Key Messages: April 2021 MCD Regional Economic Outlook

The 2021 path to recovery in the Middle East and Central Asia (ME&CA) is expected to be long and divergent. The outlook will vary significantly across countries, depending on the race between vaccine and virus, and on the underlying fragilities and responses. 2021 will be the year of policies to continue saving lives and livelihoods and promoting recovery, while balancing the need for debt sustainability and financial resilience. Policymakers must not lose sight of transformational challenges of building forward better and accelerate erecting more inclusive, resilient, and green economies.

1. The recovery has started on diverging paths, with vaccine rollouts and policy response playing a key role in 2021 outlook

Strong policy responses and a better-than-expected external backdrop are supporting the recovery in ME&CA. An average of 2 percent fiscal packages and accommodative monetary policy helped cushion the pandemic's impact. In addition, with activity in advanced and major emerging economies bouncing back, global trade rebounding and commodity prices recovering, a better-than-expected external environment emerged since the second half of 2020. Furthermore, global financial conditions have remained broadly accommodative. Capital flows stabilized in late 2020 and rose at the start of 2021, before registering some outflows in recent weeks with the rise of US long-term yields.

A multispeed recovery:

- Overall, real GDP growth for the Middle East and North Africa region is expected to pick up to 4.0 percent in 2021. In the Caucasus and Central Asia, output is projected to rise by 3.7 percent in 2021, returning to its precrisis level by end-year. However, these averages mask wide differences across countries.
- *First,* the COVID-19 vaccine offers hope that the end of the crisis could be in sight. However, wide variance in the vaccine rollout is leading to a prolonged and uneven economic recovery. Early inoculators on average (e.g., GCC countries) have lifted their 2021 growth relative to October projections, with GDP expected to reach 2019 levels in 2022. Others are risking falling behind: widespread inoculation is not likely until 2022-23 amid weak health systems.
- *Second*, fragile and conflict-affected states, especially low-income countries, will continue to face formidable challenges, and economic activity on average is expected to remain 4 percent lower than already-anemic pre-pandemic levels by 2022. Economies that rely heavily on contact-intensive sectors, particularly tourism (e.g., Georgia and Jordan), will also recover more slowly than others, with economic activity reaching pre-pandemic levels in 2022-23.
- *Third*, *countries that have provided strong fiscal support* last year (e.g., Tajikistan, Uzbekistan) experienced a smaller contraction and are therefore expected to recover faster than those that did not (returning to pre-pandemic levels in 2021). However, many countries will run out of space—thus, continued fiscal support is not likely to be a main driver of growth.
- *Fourth,* the rise in oil prices supports the fiscal and external balances of oil exporters, and would support non-oil recovery, although OPEC+ production cuts limit the impact on overall growth.

Exceptional uncertainty around the outlook and significant challenges for countries with large and increased financing needs:

- The crisis has exacerbated preexisting vulnerabilities in the region, further exposing the extent of work needed to reduce poverty; provide equal opportunities for all, particularly for women and youth.
- The pandemic has led to a surge in public financing needs over 2021-22, about $1.1 trillion compared to $784 billions in 2018-19, with already-elevated domestic bank exposure to the public sector in several of the region's emerging markets. This could be exacerbated in the event of tightened global financial conditions or if a weaker-than-expected recovery delays the planned fiscal adjustment in 2021. Higher domestic financing needs risks further crowding out credit to the private sector, weighing down recovery prospects and threatening financial stability.
- The region's emerging markets are vulnerable to a rapid rise in US bond yields, which could lead to tighter financial conditions, renewed capital outflows, and higher sovereign spreads. Relative to the taper tantrum, vulnerabilities are higher for some countries, given elevated external and public debt ratios and gross financing needs, but comfortable reserve buffers provide some support. In fact, despite recent outflows, since the end of January 2021, the region has experienced capital inflows (US$490 million) until mid-March, and spreads have remained low.
- A premature and fast withdrawal of policy support could further weigh down the private sector, leading to potential bankruptcies, higher unemployment, and increased nonperforming loans, further reducing the liquidity available to support the recovery and threatening financial stability.
- Against this backdrop, the outlook remains highly uncertain and immediate challenges are formidable, particularly in highly indebted economies, as countries balance between saving lives and livelihoods, fostering a recovery, and safeguarding debt sustainability.

2. 2021 is the year of policymaking to accelerate the recovery and build forward better toward more inclusive, resilient, and greener economies.

- **Accelerating vaccine distribution** and ensuring that health systems are adequately resourced remain the most urgent priorities for the region. In addition, low-income countries should not be left behind, and **regional and international cooperation** should be enhanced, by bolstering COVAX funding, and sharing surplus vaccines.
- **Fiscal support** should remain flexible, well-targeted, and in place until the recovery is entrenched. In *countries without fiscal space,* support should be calibrated to safeguard debt sustainability. Fiscal adjustment should be anchored on a credible medium-term fiscal framework to reduce elevated debt burdens while providing maximum support to growth.
- **Financing risks** need to be mitigated to ensure financial stability and credit growth for a healing economy. In addition to prudent fiscal policies, this requires enhancing medium-term debt management strategies while advancing in the development of domestic capital markets to diversify the investor base and ensure a stable demand for government securities.
- Support in all countries should **target viable firms**, particularly those that could be rationed out of credit markets. Moreover, labor market policies should seek to prepare workers, particularly young people, for a post-pandemic world, including **through vocational training and hiring incentives.**

- **The region must accelerate transformation and boldly address the deep-seated transformational challenges, to build forward better.** Countries should leverage trends such as digitalization and technology to prepare their economies for the future, while enhancing social safety nets to mitigate the impact of future shocks and reconstruct the inclusion nexus. Governance should be improved, and more policies are needed to adapt and invest in climate-resilient infrastructure.
- The IMF supported the region with over $17 billion in financing last year and will remain a steadfast partner in these efforts through additional financing, technical assistance, capacity development, and policy advice.