is It Finally Poised to Decline?
(Percent of GDP)



Sources: National authorities; and IMF staff estimates.

To put debt on a sustainable path, continued fiscal consolidation is needed. Revenue measures targeting the higher income segments of the population and more efficient tax collection—such as moving to a technology-based system—can advance fiscal consolidation with a smaller impact on growth than spending measures. Low oil prices provide an opportunity to complete on-budget energy subsidy reforms and reduce the losses of energy SOEs by advancing automatic pricing. The current sociopolitical environment makes shrinking large public wage bills difficult, but they could be contained through civil service and pension reforms that free resources for basic services and infrastructure, stimulating private sector growth and creating several times the job opportunities that can be found in the public sector. Improved financial management can raise efficiency. Where vulnerabilities are high, fiscal gains should be saved to build buffers against future adverse shocks. Where buffers are already strong, part of the gains could be used to increase growth-enhancing spending, which would also create jobs. Greater exchange rate flexibility would support fiscal consolidation by partly absorbing external shocks and would improve external positions by strengthening competitiveness.

Creating Jobs and Raising Living Standards

Besides macroeconomic stability, much higher, and more inclusive, economic growth is needed to create jobs and improve living standards. Targeted structural reforms are key to boosting growth.[1] The cost of doing business, as well as supply-side bottlenecks—which hold back productivity—can be reduced through better protection of investor rights, more efficient and better quality infrastructure, and regulatory reform. Raising labor market efficiency and matching education to private sector needs are both critical to reducing unemployment and increasing worker productivity. Greater coverage of credit bureaus would facilitate access to finance. And increased trade openness can enable countries to join job-creating global manufacturing supply chains.

[1] See Mitra and others (2016) "*Avoiding the New Mediocre: Raising Long-Term Growth in the Middle East and Central Asia*," available at www.imf.org.

Box 1. A Roadmap for Countries to Emerge From Conflicts

Violent conflicts continue to batter the MENAP region. Their humanitarian cost is immense. The United Nations (UN) estimates that the conflict in Syria alone has killed as many as 250,000 people, with many millions more displaced. Between October 2015 and March 2016, more than 600,000 people fled the country, bringing the total number of Syrian refugees to almost 5 million. During the same period, violent non-state actors carried out more than 30 attacks on civilians in the region (outside Syria), killing more than 800 people and wounding hundreds more. These groups were also responsible for attacks worldwide.

The massive costs in Iraq, Libya, Syria, and Yemen continue to mount. Intense violence has caused a scarcity of food and other necessities, damaged infrastructure and institutions, driven up inflation, hurt savings, and worsened fiscal and external positions. The economic impact has been sizable. Due to the protracted conflict, Syria's GDP today is less than half of what it was before the war, while Yemen's real GDP per capita is estimated to have contracted by more than 40 percent since 2010. By curtailing and diverting resources away from much-needed social spending and transfers, as well as from capital spending, conflicts undermine countries' economic prospects.

Other countries in the region have suffered significant spillovers. The task of hosting large refugee populations has put enormous pressure on government budgets, public infrastructure, and services. Worsened security and confidence have also weighed on trade, investment, and tourism, weakening growth. The World Bank estimates that the conflict in Syria has lowered Lebanon's real GDP growth by almost 3 percentage points every year since it started, and that the worsening of the crisis in Syria and Iraq in 2015 also had a negative impact on economic growth in Jordan. Conflicts also continue to diminish the willingness of countries in the region to undertake necessary, though politically difficult, economic reforms.

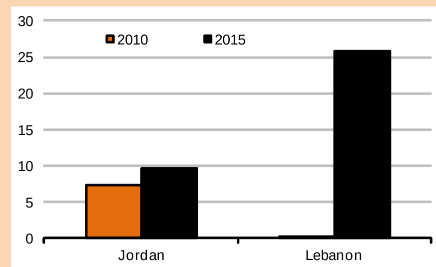
Countries in the region have been adapting to their circumstances in a number of ways. For example, Lebanese traders who suffered a drop in demand from Syria have since found new export markets.

In cooperation with the UN and other relief agencies, countries hosting refugees have developed plans to respond to the needs of refugees and host communities, such as through the provision of temporary employment subsidies, expanding the enrollment of refugees in schooling, supporting local authorities to provide public services, and various infrastructure projects.[1]

Figure 1.1

Refugees

(Percent of Total Population 1/)



Sources: UNHCR; and IMF staff estimates.
1/ Total registered refugees and people in refugee-like situations. The number of non-registered refugees is estimated to be as high as registered refugees in Jordan.

Given the mounting costs of conflicts, the international community needs to scale up and better coordinate its support. In addition to humanitarian assistance, developmental assistance should entail long-term support to rebuild infrastructure in conflict countries, and to strengthen resilience across the region. There are large financing needs, with host countries requiring additional financing to fund crisis-related projects. Aid agencies, meanwhile, are suffering from funding gaps. The international community has started to recognize these needs. The February 2016 London *Supporting Syria and the Region* conference, for example, led to commitments to step up financial support for refugees and host communities. It is now imperative that these pledges are translated into on-the-ground support in a timely and effective manner.

[1] Rother and others (forthcoming) "*The Economic Impact of Conflicts in the Middle East and North Africa Region: Macroeconomic Effects, Policy Implications, and the Role of the IMF*."

MENAP Region: Selected Economic Indicators, 2000–17

(Percent of GDP, unless otherwise indicated)

	Average 2000–12	2013	2014	2015	Projections 2016	2017
MENAP[1]						
Real GDP (annual growth)	5.2	2.3	2.8	2.5	3.1	3.5
Current Account Balance	9.5	10.0	5.5	-3.6	-6.9	-5.2
Overall Fiscal Balance	2.9	-0.3	-2.9	-9.2	-10.0	-8.2
Inflation, p.a. (annual growth)	6.8	10.0	7.0	5.7	5.2	4.9
MENAP oil exporters						
Real GDP (annual growth)	5.4	1.9	2.7	1.9	2.9	3.1
Current Account Balance	13.9	15.0	8.9	-3.1	-8.0	-5.6
Overall Fiscal Balance	6.7	4.0	-0.6	-10.1	-11.6	-9.4
Inflation, p.a. (annual growth)	7.5	10.4	5.8	5.3	5.0	4.0
***Of which:* Gulf Cooperation Council (GCC)**						
Real GDP (annual growth)	5.1	3.2	3.5	3.3	1.8	2.3
Current Account Balance	17.1	21.3	14.5	-1.0	-7.0	-4.1
Overall Fiscal Balance	10.8	10.2	3.3	-9.9	-12.3	-10.8
Inflation, p.a. (annual growth)	2.8	2.8	2.6	2.5	3.3	1.9
***Of which:* Non-GCC oil exporters**						
Real GDP (annual growth)	5.8	0.5	1.7	0.3	4.2	4.0
Current Account Balance	9.1	4.1	-0.9	-6.9	-9.6	-8.0
Overall Fiscal Balance	2.6	-3.0	-5.0	-10.3	-10.9	-7.7
Inflation, p.a. (annual growth)	12.5	19.0	9.5	8.6	7.0	6.4
MENAP oil importers						
Real GDP (annual growth)	4.6	3.1	2.9	3.8	3.5	4.2
Current Account Balance	-2.3	-5.1	-4.2	-4.6	-4.5	-4.6
Overall Fiscal Balance	-5.4	-9.4	-7.7	-7.3	-6.6	-5.7
Inflation, p.a. (annual growth)	5.5	9.1	9.4	6.6	5.8	6.7
Arab World						
Real GDP (annual growth)	5.5	3.0	2.2	2.8	2.7	3.2
Current Account Balance	11.2	11.4	6.4	-4.5	-8.6	-6.5
Overall Fiscal Balance	4.2	1.3	-3.0	-11.2	-12.7	-10.5
Inflation, p.a. (annual growth)	4.1	4.9	4.8	4.6	4.7	4.1

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

[1]2011–17 data exclude Syrian Arab Republic.

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

MENAP oil exporters: Algeria, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, the United Arab Emirates, and Yemen.

GCC countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.

Non-GCC oil exporters: Algeria, Iran, Iraq, Libya, and Yemen.

MENAP oil importers: Afghanistan, Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Pakistan, Sudan, Syria, and Tunisia.

Arab World: Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Sudan, Syria,Tunisia, United Arab Emirates, and Yemen.

Caucasus and Central Asia: Battered by External Shocks

Economic growth has slowed to a two-decade low in the Caucasus and Central Asia (CCA) region, owing to the large and sustained decline in commodity prices, wide-ranging spillovers from Russia's recession, and the slowdown and rebalancing of China's economy. Fiscal and external balances have deteriorated and financing costs have risen. Although currency weakening and fiscal easing have helped to mitigate the impact of these shocks, inflation and financial sector vulnerabilities have increased, in some cases exacerbated by policy uncertainty. Strengthening macroeconomic policy frameworks and financial sector supervision is essential to maintain stability in these challenging circumstances. Fiscal policy should strike a balance, depending on the size of buffers and available financing, between supporting economic activity in the near term and ensuring debt sustainability over the medium term. Intensifying structural reforms would facilitate the adjustment by boosting medium-term economic prospects, improving competitiveness, and creating jobs.

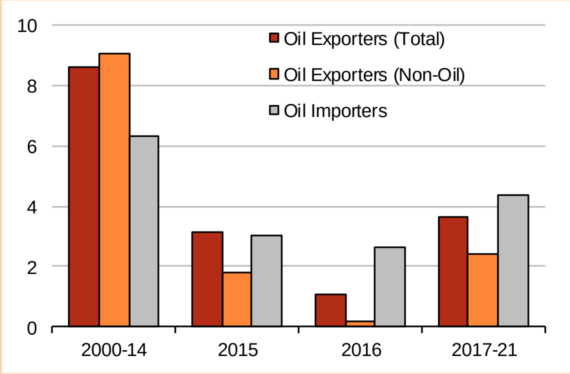
Sharp Economic Downturn

The external environment has continued to deteriorate since October 2015 from an already challenging position. Oil prices are projected to average around $35 a barrel in 2016, $16 below the 2015 average. Russia's economy is expected to contract further this year, by about 1¾ percent, reducing trade, remittances, and investment to the region. And China's slowdown is expected to weaken external demand and commodity prices further.

As a result of these external shocks, growth in the CCA region is projected to decline to 1.2 percent in 2016—a two-decade low—and recover only modestly in 2017 (Figure 1). With the shocks expected to persist, the medium-term outlook has also weakened significantly, with average growth for 2017-21 projected at 3.7 percent, well below the growth of 8.3 percent in 2000-14.

In oil exporters, growth is projected to decline to 1.1 percent this year, from 3.2 percent in 2015, because of declining oil production and public investment, softening private demand—in part, reflecting weakening confidence—and increased exchange rate and monetary policy uncertainty.

Figure 1
Dimming Growth Prospects
(Real GDP, Percent Change)



Sources: National authorities; and IMF staff estimates.

In oil importers, growth is projected at 2.6 percent, down from 3 percent in 2015. The positive impact of lower oil prices on economic activity has been limited because domestic fuel prices have declined only modestly (some 20 percent since 2014), owing to low competition and currency depreciation. Any boost to consumption has been partially offset by declining remittances from Russia (an important source of income in Armenia, the Kyrgyz Republic, and Tajikistan, where remittances ranged between 9 and 32 percent of GDP in 2015). Lower exports to

Russia and weaker direct investment from Russia, as well as subdued demand (mainly from China) and prices for key non-oil commodity exports (copper, aluminum, cotton) are also weighing on the outlook.

Risks Tilted to the Downside

Risks to the outlook stem mostly from a further deterioration of the external environment, as well as the domestic banking system. A further weakening of oil prices would affect oil exporters directly, and oil importers through its impact on Russia's economy, the value of the Russian ruble, and spillovers through trade and remittances. Lower oil prices could also reduce investment in hydrocarbons, which drive medium-term growth prospects in oil exporters. A deeper slowdown in China would also reduce external demand, both directly, as the region has seen its share of exports to China increase by about 10 percentage points of total exports since 2005, and indirectly, through other commodity prices and investor confidence.

Domestic risks mainly relate to the vulnerability of banks to further currency depreciation. Capital buffers have helped absorb the impact of the recent macroeconomic shocks so far. In countries with high vulnerabilities and weak supervision, risks to financial stability may materialize if economic conditions continue to deteriorate.

Currencies under Pressure

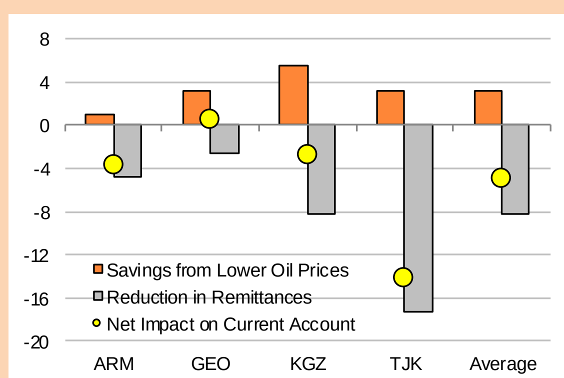
All countries have adjusted their currencies since 2014, five of them by at least 30 percent as of February 2016. This has helped mitigate the effects of the external shocks and limit foreign exchange reserve losses; reserves remain above 3 months of imports in all countries except Tajikistan, where coverage is about 1½ months of imports. Georgia, the Kyrgyz Republic, and, more recently, Kazakhstan have allowed considerable exchange rate flexibility. Others have opted for managing their currencies more tightly. Azerbaijan has maintained a narrow band after large devaluations in 2015. Tajikistan, Turkmenistan, and Uzbekistan have intervened heavily and implemented administrative controls. The exchange rate in Armenia has remained stable, supported by periodic interventions.

Despite the currency adjustment in 2015, real effective exchange rates have appreciated in Armenia, Turkmenistan, and Uzbekistan. Currencies remain under pressure as foreign exchange earnings have been declining, with parallel market spreads rising in countries with administrative controls (especially in Uzbekistan).

External Balances Adjusting

External balances are adjusting in response to the external shocks and currency depreciations. In oil exporters, the combined current account deficit is projected to widen to 4 percent of GDP this year, from 2.7 percent last year, mainly due to the sharp drop in oil export revenues, with only a partial offset from import contraction of 15 percent of GDP. In oil importers, the current account deficit is set to remain at a rather high 9.6 percent of GDP this year. Lower remittances and exports (including of non-oil commodities) offset reductions in oil import bills and non-oil imports, due to weakening domestic economic activity and currency depreciation (Figure 2). Across the region, import compression has been largest where currencies depreciated the most.

Figure 2
CCA Oil Importers: Reduction in Remittances Offsets Gains from Lower Oil Prices
(Percent of GDP, 2015)



Sources: IMF staff estimates.

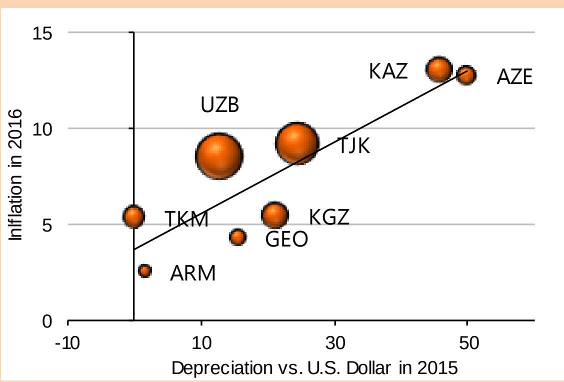
Stronger Policy Frameworks Needed

Monetary policy is expected to remain tight as currency depreciations have heightened inflationary pressures, especially in countries where inflation has been historically higher (Figure 3). In Azerbaijan and Kazakhstan, after sizable depreciations, inflation has reached double digits for the first time in more than 15 years. In oil importers, where currency depreciations have been smaller, lower fuel and food prices, along with weak domestic demand, have helped contain inflationary pressures. In Armenia and the Kyrgyz Republic, average inflation is projected to decline in 2016.

Figure 3

Currency Depreciation and Expected Inflation

(Percentt)



Sources: National authorities; and IMF staff estimates.
Note: Marker size indicates average inflation in 2000-13.

Since all central banks in the region have price stability as their main policy objective, this environment illustrates the importance of modernizing exchange rate and monetary policy frameworks. An effective interest rate instrument is needed to replace the exchange rate as the nominal anchor. To this end, it is important to enhance the independence and institutional capacity of central banks, improve transparency and accountability, and strengthen communication on policy actions.

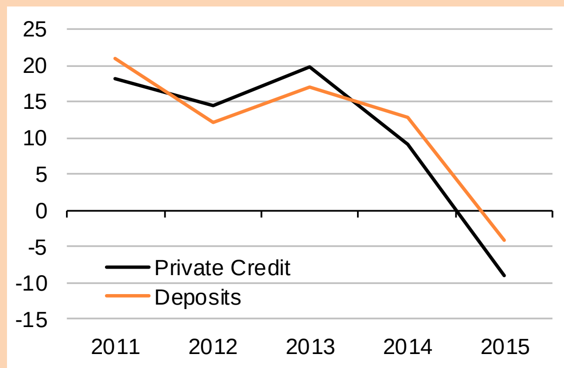
Financial Sector Risks Elevated

The highly dollarized bank balance sheets are likely to continue to weaken, at a pace augmented in some cases by bad loans from previous crises. Liquidity is declining, largely because of slowing foreign currency earnings and capital flight, exacerbated by increasing deposit dollarization. Credit risks are on the rise, as creditworthiness of unhedged borrowers declines because of slower growth and weaker currencies. With economic activity weakening, private sector credit will continue to soften (Figure 4). Bank profitability is also projected to decline further. The number of loss-making and undercapitalized banks has increased, leading to mergers and/or closures in a number of countries (Azerbaijan, Kazakhstan).

Figure 4

Financial Intermediation Slowing Down

(Private Credit and Deposits, Percent Change 1/)



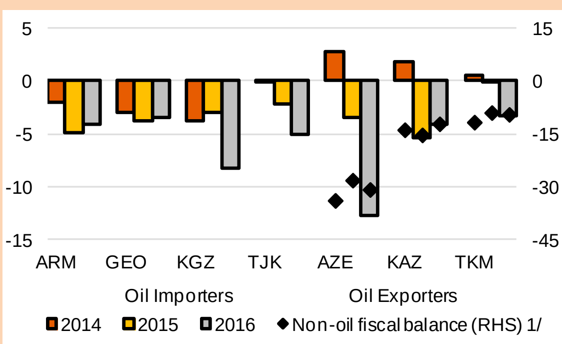
Sources: National authorities; and IMF staff estimates.
1/ Adjusted for exchange rate effects.
Note: Excludes Turkmenistan and Uzbekistan.

Country authorities have taken some measures in response, but more is needed to minimize the risks to financial stability. Some countries have changed capital adequacy and net open position requirements, and increased required reserves for foreign currency deposits. It is also essential to enhance financial surveillance through intensified monitoring of liquidity risks and regular stress-testing, as well as strengthen supervision, and macroprudential and crisis management policies. Forbearance should be avoided.

Ensuring Fiscal Sustainability While Supporting Growth

To mitigate the impact of the shocks, most CCA countries allowed their fiscal deficits to widen last year, which helped support economic activity. This year, with the shocks continuing, buffers declining, and financing costs edging up, some countries have started to consolidate their fiscal positions, and/or rationalize high levels of public investment, to help ensure fiscal sustainability. Other countries are continuing to allow their fiscal deficits to widen in support of growth (Figure 5). In oil exporters, the fiscal deficit is anticipated to widen by 1.7 percentage points of GDP to 4.9 percent in 2016, while in oil importers, it is projected to reach 4.9 percent of GDP, 1.4 percentage points higher than 2015.

Figure 5
Fiscal Tightening in Some Countries
(Overall fiscal balance in percent of GDP)



Sources: National authorities; and IMF staff estimates.
1/ In percent of non-oil GDP.

With oil prices likely to remain low and debt projected to rise (especially in the Kyrgyz Republic and Tajikistan), countries need to start fiscal consolidation as soon as cyclical conditions allow.

Countries with larger fiscal buffers can choose a slower pace of consolidation. Fiscal consolidation should avoid expenditure cuts that harm medium-term growth prospects, while safeguarding targeted social spending. Broadening the tax base and diversifying revenues would help reduce public sector exposure to commodity terms-of-trade shocks. Some countries have announced privatization plans, which, if implemented, should lead to much-needed revenue gains.

Promoting Private Sector-Led Growth

The recent external shocks have increased the urgency of unlocking the region's significant growth potential by diversifying away from commodities and reducing the reliance on remittances.

Living standards, as measured by GDP per capita, doubled over the past 12 years, largely owing to booming revenues from commodity exports and remittances. Now, with declines in commodity prices and remittances, it would take almost 25 years for living standards to double again. The region would lag behind other emerging market economies, unless structural reforms are enacted and accelerated.

The World Economic Forum's 2015–16 *Global Competitiveness Report* shows that Kazakhstan and all CCA oil importers made some progress in improving their business competitiveness last year. Yet, to foster vibrant market economies and boost economic prospects, countries need to take bolder steps to further improve the business environment, raise the quality of education, strengthen governance, and increase access to finance. This would foster private entrepreneurship, create much-needed jobs, and alleviate poverty, while improving confidence in a testing economic environment.

CCA Region: Selected Economic Indicators, 2000–17

(Percent of GDP, unless otherwise indicated)

	Average 2000–12	2013	2014	2015	Projections 2016	2017
CCA						
Real GDP (annual growth)	8.7	6.6	5.3	3.1	1.2	2.5
Current Account Balance	1.4	1.9	2.0	-3.4	-4.7	-3.0
Overall Fiscal Balance	2.8	2.8	1.4	-3.2	-4.9	-3.3
Inflation, p.a. (annual growth)	9.4	6.1	5.9	6.2	10.6	8.5
CCA oil and gas exporters						
Real GDP (annual growth)	9.0	6.8	5.4	3.2	1.1	2.4
Current Account Balance	2.8	2.9	3.4	-2.7	-4.0	-2.2
Overall Fiscal Balance	3.6	3.4	1.9	-3.2	-4.9	-3.2
Inflation, p.a. (annual growth)	9.6	6.4	6.1	6.3	11.2	8.8
CCA oil and gas importers						
Real GDP (annual growth)	6.5	5.6	4.6	3.0	2.6	3.5
Current Account Balance	-8.3	-7.2	-10.5	-9.6	-9.6	-8.7
Overall Fiscal Balance	-3.2	-2.4	-2.2	-3.5	-4.9	-3.7
Inflation, p.a. (annual growth)	7.7	3.6	4.6	4.8	5.2	5.7

Sources: National authorities; and IMF staff calculations and projections.
CCA oil and gas exporters: Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.
CCA oil and gas importers: Armenia, Georgia, the Kyrgyz Republic, and Tajikistan.