

MCD October 2021 Regional Economic Outlook

Key Messages

- **Fragile recovery continues**, with real GDP for the **Middle East and North Africa (MENA)** region projected to expand by 4.1 percent in both 2021 and 2022 following last year's sharp contraction. Real GDP for the **Caucasus and Central Asia (CCA)** region is expected to expand by 4.3 percent in 2021 and 4.1 percent in 2022.
- **The region has made good progress since the beginning of this year.** In addition to countries in the Gulf Cooperation Council, several oil-exporting and emerging market economies (such as Azerbaijan, Jordan, Kazakhstan, and Morocco) have advanced in their vaccination roll outs. In addition, data available for the first half of 2021 shows that recovery is ongoing despite the new outbreaks. Prospects for oil-exporting economies improved with higher oil prices and gradually declining production curbs.
- **Nevertheless, the recovery is uneven and incomplete, and new challenges are emerging:**
 - **A new pandemic wave is hitting countries with weak vaccination progress.** Low-income countries and fragile and conflict-affected states are relying on multilateral initiatives for vaccine access and are lagging behind.
 - **Rising inflation and declining macro policy space:** Higher inflation reduces monetary policy space, adding to the challenges posed by limited fiscal policy space. In addition, the rise in food prices increases food insecurity risks, particularly for low-income countries and fragile and conflict-affected states.
 - **Divergent recoveries persist with concerns about economic scarring:** Over the medium term, real GDP is expected to remain below precrisis projections by around 2.4 percent in the **MENA** region and by around 6.9 percent in the **CCA** region.
 - **Inequities are increasing.** The low-skilled, the young, women, and migrant workers have been affected the most by the pandemic, as have smaller firms, particularly those in contact-sensitive sectors.
- **Risks and vulnerabilities are accumulating** with the increased uncertainty about the rapidity to surmount the pandemic. Risks include delays in vaccinations; tighter global financial conditions; a premature withdrawal of policy support; persistent inflation; social unrest, geopolitical, and security risks; and climate shocks.
- **The region needs to tackle few key challenges:**
 - **Debt stabilization:** The increase in debt ratios and contingent liabilities in 2020 has worsened debt stabilization prospects for some countries, particularly if the recovery is protracted, interest rates rise, and fiscal adjustment is delayed.
 - **Weak employment recovery:** The average unemployment rate for the Middle East and Central Asia region rose to 10.7 percent in 2020—11.6 percent in **MENA** and 8.7 percent in **CCA**—far exceeding rates seen during other recent crises. Informality also has not served as a buffer, given the impact of lockdown measures. In the absence of ambitious reforms, growth might need to reach nearly 10 percent in some **MENA, Afghanistan and Pakistan** countries and more than 8 percent in some **CCA** countries to stabilize unemployment.
 - **Corporate sector impact:** The corporate sector has recovered to pre-pandemic levels, but smaller firms and those in contact-sensitive sectors are lagging behind. Digitally enabled firms as well as those with strong precrisis fundamentals and liquidity buffers were able to partly mitigate the pandemic's impact. Depending on the strength of the recovery and policy support, 15 to 25 percent of firms may need to be restructured or liquidated. This could have spillover effects to banks exposed to these firms and constrain the provision of credit in the years ahead.

- **Policy tradeoffs:** Many countries will face difficult policy tradeoffs as they manage the pandemic, particularly that both fiscal and monetary policy space has become more limited. To build the most effective recovery, policies need to be comprehensive and exploit synergies.
 - *Vaccines:* Ramping up vaccine acquisition and distribution remains the top short-term priority to save lives, support the recovery, and lessen divergences. Strong global and regional cooperation will be critical to achieve the goal of vaccinating at least 40 percent of the region's population by the end of this year and 70 percent by the first half of 2022.
 - *Fiscal support:* Additional support should be well targeted, and the eventual withdrawal of support in countries with more fiscal space should be gradual and well communicated. Countries without fiscal space would need to adjust despite the fragile recovery, highlighting the importance of the quality and composition of the adjustment.
 - *Monetary support:* If inflation proves persistent, central banks may need to raise interest rates preemptively to prevent de-anchoring of inflation expectations.
 - *Macro policy frameworks:* Improving policy frameworks will be important to reduce trade-offs. When fiscal adjustments occur, they should be anchored in a credible, medium-term fiscal plan that clearly illustrates debt sustainability. Improvements in monetary frameworks and clear communication strategies would bolster credibility and help countries effectively respond to rising inflation.
 - *Financial policies:* A gradual withdrawal of financial sector support—in a way that avoids bankruptcies while targeting support to viable firms—is critical to boosting the private sector.
 - *Labor markets:* Encouraging labor reallocation is vital once the recovery takes hold, including through modernizing public employment services and expanding vocational training, particularly for the youth and women. Labor markets need to become more responsive to growth by pursuing reforms to reduce informality, rationalize large public sector employment, and lessen regulatory burden on businesses.
- **Prepare for a new chapter by investing in a transformational recovery:** The crisis has provided silver linings to move to a developmental model that will lead to resilient, sustainable, inclusive, and greener growth.
 - *Reducing role of the state:* Reorient the state's focus toward health, education, and expanding social safety nets. In parallel, a thorough reevaluation of the ultimate objectives of state-owned enterprises and their governance, together with competition-enhancing regulatory reform, is critical to identify and reduce fiscal risks while promoting private sector innovation and growth.
 - *Leveraging global trends:* Expand digital technologies, which were key to the crisis response, would help deliver safety nets, develop new growth sectors, and ensure the region stays competitive globally.
 - *Addressing climate:* Invest in climate-resilient technology to tackle an existential crisis and create new job opportunities but will require urgent policy action and regional cooperation.
 - *IMF:* In addition to technical support and policy advice, the IMF has supported its members in the region with \$20 billion in financing since the pandemic began and allocated Special Drawing Rights that supplement the region's reserve assets by \$49.3 billion, which will help members manage policy tradeoffs.