INTERNATIONAL MONETARY FUND

REGIONAL ECONOMIC OUTLOOK

MIDDLE EAST AND CENTRAL ASIA

2020 OCT

World Economic and Financial Surveys

Regional Economic Outlook

Middle East
and Central Asia

OCT 20

The *Regional Economic Outlook: Middle East and Central Asia* is published annually in the fall
to review developments in the Middle East and Central Asia. Both projections and policy
considerations are those of the IMF staff and do not necessarily represent the views of the IMF,
its Executive Board, or IMF Management.

Contents

Tables

Acknowledgments

Assumptions and Conventions

A number of assumptions have been adopted for the projections presented in the *Regional Economic Outlook: Middle East and Central Asia.* It has been assumed that established policies of national authorities will be maintained, that the price of oil[1] will average \$41.69 a barrel in 2020 and \$46.70 a barrel in 2021, and that the six-month London interbank offered rate (LIBOR) on US dollar deposits will average 0.74 percent in 2020 and 0.41 percent in 2021. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The 2020 and 2021 data in the figures and tables are projections. These projections are based on statistical information available through early September 2020.

The following conventions are used in this publication:

- In tables, ellipsis points (. . .) indicate "not available," and 0 or 0.0 indicates "zero" or "negligible." Minor discrepancies between sums of constituent figures and totals are due to rounding.

- An en dash (–) between years or months (for example, 2011–12 or January–June) indicates the years or months covered, including the beginning and ending years or months; a slash or virgule (/) between years or months (for example, 2011/12) indicates a fiscal or financial year, as does the abbreviation FY (for example, FY 2012).

- "Billion" means a thousand million; "trillion" means a thousand billion.

- "Basis points (bps)" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

As used in this publication, the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

The boundaries, colors, denominations, and any other information shown on the maps do not imply, on the part of the International Monetary Fund, any judgment on the legal status of any territory or any endorsement or acceptance of such boundaries.

---

[1]Simple average of prices of UK Brent, Dubai Fateh, and West Texas Intermediate crude oil.

Country Groupings

The October 2020 *Regional Economic Outlook* (REO): *Middle East and Central Asia* covers countries in the Middle East and Central Asia Department (MCD) of the International Monetary Fund (IMF). It provides a broad overview of recent economic developments and of prospects and policy issues for the medium term. To facilitate the analysis, the 32 MCD countries covered in this report are divided into two groups: (1) countries of the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region—which are further divided into oil exporters and oil importers—and (2) countries of the Caucasus and Central Asia (CCA) region. The country acronyms and abbreviations used in some tables and figures are included in parentheses.

MENAP oil exporters comprise Algeria (ALG), Bahrain (BHR), Iran (IRN), Iraq (IRQ), Kuwait (KWT), Libya (LBY), Oman (OMN), Qatar (QAT), Saudi Arabia (SAU), the United Arab Emirates (UAE), and Yemen (YMN).

MENAP oil importers[1] comprise Afghanistan (AFG), Djibouti (DJI), Egypt (EGY), Jordan (JOR), Lebanon (LBN), Mauritania (MRT), Morocco (MAR), Pakistan (PAK), Somalia (SOM), Sudan (SDN), Syria (SYR), Tunisia (TUN), and West Bank and Gaza (WBG).

MENA comprises Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, the United Arab Emirates, West Bank and Gaza, and Yemen.

MENA oil importers comprise Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Somalia, Sudan, Syria, Tunisia, and West Bank and Gaza.

The **GCC** (Gulf Cooperation Council) comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

The **Non-GCC** oil-exporting countries are Algeria, Iran, Iraq, Libya, and Yemen.

CCA countries comprise Armenia (ARM), Azerbaijan (AZE), Georgia (GEO), Kazakhstan (KAZ), the Kyrgyz Republic (KGZ), Tajikistan (TJK), Turkmenistan (TKM), and Uzbekistan (UZB).

CCA oil exporters comprise Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.

CCA oil importers comprise Armenia, Georgia, the Kyrgyz Republic, and Tajikistan.

What is new: West Bank and Gaza is included in all regional aggregates starting with the October 2020 *Regional Economic Outlook: Middle East and Central Asia.*

---

[1]Somalia is included in all regional aggregates starting with the October 2017 *Regional Economic Outlook: Middle East and Central Asia.* For Sudan, data for 2012 onward exclude South Sudan. Because of the uncertain economic situation, Syria is excluded from the projection years of REO aggregates.

1. Regional Developments and Outlook

The coronavirus disease (COVID-19) pandemic continues to sweep across the region, though countries are cautiously proceeding with reopening. The necessary public health response to the pandemic has greatly decreased mobility and has come at a steep economic cost. As a result, real GDP in the region is projected to fall by 4.1 percent in 2020. This contraction is 1.3 percentage points larger than projected in April 2020. With global recovery subdued, downside risks continue to dominate the outlook as the pandemic continues to test countries. Ensuring adequate resources for health systems and correctly targeting support programs are still immediate priorities. In the near future, governments and policymakers need to continue to act decisively to secure jobs, provide liquidity to businesses and households, protect the poor, and put in place a carefully designed economic road map to recovery. Further actions will be necessary to address pressing vulnerabilities in countries with limited fiscal space to ensure a smooth recovery while maintaining macroeconomic sustainability.

Figure 1.1. New COVID-19 Cases: MCD
(Number of cases per million, seven-day moving average)
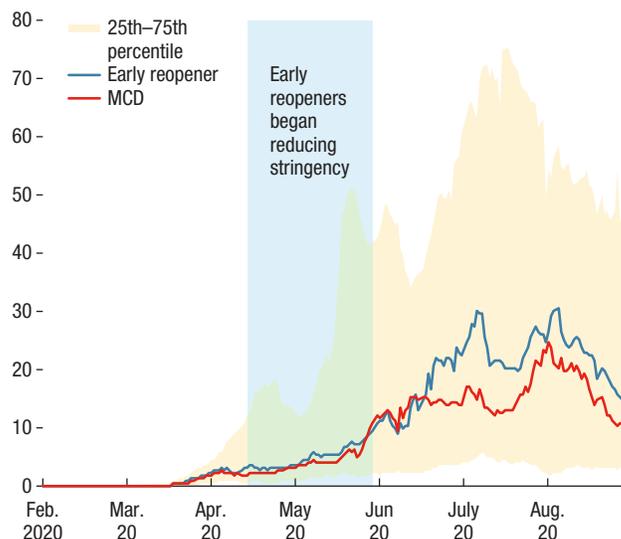
Sources: National authorities; and IMF staff calculations.
Note: MCD = Middle East and Central Asia countries. An MCD country is classified as an early reopener if its Oxford Stringency Index value at the end of May is lower than its highest, or most stringent, index value before the end of May. A country is classified as a late reopener if its index value at the end of May is its highest index value to date.

Necessary Lockdowns Came at an Economic Cost

The Middle East and Central Asia (MCD) region responded to the pandemic with swift measures to mitigate and contain the virus. Countries introduced a range of policies to restrict foreign and countrywide travel, close businesses and schools, trace and quarantine individuals at risk of contracting the virus, and require mandatory masks and gloves. The region's ability to treat those infected by the virus and protect health care workers varied significantly among countries, given respective differences in health care capacity. For example, the number of doctors per 100,000 people ranges from about 2.3 (Somalia 2014) to 712 (Georgia).

As of September 8, countries reported between 61 and 48,038 COVID-19 cases per million people and fatality rates between 2 and 304 people per million, with Armenia, Iran, Iraq, Oman, and the Kyrgyz Republic hit the hardest. With an average of 70 individuals per million, COVID-19-related deaths in the MCD region are higher than in sub-Saharan Africa and the Asia Pacific region, but well below those in Europe and the Western Hemisphere.

Since the first round of reductions in stringency, several countries saw growth in cases, which was more pronounced for many of the early reopeners (Algeria, Azerbaijan, Djibouti, Iran, Jordan, Kuwait, Kyrgyz Republic, Lebanon, Syria, United Arab Emirates, Uzbekistan, West Bank and Gaza). These countries, prior to reopening, also had higher infection rates (Figure 1.1).

The necessary public health response to the pandemic has greatly decreased mobility and brought a steep economic cost (Figure 1.2).

As a result, activity took a hit, and real GDP in the MCD region is projected to fall by 4.1 percent in 2020, after growing by 1.4 percent in 2019. The projected contraction for 2020 is 1.3 percentage points larger than in the April 2020 *Regional Economic Outlook: Middle East and Central Asia* (REO), in line with revisions to global growth over this period. The MCD countries' top 10 trading partners are also projected to contract by 1.5 percentage points more relative to the April 2020 REO. Despite supportive policies, growth revisions also appear to be reflecting a deeper-than-expected impact of lockdowns on mobility, in addition to weak global growth. Compared with other regions, the contraction in the MCD region is broadly in line with oil exporters and middle-income countries in sub-Saharan Africa, but nearly half that of Latin America and the Caribbean, reflecting the lower impact from COVID-19.

Early Signs of Improvement in a Difficult Environment

Virus containment measures since the onset of the pandemic in 2020 have had a severe adverse effect on economic activity beginning in March as shown, for example, by purchasing managers' indices across several countries (Figures 1.3 and 1.4). Partly reflecting these measures, first quarter real GDP for the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) contracted by 5 percent year over year and, while remaining positive, growth for the Caucasus and Central Asia (CCA) declined to 3 percent year over year. Although purchasing managers' indices have shown somewhat of a rebound in recent months, indicators remain subdued broadly around the expansion threshold.

Consumer demand took a hit on the back of weak tourism and remittance inflows, which are key income sources for the region. International flights have all but stopped in many countries (Figure 1.5). Remittances saw declines ranging from 6 percent year over year in Uzbekistan to more than 25 percent in the Kyrgyz Republic during the first half of 2020 (Figure 1.6). Remittances in Pakistan have so far bucked the trend on the back of strong flows from the United States and increased usage of formal remittance channels. Recent data are not available for fragile states, but the impact will likely be sizable for countries such as Yemen and Syria, which depend highly on Gulf Cooperation Council (GCC) remittances. These declines, in turn, could have a sizable impact on poverty and inequality (Chapter 2).

Oil-exporting countries were hit hardest by a double-whammy of the pandemic and the resulting sharp decline in oil demand and prices. After dropping to 20-year lows between March and April, the Organization of the Petroleum Exporting Countries and other major oil producers (OPEC+) agreement in April and extension in June (which entailed oil production curtailment) succeeded at stabilizing oil prices, which have recovered more than 50 percent of the losses suffered since the end of 2019 but still currently trade at 40 percent below pre-COVID-19 levels (Figure 1.7). With the plunge in oil prices and output, available data point to a collapse in oil revenues during the first half of 2020, approaching a maximum of 50 percent (for Iraq). In the near and medium term, oversupply and large inventories remain concerns, while demand continues to be dampened by low air traffic volume (despite recovering road traffic). Oil futures curves indicate that prices are expected to increase toward $48 a barrel in the medium term (from $41 for 2020), remaining some 25 percent below the 2019 average.

Mirroring measures taken to tackle COVID-19 (Box 1.1) and the oil price shifts, fiscal accounts in several countries deteriorated during the first half of 2020 (Figure 1.8), although less so than in other regions, reflecting smaller packages and expenditure reallocation (Chapter 3). For

Figure 1.2. Lockdowns Took a Toll on Activity

Mobility collapsed as countries locked down to fight the pandemic ...

1. MCD: Mobility and Stringency Index
   (Seven-day moving average)

Legend:
- Mobility around workplaces, MCD
- Mobility around workplaces, rest of the world
- Stringency index, MCD, rhs
- Stringency index, rest of the world, rhs
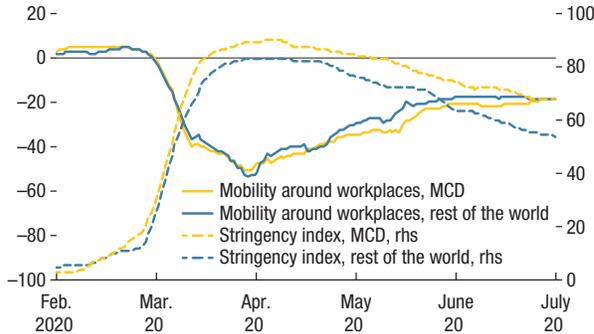
... leading to a collapse in economic activity in the second quarter of 2020 ...

2. Real GDP Growth
   (Year over year, percent change)

Legend: MENAP OE — MENAP OI — CCA — MCD
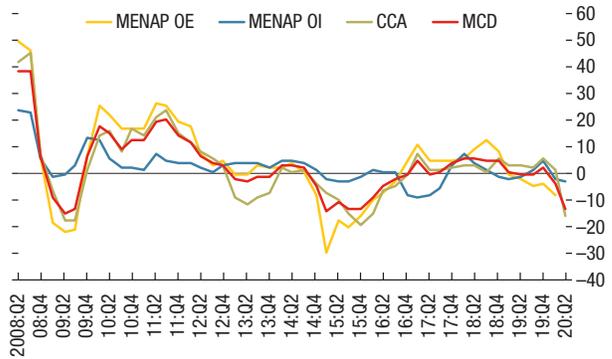
... in line with global trends.

3. Global Growth
   (Year over year percent change)

Legend: Euro area — United States — Russia — China
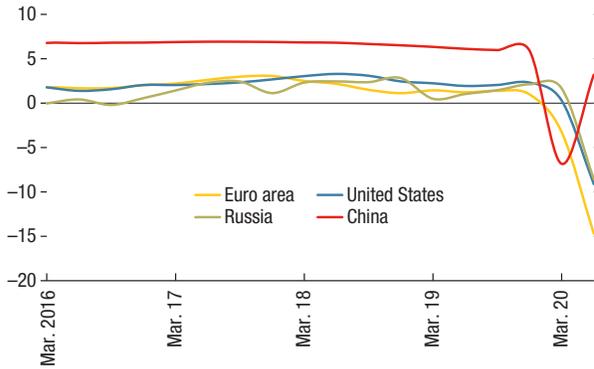
Consequently, GDP growth has been revised further down ...

4. MCD: Real GDP Projections
   (Percent change)

Legend: Oct. 2019 — Apr. 2020 — Current
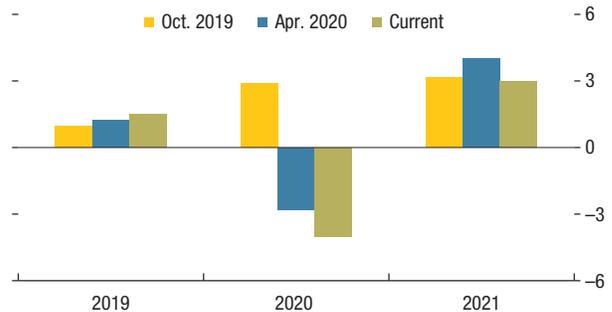
... in line with trading partners' revisions ...

5. MCD: Top 10 Trading Partners' Real GDP Growth
   (Percent change)

Legend: Oct. 2019 — Apr. 2020 — Current
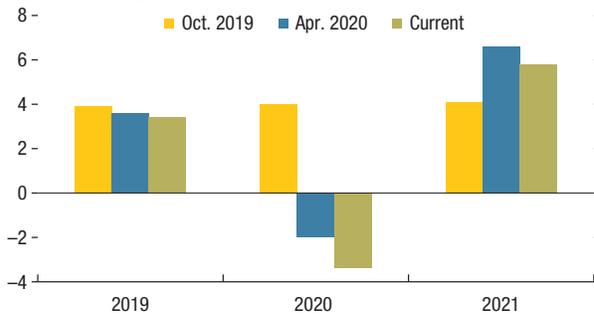
... and partly linked to lockdown stringency.

6. Revisions in 2020 GDP Growth since April 2020 and Stringency of COVID-19 Measures
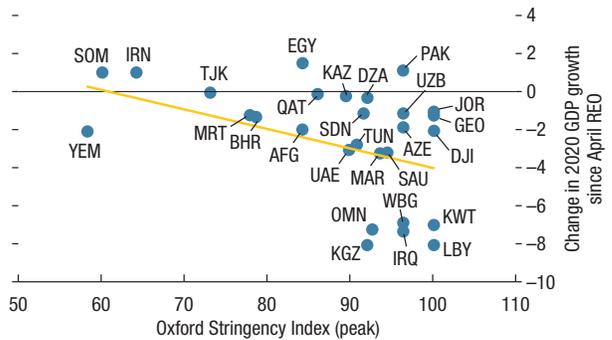
Sources: Oxford Coronavirus Government Response Tracker; Google Mobility Trends; national authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; lhs = left-hand scale; MCD = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers; rhs = right-hand scale. Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 1.3. PMI: Oil Exporters
(Seasonally adjusted, 50+ = expansion)
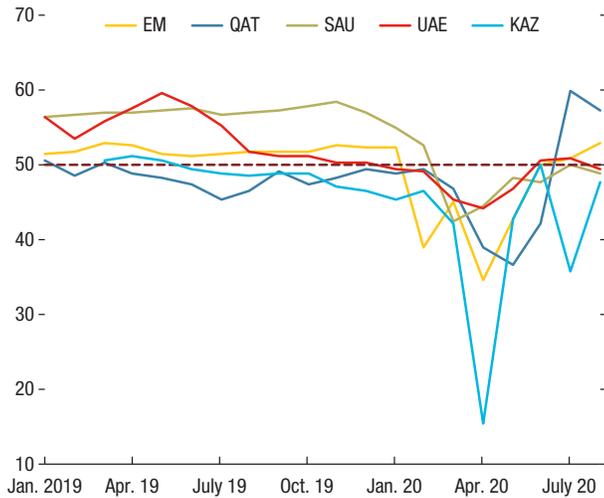
Sources: Haver Analytics; Thomson Reuters Datastream; and IMF staff calculations.
Note: PMI = purchasing managers' index. Country abbreviations are International Organization for Standardization (ISO) country codes. EM = emerging market economies.

Figure 1.4. PMI: Oil Importers
(Seasonally adjusted, 50+ = expansion)
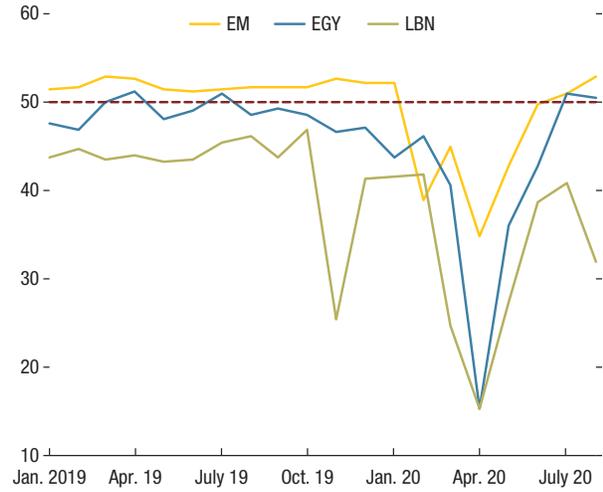
Sources: Haver Analytics; Thomson Reuters Datastream; and IMF staff calculations.
Note: PMI = purchasing managers' index. Country abbreviations are International Organization for Standardization (ISO) country codes. EM = emerging market economies.

Figure 1.5. Change in International Flight Arrivals
(Percent, year-over-year change)
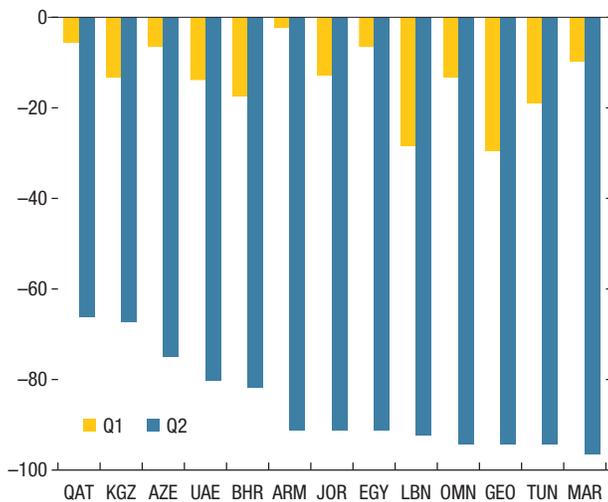
Sources: FlightRadar24; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan. Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 1.6. Remittances
(Percentage difference between 2020:H1 and 2019:H1)
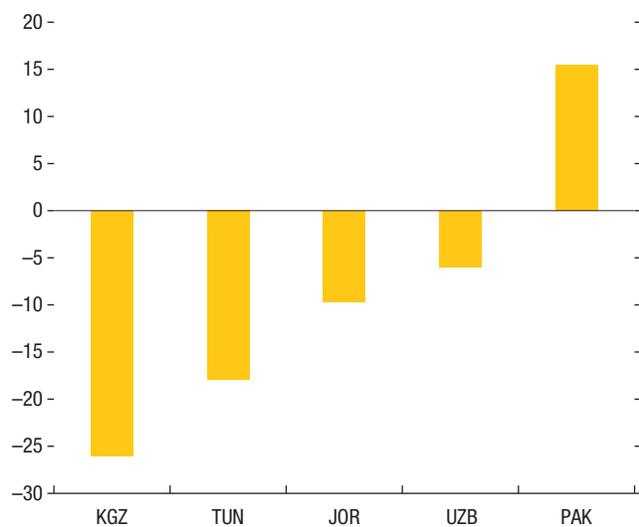
Sources: National authorities; and IMF staff calculations.
Note: For KGZ, the difference is between the first five months of each year. Country abbreviations are International Organization for Standardization (ISO) country codes.

countries for which such data are available, fiscal deficits ranged from about 0.8 percent of GDP in Azerbaijan to 4 percent of GDP for Jordan and

Tunisia, implying sizable deterioration compared with the same period last year.

Figure 1.7. Oil Prices and Oil Volatility
(Index, US dollars a barrel)
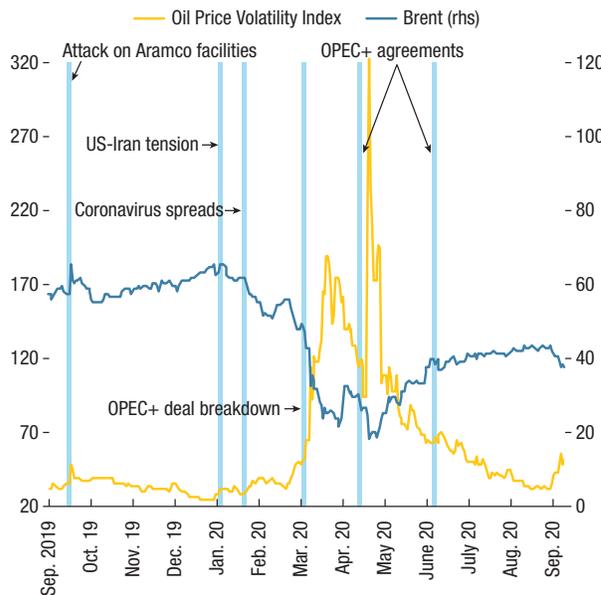
Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: OPEC+ = Organization of the Petroleum Exporting Countries and other major oil producers; rhs = right-hand scale.

Figure 1.8. Fiscal Balances
(Percent of GDP)
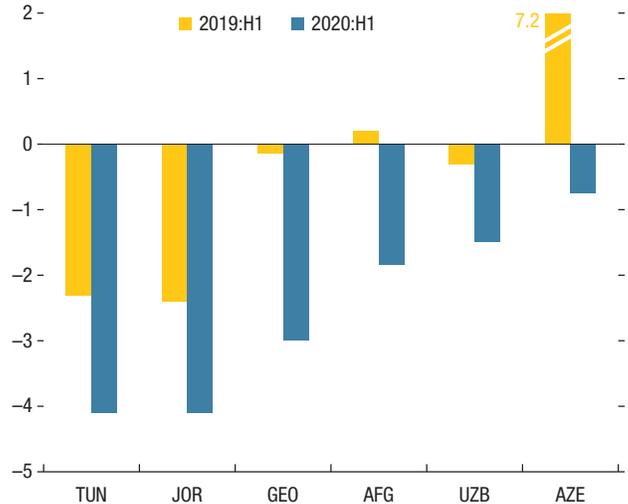
Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 1.9. Change in Trade
(Difference between 2020:H1 and 2019:H1, percent of GDP)

Sources: National authorities; and IMF staff calculations.

With the exception of Bahrain, trade balances for several countries improved (Pakistan, Tunisia, Uzbekistan), as activity collapsed and imports were compressed (Figure 1.9). Although export declines during the first half of 2020 were sizable and ranged from 1 percent of GDP in Pakistan to nearly 4 percent of GDP in Uzbekistan, import compression was of the same or even larger magnitude.

Capital flows were highly volatile in March and April, with the MCD region seeing estimated outflows of $6 billion to $8 billion during this time. They have since stabilized, and MCD countries have accounted for more than 40 percent of sovereign issuances by all emerging markets since the end of March. Nonetheless, cumulative outflows from the region since the start of the crisis remain negative and total more than $5 billion.

Amid COVID-19 lockdown measures, social tensions and geopolitical risk appear to have de-escalated during the pandemic. Nonetheless, regional uncertainty remains high given ongoing

conflicts in Afghanistan, Libya, Somalia, Syria, and Yemen, limiting policy reactions. The renewed hostilities in the Nagorno-Karabakh conflict zone add further risk. Lebanon, in particular, remains in a difficult situation, with a projected contraction of 25 percent for 2020. The country experienced

political upheaval in October 2019, exacerbated by a sovereign debt default in March 2020, the first in the country's history. Deterioration of the local currency (whose parallel rate has lost 70 percent of its value since the end of 2019), imposition of informal capital controls by individual banks, and foreign exchange shortages caused a hyperinflationary spiral, resulting in food and electricity shortages and increasing poverty. In August, a massive explosion at the Beirut port caused sizable loss of life and physical damages. The event also led to the resignation of the government and renewed protests, exacerbating the country's difficulties and uncertainties.

Swift Support with Room for Enhancements

Most countries deployed an array of health, fiscal, monetary, and financial policies to mitigate the pandemic's immediate impact (Box 1.1, Figure 1.10).

Nearly all countries have boosted the health sector's capacity. Measures have included tax exemptions on food and medical supplies, increased spending on medical equipment and supplies, allowances for health care staff, and augmentation of hospital capacity and building quarantine facilities.

Fiscal policy has also been used to cushion the blow to households and businesses, and fiscal packages in the region, including off-budget measures, average about 2 percent of GDP, lower than the emerging market and developing economy average of about 3 percent of GDP. Revenue measures included exemption from rents and property and land taxes, deferrals or exemptions on declaration and payments of individual and corporate taxes, and suspension or reduction of various government fees and penalties. Spending measures focused on strengthening unemployment benefits, cash transfers to low-income households, subsidies to small and medium-sized enterprises (SMEs), and utility subsidies. Many governments also

provided subsidized loans to SMEs (Box 4.2), businesses in hard-hit sectors, and low-income households. The fiscal support, in several cases, however, did not translate into a fiscal impulse, as countries also introduced offsetting revenue and expenditure measures.

Central banks in the region have also deployed monetary and financial policy, including unconventional tools. In countries with flexible currencies, the exchange rate was allowed to act as a buffer, with depreciations in mid-March, which have since partially reversed. Among pegged currencies, those of most GCC countries (with the exception of Oman) fared relatively well compared with during previous oil shocks, supported by bond issuances and the rebound in oil prices. By the end of August, most central banks had cut their policy rates. Those with pegs, managed floats, and crawls cut rates in line with the Federal Reserve. Cuts were especially deep in Egypt and Pakistan, by a cumulative 300 and 625 basis points, respectively, with Egypt reducing its rate by a further 50 basis points at the end of September. Half of the region's central banks supplied additional liquidity to the banking system, totaling more than $40 billion. Central banks also deployed many instruments to boost lending, including cutting the reserve requirement ratio, encouraging loan repayment moratoriums, introducing repo arrangements, providing liquidity support for lending and loan guarantees, and lowering the cost of refinancing. The Central Bank of Azerbaijan opened a bilateral swap line with the European Bank for Reconstruction and Development.

About half of the region's central banks have loosened their macro-financial stance (Box 1.1). Central banks have relaxed countercyclical capital requirements while also relaxing the liquidity ratio, capital adequacy requirements, and, in some countries, loan classification and provisioning rules (Chapter 4). In addition, direct central bank financing of the public sector has been used in Bahrain and Turkmenistan, in the latter partly reflecting underdeveloped financial markets.

Figure 1.10. Policy Responses to COVID-19

1. Cost of Fiscal Measures in Response to COVID-19
(Percent of GDP, includes off-budget measures)
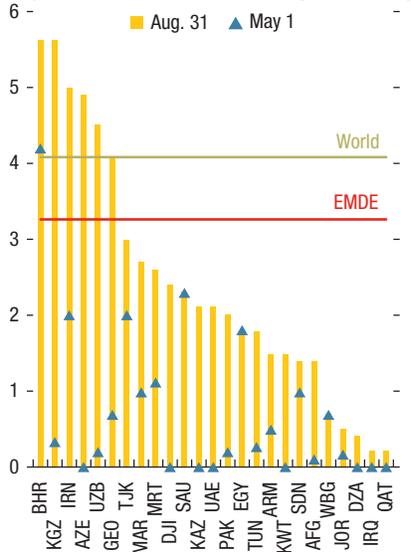
2. Monetary Policy Rate Adjustment
(Change in bps since end-2019)

3. Macro-Financial Support Package
(Percent of GDP)

Source: IMF staff calculations.
Note: EMDE = emerging market and developing economies. Country abbreviations are International Organization for Standardization (ISO) country codes.
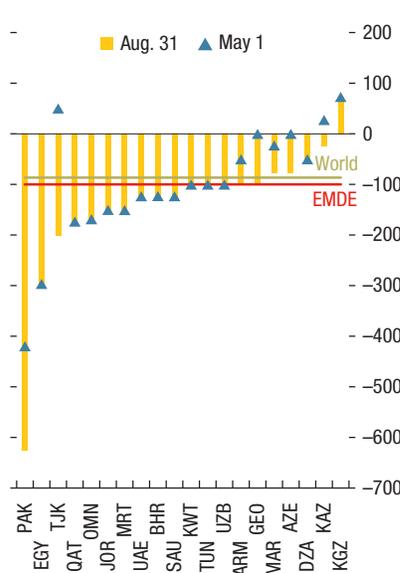
Source: IMF staff calculations.
Note: bps = basis points; EMDE = emerging market and developing economies. Country abbreviations are International Organization for Standardization (ISO) country codes.

Sources: Elgin, Basbug, and Yalaman (2020); and IMF staff calculations.
Note: Macro-financial support is defined as the sum of liquidity injections into banks, change in reserve requirement, asset purchases, and funding for lending. EMDE = emerging market and developing economies. Country abbreviations are International Organization for Standardization (ISO) country codes.

The authorities have also implemented tools to influence goods and capital flows. Several countries with a flexible exchange rate implemented foreign exchange interventions to prevent disorderly market conditions and to counter excessive depreciation pressures (Egypt, Iran, Tajikistan, Turkmenistan). Many implemented some trade restrictions (Algeria, Iran, Jordan, Kazakhstan, Mauritania, Pakistan, Somalia, Sudan, Tajikistan, Turkmenistan) and price controls, mainly on essential and medical goods (Iran, Jordan, Kazakhstan, Kyrgyz Republic, Morocco, Pakistan, Qatar, Sudan, Tajikistan, Turkmenistan). Although some countries had strong capital flow controls in place before the pandemic, the use of additional capital flow management measures has so far been very limited.

Policies adopted across the region have been instrumental in dealing with the immediate

impact of the crisis, but several areas demand policymakers' attention. The average size of fiscal support in the region is the smallest among regional groups, reflecting both existing fiscal constraints and those created by the crisis (Chapter 3). For GCC countries, this also reflects the already large public spending in the health sector. Some fiscal measures (tax increases) were necessary to shore up fiscal accounts in the short term but may pose a risk to the recovery. Land and property tax exemptions tend to be regressive, if not well targeted, and should be unwound. Income and consumption tax deferral and lending programs should be better targeted toward the neediest households or SMEs and, if necessary, distinguish recipients by income levels, sectors, or firms' preconditions. Effective communications and streamlined procedures will ensure that support reaches those who need it most. Policies such as regulatory forbearance may contribute

to financial instability, and direct central bank financing of fiscal deficits should be removed because it could lead to inflation pressures and jeopardize institutional credibility. Banking supervision and financial inclusion should be strengthened (Chapter 4).

Examining the MENAP and CCA Outlooks

Countries in the MCD region face many shared challenges in coping with the crisis, but there are important distinctions in the outlooks for subregions:

Change in real GDP for MENAP oil exporters (MENAPOE) is projected at –6.6 percent in 2020. The weakness in 2020 follows a tepid year in 2019—which saw activity shrink marginally by 0.3 percent—and is manifested in both the oil and non-oil sectors. Oil GDP is expected to contract by 7.7 percent, reflecting the OPEC+ agreements on production cuts caused by sluggish external and internal oil demand and the US sanctions on Iran's exports. Non-oil GDP is expected to contract by 5.8 percent in 2020, mainly reflecting a collapse in the service sector caused by a decline in both domestic and external demand.

Hampered trade, tourism, and remittances are mostly offsetting the benefits from lower oil prices for MENAP oil importers (MENAPOI). These factors, along with confinement measures, continue to depress growth, which is now projected at –1 percent for 2020, after an expansion of 2.8 percent in 2019. All countries in the group except Egypt are expected to see negative growth in 2020, with a rebound to 2.2 percent growth in 2021. Sizable contractions are projected for Morocco and Jordan—7 percent and 5 percent, respectively—driven by severe impacts on tourism and manufacturing, as trading partners' growth continues to lag and travel remains disrupted (Chapter 2). For Egypt, weaknesses in growth during the second half of 2020 are reflected in lower projections for fiscal year 2020/21 (which started July 2020).

Projections for the CCA region point to a contraction of 2.1 percent in 2020. This is a sizable turnabout after a year of strong growth in 2019 (4.8 percent). Contrary to the trends in MENAP, the weakness in CCA is largely driven by oil importers (a contraction of 5 percent in 2020, after growth of 6.1 percent in 2019), reflecting the larger-than-expected economic impact from pandemic-related lockdowns, weak trade, a collapse in tourism activity (Armenia, Georgia, Tajikistan), and a sharp drop in remittances (Kyrgyz Republic), especially from Russia. The region's oil exporters are also projected to experience a downturn of 1.6 percent in 2020 but much less pronounced than that of the MENAPOE. This difference is due to the region's rapid and strong crisis response (Azerbaijan, Kazakhstan), smaller oil production cuts under the OPEC+ agreements, and more diversified economies. In addition, non-oil commodity producers benefited from the increase in gold prices (Kazakhstan, Uzbekistan), and favorable weather and price liberalization boosted agricultural output in Uzbekistan.

The crisis will also exacerbate economic and human challenges for fragile and conflict-affected states (Box 1.2). These countries are projected to contract by nearly 13 percent in 2020, after modest growth of 2.4 percent in 2019. This will imply a significant decline in GDP per capita— from $2,900 in 2018–19 to under $2,000 in 2020 (or about $5 a day). Medium-term projections also suggest a more permanent loss and thus deeper scarring in relation to GDP.

In an environment of weaker demand, inflation is projected to remain low for most countries in the region. Two notable exceptions are Lebanon and Sudan, both affected by deep economic crises. The former is facing hyperinflation caused by food and electricity shortages, and a collapse in the exchange rate. For the latter, inflation, which accelerated starting in 2018, does not show any signs of abating. In general, risks from higher inflation because of looser monetary policies remain low, given subdued economic activity.

The crisis will lead to a significant deterioration in external accounts for oil exporters in 2020, driven by dramatic drops in oil exports. For MENAPOE, the current account balance will turn into a deficit of 3.4 percent of GDP in 2020, relative to a surplus of 3.2 percent of GDP in 2019. Similarly, CCA oil exporters will see their current account deficit widen from 0.9 percent of GDP in 2019 to 3.3 percent of GDP in 2020. These are the largest deteriorations in current account balances across regional groups. For example, current account balances of sub-Saharan oil exporters are projected to deteriorate only by less than 2 percentage points of GDP, on average.

For oil importers, the picture on the external accounts is mixed, with modest improvements among MENAPOI (driven by import compression) but deterioration in CCA oil importers (driven by weak remittances).

Projected reserve coverage remains generally adequate, at more than four months of imports for most countries, as lower imports compensate for reserve losses. However, attention is warranted for the few countries where reserve coverage is projected to be quite low (Bahrain, Djibouti, Pakistan, Sudan, Tunisia).

Fiscal deficits among oil importers are expected to worsen in 2020 compared with 2019. Although fiscal balances in MENAPOI are projected to decline by 0.6 percentage point of GDP (to –7.9 percent of GDP) in 2020, those among CCA importers are foreseen to deteriorate more significantly, by nearly 6 percentage points of GDP (to –7.1 percent of GDP in 2020), reflecting stronger policy responses to COVID-19 in Georgia, the Kyrgyz Republic, and Tajikistan. Risks to debt sustainability are high as debt levels in MENAPOI and CCA oil importers are expected to reach over 90 percent of GDP and nearly 60 percent of GDP, respectively, by the end of 2020.

For MENAPOE, the non-oil fiscal deficit in 2020 is projected at 33 percent of non-oil GDP, broadly the same as 2019 levels despite the policy responses. This is due to spending reallocation

Figure 1.11. External Debt Amortizations
(Billions of US dollars, and percent of GDP)
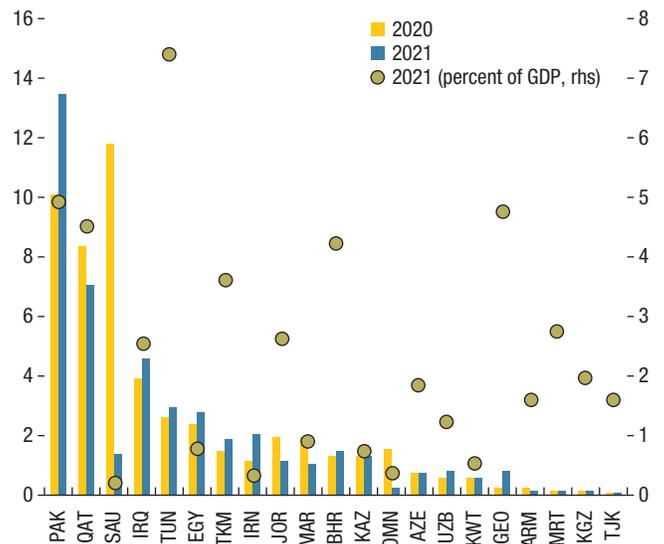
Sources: National authorities; and IMF staff calculations.
Note: rhs = right-hand scale. Country abbreviations are International Organization for Standardization (ISO) country codes.

and revenue measures being deployed to offset higher health and social spending. For CCA oil exporters the non-oil fiscal balance is projected to widen by over 2 percentage points (from 12.3 to 14.6 percent of non-oil GDP) in 2020 compared with 2019, partly because of their stronger policy responses. Nonetheless, for the group, debt-to-GDP levels among oil exporters remain relatively subdued (at 46 and 27 percent of GDP for MENAPOE and CCA oil exporters, respectively), but some oil exporters are facing much higher levels of gross debt (Algeria, Bahrain, Iraq, Oman, Qatar, Yemen), which, in some cases, are offset by substantial financial assets (Qatar).

The region will face external debt amortizations of about $45 billion in 2021, most of which correspond to sovereign debt service (Figure 1.11). In particular, Tunisia will face external amortizations of more than 7 percent of GDP, while Bahrain, Georgia, Pakistan, Qatar, and Turkmenistan, will each face external amortizations of about 4 percent of GDP. So far, countries have pursued different strategies to finance the larger needs, including external

debt placements, tapping of domestic markets, monetary financing, and the reduction of buffers by using reserves, sovereign wealth funds, and deposits.

Beyond 2020, countries in the region will likely continue to face a challenging outlook. For 2021, all countries in the region except Lebanon and Oman are projected to see positive growth, albeit subdued. For MENAPOI and CCA, the rebound in 2021 will be enough to return real GDP to its 2019 level, but well below the precrisis trend. In contrast, real GDP levels in MENAPOE will be nearly 4 percent below the levels of 2019. Even these modest outcomes are subject to high uncertainty regarding the path of the pandemic. In the medium term, growth rates will not be enough to return GDP levels to precrisis trends as economic scarring from the crisis is expected to persist for the foreseeable future (Chapter 2).

Subdued prospects for global recovery will continue putting pressure on current accounts. For oil exporters, this will come from subdued oil prices, while for oil importers, this will be driven by weak remittances, tourism, and trade. For 2021, current account balances are expected to improve for oil exporters and CCA oil importers on the back of stronger oil exports and remittances, respectively, but widen somewhat for MENAPOI as export recovery lags. As the recovery progresses, imports are expected to recover more slowly than exports for most countries, leading to a modest improvement in current account balances and reserve coverage for the region.

While projections incorporate a gradual unwinding of COVID-19 fiscal support, medium-term prospects for debt remain risky. In 2021, fiscal balances are projected to improve for all regions (but especially for CCA oil importers) as COVID-19-related measures are unwound. Beyond 2021, for oil importers, a projected return to fiscal consolidation is expected to help close deficits by more than 4 percentage points of GDP, and debt is projected to modestly decline. It will, nonetheless, remain higher than precrisis levels for some countries. For oil exporters, medium-term

prospects for both non-oil fiscal balances and debt remain risky, as the former is expected to remain broadly flat, with an increasing path for public debt.

Downside Risks Continue to Prevail

Considerable uncertainty continues to plague the outlook. On the upside, global recovery could proceed faster than expected supported by extensions in fiscal support and low infection rates. A safe and effective vaccine could be discovered and widely distributed, and new treatments and therapies for the disease could be created. Advances in digital technology could accelerate, leading to significant shifts in sectors with employees able to work from home.

Nonetheless, the crisis has exacerbated important vulnerabilities in the region, including excessive debt, elevated financing needs, exposure to oil market volatility, and high unemployment and informality, all of which may hinder the recovery and worsen scarring (Chapter 2).

As a result, risks of a worse-than-projected scenario loom large. Given recent surges in COVID-19 infections in many countries around the world that have reopened, the possibility of stop-start containment measures would prolong uncertainty for firms and households and hinder long-term planning. Businesses that survived the first lockdown may not be able to survive a second one because the ongoing need for social distancing continues to weigh on contact-intensive sectors. The region's relatively low access to finance for SMEs (Box 4.2) could turn liquidity concerns into insolvencies. Stop-start containment would lead to continued declines in productivity as furloughs and reduced work hours translate into permanent job losses. This would exacerbate unemployment—which is already expected to remain high for a long time (Chapter 2)—and poverty.

Inequality will also likely widen as informal jobs are hit harder by the crisis and social safety nets

Figure 1.12. GCC Labor Market Indicators

1. GCC Share of Expatriates in Population, Labor Force, and Private Consumption[1]
(Percent of total)
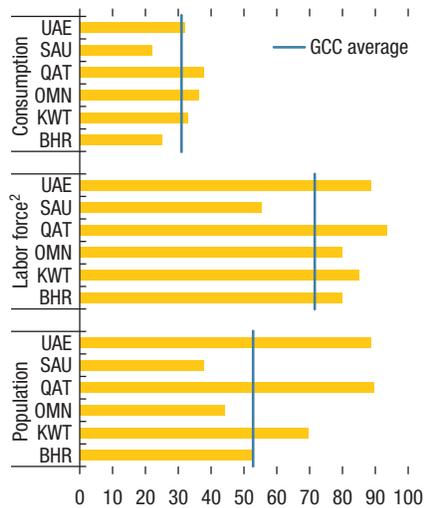
2. GCC Total Expatriate Employment by Sector
(Percent of total)
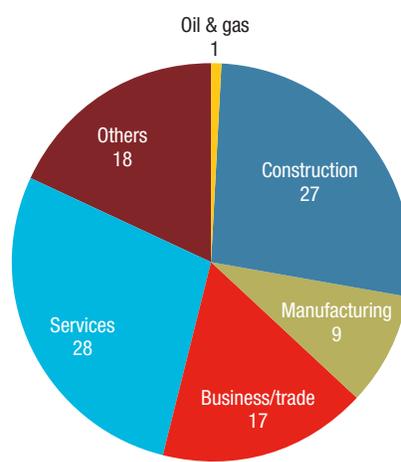
- Oil & gas 1
- Others 18
- Construction 27
- Manufacturing 9
- Business/trade 17
- Services 28

3. Expatriates by Income Level
(Percent)

- High (bachelor's degree or higher)
- Medium (high school)
- Low (less than high school)

BHR OMN SAU UAE GCC Average

Sources: Country authorities; and IMF staff estimates and calculations.
Note: GCC = Gulf Cooperation Council. Country abbreviations are International Organization for Standardization (ISO) country codes.
[1]Data are latest available, unless indicated otherwise. Labor force, population, low-income expatriate, and remittance numbers include domestic workers.
[2]Due to data limitations, employment figures for Bahrain, Oman, and the United Arab Emirates are used.

Sources: Country authorities; and IMF staff estimates and calculations.
Note: GCC = Gulf Cooperation Council.

Sources: Country authorities; and IMF staff estimates and calculations.
Note: GCC = Gulf Cooperation Council. Country abbreviations are International Organization for Standardization (ISO) country codes.

remain weak. In addition, school closures are more likely to impact youth in lower-income households, leading to long-term scars. All these factors will contribute to widening existing social gaps, potentially leading to widespread social discontent and political instability as restrictions on gatherings are lifted. The latter would worsen fiscal and debt concerns since governments would face difficult decisions around unwinding economic support. All of these risks will be amplified in fragile and conflict-affected states (Box 1.2).

On the external front, stop-start lockdowns could also lead to a weaker global recovery, with concurrent oversupply and volatility in the oil market. Remittances and tourism, key flows for the region, could face a more protracted recovery. As debt sustainability concerns rise in many

countries, tighter financial conditions could restart capital outflows, accelerating financing risks and tipping vulnerable countries into debt and balance of payments crises.

Additional structural risks could come from intensifying geopolitical tensions and security concerns, which would constrain trade, and accelerating deglobalization and supply-chain breakdowns. Furthermore, the crisis has brought the region's dependence on expatriate labor into sharp focus, especially in GCC countries (Figure 1.12). According to the World Bank, since these groups enjoy limited social protection job loss often leads to immediate economic hardship, which then compounds the high risk of disease exposure from poor living and working conditions. The fact that expatriates are heavily

employed in the hard-hit services sector poses further risks.

The financial sector remains stable but faces risks from weakening corporate balance sheets (Chapter 2), which increase credit risks, while declining oil prices affect banking system liquidity. Banks' operational risks have increased, including cyber and technology-related risks. The risk of bankruptcies and debt overhangs could have important implications for financial stability and the recovery if not addressed correctly (Chapter 4).

Near- and Medium-Term Policy Recommendations

Policies should be based on the evolution of the pandemic and countries' policy space and buffers.

In terms of the pandemic, in countries where cases are rising again, containing the health crisis will be the first and foremost priority. For countries that reopened and have infection rates under control, the health care sector's capacity should continue to be strengthened to ensure a safe return to work through timely testing, tracing, isolation, safe distancing practices, and localized lockdowns. For all countries, it will be key to develop a strategy for securing vaccine supplies once one is available.

Fiscal policy should remain supportive and flexible until a safe and durable exit from the crisis is secured. Continuation of the most critical support measures increases fiscal costs and public debt, but premature and rapid retrenchment could derail a nascent recovery, with even larger fiscal costs in the future. For countries with limited fiscal space, expenditure reallocation will be key for creating space in the short term. The type of fiscal support should also change as the recovery progresses. Different sectors will recover to different degrees, and the distinction between illiquidity and insolvency should become more prominent in designing support measures. Any further support should be complemented by governance reforms to ensure that financing is used efficiently.

In the short term, cushioning income losses (to the extent possible) will minimize damage to the economy and ensure activity can normalize quickly once the restrictions are lifted. Social spending should be expanded to protect the most vulnerable. Where gaps exist and as needed, authorities could enhance social protection and assistance measures such as paid and family sick leave, expanded eligibility for unemployment insurance, and strengthened health benefit coverage.[1]

For countries with limited fiscal space—most oil importers, except Armenia and Georgia, and several oil exporters (Algeria, Bahrain, Iran, Iraq, Oman)—it will be paramount to pursue a well-targeted approach, effective reorientation of spending, and further efforts to rebuild fiscal buffers (Chapter 3). These countries will need to rely on reorienting non-priority spending to the health, education, and social sectors and providing critical liquidity support measures rather than additional spending.

For low-income countries and fragile states, international and donor support will be crucial to avoid abrupt adjustments.

As the recovery materializes, the policy focus should gradually move to incentivizing worker reallocation, as needed, through hiring subsidies, additional spending on active labor policies, and measures to reduce labor market rigidities that deter firms from hiring. These support measures should be designed to enable a smooth shift of resources away from sectors that could emerge smaller after the pandemic (for instance, contact-intensive sectors). This will be key for countries with high dependence on travel and tourism (Armenia, Azerbaijan, Georgia, Jordan, Lebanon, Morocco).

Once the economy is on sound footing, fiscal adjustments will need to begin with a credible medium-term fiscal plan that focuses on improving revenue mobilization, minimizing tax avoidance, greater tax progressivity in some cases, and higher efficiency in spending. For countries

---

[1]For an in-depth discussion, see Mathai and others (2020).

with limited fiscal space, urgent adjustments may be needed to restore fiscal and external sustainability. Oil exporters in both MENAP and CCA should avoid repeating procyclical fiscal policy as the new cycle begins—spending should be contained even if oil revenues rebound.

Many sovereigns will face higher financing needs. Oil importers, many of which have debt sustainability concerns but still enjoy market confidence, should seek maturity extensions and reduce rollover risk. Countries with very high spreads may need to resort to more difficult options that likely will require private sector participation, such as restructuring with interest and principal reductions. Low-income countries and fragile states should seek support in the form of concessional financing, grants, and debt relief.

Monetary and financial stances should remain accommodative, with central bank interventions focused on keeping borrowing costs low and credit conditions supportive. Firms in certain sectors may shift from liquidity to solvency pressures. Timely recognition of credit losses will be key. Capital injections in some banks and systemic nonfinancial firms may become necessary for maintaining financial stability, but care should be taken that central banks' balance sheets are not excessively impacted.

For countries that entered the crisis with limited loss-absorbing buffers, namely MENAPOI (Chapter 4), banking sector resilience has yet to be tested but may emerge as a stress point later. For these countries, enhanced surveillance of financial systems is needed to facilitate timely policy responses, and liquidity management should be strengthened to prevent liquidity challenges from morphing into insolvency.

International Support and Rebuilding Sustainably Stronger

As the crisis progresses, countries in the region may require further support from the international community through debt relief, grants, and concessional financing so that these countries

Figure 1.13. New IMF Financing to MCD Countries
(January–July 2020, millions of US dollars)
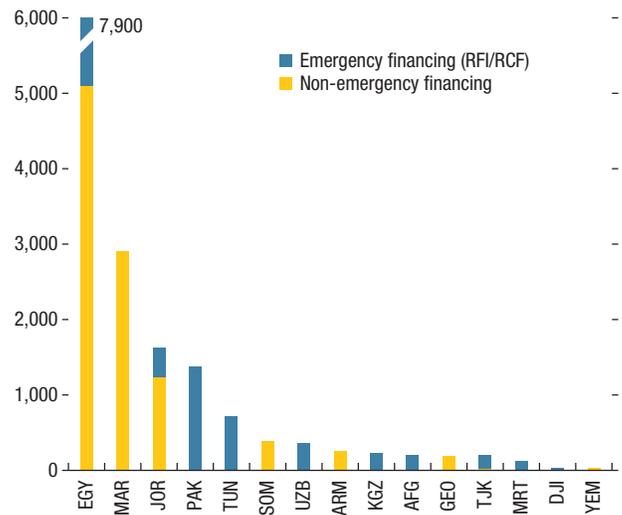
Source: IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes. RCF = Rapid Credit Facility; RFI = Rapid Financing Instrument.

can conserve international liquidity and direct resources to priority health spending and relief measures.

The IMF and the international community will continue supporting MCD countries through financing, policy advice, and global and regional coordination. During the first seven months of 2020, the IMF approved nearly $17 billion in new financing for the region (Figure 1.13). Support has been in the form of emergency financing and augmented programs, in addition to debt relief, and catalyzing funding from other official creditors. Support to low-income and fragile states, while smaller in nominal terms, has been significant in relative terms. Access limits to IMF emergency financing facilities have been temporarily increased, and the institution has improved its ability to provide grant-based debt service relief. In addition, the IMF continues to provide policy support and technical advice to countries, including through remote capacity development, which has increased for MCD fragile states since the crisis began.

Beyond the recovery, structural reforms should aim at expanding access to opportunities for all by permanently strengthening social safety nets, investing in strong and climate-friendly infrastructure, enhancing the reach of digital technology, and boosting human capital accumulation.

Inequality and poverty will become an even more pressing issue after the crisis, particularly for low-income countries and fragile states. Among this group and oil importers, social safety nets should be permanently strengthened, with social assistance and social insurance systems featuring wider coverage and better targeting.

As countries free fiscal resources from targeted support, some should be redeployed to public investment in renewable energy, improvements in the efficiency of power transmission, and retrofitting buildings to reduce their carbon footprint. Countries should also redouble efforts toward diversification to lower the region's heavy dependence on oil (MENAPOE), tourism (Georgia, Jordan, Lebanon, Morocco), and

remittances (Egypt, Kyrgyz Republic, Pakistan, Tajikistan).

In addition, governments should invest in digital infrastructure to support the accelerated shift to e-commerce and increased digitalization of the economy. This should be complemented by labor market reforms that focus on creating jobs for young people and women in the private sector along with ensuring technological skills and literacy for the growing digital economy. Policies directed at informality and expatriate labor, especially in MENAPOE, should be reexamined to improve productivity and tax revenues.

To undo some of the damage caused by the loss in learning during the pandemic, countries should consider direct policies to make up this loss, including adjustments to the length of the school year, training teachers on remedial approaches, and broadening tutoring programs. Educational programs should also be retooled toward skills that are likely to be in high demand (health sector skills and digital literacy more broadly) so that increasing numbers can take advantage of teleworking opportunities.

Box 1.1. Policy Responses to the Pandemic

Most countries have not enacted additional major policy measures since the July 2020 *Regional Economic Outlook Update: Middle East and Central Asia*. Instead, countries have focused on implementing already announced measures and, in some cases, extending measures deemed crucial for the economy. Major policies adopted by countries in the MCD region to mitigate the pandemic's impact are as follows:

Fiscal policy

- Exempting or postponing rent payments or property and land taxes (Bahrain, Egypt, Georgia, Kyrgyz Republic, Lebanon, Oman, Qatar, Tajikistan, United Arab Emirates)

- Deferring or exempting tax declarations and payments (Afghanistan, Algeria, Egypt, Lebanon, Saudi Arabia, Turkmenistan, West Bank and Gaza)

- Suspending or reducing various government fees and penalties (Algeria, Bahrain, Iran, Kuwait, Lebanon, Oman, Saudi Arabia, Tunisia)

- Strengthening and/or broadening unemployment benefits (Algeria, Azerbaijan, Bahrain, Iran, Jordan, Morocco, Qatar, Saudi Arabia, Sudan, United Arab Emirates, Uzbekistan, West Bank and Gaza)

- Expanding cash transfers to low-income households (nearly all countries in the region)

- Expanding energy subsidies for small and medium-sized enterprises (SMEs) and households (Bahrain, Djibouti, Georgia, Iran, Kazakhstan, Oman, Pakistan, Qatar, Turkmenistan, United Arab Emirates)

- Providing subsidized loans to SMEs, businesses in hard-hit sectors, and low-income households (Armenia, Bahrain, Egypt, Iran, Kuwait, Qatar, Saudi Arabia, Tunisia, United Arab Emirates, Uzbekistan)

Monetary policy

- Cutting policy interest rate (Algeria, Armenia, Bahrain, Egypt, Georgia, Jordan, Kazakhstan, Kuwait, Mauritania, Morocco, Oman, Pakistan, Qatar, Saudi Arabia, Tajikistan, Tunisia, United Arab Emirates, Uzbekistan)

- Injecting liquidity into the banking system (Armenia, Georgia, Jordan, Morocco, Qatar, Saudi Arabia, Tajikistan, Tunisia, United Arab Emirates, Uzbekistan)

- Expanding lending tools, including cutting the reserve requirement ratio and extending the maturity of loans (Algeria, Bahrain, Iraq, Jordan, Lebanon, Morocco, Qatar, Saudi Arabia, Tajikistan)

- Introducing repo arrangements, providing liquidity support for lending and loan guarantees, and lowering the cost of refinancing (Armenia, Bahrain, Georgia, Iran, Kazakhstan, Qatar)

- Opening bilateral swap lines with the central banks of their major trading partners (Azerbaijan)

Macro-financial policy (see also Chapter 4)

- Easing countercyclical buffers or the liquidity ratio (Kazakhstan, Kyrgyz Republic, West Bank and Gaza)

- Lowering capital adequacy requirements (Iran, Kazakhstan, Morocco, Sudan, United Arab Emirates)

- Relaxing loan classification and provisioning (Afghanistan, Iran, Kazakhstan, Kyrgyz Republic, Morocco, Oman, Pakistan, United Arab Emirates, West Bank and Gaza)

- Providing direct central bank financing to the public sector (Bahrain, Turkmenistan)

Overall, the policies adopted by MCD countries have covered the key areas where support to deal with the pandemic is most needed. Nonetheless, there is some room for improvement for the next phase.

Box 1.1 *(continued)*

- A few countries implemented measures to raise revenues (Afghanistan, Egypt, Saudi Arabia, Tunisia) and cut or postponed spending elsewhere (Afghanistan, Jordan, Oman, Saudi Arabia) to compensate for either lower oil revenues or pandemic-related spending. Notable examples are Saudi Arabia (which tripled its value-added tax rate and increased customs duties substantially) and Egypt (which introduced a temporary 1 percent tax deduction on all salaries and 0.5 percent on pensions, applicable to all public and private sector employees for 12 months; very low-income workers are exempt from the tax increase). Although some of the tax measures may be desirable medium-term reforms, in general, tax increases would be more effective after the crisis. These measures may improve the short-term fiscal situation somewhat, but they will likely be a drag on the recovery and invite larger fiscal costs in the future. Compensation measures are also needed to protect the most vulnerable groups from the tax increases.

- Monetary and financial policies need to balance the immediate need for market stabilization and the credibility of future policies. Further reduction of policy rates and liquidity injections should be carefully designed in countries where inflation is high or where potential financial instability due to capital outflows is still a risk. Some countries resorted to regulatory forbearance such as relaxing loan classification, which may negatively affect financial stability and market development in the future. Direct central bank financing of fiscal deficits may undermine the credibility of central banks, alter inflation expectations, and lead to difficulties in conducting monetary policy in the future.

- A well-targeted approach is crucial for pandemic-related policies. Some of the lending and subsidy programs target SMEs (Box 4.2), businesses in hard-hit sectors, or low-income households. Nonetheless, targeting could be improved further to maximize the efficiency in the use of government, as exemplified in Armenia, where the government provides subsidized loans only to firms with good credit history. Furthermore, many of the tax deferral and exemption programs are broad-based. Policymakers should consider tailoring such programs to distinguish among income levels, sectors, or firms' preconditions. Exemptions on land and property taxes, for example, tend to be highly regressive if implemented broadly. However, in general, most measures other than those related to health are not designed to benefit expatriates. Measures should extend health and basic financial support to all residents, including expatriates who are unable to leave the country, to help contain the spread of the virus, aid economic recovery, and enhance social cohesion.

- Effective communication and streamlined procedures are important to realize the full benefits of social spending and SME support (Box 4.2). Many poor households and SMEs do not have enough capacity to navigate the regulatory process to file applications and receive support. Capacity constraints may lead to underuse of some SME and social transfer programs that have lengthy bureaucratic procedures. Governments should make administrative processes as simple as possible by using digital technology and self-service wherever possible and communicate policies extensively through all channels to inform those who are eligible for the support programs (Box 2.2).

Box 1.2. Impact of the Coronavirus Pandemic on Fragile States

The coronavirus pandemic presents a major humanitarian and economic challenge for fragile states in the MCD region.[1] It aggravates the underlying difficult challenges facing each fragile state: armed conflicts in Afghanistan, Iraq, Libya, Somalia, Syria, and Yemen; anti-government protests and fear of a humanitarian crisis in Lebanon; years of conflict and political uncertainty in West Bank and Gaza; and climate vulnerabilities in Afghanistan, Somalia, and Yemen. The region also hosts a large share of the world's refugees and internally displaced people (Figure 1.2.1).

The pandemic is likely to increase the risk of social unrest for this group of countries. The large informal sectors of fragile states have been hit particularly hard by coronavirus containment measures, with lack of digitalization and limited remote working. The effectiveness of monetary policy to support activity is constrained by weak monetary transmission amid shallow financial markets, dollarization, and explicit or implicit exchange rate pegs (or lack of a domestic currency altogether as in West Bank and Gaza). Although most governments have activated social safety nets, these remain weak because of poor design and insufficient information about recipients (especially given the presence of internally displaced people and refugees) or weak delivery mechanisms given cash dominance and difficult security circumstances. The decline in incomes will thus directly translate into higher unemployment and poverty. In addition, poor living conditions among refugees and internally displaced persons increase the risks of infection, and weak health systems raise concerns

Figure 1.2.1. Refugees and Internally Displaced Persons
(Percent of host population, 2019 or the latest available)

Sources: United Nations High Commissioner for Refugees, Internal Displacement Monitoring Centre; United Nations Relief and Works Agency for Palestine Refugees in the Near East; United Nations, Department of Economic and Social Affairs, Population Division; and IMF staff calculations.
Note: These numbers are based on registrations and thus are lower bound estimates. Country abbreviations are International Organization for Standardization (ISO) country codes.

about their treatment; border closures are affecting asylum seekers, and risks of food insecurity loom large. A lack of timely support for those in need or an unequal distribution of human and economic losses across political factions and communities can fuel tensions, insecurity, and localized violence.

Policy space is extremely limited in the fragile states of the MCD region, underscoring the need for continued and timely support from the international community. Although external financing needs have increased and become more urgent, financing has become more constrained. This is because of the adverse impact that declines in growth and trade have on revenues and the extremely limited market access, given the risk of debt distress. The IMF has been helping by providing emergency financing and debt relief (Afghanistan, Djibouti, Tajikistan, Yemen; see Table 1.2.1), by offering policy advice and targeted technical assistance in crucial areas (spending efficiency, revenue collection, and debt management), and by reinforcing collaboration with other international financial institutions. Beyond financing, international support will also be key to ensure that fragile states have access to vaccines, once one is available. All these efforts will need to continue to protect

---

[1]Fragile states in the Middle East and Central Asia region include Afghanistan, Djibouti, Iraq, Lebanon, Libya, Somalia, Sudan, Tajikistan, West Bank and Gaza, and Yemen. Syria is not covered given data limitations.

Box 1.2 *(continued)*

hard-earned progress on reforms in some countries and avoid a new humanitarian crisis, reducing the twin risks of future demands for international aid and increased refugee flows, and ensuring that reinfections do not propagate after the virus comes under control.

Table 1.2.1. Fragile States: Policy Response to the Coronavirus Outbreak

	Fiscal	Monetary	Macroprudential Banking Supervision	IMF Emergency Support	Debt Relief
Afghanistan	✓		✓	RCF	✓
Djibouti	✓		✓	RCF	✓
Iraq	✓	✓	✓		
Lebanon	✓	✓			
Libya	✓				
Somalia	✓		✓		
Sudan	✓		✓		
Tajikistan	✓	✓	✓	RCF	✓
West Bank and Gaza	✓		✓		
Yemen					✓

Source: National authorities, as of July 6, 2020.
Note: RCF = Rapid Credit Facility.

References

Ceyhun Elgin, Gokce Basbug, Abdullah Yalaman. 2020. "Economic policy responses to a pandemic: Developing the COVID-19 Economic Stimulus Index." A VoxEU.org eBook, CEPR Press.

2. Addressing Economic Scarring from the Crisis

The coronavirus disease (COVID-19) pandemic may inflict a deeper and more persistent economic impact than previous recessions in the Middle East and Central Asia (MCD) region did, as the unique characteristics of a global pandemic shock collided with long-standing vulnerabilities in the region. In particular, the region's large exposure in the hard-hit services sector (including tourism), strained corporate balance sheets, low ability to work from home, and dependence on remittances will weigh heavily on recovery prospects. Real GDP in the region could remain below precrisis trends for a decade. As the pandemic continues, policymakers must carefully balance preserving livelihoods, minimizing scarring, and promoting recovery, without hampering necessary reallocation. In the medium term, it will be key to rebuild buffers to guard against future shocks.

A Crisis Like No Other amid Limited Policy Space

The COVID-19 crisis represents the fastest moving economic shock of its depth in recent history. In addition to its significant human toll, the crisis's indirect economic impact through lockdowns, labor disruptions, and global spillovers has been unprecedented. The impact was particularly strong on the services sector. Dampened activity also led to a fall in global oil demand and plummeting oil prices. As a result, growth in 2020 has been severely marked down for the region (Chapter 1, Figure 2.1).

Whether the current crisis is a temporary contraction in activity or a permanent setback to the region's development will depend on the extent of economic scarring. The literature has defined this phenomenon as lower supply capacity that remains after shocks have dissipated, and the

Figure 2.1. MCD Real GDP Growth
(Percent change)
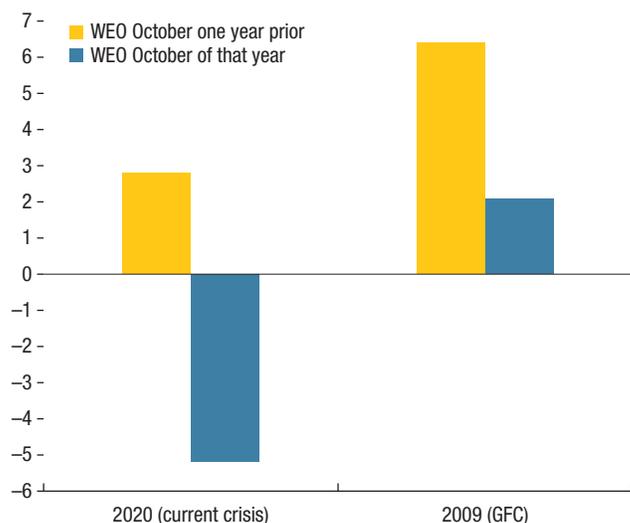
Sources: National authorities; and IMF staff calculations.
Note: GFC = global financial crisis; WEO = *World Economic Outlook*.

persistently subdued demand driven by lasting negative labor market outcomes. The extent of scarring depends not only on the depth of the shock but also on each country's initial conditions and policy reactions during the crisis.

The region entered the crisis with little policy space.[1] In the run-up to the crisis, weak external demand and subdued oil prices lowered current account balances, while persistent fiscal deficits contributed to rising debt levels. Compared with conditions before the global financial crisis (when countries in the region averaged fiscal and current account surpluses of 4.7 and 7 percent of GDP, respectively), in 2019 countries averaged deficits of 2.5 and 2 percent of GDP. Meanwhile, debt to GDP rose from 43 percent in 2006 to 59 percent by 2019 (Figure 2.2).

[1]Chapter 3 examines the concept of fiscal space in the region more closely.

Figure 2.2. Preexisting Economic Conditions
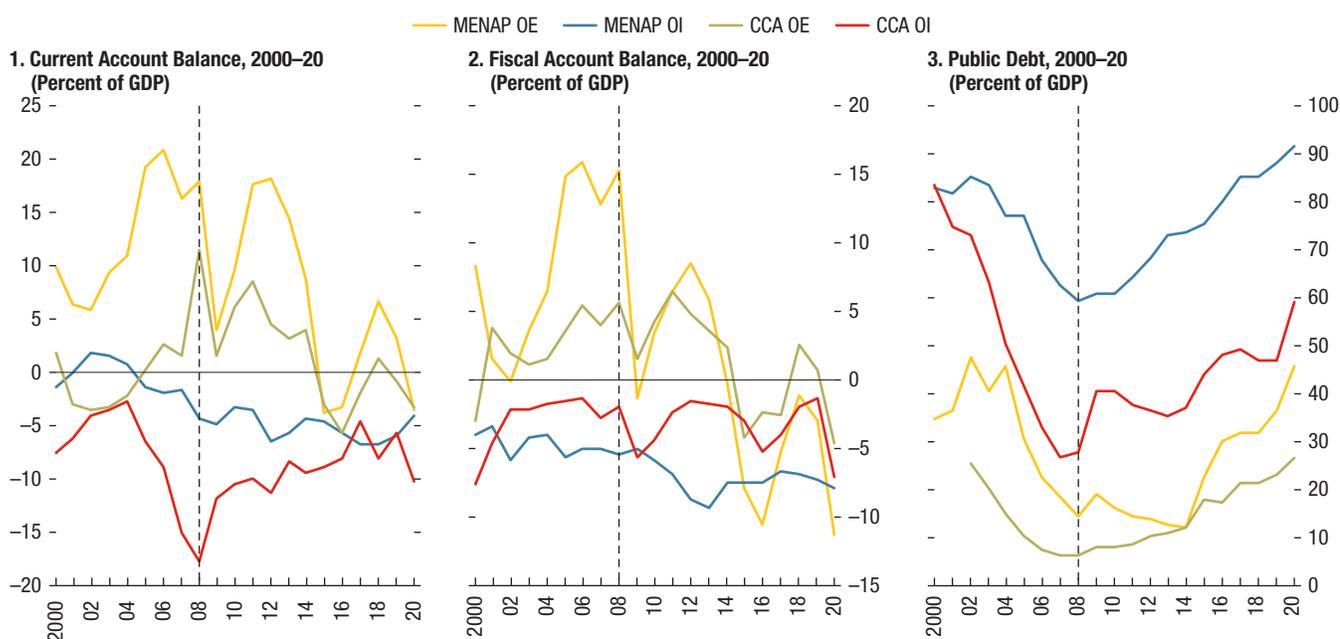
Sources: National authorities; and IMF staff calculations.
Note: CCA OE = Caucasus and Central Asia oil exporters; CCA OI = Caucasus and Central Asia oil importers; MENAP OE = Middle East, North Africa, Afghanistan, and Pakistan oil exporters; MENAP OI = Middle East, North Africa, Afghanistan, and Pakistan oil importers.

The COVID-19 crisis has also highlighted the region's long-standing structural vulnerabilities. Oil exporters remain largely undiversified, with dominant energy companies. Among oil importers, tourism and remittances (both of which were affected by the pandemic) each account for greater than 10 percent of GDP in some countries (Figure 2.3). The region entered the crisis with a structurally high unemployment rate of about 9 percent for the last 10 years, with youth unemployment over 20 percent for half of the countries. The estimated size of the informal sector remains high across the region and is most pronounced in the Caucasus and Central Asia region (CCA), standing at 40 percent of GDP. Social safety nets remain largely subsidy-based, with better-targeted support still underused. The region is also home to several fragile and conflict-affected states, which will likely see a significant worsening in their humanitarian situation (Box 1.2).

Implications of Economic Scarring for the Recovery

Given the backdrop in the MCD region, how deep could the economic scarring from the COVID-19 crisis be? For example, the global financial crisis inflicted significant scarring (Box 2.1). Five years after that crisis, real GDP in MCD countries remained more than 4 percent below its precrisis trend. By the end of 2019, 12 countries still had not returned to their precrisis growth trends, and for those that had, it took more than five years, on average. This time, given preexisting vulnerabilities, it is estimated that five years from now, countries in the region could be 12 percent below the GDP level implied by precrisis trends, and a return to the trend level could take more than a decade. Although these numbers are sizable, they are likely underestimates, given the unprecedented nature of the current shock and downside risks, as highlighted in Chapter 1.

Figure 2.3. Travel and Tourism, Remittances, and Structural Vulnerabilities

1. Travel and Tourism Contribution to GDP[1]
   (Percent of GDP, 2019)
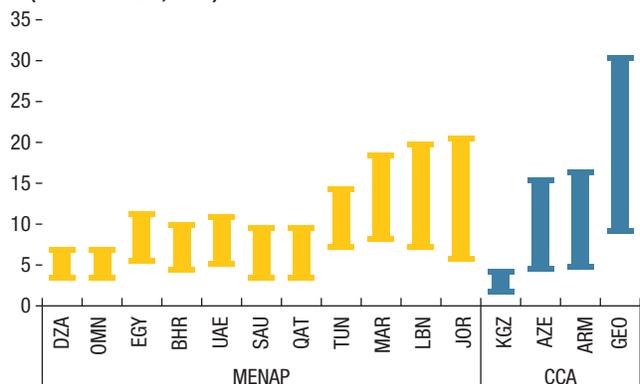
2. Remittances
   (Percent of GDP, 2019)
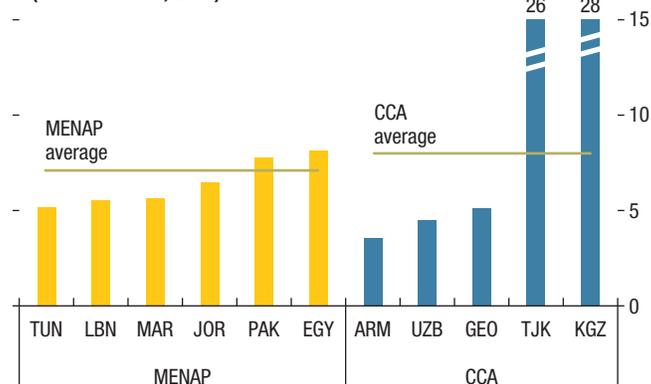
Sources: World Travel and Tourism Council; national authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan. Country abbreviations are International Organization for Standardization (ISO) country codes.
[1]The data show the ranges between direct and total contribution of travel and tourism spending to GDP and employment, respectively. The direct impact is defined as GDP (employment) generated by industries that deal directly with tourists; i.e., hotels, travel agencies, airlines, other passenger transport services, and activities of restaurant and leisure industries. It is equivalent to total internal travel and tourism spending (by residents and international visitors) within a country minus the purchases made by those industries (including imports). The indirect impact (as described by the Organisation for Economic Co-operation and Development Tourism Satellite Accounts) is defined as the impacts generated by the intermediate consumption of the producers who are directly in contact with the visitors plus the induced impacts, defined as the impact generated by the production factors implemented by these producers who are in contact with the visitors.

3. Unemployment Rate, 2019
   (Percent)
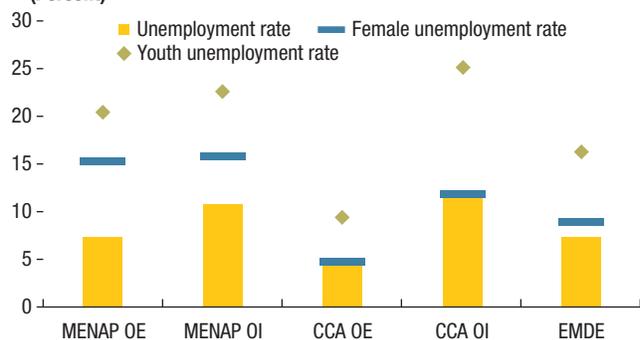
4. Size of the Shadow Economy, 2000–17
   (Percent of GDP)
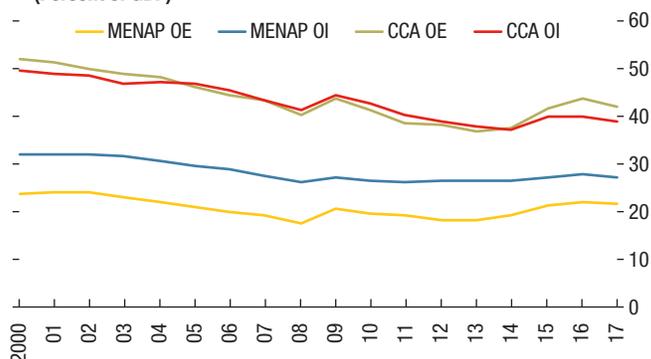
Sources: International Labour Organization; Medina and Schneider (2019); and IMF staff calculations.
Note: CCA OE = Caucasus and Central Asia oil exporters; CCA OI = Caucasus and Central Asia oil importers; MENAP OE = Middle East, North Africa, Afghanistan, and Pakistan oil exporters; MENAP OI = Middle East, North Africa, Afghanistan, and Pakistan oil importers.

What are the drivers of this persistently negative outcome? Although there are many channels through which scarring can occur, this section identifies four key channels:

- Large exposure in the hard-hit services sector, particularly tourism, could reduce baseline GDP and employment growth for MCD tourism-intensive countries by about 5 percentage points each on average in

2020, with potential lingering effects for the next two to five years.

- High leverage and a sizable contraction in revenues and profitability for firms in 2020 have raised medium-term solvency risks, with firms about twice as likely to default by early 2021 as they were before the pandemic.

- The protracted impact of the crisis on contact-intensive sectors, coupled with limited ability to work from home in the region, will exacerbate unemployment. A slow reallocation of labor away from the most affected sectors could lead to higher unemployment for several years, as has been the case following past recessions.

- The sharp drop and protracted recovery in remittances could increase the number of new extreme poor by 1.3 million, reaching a poverty headcount of about 5.25 percent of the population of MCD remittances-dependent countries, with fragile and conflict-affected states overwhelmingly representing the new extreme poor.

A Protracted Rebound in Services

The first channel through which scarring can occur focuses on the large exposure of some MCD economies to services. Because the services sector's contribution to value added exceeds 34 percent for more than two-thirds of MCD countries, a severe disruption in these activities will markedly weigh on the eventual overall recovery. This is particularly the case for travel and tourism activities, which account for up to 26.6 percent of total employment and contribute as much as 30.5 percent of GDP in some MCD tourism-intensive countries. For these countries, a severe six-month disruption to these activities, calibrated to match broadly the evolution of high-frequency indicators between April and June 2020, is expected to reduce baseline GDP and employment growth in 2020 up to 5.4 and 4.9 percentage points on average, respectively, with Georgia, Jordan, Lebanon, and Morocco being hurt the most (based on the direct and indirect contribution of these activities to overall GDP and employment; Figure 2.4, panels 1–2).

An event study of past shocks in the region indicates that the resumption in travel and tourism could take several years. In the five years since the global financial crisis and Arab uprisings, tourism receipts remained on average 13 percent below

their precrisis levels in the Middle East, North Africa, Afghanistan, and Pakistan oil importers (Figure 2.4, panel 3). This reflects particularly protracted contractions in Egypt (where tourism receipts in 2015 remained 50 percent below 2010 levels) and Tunisia (about 50 percent below 2010 levels).[2] The 2014–15 oil shock also reduced tourism inflows to Egypt, Jordan, and Morocco, though for a shorter period (between two and four years). The protracted impact after the Arab uprisings seems to be driven by tourists choosing different destinations, but the experience after the 2014–15 oil shock was temporary because negative wealth effects kept tourists from oil-dependent countries at home. This time the recovery could be even more protracted because of both the negative wealth effects from the crisis and the potential that travelers could avoid MCD countries if the region lags the rest of the world in controlling COVID-19 and reopening to air travel.

Further Strains on Corporate Balance Sheets

Firms in the region entered the pandemic with relatively weak fundamentals. Compared with preexisting conditions in other crises, firms had, on average, lower profitability, liquidity, and revenue growth before the current crisis (Figure 2.5).[3] Compared with other regions, MCD firms entered the pandemic with higher leverage and lower capacity to cover interest expenses (Table 2.1, panel 1). Firms in oil-exporting countries, although more liquid, had worse pre-pandemic revenue growth and

---

[2]Although terrorism incidents in Tunisia in 2015–16 had a more pronounced impact than the global financial crisis and the Arab uprisings.

[3]Quarterly data on listed companies were obtained from the S&P Global Intelligence Compustat database. The average number of firms per quarter in the Middle East and Central Asia since 2007 is about 1,200, covering eight oil-importing countries (Egypt, Georgia, Jordan, Lebanon, Morocco, Pakistan, Sudan, Tunisia) and seven oil-exporting countries (Bahrain, Kazakhstan, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates). Selected financial indicators are defined as (1) return on equity = net income ÷ equity; (2) net profit = net income ÷ cost of goods sold; (3) revenue growth; (4) leverage = total liabilities ÷ total assets; (5) liquidity = (cash + receivables) ÷ current liabilities; and (6) interest coverage ratio = earnings before interest and tax ÷ interest expense.

Figure 2.4. Impact of Crisis on Tourism in MCD Countries

1. Tourism: 2020 Impact of a Severe Six-Month Disruption on GDP[1]
(Percent of GDP)

2. Tourism: 2020 Impact of a Severe Six-Month Disruption on Employment[1]
(Percent of employment)

3. Median Impact of Crisis on Inbound Tourism Expenditure
(Index)
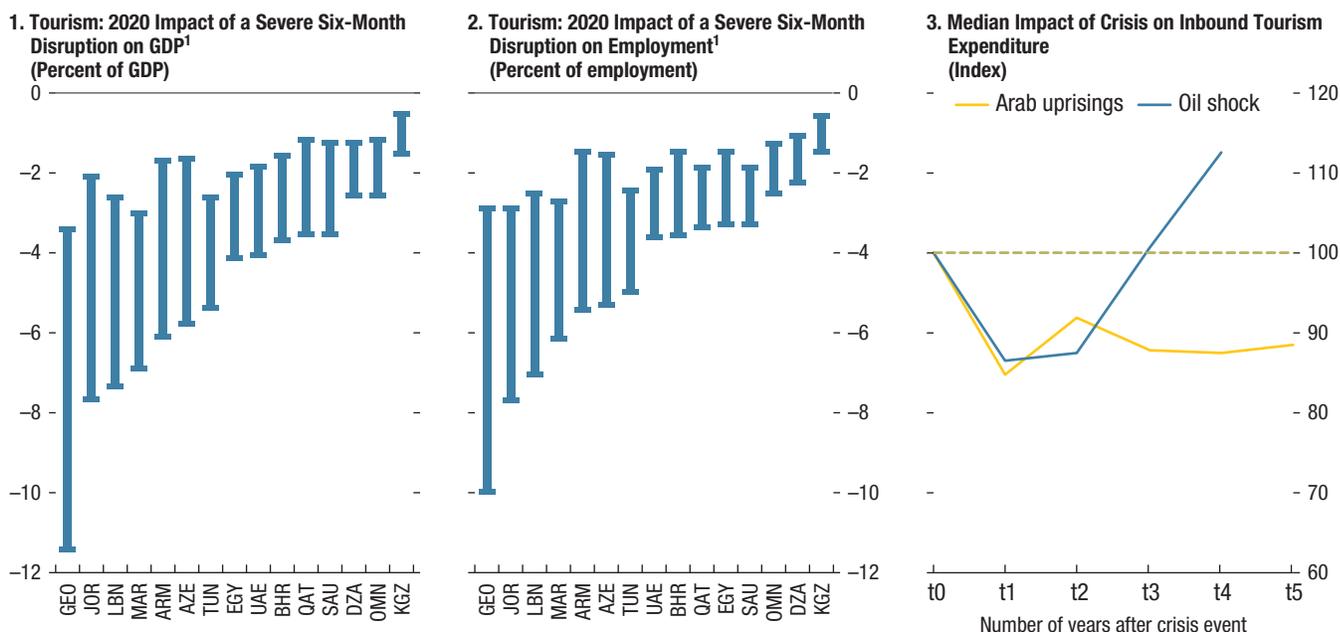
Sources: World Tourism Organization; World Travel and Tourism Council; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.
[1]These estimates do not consider the potential mitigating effect from residents substituting foreign travel for domestic tourism. The data show the ranges between direct and total contribution of travel and tourism spending to GDP and employment, respectively. See Figure 2.3 for the definition of direct and indirect contribution of travel and tourism to GDP and employment.

slightly higher leverage than those in oil-importing countries, reflecting the lasting impact from the 2014–15 oil shock.

These conditions deteriorated further during the first half of 2020, compared with the average performance in 2018–19. Revenue growth contracted by 11 percentage points, reflecting a deeper impact on oil importers than on oil exporters (–17.5 and –7.5 percentage points, respectively). As a result, profitability has taken a bigger hit in oil-importing countries, where it has more than halved. Leverage throughout the region has increased during the pandemic. Performance during the second quarter shows a deeper impact on revenue growth (a contraction of 19 percentage points) and a continued increase in leverage (Table 2.1, panel 2).

The pandemic has also had a significant adverse impact across sectors (Table 2.1, panel 3). The energy sector, the main revenue source in the

region, has been hit severely, with revenue growth and profitability contracting by 28.4 and 4 percentage points, respectively. Services, durable goods, business equipment, and manufacturing also saw double-digit declines in revenues.[4] In most sectors, profitability dropped and leverage rose, hampering the ability to cover interest expenses. Liquidity and solvency risks have risen as the capacity to service debt deteriorated, including through a 6 percent increase in the number of firms whose interest coverage ratio dropped below 1.

The damage to firms in the region will likely take years to undo, raising medium-term solvency risks. To assess such risks, stress tests were conducted under two macroeconomic scenarios:

---

[4]The service sector has been hit the hardest, with plummeting revenues, a marked contraction in profitability, and a significant deterioration in its capacity to cover interest expenses (the only sector with a negative interest coverage ratio).

Figure 2.5. Fundamentals Relative to Crisis Episodes
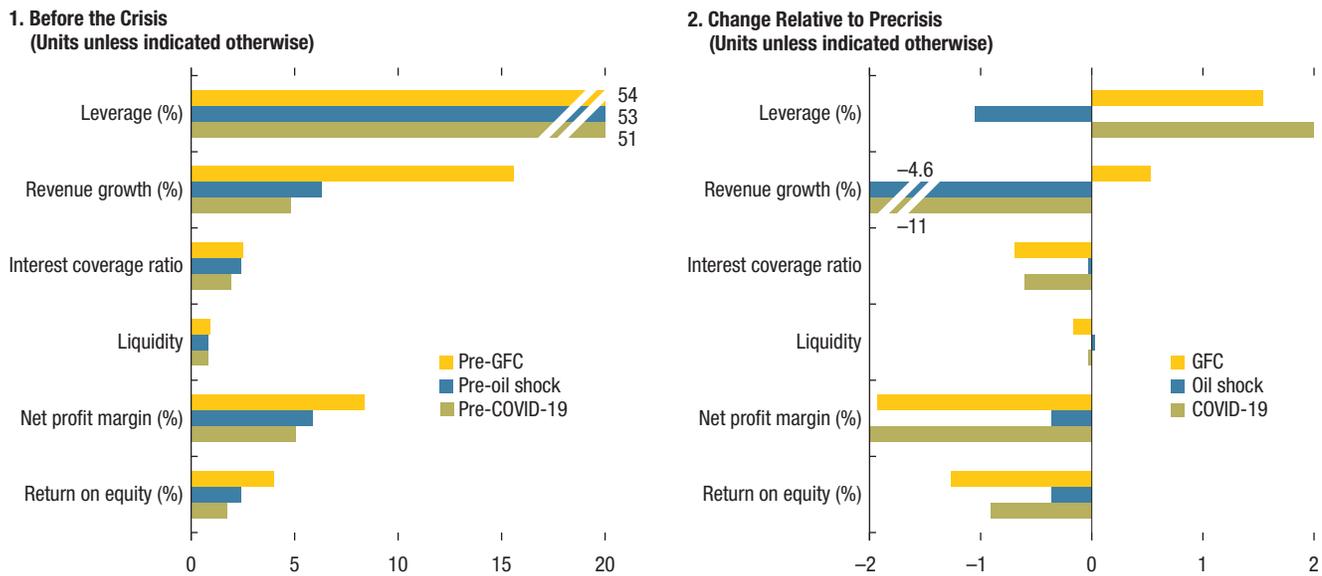
1. Before the Crisis
(Units unless indicated otherwise)

2. Change Relative to Precrisis
(Units unless indicated otherwise)

Sources: S&P Global Market Intelligence, Compustat; and IMF staff calculations.
Note: GFC = global financial crisis. Precrisis is defined as two years before each crisis episode.

pre-pandemic *World Economic Outlook* (WEO) projections and current WEO projections.

The approach uses a Bottom-Up Default Analysis that projects probabilities of default of individual firms conditional on macroeconomic conditions and financial risk factors. Results suggest that firms on average are now about twice as likely to default by early 2021 as they were before the pandemic, raising their risk of a credit rating downgrade. All industries, except technology, face greater default risks, albeit more pronounced in the case of services and energy-related firms. Although default risks improve steadily over time in the stress scenario, they remain higher than pre-pandemic levels, three years later (Figure 2.6).

Persistent Adverse Labor Outcomes

By affecting firms, lockdown measures will exacerbate adverse labor market outcomes, though somewhat less so in countries where there are more opportunities to work from home. However, using recent studies on the types of occupations that can be performed from home (see Dingel and

Figure 2.6. Firms' Probability of Default
(Basis points)
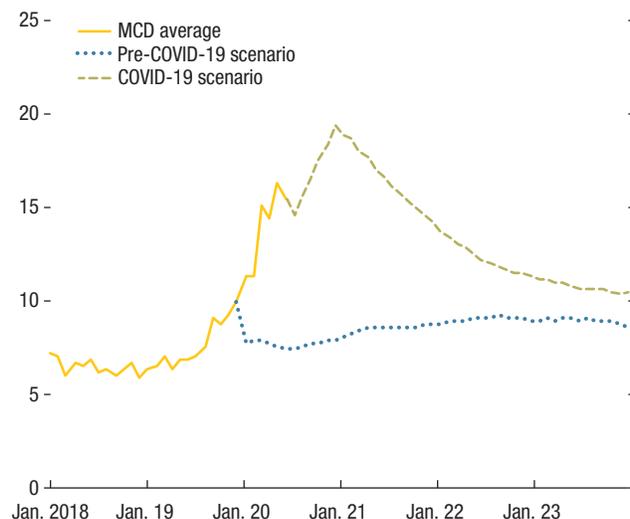
Sources: CRI (2019); and IMF staff calculations.
Note: MCD = Middle East and Central Asia. The series show the average one-year-forward probability of default for listed nonfinancial firms in a few countries in the region (Kazakhstan, Qatar, Saudi Arabia, United Arab Emirates).

Table 2.1. Selected Operating Metrics
(2018–19 average versus 2020)

Operating Metrics	Revenue Growth (%)		Net Profit Margin (%)		Return on Equity (%)		Interest Coverage Ratio		Leverage (%)		Liquidity	
	Average 2018–19	2020	Average 2018–19	2020	Average 2018–19	2020	Average 2018–19	2020	Average 2018–19	2020	Average 2018–19	2020
Panel 1. Regional Comparison												
MCD Oil Exporters	2.9	−4.6	4.7	3.4	1.3	0.9	2.6	1.5	50.9	54.8	1.1	1.0
MCD Oil Importers	10.3	−7.2	3.7	2.1	1.9	0.8	2.2	1.2	50.3	51.2	0.7	0.7
Advanced Economies	5.1	−5.8	2.7	1.5	1.3	0.7	4.2	1.9	47.4	48.6	1.2	1.2
Emerging Markets	8.4	−9.2	4.2	2.7	1.8	1.1	3.4	2.0	46.2	47.1	1.0	1.0
Panel 2. Comparison over Time												
Q1	5.7	−2.4	4.1	2.6	1.5	0.9	2.3	1.4	50.6	54.0	0.9	0.8
Q2	4.1	−14.9	4.5	3.2	1.4	0.7	2.2	1.4	52.5	54.5	0.9	0.9
Panel 3. Sectoral Comparison												
Energy	9.9	−18.5	−0.9	−4.9	0.8	−0.9	1.4	0.4	52.9	56.7	1.1	1.2
Services	4.7	−29.7	3.9	−1.5	1.3	−0.6	6.0	−1.5	37.2	41.1	1.0	0.9
Retail	1.4	−6.2	3.7	3.0	2.2	1.7	6.9	3.2	43.1	45.6	0.7	0.6
Transportation	5.8	−2.9	11.6	7.7	2.1	1.2	5.9	2.5	39.5	41.8	1.2	1.2
Consumer Non-Durable	10.3	2.2	2.8	2.8	1.6	1.1	2.3	1.4	54.1	54.8	0.6	0.5
Consumer Durable	−1.2	−32.6	3.0	−1.5	2.1	1.4	17.8	1.1	47.4	50.7	0.9	0.8
Manufacturing	2.5	−12.0	3.1	0.0	0.9	0.3	2.3	0.7	43.8	45.7	0.7	0.7
Chemicals	17.2	−7.2	6.8	2.2	2.1	0.7	3.8	1.7	46.5	46.9	0.9	0.8
Business Equipment	5.0	−12.1	3.3	4.7	0.9	1.7	2.6	3.4	49.0	49.7	0.9	0.9
Telecommunications	3.0	−0.3	10.3	9.8	3.0	2.3	3.6	2.7	46.9	52.3	0.9	0.9
Utility	3.4	7.0	1.4	1.7	1.0	0.3	1.9	1.3	73.9	72.2	0.9	1.0
Health	9.6	6.1	8.8	8.5	2.3	2.2	7.9	4.1	36.8	39.1	1.2	1.0
Others	2.6	−22.3	5.0	4.2	1.4	0.8	2.8	1.7	38.6	39.5	1.0	1.0

Sources: S&P Global Market Intelligence, Compustat; and IMF staff calculations.
Note: MCD = Middle East and Central Asia. Results are based on firms that released annual reports in 2020, and performance is reported for the same set of firms over time in each row.
Highlighted numbers denote worsening conditions in 2020 compared with the 2018–19 average.

Figure 2.7. Share of Jobs that Can Be Performed from Home
(Percent)
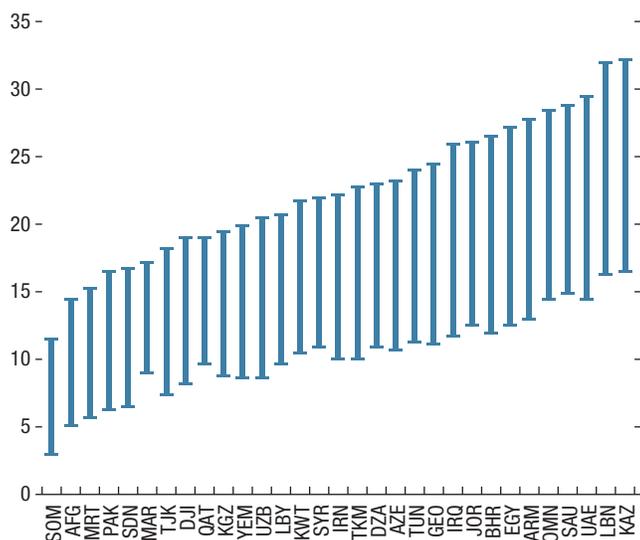
Sources: International Labour Organization; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes. Upper and lower bound estimates are based on analysis of occupations performed from home by Dingel and Neiman (2020) and Saltiel (2020) respectively.

Figure 2.8. Per Capita Income and the Share of Jobs that Can Be Performed from Home
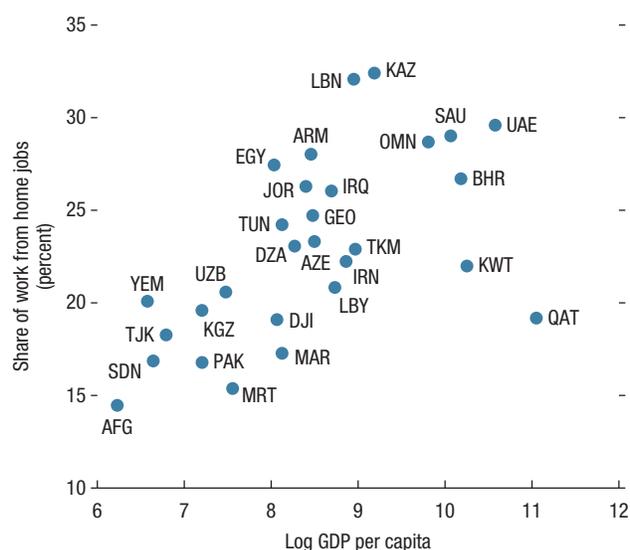
Sources: International Labour Organization; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes. Work from home estimates are based on the analysis by Dingel and Neiman (2020) of which occupations can be performed from home. GDP per capita is in 2019 current prices.

Neiman 2020 for US occupations and Saltiel 2020 for developing economies) and the distribution of employment across occupations in MCD countries, estimates suggest that the ability to work from home in the region is limited. In fact, the share of jobs that can be performed at home averages between 10 and 23 percent for countries in the region (Figure 2.7)—this compares to Dingel and Neiman's study of 86 countries in which the average share was 26 percent.

The limited ability to perform jobs at home is likely to be even more pronounced in lower-income countries with higher shares of employment in agriculture and elementary occupations (Afghanistan, Mauritania; Figure 2.8).

Those estimates likely represent an upper bound, because of low internet access in these countries (Garrote Sanchez and others 2020). In addition, there is considerable variation across workers. Evidence from labor force surveys for Egypt and Jordan suggests that workers in the informal sector are considerably more likely to be in jobs that

cannot be performed from home. In the Gulf Cooperation Council (GCC) countries, the ability to work from home is higher for nationals than for expatriates (Figure 2.9) because of a much greater prevalence of national workers in managerial and professional occupations and within the government sector.

Preliminary evidence suggests that the unprecedented current crisis will likely have a deeper impact on the labor market than past recessions had. According to International Labour Organization estimates, working hours in Arab states declined by 1.8 percent during the first quarter of 2020 (equivalent to about 1 million full-time jobs), further declining by 10.3 percent in the second quarter (equivalent to about 6 million full-time jobs), both compared with precrisis conditions. The toll on employment could be much more severe than after the global financial crisis, with about one-third of individuals in the Arab region employed in sectors that are considered most at risk from the COVID-19 shock (ILO 2020).

These adverse labor market outcomes can have a long-lasting impact on individuals, either by making future employment more difficult or through discouraging labor force participation. Several studies have documented scarring effects on employment prospects from not working for an extended period, estimating persistent earnings losses in the range of 20 to 40 percent in the United States (Guvenen and others 2017). Similarly, evidence from labor panel surveys for Egypt and Jordan suggests that unemployment spells can have long-lasting effects on employment prospects. This chapter's estimates signal that in Jordan and Egypt, those who are unemployed are about 9 and 14 percent more likely to remain unemployed or out of the labor force six years later, respectively, after controlling for factors such as age, sex, education, and wealth.[5]

Evidence from past shocks also points to long-lasting hysteresis effects for the overall labor market, which is especially important in a region with relatively weak social safety nets (Box 2.2). In the short term, unemployment typically increases when output contracts—an empirical regularity known as Okun's law. However, in the MCD region, unemployment typically remains elevated several years after a downturn. Recessions, on average, have been associated with a 1 percentage point increase in the unemployment rate after five years in both oil-exporting and -importing countries (Figure 2.10). For the latter, this estimate increases to almost 2 percentage points for recessions that inflicted deeper output contractions over the past three decades. For oil exporters, the initial impact on unemployment is relatively muted, in contrast to Okun's law, potentially reflecting the reliance of GCC countries on expatriate workers, whose exit from the labor market may reduce the supply capacity of these economies, but with little impact

[5]The longitudinal dimension of the labor panel surveys is exploited. Specifically, a linear probability model is used to assess the probability of an individual being unemployed in a given survey year, given the employment status of that individual in a previous survey year, based on surveys during 2012 and 2018 for Egypt, and 2010 and 2016 for Jordan. The data sets used are the Egypt Labor Market Panel Survey, ELMPS 2018, and the Jordan Labor Market Panel Survey, JLMPS 2016.

Figure 2.9. GCC: Share of Jobs that Can Be Performed from Home for Expatriates and Nationals
(Percent)
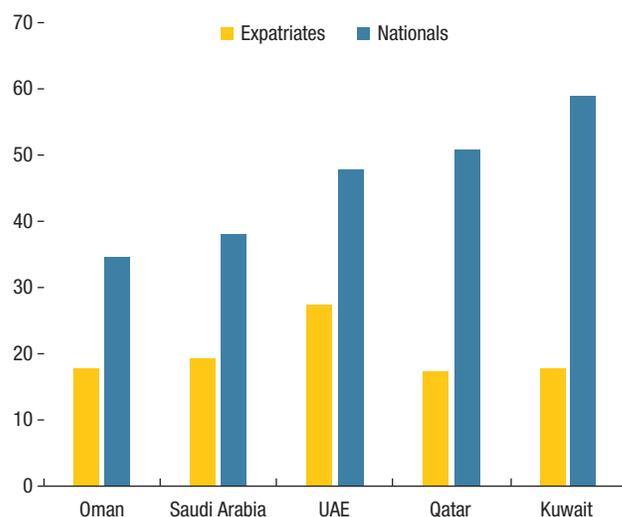
Sources: National authorities; and IMF staff calculations.
Note: GCC = Gulf Cooperation Council. Work from home estimates are based on the analysis by Dingel and Neiman (2020) of which occupations can be performed from home. Data availability varies across countries, and the data used are as follows: Kuwait (2016), Qatar and UAE (2018), Oman (2019), Saudi Arabia (2020:Q1). Data for Oman exclude the public sector, and data for Saudi Arabia exclude civil servants.

on the unemployment rate. Over the longer term, however, the impact on unemployment increases in oil-exporting countries, which may reflect the enduring impact of crises on the job-creating capacity of these economies. Given the depth of the current downturn and its uneven effect across sectors, its eventual impact on unemployment across the region could be greater if the recovery proves to be protracted or if significant structural change of the workforce is required.

Remittances, Poverty, and Inequality

Beyond labor earnings, workers' remittances are key external flows that support households in the region. Remittances are a sizable source of income for 14 countries in the MCD region, for which these flows exceed 5 percent of GDP (Figure 2.2). GCC countries, Russia, and the United States account for two-thirds of total remittances to these countries (Figure 2.11).

Figure 2.10. Impact of Recessions on Unemployent

1. MCD Oil Exporters

2. MCD Oil Importers
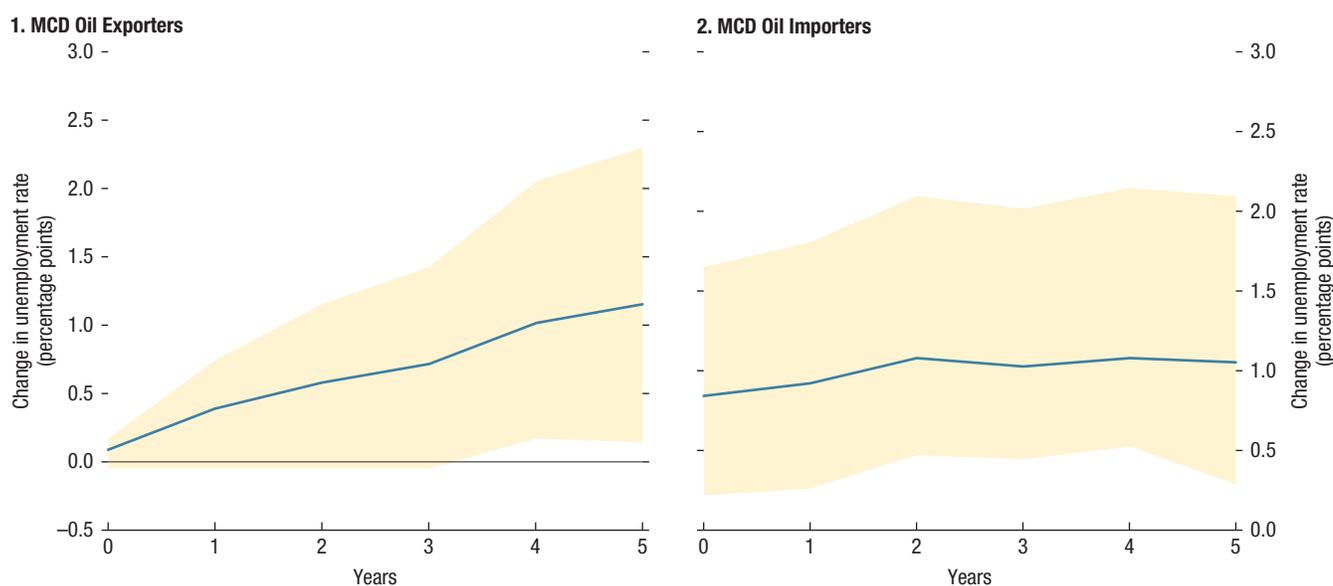
Sources: International Labour Organization; national authorities; and IMF staff calculations.
Note: MCD = Middle East and Central Asia. The solid lines plot the impulse responses of unemployment to a recession shock, defined as a year in which annual GDP growth was negative. Year 0 is the year of the shock. The yellow shaded areas display the 90 percent confidence intervals.

[1]The long-term impact of recessions on unemployment is analyzed using a local projection approach (Jordà 2005). The following specification is estimated over 1991–2019, using a panel of 31 MCD countries:

$$u_{i,t+h} - u_{i,t} = \alpha_{i,h} + \delta_{t,h} + \beta_h\, Recession_{i,t} + \sum_{j=1}^{2} \gamma_{i,h}\, X_{i,t-j} + \varepsilon_{i,t+h}\,,$$

where $u_{i,t+h}$ is the unemployment rate at horizon $t + h$, α_i is a country fixed effect, δ_t is a time fixed effect, $Recession_{i,t}$ is an indicator equal to 1 if GDP contracts in year t and zero otherwise, and X_{t-j} is a matrix of controls including GDP growth and changes in unemployment j periods before the shock.

Remittances are estimated to have contracted by 19 percent on average, year over year, during the first half of 2020 (Figure 2.12). The contraction was particularly strong in Armenia, the Kyrgyz Republic, and Tajikistan (greater than 34 percent) during April and May, both periods of increased lockdown stringency in Russia, their main remittance source country.[6] Under a moderate recovery in the second half of the year, remittances could fall on average by 20 percent. Countries depending on flows from the GCC region are likely to see an above average drop

in remittances because of the GCC's subdued outlook. On average, remittances to Middle East, North Africa, Afghanistan, and Pakistan oil importers would take more than four years (twice as long as the recovery following both the global financial crisis and the 2014–15 oil shock) to recover to precrisis levels (Figure 2.13). By contrast, CCA oil-importing countries and some fragile and conflict-affected states would see a smaller-than-average drop (of about 13.5 and 18 percent, respectively) and a faster recovery (one to three years to recover to precrisis levels) because of a more favorable outlook for the countries that are their main sources of remittances (Russia and the rest of the world). However, risks are tilted to the downside. For instance, remittance flows may not recover as fast as in the period after the global financial crisis

[6]Pakistan and Somalia have been the exceptions so far, showing resilient remittances because of a mix of idiosyncratic factors such as migrants benefiting from the payroll protection program in the United States, to increases in the use of formal remittance channels because of obstacles the current crisis poses to sending money through informal means (flows not previously captured in official statistics).

Figure 2.11. Share of Remittances by Origin, 2018
(Percent of total remittance inflows)
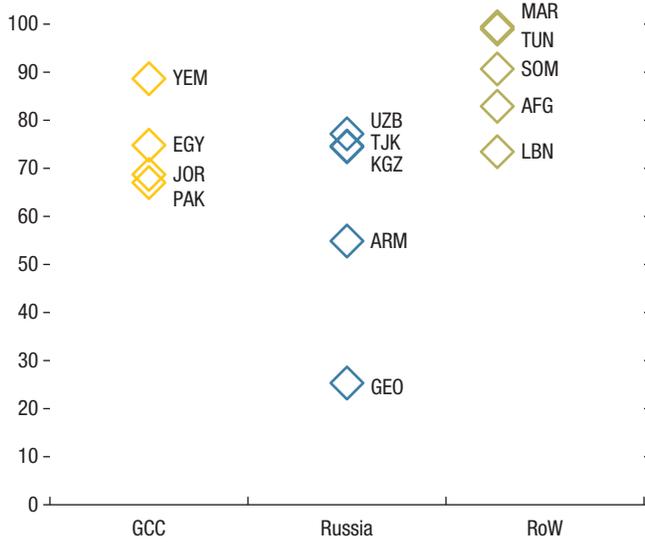
Sources: World Bank, *Migration and Remittances*; national authorities; and IMF staff calculations.
Note: GCC = Gulf Cooperation Council; RoW = rest of the world. Country abbreviations are International Organization for Standardization (ISO) country codes. Data reflect an estimate of 2018 bilateral remittance flows to observed countries.

Figure 2.12. Change in Remittance Inflows
(Percent change from 2019 to 2020)
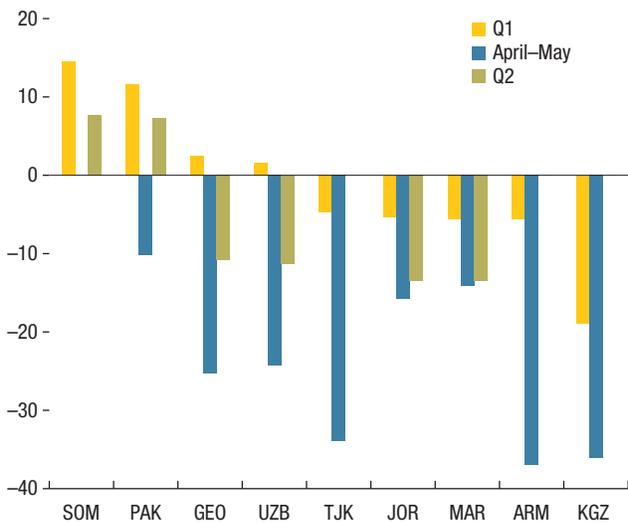
Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 2.13. Impact of Crisis on Remittance Inflows to MCD Countries
(Billions of US dollars)
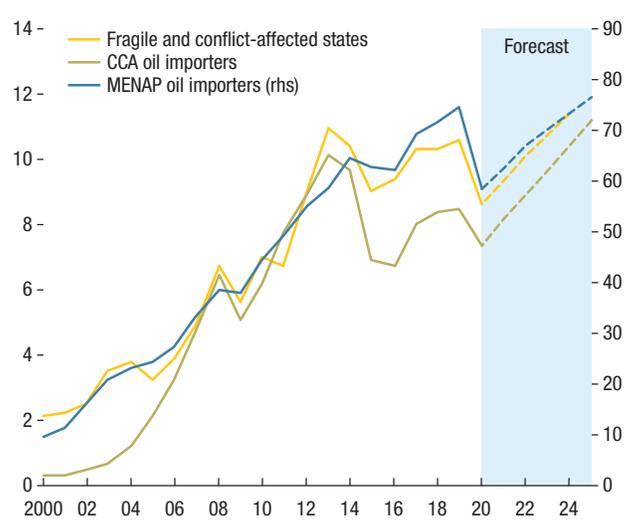
Sources: World Bank, World Development Indicators databases; national authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MCD = Middle East and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; rhs = right-hand scale.
[1]Remittances were projected using the elasticity of remittances per capita with respect to sending country per capita income. The elasticity of remittances for MCD countries was estimated as in Abdih and others (2012):

$$log(RPC_{it}) = \beta_0 + \beta_1 log(YPCR_{it}) + \beta_2 log(YPCS_{it}) + X'_{it}\gamma + u_i + n_t + e_{it},$$

where RPC_{it} is remittances per capita, $YPCR_{it}$ and $YPCS_{it}$ represent per capita income of remittances receiving and sending countries, respectively, X_{it} is a matrix of other variables that affect RPC_{it}, u_i and n_t are country and year fixed effects, and e_{it} is the error term. β_2 is the elasticity of remittances with respect to per capita income of sending countries.

because the crisis has disproportionately affected sectors of migrant employability.

The sharp drop and protracted recovery in remittances will be one of the many factors expected to worsen poverty and inequality because of the pandemic. In 2020, poverty headcount in the region could rise by more than 3.7 percent, reaching about 5.25 percent of the population of MCD remittance-dependent countries or adding more than 1.3 million new extreme poor.[7]

Likewise, inequality measured by the median Gini coefficient would deteriorate because of lower

[7]Measure of extreme poverty refers to the $1.90 a day international poverty line.

Figure 2.14. Impact of Remittances on Poverty and Inequality in MCD Countries

1. Remittances' Impact on Poverty
(Millions of extreme poor and percent of
population)

2. Impact of Remittances on Gini Coefficient
(Units)

3. Proportion of New Extreme Poor,
2020 Forecast
(Percent)
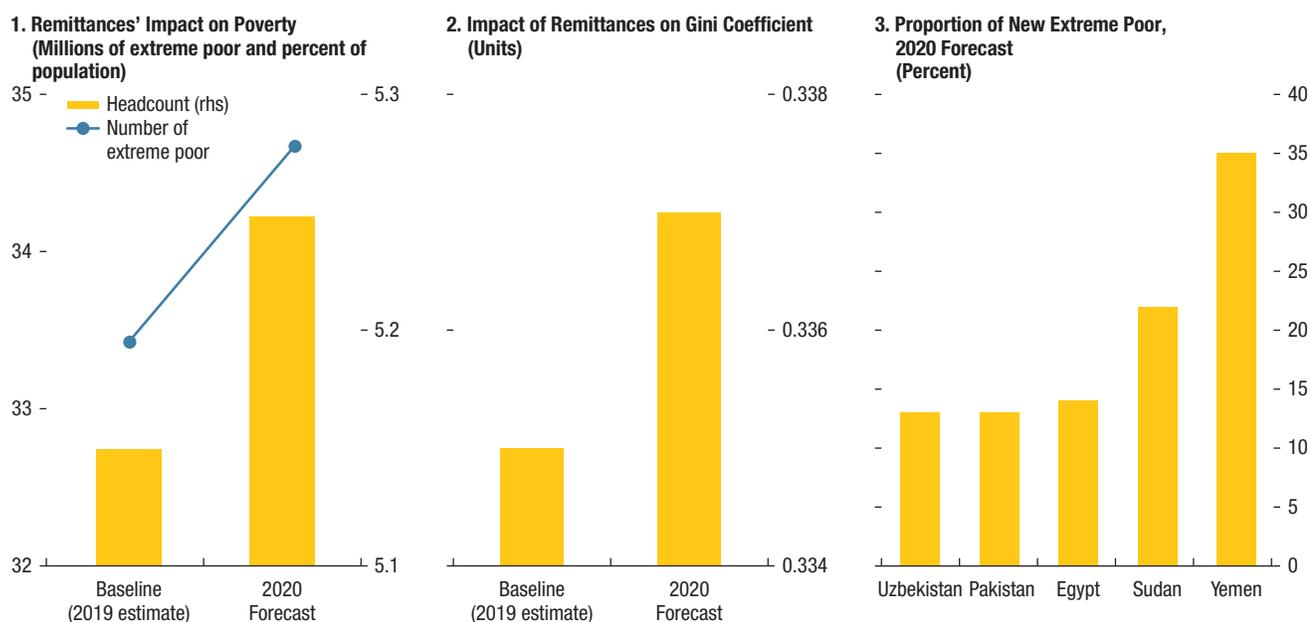
Sources: World Bank PovacalNet and World Development Indicator databases; national authorities; and IMF staff calculations.
Note: rhs = right-hand scale. The measure of extreme poverty refers to $1.90 a day international poverty line.
[1] Following Azizi (2019), the following equation was estimated over 1993–2015, for 80 countries, including 10 MCD countries:

$$log(H_{it}) = \beta_0 + \beta_1 log(RPC_{it}) + \beta_2 log(YPC_{it}) + X'_{it}\gamma + e_{it},$$

where H_{it} is the poverty or inequality measure, RPC_{it} is remittances per capita, YPC_{it} is per capita income, X_{it} is a matrix of other variables that affect H_{it}, and e_{it} is the error term. β_1 is the elasticity of remittances with respect to poverty or inequality. To deal with the endogeneity problem, a first stage regression of remittances per capita was estimated on instruments (weighted per capita income, unemployment, real interest rate and real exchange rate of the sending countries, where the weight is bilateral remittances).

remittances by about 1 percent, with an estimated 2 percentage point decline in the share of income of those in the lowest 20 percent (Figure 2.14). The new extreme poor would be overwhelmingly represented by fragile and conflict-affected states such as Sudan and Yemen (about 57 percent of the new extreme poor) and other countries that rely on remittances, such as Egypt, Pakistan, and Uzbekistan. These results are likely lower bounds for the worsening in monetary poverty and inequality in the short term because they reflect only the immediate remittance channel. For example, Furceri and others (2020) estimated a much larger and persistent worsening in inequality, for up to five years after the pandemic, because of labor market and human capital channels—a higher share of income goes to the more educated workers at the top and a lower

share to the less educated workers at the bottom of the distribution.

Policies to Minimize Economic Scarring

Evidence across the different channels points to a high likelihood of lasting scars that could significantly weigh on the post-pandemic recovery.

Given the region's high exposure to the services sector, particularly contact-intensive tourism, policymakers should strike a careful balance between preserving livelihoods, minimizing scarring, and promoting recovery without creating "zombie" sectors reliant on extended government support beyond the crisis phase. As the current crisis progresses, difficult decisions will have to

be made about when the gradual unwinding of existing lifelines should begin and which sectors should see their support cut instead of boosted. Such decisions should be made with a long-term view and, in oil-exporting countries, be supportive of ongoing efforts to diversify economies. Where businesses remain viable, policies should be put in place to support them; for sectors that will be permanently scarred by the pandemic, however, policies should encourage the retraining and reallocation of these workers and capital.

As these decisions are made, corporate vulnerabilities should be mitigated through policies that alleviate solvency pressures and ensure a swift resumption in business operations after the pandemic. Measures such as temporary support for wages, interest subsidies, and tax deferrals could help ease liquidity pressures when revenues dry up. These support measures could be implemented, conditional on firms maintaining employment, so that firms can restart immediately when the situation improves. In addition, firms are encouraged to work with creditors to refinance their debts into longer maturity to ease short-term liquidity pressures. At the same time, there will be a need to put in place strong insolvency frameworks and mechanisms for restructuring and disposing of distressed debt so that weak private balance sheets do not stall the recovery. Ensuring that the banking sector maintains sufficient capital buffers while limiting the risks from zombie lending will help minimize financial sector vulnerabilities, which could slow the recovery (Chapter 4).

In response to the higher unemployment in the region, policymakers should ensure that the most vulnerable are protected from immediate income losses. For countries with well-developed safety nets and employment benefit programs, automatic stabilizers should be allowed to work to prevent scarring. Given resource constraints among low-income countries and fragile and conflict-affected states, and the high degree of informality in the region, innovative solutions, including big data analysis and geographic and age targeting, should be deployed to reach those not

in registries. For countries with fiscal space and underdeveloped safety nets, unconditional direct cash transfers can be important stopgap measures as better targeting is developed. In view of their size, exceptional nature, and speed of deployment, it will be key to ensure that additional measures are transparently recorded and costed. Social assistance should also be calibrated to consider the fall in remittances.

Given that expatriate workers have an especially low ability to work from home, measures should be put in place to encourage greater internal mobility for expatriates in vulnerable sectors. Large-scale withdrawals of expatriates could have costly and long-lasting effects on per capita income growth, especially if they cannot be easily replaced when the crisis abates. Thus, policies to support employment retention and employment services such as job matching and search programs will be an important complement to social safety nets for expatriates. Countries receiving returning migrants should also ensure that social safety nets support their reintegration and promote retraining.

In the medium term, employment can be supported through encouraging a competitive, business-friendly environment and policies that promote labor mobility toward higher-value-added sectors. The crisis has also highlighted the importance of digital connectivity to enable people to work from home. Countries with poor connectivity should invest in improving access to high-speed internet, which will boost labor market resilience and allow countries to harness the value of the digital economy. Measures to deepen labor market reforms, including formalization and unemployment insurance, fostering re-skilling and human capital development of workers, adapting the education system for innovation and technology, promoting diversification, increasing infrastructure investment, and enabling private sector competition, will also be paramount to ensure that the region is less vulnerable to the next global shock.

Over time, to help wean the region from its high dependence on remittances (at least for basic consumption), countries should also structurally

strengthen social safety nets. Given the region's small available fiscal space, shifting resources from inefficient blanket subsidies toward better-targeted social programs would lower inequality, enhance progressivity, and improve individual benefits levels.

To ensure that the recovery is long-lasting and sustainable, the region will have to rebuild its

policy space. Improving institutional frameworks for sustainable fiscal, monetary, and financial policies (Chapters 3 and 4) will help rebuild and preserve buffers against external shocks and macroeconomic volatility. Improving governance and cutting red tape will enhance government efficiency and help provide a growth-friendly environment for the long term.

Box 2.1. Persistent Effects from the Global Financial Crisis in Middle East and Central Asia

Economic scarring can be driven by both the nature of the shock and a country's vulnerabilities. Factors such as external and fiscal buffers, openness to trade, commodity dependence, unemployment, dependence on remittances and tourism, and level of poverty at the time of the shock can all play a role in how quickly an economy recovers after a recession. Recovery can also be measured by, for example, how much lower the level of real GDP is five years after the crisis or how many years it takes for the level of real GDP to return to its precrisis trend. Such relationships are tested in a cross-section of 126 countries, excluding advanced economies, for the aftermath of the global financial crisis. Table 2.1.1 summarizes the regression results. It is important to note that many factors ultimately shape a country's recovery, including endogenous effects from the global recovery. As such, this regression is purely illustrative, pointing to *some* of the possible drivers. The results suggest the following:

- Macroeconomic buffers improve recovery. High fiscal and current account balances are associated with a faster recovery. Once these and other country-level characteristics are controlled for, debt-to-GDP ratios are insignificant.

- While results point to openness being associated with a slower recovery after a crisis (reflecting the country's exposure to global shocks), openness in general has been associated with higher growth. Similarly, commodity dependence is also associated with a wider post-crisis GDP gap and a slower recovery. This likely reflects countries' inability to pivot toward new growth sectors that emerge after the crisis.

- Entering the crisis with a higher unemployment rate is associated with a slower recovery, because space for labor market adjustments and reallocation is more limited.

Box 2.1 *(continued)*

Table 2.1.1. Regressions of Real GDP Levels after the Global Financial Crisis

VARIABLES	(1) Level 5 years	(2) Duration	(3) Level 5 years	(4) Duration	(5) Level 5 years	(6) Duration	(7) Level 5 years	(8) Duration
Current Account Balance	0.843*	−0.0609*	0.828*	−0.0511	1.238***	−0.00161	−0.220	0.133
	(0.453)	(0.0344)	(0.443)	(0.0315)	(0.459)	(0.0588)	(0.934)	(0.145)
Fiscal Balance	0.768	−0.201**	0.759	−0.201**	1.517*	−0.235**	1.100*	−0.490***
	(0.467)	(0.0876)	(0.465)	(0.0862)	(0.869)	(0.113)	(0.647)	(0.129)
Openness (X+M/GDP)	−0.0140	0.0251**	−0.00571	0.0267**	0.00514	0.0181	−0.0763	0.0289*
	(0.0433)	(0.0118)	(0.0459)	(0.0120)	(0.0623)	(0.0132)	(0.0712)	(0.0160)
Debt to GDP	0.127	−0.0236	0.115	−0.0216	0.757	−0.00277	0.131	0.0199
	(0.185)	(0.0272)	(0.187)	(0.0293)	(0.567)	(0.0713)	(0.947)	(0.0940)
Commodity Dependence	−0.000907*	0.000144	−0.000863	0.000127	−0.000948*	0.000211**	0.00105	−0.000379
	(0.000529)	(9.48e−05)	(0.000571)	(9.59e−05)	(0.000520)	(0.000100)	(0.00251)	(0.000253)
Unemployment Rate	−0.572	0.293**	−0.515	0.293**	−0.813*	0.371***	−0.755	0.130
	(0.393)	(0.122)	(0.399)	(0.120)	(0.413)	(0.131)	(0.995)	(0.182)
Remittances to GDP			−3.109	0.370				
			(2.100)	(0.378)				
Poverty					−1.310	0.217		
					(1.838)	(0.356)		
Tourism Arrivals							0.165	1.073
							(4.585)	(0.705)
Constant	−43.19***	14.73***	−42.31***	13.97***	−45.58***	18.76***	−25.93	−3.502
	(12.28)	(2.534)	(14.18)	(2.569)	(12.99)	(2.795)	(79.29)	(10.87)
Observations	126	127	126	127	103	103	75	76
R-squared	0.341	0.316	0.366	0.334	0.418	0.391	0.286	0.382

Sources: National authorities; and IMF staff calculations.
Note: Robust standard errors are in parentheses.
* $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

Box 2.2. Social Safety Nets in the Middle East and Central Asia Region

The level and adequacy of social safety nets in the Middle East and Central Asia region vary widely across countries. Some provide coverage to the most vulnerable, in line with levels seen in advanced economies, but the coverage of even the poorest groups remains inadequate among others (Figure 2.2.1). Although there have been advances in recent years, most of the region's spending on social safety measures remains focused on subsidies, which crowds out more effective interventions. Countries in the Middle East and North Africa and in the Caucasus and Central Asia spend, on average, 14 and 17 percent of GDP, respectively, on subsidies, compared with a world average of 7 percent. By contrast, health spending in the region averages about 6 percent, compared with a world average of 10 percent. Furthermore, direct social programs average only less than 1 percent of GDP in the region, and many programs are fragmented, overlapped, and ill-targeted. Although subsidies are inefficient and provide more benefit for the rich, they remain key to keeping many households out of poverty because of their sheer size.

Figure 2.2.1. Population in the Lowest Quintile Covered by Social Assistance
(Percent)

Sources: World Bank, World Development Indicators; and IMF staff calculations.
Note: AE = advanced economies; EMDE = emerging market and developing economies. Country abbreviations are International Organization for Standardization (ISO) country codes.

Governments expanded social safety nets significantly in response to the crisis. Most countries relied on a combination of cash and in-kind transfer programs (used by more than two-thirds of countries), paid leave, unemployment benefits, and wage subsidies (Figure 2.2.2). Social programs were expanded to previously uncovered households by, for instance, waiving the requirement of previous social security system contributions. Increases in cash transfers, in some cases, were quite generous. For example, according to the World Bank, Egypt's cash transfer—which includes the Takaful and Karama Cash Transfer Program and a one-off monetary compensation program for informal workers—increased by more than 150 percent compared with pre-COVID-19 levels (Gentilini and others 2020).

The widespread use of cash and in-kind transfers in the region reflects the need to provide immediate but temporary relief to informal and migrant workers, who are often outside traditional social safety nets. According to the Organisation for Economic Co-operation and Development, formal private employment is limited and accounts, on average, for less than one-fifth of employment in the region. Informal employment reaches up to 74 percent in Yemen, 71 percent in Lebanon, and 63 percent in Morocco and represents, on average, 68 percent of employment in the region. For example, Iraq reached many of its migrant workers through contacting the embassies of the main origin countries. In addition, several countries implemented innovative technological solutions, including a mobile payment mechanism, to distribute compensation for informal sector workers, with online registration and leveraging health databases for information (Morocco), digital wallets to allow beneficiaries to receive and use transfers via mobile phones (Tunisia), and online beneficiary registration and eligibility verification, with facilitated e-money payments (Jordan and Pakistan).
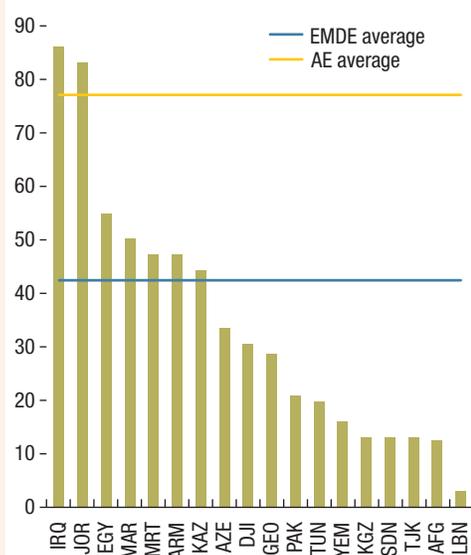
Box 2.2 *(continued)*

Utility support, temporary tax exemptions on essential goods, and tax holidays have also been widely deployed (Afghanistan, Azerbaijan, Bahrain, Egypt, Georgia, Iran, Morocco, Pakistan, Saudi Arabia, Tajikistan), as have credit lines to small and medium-sized enterprises (Djibouti, Iran, Saudi Arabia, United Arab Emirates, Uzbekistan). In addition, job retention and protection programs, flexible annual and unpaid leave, permission for foreign workers to switch employers, virtual job-matching platforms for employers and workers, and vocational and language training have been deployed (Saudi Arabia, United Arab Emirates, Uzbekistan), targeting migrant workers. Work permit fees were suspended (Bahrain, Saudi Arabia, United Arab Emirates). Online remittances have been introduced, together with education programs for workers about online remittance services (Qatar).

Figure 2.2.2. Social Protection Responses to COVID-19
(Share of MCD countries that have implemented each measure)
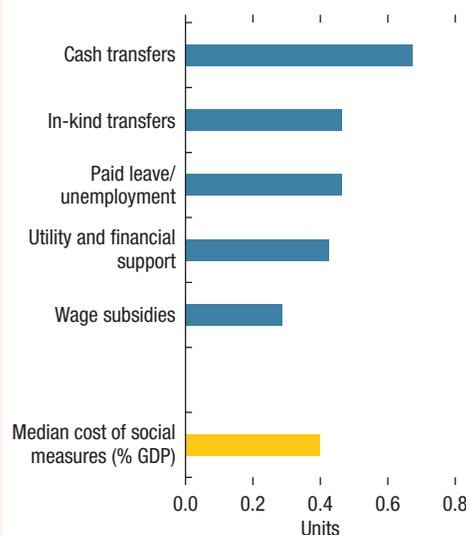
Source: IMF Policy Tracker.

References

Abdih, Yasser, Adolfo Barajas, Ralph Chami, and Christian Ebeke. 2012. "Remittances Channel and Fiscal Impact in the Middle East, North Africa, and Central Asia." IMF Working Paper 12/104, International Monetary Fund, Washington, DC.

Azizi, SeyedSoroosh. 2019. "The Impact of Workers' Remittances on Poverty and Inequality in Developing Countries." *Empirical Economics* 1–23.

Castañeda Aguilar, R. A. Andrés, Christoph Lakner, Espen B. Prydz, Jorge Soler Lopez, Ruoxuan Wu, and Qinghua Zhao. 2019. "Estimating Global Poverty in Stata: The Povcalnet Command." Global Poverty Monitoring Technical Note 9, World Bank, Washington, DC.

Credit Research Initiative (CRI). 2019. "Bottom-Up Default Analysis (BuDA v3.1.1) White Paper." National University of Singapore Risk Management Institute, Singapore.

Credit Research Initiative (CRI). 2020. "Probability of Default-Implied Rating (PDiR2.0) White Paper." National University of Singapore Risk Management Institute, Singapore.

Dingel, Jonathan, and Brent Neiman. 2020. "How Many Jobs Can Be Done at Home?" NBER Working Paper 26948, National Bureau of Economic Research, Cambridge, MA.

Duan, Jin-Chuan, and Li Shuping. 2020. "Enhanced PD-Implied Ratings by Targeting the Credit Rating Migration Matrix." National University of Singapore–Credit Research Initiative Working Paper. https://rmi.nus.edu.sg/DuanJC/index_files/files/PDiR2.0.pdf.

Furceri, Davide, Prakash Loungani, Jonathan D. Ostry, and Pietro Pizzuto. 2020. "Will COVID-19 Affect Inequality? Evidence from Past Pandemics." *COVID Economics* 12 (1): 138–57.

Garrote Sanchez, Daniel, Nicolas Gomez Parra, Caglar Ozden, Bob Rijkers, Mariana Viollaz, and Hernan Winkler. 2020. "Who on Earth Can Work from Home?" Policy Research Working Paper 9347, World Bank, Washington, DC.

Gentilini, Ugo, Mohamed Almenfi, Ian Orton, and Pamela Dale. 2020. "Social Protection and Jobs Responses to COVID-19: A Real-Time Review of Country Measures." World Bank, Washington, DC.

Gottlieb, Charles, Jan Grobovšek, Markus Poschke, and Fernando Saltiel. 2020. "Working from Home: Implications for Developing Countries." In *COVID-19 in Developing Economies*, edited by Simeon Djankov and Ugo Panizza. London: CEPR Press.

Guvenen, Fatih, Fatih Karahan, Serdar Ozkan, and Jae Song. 2017. "Heterogeneous Scarring Effects of Full-Year Nonemployment." *American Economic Review* 107 (5): 369–73.

International Labour Organization (ILO). 2020. "COVID-19: Labour Market Impact and Policy Response in the Arab States." ILO Briefing Note, Beirut, Lebanon.

Jordà, Òscar. 2005. "Estimation and Inference of Impulse Responses by Local Projections." *American Economic Review* 95 (1): 161–82.

MacDonald, Margaux, Roberto Piazza, and Galen Sher. 2020. "COVID-19 and Travel and Hospitality Sectors." IMF Research Department, Special Series on COVID-19, International Monetary Fund, Washington, DC.

Medina, Leandro, and Friedrich Schneider. 2019. "Shedding Light on the Shadow Economy: A Global Database and the Interaction with the Official One." CESifo Working Paper No. 7981, CESifo, Munich.

Open Access Micro Data Initiative (OAMDI). 2018. Labor Market Panel Surveys (LMPS). http://erf.org.eg/data-portal/. Version 1.1 of Licensed Data Files; JLMPS 2016. Egypt: Economic Research Forum (ERF).

Open Access Micro Data Initiative (OAMDI). 2019. Labor Market Panel Surveys (LMPS). http://erf.org.eg/data-portal/. Version 2.0 of Licensed Data Files; ELMPS 2018. Egypt: Economic Research Forum (ERF).

Okun, Arthur M. 1962. "Potential GNP: Its Measurement and Significance." Reprinted as Cowles Foundation Paper 190, Cowles Foundation for Research in Economics, New Haven, CT.

Organisation for Economic Co-operation and Development (OECD). 2020. "Corporate Sector Vulnerabilities during the Covid-19 Outbreak: Assessment and Policy Responses." *Tackling Coronavirus Series,* Paris.

Saltiel, Fernando. 2020. "Who Can Work from Home in Developing Countries?" *COVID Economics* 7: 104–18.

Sumner, Andy, Chris Hoy, and Eduardo Ortiz-Juarez. 2020. "Estimates of Impact of COVID-19 on Global Poverty." UNU WIDER Working Paper 2020/43, United Nations University World Institute for Development Economics Research, Helsinki, Finland.

3. Fiscal Challenges from the Pandemic

The coronavirus disease (COVID-19) pandemic has required a substantial fiscal response from all countries, resulting in the largest synchronous fiscal easing in oil importers and a significant one in oil exporters. Nonetheless, the size of fiscal measures is slightly below that of other emerging market and developing economies, reflecting already-strong health and welfare systems in some economies and limited fiscal space in others. While the emergency measures have been critically important, these, along with significant declines in revenues, will increase financing needs for the region. Higher debt and deficits will erode fiscal space, leaving the region vulnerable to a resurgence of the virus and, for some countries, resulting in unsustainable debt dynamics. These adverse impacts are somewhat mitigated by lower borrowing costs, reflecting the large monetary easing in major advanced economies and increased official financing. Nevertheless, even with ambitious baseline fiscal adjustments, albeit not unprecedented, countries are not expected to revert to their pre-pandemic debt levels. In response to the increased fiscal vulnerabilities, governments should mitigate fiscal risks by developing medium-term fiscal frameworks, adopting fiscal rules, and strengthening debt management. At the same time, they must seek to expand fiscal space by, for example, enhancing tax compliance, increasing the progressivity of tax systems, and raising expenditure efficiency, including through improving governance and gradually eliminating fuel subsidies. Meanwhile, policymakers must also seek to support an inclusive recovery by enhancing social safety nets and prioritizing spending on health, education, and job retraining.

COVID-19 Created Unprecedented Recessions and Deficits

The economic fallout of the pandemic, as outlined in Chapter 1, is expected to result in the largest output contraction in the past 20 years for most countries in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) and the Caucasus and Central Asia (CCA) regions.[1] The costs of dealing with the crisis and the loss of revenues, especially in oil-exporting countries where oil receipts have plummeted, are expected to result in the highest primary deficits in 10 of the 29 countries, with 8 more having their second-highest deficits in the past 20 years.

In this context, this chapter takes stock of fiscal policy responses to the crisis so far and their expected impact on government debt and fiscal buffers. It then seeks to answer three questions:

1. How much fiscal space is left to support the recovery?

2. What would it take to rebuild fiscal buffers over the medium term?

3. What measures could expand fiscal space while spurring an inclusive recovery?

The Crisis Prompted Diverse Policy Responses across the Region

The region's governments have used a variety of tools to deal with the pandemic's consequences, broadly in line with IMF policy advice and responses outside the region.[2] Most oil importers focused on increasing health spending and

---

[1]This chapter excludes Libya, Somalia, and Syria from the analysis because of lack of relevant data.

[2]Calculations concerning frequency of country policies and their fiscal impact reflect information available as of August 7, 2020.

Jeta Menkulasi, Sergejs Saksonovs, and Ling Zhu prepared this chapter, and Tucker Stone provided research assistance.

Figure 3.1. Share of Countries Adopting Policies in Response to COVID-19[1]
(Percent of total number of MENAP and CCA OEs and OIs)
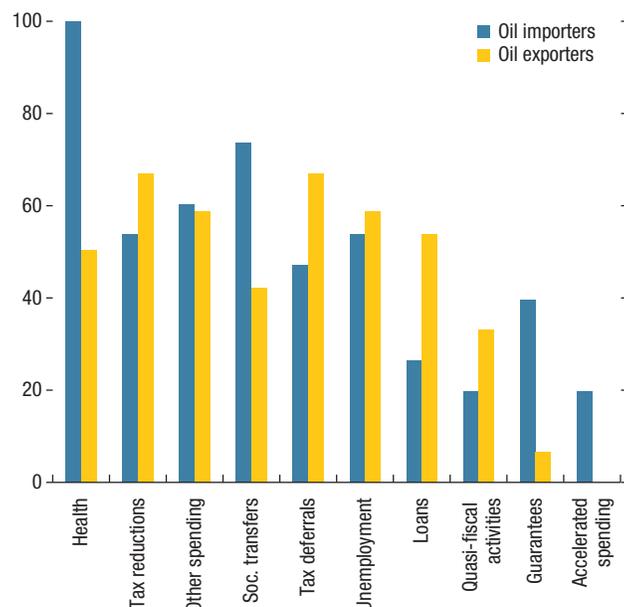
Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.
[1]Oil exporters comprise 12 countries, excluding Yemen and Turkmenistan. Oil importers comprise 15 countries.

targeted social transfers, and most oil exporters centered their efforts on temporarily reducing taxes, extending tax payment deadlines, increasing other spending (for example, on partial payment of salaries to preserve employment), and providing loans (Figure 3.1).

The median size of revenue and expenditure measures in 2020 was 2 percent of GDP in the region's oil importers, which is equal to the median of emerging market and developing economies and double the median of the region's oil exporters (1 percent of GDP). Taking into account measures that do not have a direct impact on the deficit, such as extending tax collection deadlines and providing loans and guarantees to firms and households, increases the median cost to 2.7 percent of GDP in oil importers and 1.9 percent of GDP in oil exporters.

Spending increases caused by COVID-19 have been broadly offset by cuts in other categories.[3] For example, 24 countries are expected to cut capital spending this year. In fact, total government spending, in nominal terms, is projected to increase in only eight countries (out of 29), while non-interest current expense is expected to increase in 18 countries.

However, the unprecedented contraction in economic activity is projected to increase non-interest spending as a share of GDP in 22 countries. The median increase is expected to be at its second highest for oil exporters (at 2.2 percent of GDP compared with 2.3 in 2009) and at its highest for oil importers (2 percent of GDP compared with 1.1 in 2007).

The COVID-19 crisis will also increase deficits because of significant projected declines in revenues, which in nominal terms, compared with their precrisis baseline, are projected to decline by 4.8 percent of 2019 GDP—5.9 in oil exporters and 3.7 in oil importers (Figure 3.2).

Accordingly, the median expected decline in primary balances in 2020 for oil importers is 4 percent of GDP, in line with other emerging market and developing economies (3.6 percent) and the highest in the past 20 years, although three-quarters of oil importers have previously experienced greater fiscal easing.[4] For oil exporters, the median non-oil primary balance as a share of non-oil GDP is expected to decline by 1.4 percentage points from its level in 2019, representing the fourth largest annual decline in the past 20 years. The crisis has thus resulted in the largest synchronous fiscal easing in oil importers and a significant one in oil exporters. The easing at the individual country level, however, is not unprecedented.

[3]The comparison is to a precrisis baseline defined as October 2019 *World Economic Outlook* projections.
[4]This chapter uses the change in the headline (non-oil) primary balance in percent of (non-oil) GDP as a measure of the fiscal policy stance. This may overstate the underlying adjustment given the unprecedented recessions. However, cyclically adjusted balances are unavailable in most countries and subject to high uncertainty and inaccuracy from the estimation of output gaps with structural breaks, particularly at the current juncture.

Figure 3.2. Change in Expected Revenues and Spending, 2020[1]
(Percent of 2019 GDP)
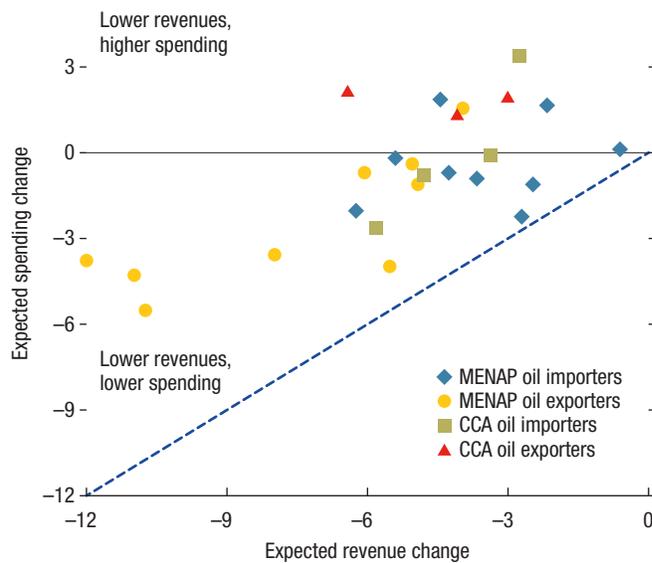
Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers;
[1]Most recent projections compared with precrisis. Iraq and Sudan are excluded.

Figure 3.3. COVID-19-Related Health Spending Measures
(Percent of GDP)
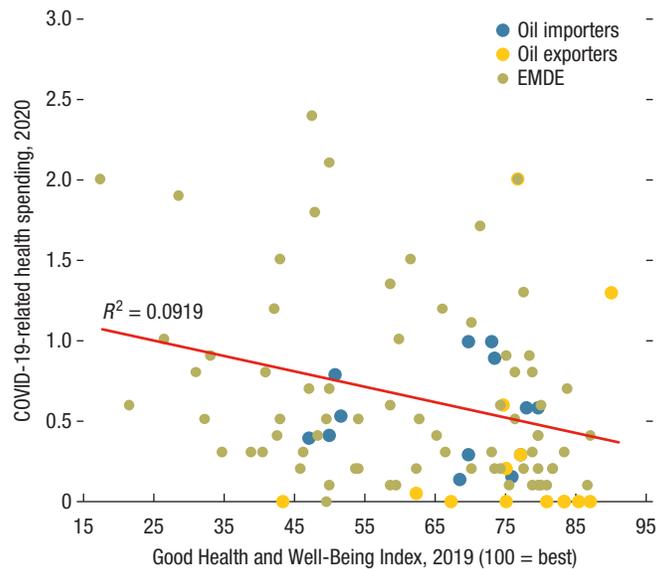
Sources: National authorities; Haver Analytics; Bertelsman Stiftung and the Sustainable Development Solutions Network; and IMF staff calculations.
Note: EMDE = emerging market and developing economies.

Several considerations may drive the fiscal response at the individual country level: direct impact of the pandemic, existing health infrastructure (Figure 3.3), and available fiscal space and the desire to preserve some of it to guard against considerable downside risks (for example, a second wave of the virus).

Revenue and expenditure measures in oil exporters were smaller than in emerging market and developing economies, even when comparing countries with similar incidence of COVID-19, which in oil exporters was relatively higher (Figure 3.4).[5] For some countries (for example, the Gulf Cooperation Council [GCC]), this is because of already-strong health and welfare systems and the ability to absorb additional health care costs within existing budget envelopes. For other oil

[5]COVID-19 incidence is measured as the number of COVID-19 cases per million people as of July 16, 2020. Most oil exporters in the region are in the fourth quartile of COVID-19 incidence (10 out of 14). Six out of 14 oil importers are in the third quartile, and 4 are in the second quartile, with 2 each in the fourth and first quartiles.

Figure 3.4. Median Revenue and Expenditure Measures by COVID-19 Incidence, 2020
(Percent of GDP)

Sources: National authorities; and IMF staff calculations.
Note: EMDE = emerging market and developing economies.

Figure 3.5. Fiscal Responses to COVID-19 and 2019 Debt Levels
(Percent of GDP)
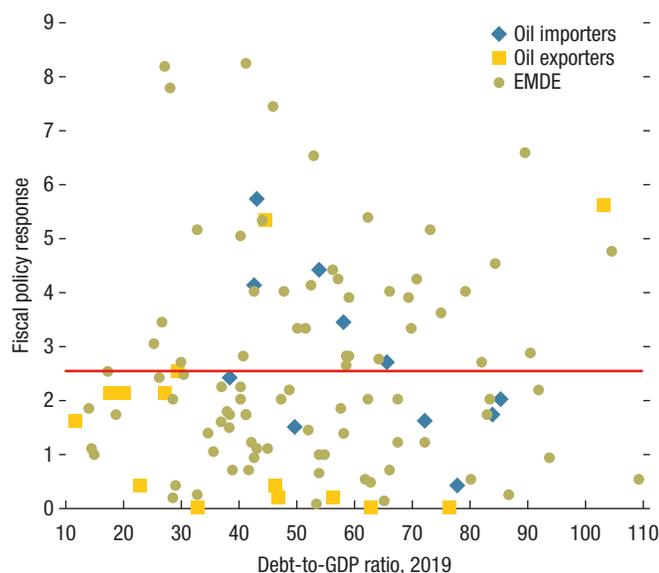
Sources: National authorities; and IMF staff calculations.
Note: EMDE = emerging market and developing economies. Fiscal responses are above-the-line expenditure and revenue measures.

Figure 3.6. Number of Countries by Quartiles of COVID-19 Pressure Index
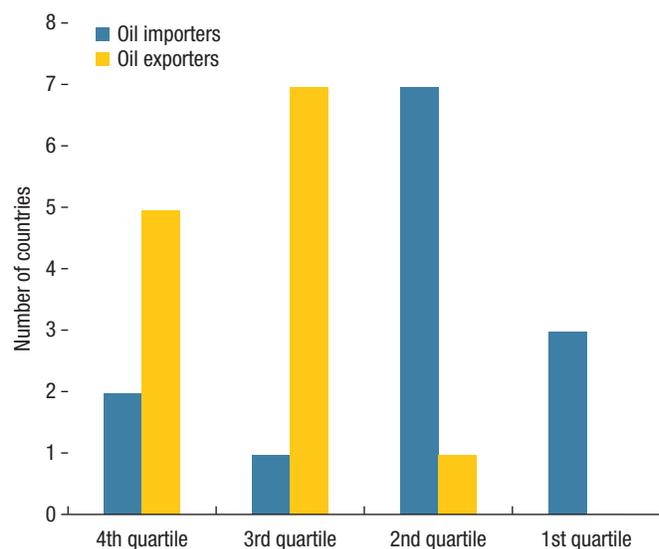
Sources: COVID-19 Pressure Index; and IMF staff calculations.
Note: Excludes Armenia, Turkmenistan, and West Bank and Gaza.

exporters, however, this reflects their fragility and limited fiscal space (*Iraq, Yemen*).

Oil importers, however, have generally spent more than emerging market and developing economies with similar COVID-19 incidence, except for those in the highest quartile (*Armenia, Djibouti*).[6] This reflects generally strong responses in the CCA. Median health spending associated with COVID-19 was 0.6 percent of GDP in oil importers compared with 0.5 percent of GDP in other emerging market and developing economies.

Although initial levels of indebtedness will have a major impact on the medium-term implications of the pandemic, there does not seem to be any relationship between the size of the measures taken so far in the emerging markets as a whole and their 2019 debt levels (Figure 3.5). There is, however, a slightly negative relationship between the two

for oil importers, suggesting their responses were constrained by their pre-pandemic fiscal space.

The measures taken so far are unlikely to be the last policy responses to COVID-19 in all countries in the region, particularly in oil exporters. A broader measure of policy pressures caused by COVID-19—that combines epidemiological data and countries' capacity to deal with the pandemic—shows that certain oil exporters (*Algeria, Iraq, Uzbekistan, Yemen*) are facing higher pressures than those faced by median emerging market and developing economies, reflecting higher incidence of the disease and greater vulnerability to intensified pressures from the virus (Figure 3.6).[7]

---

[6]Armenia had a substantial below-the-line component in its fiscal package.

[7]The pressure index is based on a principal component analysis of epidemiological data (new cases, new deaths, and respective trends) and indicators of capacity to deal with the pandemic that include health care infrastructure and spending and the fiscal response to the pandemic.

Table 3.1. 2020 Public Financing Needs and Sources in the Region
(Percent of region GDP)

	Oil Importers		Oil Exporters	
	MENAP	**CCA**	**MENAP**	**CCA**
Financing Needs				
Overall Balance	7.9	7.0	11.2	6.1
Debt Amortization	20.6	3.8	2.8	1.5
External	2.2	2.0	0.7	1.3
Domestic	18.4	1.8	2.1	0.2
Total	**28.5**	**10.8**	**14.0**	**7.6**
Financing Sources	**28.5**	**10.8**	**14.0**	**7.6**
Domestic	**23.7**	**1.5**	**11.1**	**4.6**
Government and SWF Resources	0.8	−1.4	3.8	3.2
Central Banks	0.0	0.3	0.4	0.0
Commercial Banks	22.9	2.6	6.9	1.4
External	**4.8**	**9.3**	**2.9**	**3.0**
Bond Issuance	1.2	0.0	2.6	0.5
Commercial Loans	0.3	0.0	0.2	1.1
IFI, Official Bilateral	3.2	9.3	0.1	1.4

Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; IFI = international financial institution; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; SWF = sovereign wealth fund.

Higher Deficits Imply Higher Financing Needs and Debt

Higher fiscal deficits will increase financing needs in the region, with a median increase of 4.3 percent of GDP. A few patterns emerge regarding near-term financing needs across the region (Table 3.1).

First, financing needs are higher in MENAP and oil importers compared with CCA and oil exporters, respectively. CCA oil exporters, which are projected to increase nominal spending, have the lowest financing needs because of their relatively low stocks of debt.

Second, MENAP countries are expected to rely primarily on domestic financing sources to cover their 2020 financing needs, notably commercial banks (for example, *Egypt and Morocco*).[8] This reliance on domestic financing sources reflects more-developed banking systems in the region, but it may lead to an intensification of elevated linkages between the solvency of banks and sovereigns over the medium term (Chapter 4).

By contrast, CCA economies rely more on external financing sources. This is especially the case for CCA oil importers, which expect significant borrowing from international financial institutions, while CCA oil exporters rely mostly on government and sovereign wealth fund resources.

The crisis is also expected to markedly increase government debt and attendant vulnerabilities in the region. In 2020, the highest increases in government-debt-to-GDP ratios are expected in MENAP oil exporters and CCA oil importers (median at about 11 and 12 percentage points, respectively). In the former group, the increase in the government-debt-to-GDP ratio is driven by higher primary deficits, mostly because of lower revenues, while in the latter, it is driven by automatic debt dynamics, especially contributions from negative real GDP growth and exchange rate depreciation (Figure 3.7). The share of foreign-currency-denominated debt is expected to increase in 10 out of 29 countries in the region, although it is often due to an increase in official financing, which would mitigate the resulting vulnerabilities somewhat.

---

[8]Algeria, Armenia, Bahrain, and Yemen are expected to rely on monetary financing to varying degrees. The central bank has financed most debt in Algeria.

Figure 3.7. Contribution to Projected Annual Change in Debt-to-GDP Ratio, 2020
(Percent of GDP)
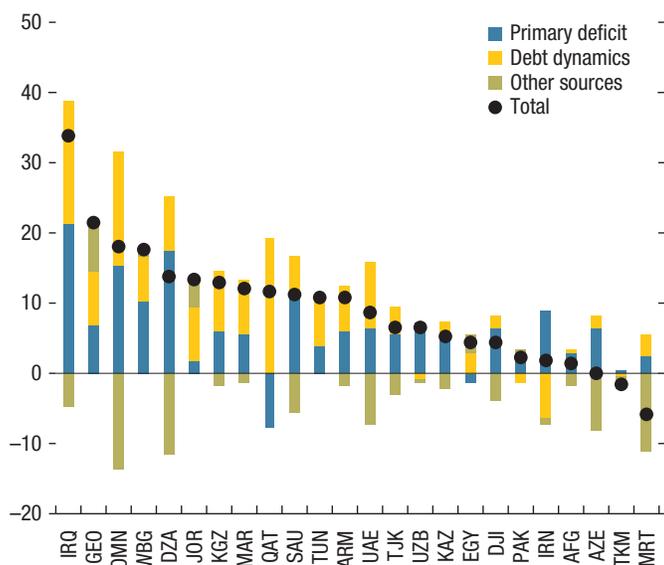
Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 3.8. Revisions to Debt Accumulation Projection from Pre-COVID-19 WEO, 2020–24
(Percent of GDP)
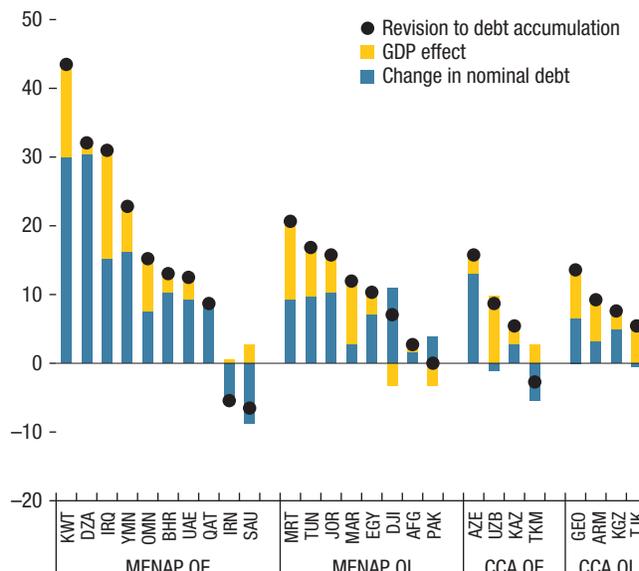
Sources: National authorities; and IMF staff calculations.
Note: Pre-COVID-19 refers to October 2019 *World Economic Outlook* (WEO) projections. Country abbreviations are International Organization for Standardization (ISO) country codes. CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.

Rising Debt Erodes Fiscal Space and Increases Fiscal Risks

The near-term revisions to the government debt outlook carry over to the medium term. Since the onset of the pandemic, medium-term projections of government-debt-to-GDP ratios have been significantly revised for most countries up to 44 percentage points of GDP, with the largest revisions in MENAP oil exporters—reflecting the combined impact from the pandemic and the oil shock (Figure 3.8).[9] Lower projected GDP growth rates account for about half of these revisions in many countries.

These expected dynamics will increase government debt to elevated levels over the medium term in some countries (for example, *Algeria, Iraq, Kuwait, Morocco*) and heighten debt sustainability concerns in those with large initial debt stocks (for example, *Bahrain* and *Oman*). Combined with the 2020

[9]Iran, Saudi Arabia, and Turkmenistan are the only exceptions.

level shift in debt, debt does not stabilize under baseline projections for *Algeria, Bahrain, Kuwait,* and *Oman*. Large fiscal buffers for *Kuwait* and sizable central bank holdings of government debt in *Algeria* are mitigating factors to their debt sustainability concerns.

Within MENAP, median government debt is projected to rise above 70 percent of GDP over the medium term, reflecting high precrisis debt stock in oil importers and expected rapid debt accumulation in oil exporters, including *Algeria, Bahrain, Iraq,* and *Oman.*

Although sovereign spreads remain elevated in some countries (including *Bahrain, Georgia, Oman,* and most MENAP oil importers), overall borrowing costs, as measured by effective interest rates, are projected to decline over the medium term from their precrisis levels for MENAP oil exporters and CCA oil importers (Figure 3.9). This development is mainly due to the large

monetary easing in advanced economies and the increased provision of official financing to many countries in the region.

Despite the decline in expected borrowing costs, risks have risen, particularly those associated with increased reliance on domestic financing—including fiscal dominance and closer sovereign-bank linkages.

Moreover, international capital markets remain fickle. Although *Jordan* and several GCC countries have been able to tap international capital markets at reasonable rates since April, *Egypt* paid a higher premium when it issued bonds in May.[10]

The mix of higher debt, larger financing needs, and the challenges of implementing the projected ambitious fiscal adjustments is expected to erode fiscal space across the region. Figure 3.10 shows a range of fiscal sustainability indicators across countries, including ease of obtaining financing, strength of fiscal positions, size of financing needs, and realism of projected fiscal adjustments. These indicators, computed using data before and after the onset of the pandemic, are then used to assess each country's fiscal space (see Box 3.1 for the methodology).[11]

Several countries entered the pandemic with essentially no fiscal space assessed, such as *Egypt, Jordan, Lebanon, Pakistan, and Tunisia* among oil importers, and *Iran* and *Oman* among oil exporters.[12] The deterioration in access to market financing, along with the debt outlook and

Figure 3.9. Expected Effective Interest Rate: 2021–23
(Percent, simple average)
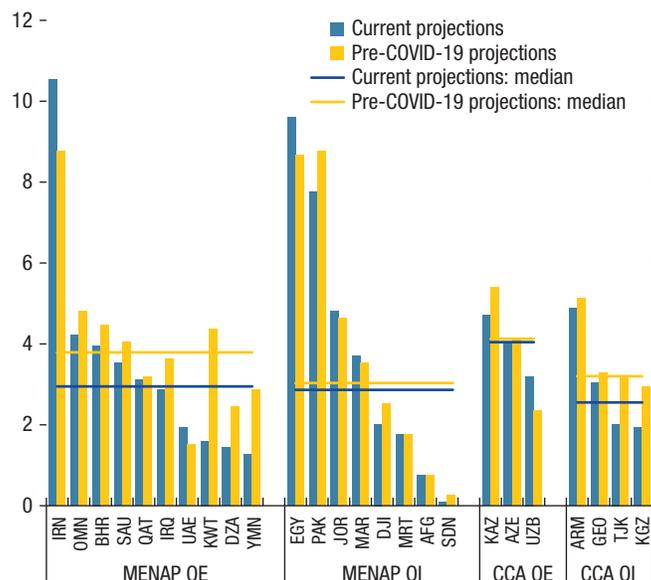
Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers. Effective interest rate is computed as the ratio of government interest expense and initial government debt stock. Pre-COVID-19 projections refer to October 2019 *World Economic Outlook* projections. Country abbreviations are International Organization for Standardization (ISO) country codes.

---

[10]In April, Qatar issued $10 billion, Abu Dhabi and Saudi Arabia both issued $7 billion, with spreads of 250–350 basis points (bps) above US treasuries. In May, Abu Dhabi issued another $3 billion with spreads at 135–180 bps, Egypt issued $5 billion with spreads above 550 bps. In June, Jordan issued $1.75 billion with spreads below 520 bps. Sharjah (United Arab Emirates) issued $1 billion in June followed by another $1 billion in July, with spreads below 300 bps for both.

[11]The analysis has benefited from comments and suggestions by staff from other IMF departments, including the interdepartmental working group on fiscal space, and builds on earlier work done by the Strategy, Policy, and Review Department on post-COVID-19 policy space. This interim update of fiscal space for countries with sustained market access will be reassessed in the context of debt sustainability analysis conducted under bilateral surveillance.

[12]Without recent reforms, which had significantly reduced debt (though still high) before the crisis, Egypt would have entered the crisis in a more vulnerable position.

consolidation plans for *Lebanon* and *Oman,* underscore the unsustainability of debt for Lebanon and heightened fiscal risks for Oman.

Other countries with fiscal space assessed as none or at risk because of the pandemic include *Iraq*, reflecting upward revisions in its medium-term debt outlook by about 20–30 percentage points of GDP, in turn raising debt sustainability concerns.

Countries with some fiscal space before the crisis, such as *Algeria* and *Morocco*, have eroded this space either because of more elevated debt levels (*Algeria, Morocco*) or higher medium-term adjustment needs (*Morocco*).

Generally, most countries in the region lack fiscal space to support the recovery. At the current juncture, the only countries with some or substantial fiscal space are *Armenia* and *Georgia* among oil importers, followed by *Azerbaijan, Kazakhstan, Kuwait, Qatar, Saudi Arabia,*

Figure 3.10. Pre- and Post-COVID-19 Financing Conditions and Medium-Term Outlook
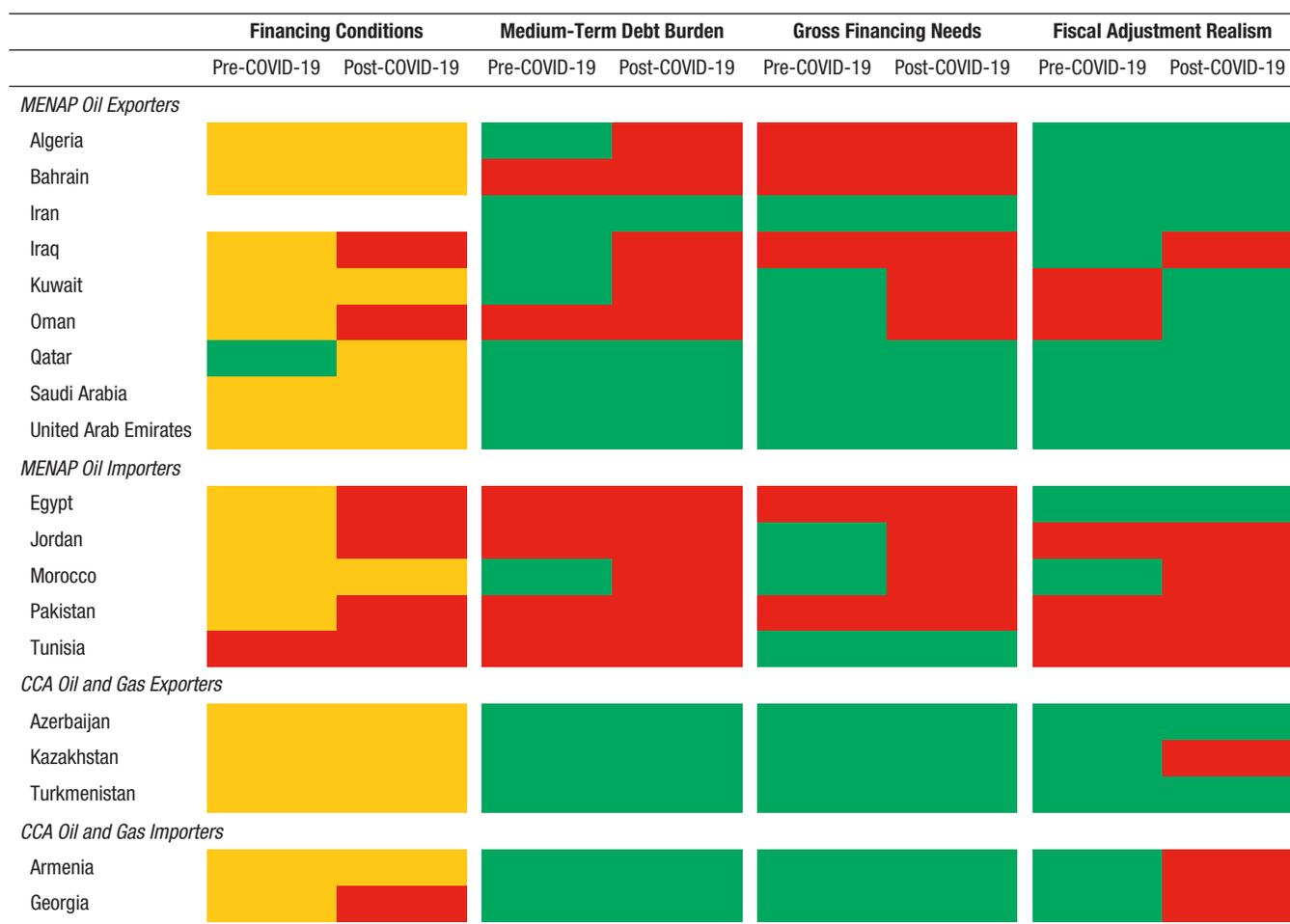
Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan. This figure reflects the second stage of IMF fiscal space assessment (Box 3.1.1). Green denotes low risk, orange denotes medium risk, and red denotes high risk (see Box 3.1 for detailed explanations).

Turkmenistan, and the *United Arab Emirates* among oil exporters.

Most countries with no fiscal space are expected to see their real GDP contract by 5–13 percent this year (Figure 3.11), highlighting the debt sustainability constraints on supporting growth through additional fiscal stimulus.

Baseline Fiscal Adjustments Sensitive to Growth Assumptions

Mitigating debt sustainability concerns would require many countries in the region to embark on strong and front-loaded fiscal consolidations. Such consolidations would require an ambitious effort and a timely economic recovery, both of which could be muted or delayed if a second wave of COVID-19 occurs.

The median projected fiscal adjustment over the next three years (measured as the cumulative

Figure 3.11. 2020 GDP Growth Projection and Fiscal Space Rating
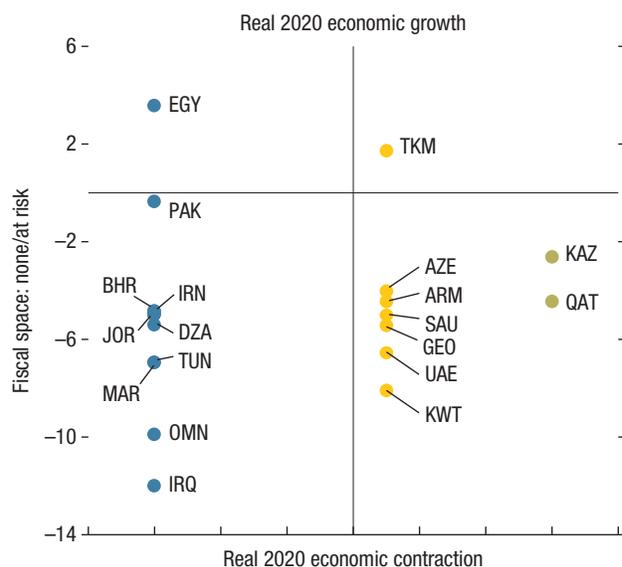
Sources: National authorities; and IMF staff calculations.
Note: Fiscal space rating is based on the standard IMF methodology, combined with the interim update of the financing block up to late August 2020. Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 3.12. Decomposition of Cumulative Fiscal Adjustment, 2021–23
(Percent of GDP)


Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers. Cumulative adjustments are computed as the sum of annual fiscal adjustment—measured as annual change in primary balance in percent of GDP for OIs and change in non-oil primary balance in percent of non-oil GDP for OEs. Non-oil revenue and non-interest expenditure, both in percent of non-oil GDP, are used for OEs. Total revenue and non-interest expenditure, both in percent of total GDP, are used for OIs. Country abbreviations are International Organization for Standardization (ISO) country codes.

change in primary balance for oil importers and the cumulative change in non-oil primary balance for oil exporters) is expected at 3.6 percent of GDP for MENAP oil importers (excluding *Sudan*) and 5.8 percent of non-oil GDP for MENAP oil exporters. For CCA oil importers and CCA oil exporters the median adjustment stands at 4.1 percent of GDP and 1.3 percent of non-oil GDP, respectively. These adjustments mostly reflect increases in projected revenue growth in oil importers, and declines in expenditure-to-GDP ratios in oil exporters (Figure 3.12)—the latter is driven by a projected strong recovery in non-oil GDP, which is subject to sizable uncertainties.

Looking at historical episodes of fiscal consolidations within each country group over the 2003–19 period, the projected three-year cumulative consolidations from 2021–23 appear optimistic for all oil importers and for Iraq (Figure 3.13), reflecting significant upward revisions compared with the pre-COVID-19 projections for oil importers.

However, the projected adjustment is not unprecedented. The assumed three-year adjustment for oil importers lies on the upper quartile of the distribution of past adjustments, implying that historically the expected consolidations are undertaken between 10 and 25 percent of the time. Among oil exporters, this appears to be the case for *Iraq* and *Kazakhstan*. These results should be interpreted with caution because the measure of fiscal adjustment does not account for the cyclical changes to the fiscal balance. Specifically, the sharp deteriorations in fiscal balances in 2020 tend to inflate the adjustments in the subsequent year. Moreover, the projected fiscal paths in part reflect improvements through automatic stabilizers because of the assumed strong rebound after the unprecedented

Figure 3.13. Projected Three-Year (2021–23) Cumulative Fiscal Adjustments and Historical Comparisons
(Percent of GDP)
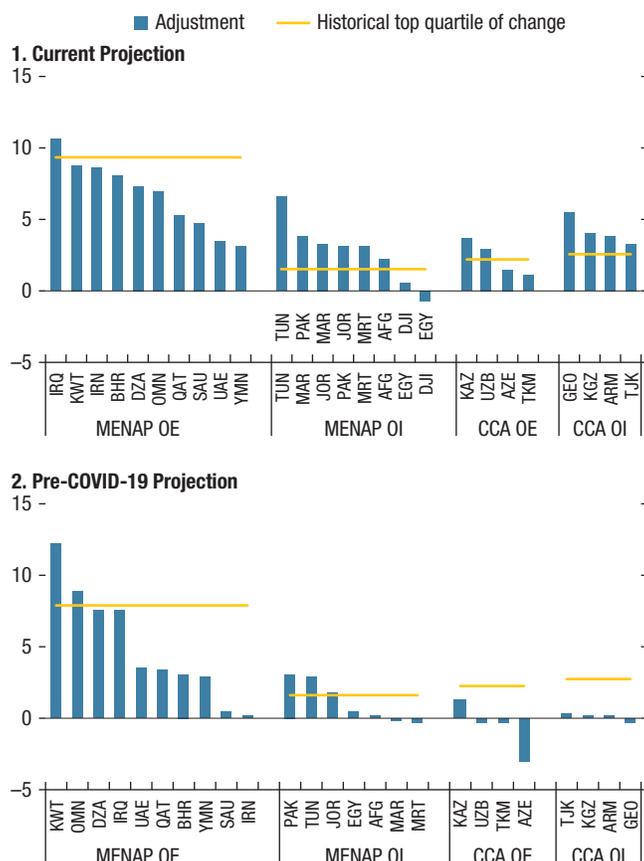
Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan. Cumulative changes are computed as the sum of annual fiscal adjustment—measured as annual change in primary balance in percent of GDP for OIs and change in non-oil primary balance in percent of non-oil GDP for OEs. Due to data limitations, Uzbekistan is measured in percent of GDP. Pre-COVID-19 projections refer to October 2019 *World Economic Outlook* projections. Country abbreviations are International Organization for Standardization (ISO) country codes.

crisis. Finally, fiscal policies in oil exporters can be highly susceptible to volatile oil prices.

There are significant downside risks to the projected fiscal improvements, which remain vulnerable to a delayed or weaker-than-expected economic recovery. These risks raise the importance of measures to mitigate fiscal risks and additional growth-friendly and equitable policies to expand fiscal space through efficiency gains.

Mitigate Fiscal Risks and Improve Debt Management

Protecting public health and supporting the most vulnerable remain top policy priorities, but mitigating fiscal risks—particularly those stemming from the crisis—will help prevent a further deterioration of fiscal space in the region.

One way to manage fiscal risks during this crisis is to make transparent the extent and impact of COVID-19-related fiscal support by embedding it into a medium-term fiscal framework (MTFF). Anchoring the fiscal response to the crisis in an MTFF will help improve public financial management by accounting for the full cost of such support, including potential contingent liabilities. To enhance the monitoring and disclosure of contingent liabilities, governments could add fiscal risk statements into their budgets (as in *Georgia,* for example), including a stocktaking of new contingent liabilities stemming from the COVID-19 response, particularly on measures such as government loans or guarantees.

MTFFs can also help enhance the credibility of fiscal adjustment programs by including clear plans on how crisis support could be gradually unwound. Targeted support, however, should not be withdrawn prematurely because the costs of early withdrawal could outweigh those of continued support.

With an uncertain economic outlook and fickle capital markets, debt management offices will have a crucial role to play in ensuring that large financing needs are met at reasonable costs. In this regard, strengthening communication with external stakeholders and increasing outreach can help gauge changes in market sentiment and demand, and identify the best timing for issuances, while revising debt management strategies (for example, as in *Egypt*) can help prepare borrowing plans for sudden changes in market conditions.

The potential gains from these fiscal risk mitigating measures—through developing and improving MTFFs and strengthening debt

management—can be particularly large in the region given its relatively weak fiscal institutions (October 2019 *Regional Economic Outlook: Middle East and Central Asia*).

Expand Fiscal Space and Spur Inclusive Recovery

The epidemiological consequences of the virus and their impact on the economic outlook will remain uncertain until a viable vaccine exists. In this context, fiscal support for vulnerable households and viable companies in sectors facing economic scarring will continue to be needed (Chapter 2). Therefore, all countries—especially those with limited policy space—should seek to expand their fiscal space.

To preserve fiscal revenues, plans should be in place to restore taxpayer compliance. Compliance likely has deteriorated because of extended deadlines, limited availability of staff, and taxpayers' weakened financial positions. In addition, revenue administrations may face a surge in workload from taxpayer requests for assistance and support. This may cause a substantial risk to the revenue stream if not managed adequately. Starting preparations now will allow operations to be scaled up gradually in a timely fashion.

A combination of growth-friendly expenditure and revenue measures, focusing on equity and efficiency gains, will be needed to expand fiscal space over the medium term. On the revenue side, strengthening the progressivity of the tax system, in addition to curbing broad-based tax and fee exemptions that disproportionately benefit those with the capacity to pay, could both expand tax bases and improve equity. If a longer provision of targeted support is needed, temporary social solidarity taxes could also be considered to partly offset the cost.

On the expenditure side, governments across the region should continue improving spending efficiency—including gradually lifting fuel subsidies, rationalizing public wage bills and, to the extent possible, further reorienting spending

within existing budgets and reducing nonpriority spending—to provide space for priority spending, such as on social protection, education, and health. The exact mix of measures will involve trade-offs and should depend on country-specific circumstances.

These efforts could be supported by the adoption of fiscal rules and continued reforms to curb corruption and improve governance in the region.

Fiscal rules, an essential building block of MTFFs, could help rebuild fiscal buffers by reducing fiscal procyclicality. Only one-third of the countries in the region have enacted fiscal rules. At the same time, the region's fiscal policies have been found to be the most procyclical among emerging market and developing countries (Bova, Carcenac, and Guerguil 2014). Fiscal procyclicality is particularly severe among oil exporters, where government expenditure is usually linked closely to oil prices. Having well-designed fiscal rules that decouple expenditure from revenue (and for oil exporters, from oil prices) amid strengthened public financial management practices, including stronger budgeting processes, could credibly allow countries to rebuild buffers in the aftermath of the crisis, boosting their capacity for countercyclical policy during future economic downturns (Eyraud and others 2018).

More broadly, by improving governance in the public sector—an area where the region lags the average for emerging market and developing economies—and curbing corruption, governments could achieve the dual objectives of mitigating risks and expanding fiscal space. Fiscal risks could be mitigated by increasing transparency, revenues would be boosted from reducing tax evasion and avoidance, and government projects could become more cost-effective through better controls on waste (April 2019 *Fiscal Monitor*).

A protracted recession in the region (for example, because of a second wave of the virus) may require additional external support—including concessional loans and debt relief—for some countries, particularly among oil importers. Moreover, some governments, particularly

those with already-elevated debt and no fiscal space, might face the need for debt operations as a last resort to create fiscal space without further deepening the recession. In this context, involving the private sector in the restructuring of government debt will be critical.

Because poverty and inequality are expected to rise across the region after this crisis (Chapter 2), ensuring an inclusive recovery should be a medium-term policy priority. In countries with available fiscal space and major economic scarring, a temporary stimulus can be considered to bolster growth once the health crisis recedes. In those where policy space is limited, the focus should be on protecting the vulnerable and improving efficiency (October 2020 *Fiscal Monitor*).

In addition to continuing targeted support as needed, fiscal measures could include spending aimed at providing universal access to healthcare and education. With unemployment likely rising, governments should also facilitate labor reallocation from less productive sectors to more productive ones through job retraining.

Governments could strengthen the efficiency and effectiveness of their social safety nets, by better targeting the most vulnerable and by advancing digitalization, including for the delivery of government services and transfers. For example, automatic transfers on digital platforms should be prioritized where bank and phone coverage

are broad enough, with the latter also useful to scale up the coverage of existing official registries (as in *Azerbaijan, Jordan, Morocco*, and *Pakistan*). The experience with digital delivery during the crisis could be further expanded to reach informal workers, who so far have remained outside the reach of social safety nets in the region (as in *Morocco*; see Box 3.2).

Some of these measures—for example, reorienting expenditure within current budgets and embedding COVID-19 support in a preexisting MTFF—can be implemented quickly. However, others, particularly those that will require pushing through reforms to tax and subsidy systems and budget rules, would take longer to carry out. For those medium- to long-term measures, authorities should act now to build up domestic support for necessary reforms by making a case for why they are important and communicating their potential benefits to domestic constituents.

Policymakers should also prepare a clear and feasible road map to guide actions and ensure that progress can be achieved over time. In countries that lack existing fiscal frameworks—for example, those that have not yet established an MTFF or a debt management office—seeking external expertise might be necessary. In this regard, the IMF can provide technical support, including through remote capacity development courses.

Box 3.1. Fiscal Space Assessment

The fiscal space assessment framework was first developed by the IMF in 2016 and later updated in 2018. Fiscal space is defined as the room for undertaking discretionary fiscal policy without endangering market access and debt sustainability. Discretionary fiscal policy can take the form of fiscal stimulus or a slower pace of consolidation versus existing plans. It allows for a systematic approach to assessing fiscal space over a three- to four-year horizon using a qualitative framework that facilitates consistency and comparability across countries. References to the fiscal space assessment in this chapter refer to the interim update of the second stage below (fiscal sustainbility).

Figure 3.1.1. Assessing Fiscal Space: A Four-Stage Framework

1. **Initial state of the economy**: establishes the cyclical position and external imbalances

2. **Fiscal sustainability**: evaluates
- the availability of financing;
- sustainability of the level and trajectory of public debt;
- financing needs over the medium term;
- realism of medium-term adjustment needs

3. **Analysis of discretionary fiscal policy** in a dynamic model: simulates the macro-fiscal effects of fiscal stimulus or a slower pace of consolidation and assesses trade-offs between growth and fiscal sustainability

4. **Country team bottom-line assessment**: the above indicators are evaluated versus benchmarks set out in the IMF's Debt Sustainability Framework. The overall assessment is informed by whether these benchmarks are breached as well as by country-specific factors not captured by them

Source: IMF (2016, 2018).

Benchmarks used for the heatmap in Figure 3.10, which are indicative and correspond to those used in the Debt Sustainability Framework for Market Access Countries, include the following:

External financing conditions:

- Sovereign spreads: Below 200 (400) basis points (bps) for low risk (green); between 200 and 600 (400 and 600) bps for medium risk (orange); and above 600 (600) bps for high risk (red) for emerging markets (advanced economies). The values correspond to the latest three-month average spread and the average spread over the past five years.

- Share of public debt in foreign currency: For emerging markets only; below 20 bps for low risk (green); between 20 and 60 bps for medium risk (orange); and above 60 bps for high risk (red).

- External financing requirements as a share of GDP: Below 5 (17) bps for low risk (green); between 5 and 15 (17 and 25) bps for medium risk (orange); and above 15 (25) bps for high risk (red) for emerging markets (advanced economies).

Debt burden indicators:

- Does the debt level breach the benchmark during the projection period? No/green (yes/red) if below (above) 70 for emerging markets and 85 for advanced economies.

Box 3.1 *(continued)*

• Public gross financing needs over the projection period: Green (red) if below (above) 15 percent of GDP for emerging markets and 20 percent of GDP for advanced economies.

Realism of fiscal adjustment needs:

• Because of data limitation on cyclically adjusted balances, three-year adjustment in primary balance as a share of GDP is used, and the historic (2003–19) upper quartile is applied as the threshold for green and red.

Box 3.2. Recent Innovative Digital Solutions to Expand Social Protection

A major challenge in the implementation of coronavirus-related support for emerging market and developing economies has been reaching informal workers. In this regard, several innovative digital solutions have been introduced recently to tackle this challenge, thereby expanding the coverage and better targeting social safety nets.

Morocco is a sucess story. The government has been able to reach informal workers through a combination of mobile payments for those who qualify for noncontributory health insurance benefits (the RAMED medical insurance program) and online cash claims for those who do not qualify.[1] Households benefiting from RAMED received a mobile payment of 800–1,200 dirhams (US$80–$120), depending on household composition. As of April this year, the program had reached 85 percent of eligible households in the informal sector.

In Pakistan, the authorities are developing digital infrastructure to better identify households for targeted support. The National Socio-Economic Registry is underway to collect household data on socioeconomic conditions at the grassroots level. Once completed, new data about people's socioeconomic conditions will be used in the provision of all benefits.[2] In addition, the one-window registry Ehsaas-Emergency Cash Program for social protection and livelihoods has been developed to assist beneficiaries and reduce duplication and abuse.

Outside the region, Togo is another bright spot. A new mobile cash-transfer program, NOVISSI, aimed at supporting informal workers, was launched in April. Eligible applicants receive a state grant of at least 30 percent of the minimum wage, with payouts from 10,500 CFA francs (US$18) to 20,000 CFA francs (US$34). Based on the program data, 65 percent of the beneficiaries are women. In total, 1.4 million individuals have registered, and nearly 600,000 have received a NOVISSI payment.

When reaching out to the informal sector, government support could be designed to incentivize formalization, which will provide a boost to the tax base once recovery takes hold. The potential gain can be particularly large in Caucasus and Central Asia (CCA) countries, where the informal economy represents more than 40 percent of GDP on average. For example, in Armenia, the amount of government support channeled to small businesses during the pandemic would be higher if they adopted cash registers that help record transactions for tax administration purposes.

In addition to expanding targeted coverage, moving to digital solutions helps minimize the need for human interaction during a pandemic. In Eswatini during the crisis, for example, the government migrated monthly payments to citizens older than 60 from cash distribution through post offices to electronic funds transfers.

The benefits of digital solutions are not limited to fiscal responses, because they can also help implement donor support. For example, in The Gambia, many donors are expanding their social assistance support through cash transfers using mobile money and direct payments targeted to poor households, new mothers, and farmers by using existing databases of past recipients, village lists, and voter rolls.

---

[1]Direct cash transfers have also been extended to informal workers in Jordan and Tunisia.
[2]The National Socio-Economic Registry database completion is expected by June 2021.

References

Bova, Elva, Nathalie Carcenac, and Martine Guerguil. 2014. "Fiscal Rules and the Procyclicality of Fiscal Policy in the Developing World." IMF Working Paper 14/122, International Monetary Fund, Washington, DC.

Eyraud, Luc, Xavier Debrun, Andrew Hodge, Victor Lledó, and Catherine Pattillo. 2018. "Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability." IMF Staff Discussion Note 18/04, International Monetary Fund, Washington, DC.

International Monetary Fund (IMF). 2016. "Assessing Fiscal Space—An Initial Consistent Set of Considerations." IMF Staff Paper, Washington, DC.

International Monetary Fund (IMF). 2018. "Assessing Fiscal Space: An Update and Stocktaking." IMF Policy Paper, Washington, DC.

4. Financial Stability Considerations amid the Pandemic

Banks in the Middle East and Central Asia (MCD) region began the year in a generally strong position, but the unprecedented crisis caused by the coronavirus disease (COVID-19) pandemic could trigger significant increases in defaults and nonperforming loans (NPLs). The results from a streamlined stress-testing exercise show that the potential costs from asset impairment for countries in the region could reach $190 billion. In this exercise, the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) region is hit particularly hard—oil exporters face the largest losses while bank capital in several oil importers falls below regulatory minimum requirements. Banking systems in the Caucasus and Central Asia (CCA) are more resilient due to higher starting capital and low private sector credit. So far, supportive financial sector policies have helped prevent some short-term financial risks from materializing, including some of the worst-case outcomes highlighted by the stress test, and helped ease the provision of credit. Going forward, authorities should carefully balance the sustained provision of credit and the preservation of financial stability. As the pandemic subsides, efforts should focus on removing regulatory easing, strengthening supervision, and continuing to improve financial inclusion—including for small and medium-sized enterprises (SMEs)—to boost inclusive growth.

Financial Stability before the Pandemic

Banking systems in most MCD countries have strengthened over the past decade and have mostly recovered from the 2014–15 oil crisis. Despite some localized vulnerabilities related to significant credit to government or weak asset quality, the banking systems in most countries entered the pandemic with sizable capital buffers. The

following are some key characteristics of banking systems in the region before the pandemic:

- **Heterogeneous banking systems.** The banking systems of oil exporters in the MENAP are the largest in the MCD region, with total assets of about 110 percent of GDP.[1] Those of the MENAP oil importers are very heterogeneous in size—few are comparable to the oil exporters, and most are small. With assets at approximately 50 percent of GDP, the banking system in the CCA region remains small. The small size reflects a variety of factors, including lower access to finance, especially for SMEs (see Box 4.2).

- **Adequate capital buffers** (Figure 4.1). Healthy profitability has supported capital buffers, and capital adequacy ratios (CARs) at the end of 2019 were well above regulatory requirements in the region, except in Iran and Lebanon, which experienced some financial distress even before the current crisis. CARs were highest in the CCA, at above 20 percent, reflecting large buffers and low credit and risk-weighted assets, but also less stringent definitions for capital instruments. MENAP oil exporters had CARs above 16 percent, with sizable buffers but also lower risk-weighted assets, reflecting large exposures to domestic governments. MENAP oil importers entered the crisis with relatively weaker loss-absorbing buffers and CARs of about 12 percent.

- **Significant improvement in NPL resolution and coverage** (Figure 4.2). The NPL ratio in all MCD subregions improved significantly over the past 10 years and reached 5.2 percent at the end of 2019—almost half the value at the end of 2010. The CCA countries saw the largest improvement over this period, and for some, through the transfer of bad loans to

[1]Total assets excluding offshore or international banks.

Figure 4.1. Capital Adequacy Ratio and Profitability
(Percent)
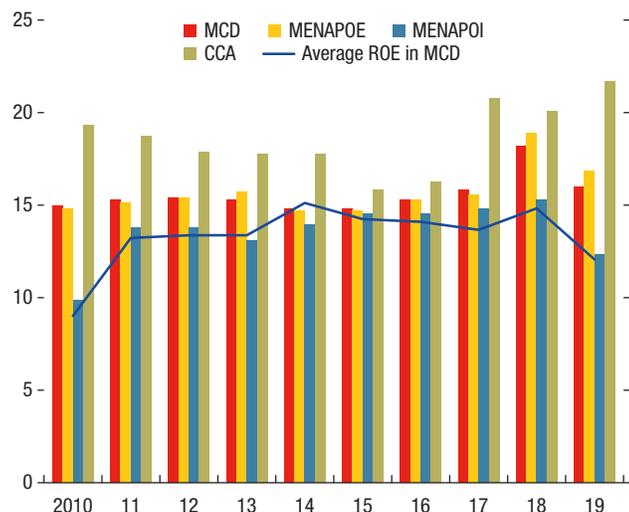
Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MCD = Middle East and Central Asia; MENAPOE = Middle East and North Africa oil exporters; MENAPOI = Middle East and North Africa oil importers; ROE = return on equity.

Figure 4.2. NPLs Net of Provisions to Capital
(Percent)
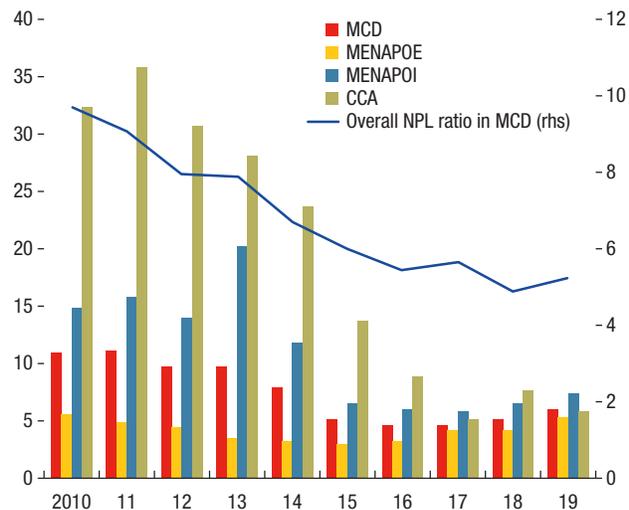
Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MCD = Middle East and Central Asia; MENAPOE = Middle East and North Africa oil exporters; MENAPOI = Middle East and North Africa oil importers; NPL = nonperforming loans; rhs = right-hand scale.

special asset management companies. Across the MCD region, the implementation of more stringent provisioning frameworks brought NPLs net of provisions to very low levels in most countries, though in some countries, evergreening of existing NPLs could have also contributed to underreported NPLs. That said, there are some exceptions, and a few countries entered the pandemic with weak asset quality (Algeria, Iran, Lebanon).

- **Rising credit to government** (Figure 4.3). Net domestic credit to government expanded rapidly over the past decade, mainly in the MENAP countries (and most significantly among oil exporters), to finance large fiscal deficits. This expansion has created strong balance sheet linkages between the public sector and banks. In some countries, bank credit to government has begun crowding out lending to the private sector and has developed into a systemic exposure or an emerging fiscal dominance problem.

- **Slowing private sector credit before the pandemic** (Figure 4.4). Private sector credit rebounded briefly in the years after the 2014–15 oil price shock, but the credit cycle began slowing toward the end of 2017, with credit growth lagging non-oil GDP in some countries.[2] Because of credit cooling down, the credit gap (a measure of the credit cycle) in the three MCD subregions turned negative in 2019.[3] The state of the MCD region's credit cycle is driven by developments in MENAP oil exporters because those countries have the lion's share of total bank loans in the region (more than 80 percent). The cooling of the credit cycle among MENAP oil exporters might signal some underlying real sector weakness before the pandemic.

[2]A detailed discussion of sectoral credit, which could further enhance the analysis of precrisis vulnerabilities, was not feasible because data were not available.

[3]The credit gap is defined as the difference between the observed credit-to-GDP ratio and its long-term trend derived from the Hodrick-Prescott filter.

Figure 4.3. Net Domestic Credit to Government
(Percent of GDP)
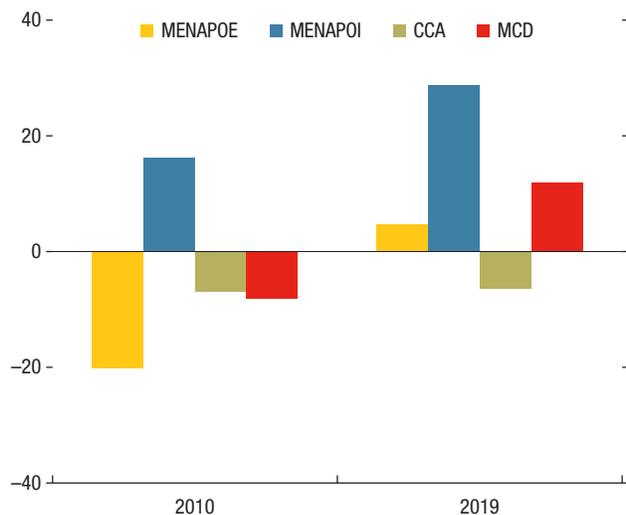
Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MCD = Middle East and Central Asia;
MENAPOE = Middle East and North Africa oil exporters; MENAPOI = Middle East
and North Africa oil importers.

Figure 4.4. Financial Cycle in MCD Countries[1]
(Credit to private sector in percent of GDP)
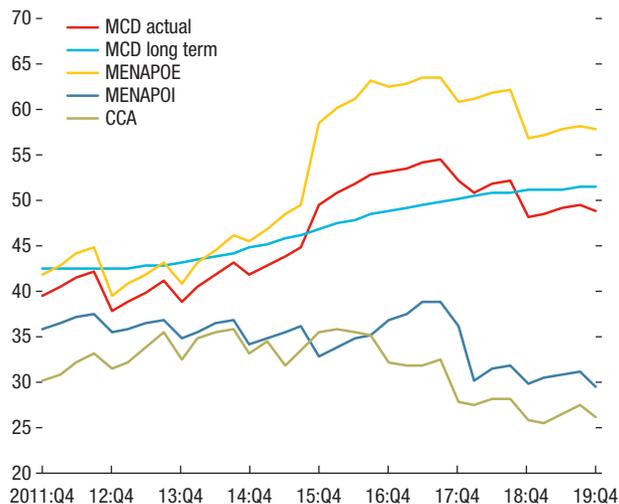
Source: IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MCD = Middle East and Central Asia;
MENAPOE = Middle East and North Africa oil exporters; MENAPOI = Middle East
and North Africa oil importers.
[1]Calculated using the ratio of credit to the private sector and GDP. The long term
is estimated using the Hodrick-Prescott filter on a time series starting in 2001:Q4
and a lambda parameter of 1600 for quarterly data.

A Shock Like No Other

Banks started 2020 with generally sound balance sheets, but the pandemic and the resulting severe disruption in domestic and regional economic activity are massive shocks that directly affect otherwise sound borrowers, with SMEs likely to be disproportionately affected (Box 4.2). Preliminary data for the first quarter of 2020, available for seven MCD countries only, do not show a deterioration of financial soundness indicators except in *Lebanon* (where the NPL ratio increased to 20 percent) and *Bahrain, Georgia, Oman*, and the *United Arab Emirates* (where profitability deteriorated). However, vulnerabilities such as deterioration of asset quality or a sharp decline in profitability might show in the data with a lag of a few quarters after the shock. Furthermore, policy support at the onset of the crisis (see Chapter 1) may have initially delayed the impact of the macroeconomic shock on the financial sector.

In this context, this section engages in a forward-looking exercise, identifying channels through which banks' balance sheets may be impaired and designing a stress test to assess the impact of such shocks. The propagation of the macroeconomic shock to the banking system may occur through different channels and, in a most severe scenario, could both raise recapitalization needs and result in a prolonged credit crunch, further weighing on economic growth and the recovery. Using a streamlined macro-level stress test, the chapter performs a sensitivity analysis of CARs based on a scenario with credit and foreign exchange risks as the two propagation channels for the shock (see Box 4.1).

There are, of course, additional risks to balance sheets that are not included in the following exercise. Those include risks to *liquidity*, especially stemming from capital outflows or sudden foreign exchange deposit withdrawals, and headwinds to *profitability*, caused by low interest rate margins, low demand for credit, and losses on holdings of government securities from rising domestic rates (in addition to provisioning requirements from higher NPLs). The motivation for choosing a stress

Figure 4.5. Aggregate Stress Test Results
(Percent)
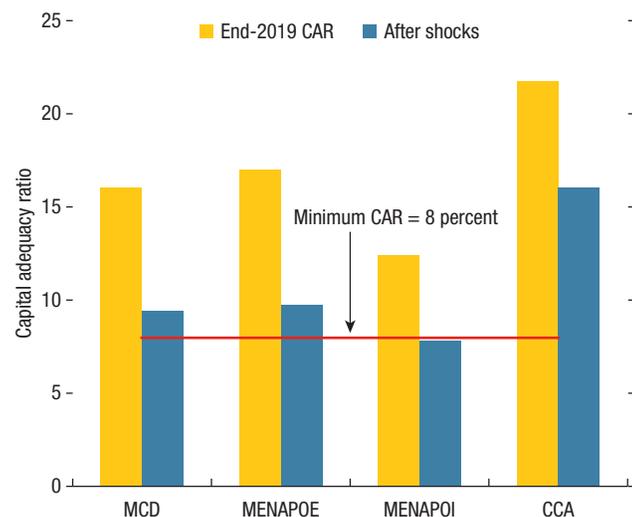
Sources: National authorities; and IMF staff calculations.
Note: CAR = capital adequacy ratio; CCA = Caucasus and Central Asia;
MCD = Middle East and Central Asia; MENAPOE = Middle East and North Africa
oil exporters; MENAPOI = Middle East and North Africa oil importers.

test focused on credit risk is to provide a concise, clear picture of balance sheet repercussions from the ongoing recession, without the need to make the many assumptions required for a full scenario.[4]

The stress test shows that the potential costs from asset impairment in MCD banking systems could be very large. We estimate that total losses for MCD countries could amount to $190 billion (5 percent of GDP). The CCA region seems to be the most resilient to the credit risk shock, mainly because of higher starting capital and overall small exposures. Losses in the CCA could amount to $10 billion, or up to 2 percent of GDP. Although total losses for MENAP oil importers could amount to $30 billion, or a comparable 3 percent of GDP, several countries could see their capital ratios drop below the Basel regulatory minimum[5] of 8 percent because of a weaker initial

[4]Widespread data limitations at the regional level would also need to be addressed for a more comprehensive scenario analysis.

[5]The stress test focuses on overall CARs as opposed to common equity tier 1 ratios due to widespread data limitations at the regional level. Also, as background, the Basel Accords are international standards for banking supervision established by the Basel Committee on Banking Supervision. In Basel I and II versions of the accords, one

position combined with the large increases in NPLs (Figure 4.5). Among MENAP oil exporters, losses are very large at $150 billion, or 6 percent of GDP. These losses result from the larger size of the banking system and loan portfolios; that said, in the scenario considered, capital would remain above 8 percent in all MENAP oil exporters except *Iran*.

Recapitalization costs in the stress test could amount to $40 billion at the MCD level, which could arise at a time when several MCD countries already have limited policy space. They are concentrated in *MENAP oil importers* ($8 billion, or 1 percent of GDP) and *Iran* ($33 billion, or 6 percent of GDP). To illustrate, capital injections are calculated to bring average capital to the standard Basel minimum of 8 percent. However, actual costs may yet be higher because of the following factors: (1) the actual distribution of CARs within countries (which may require capital injections to specific banks even in a country that passed this macro stress test at the aggregate level), and (2) several jurisdictions having implemented minimum CAR requirements higher than the 8 percent threshold this stress test used. Even jurisdictions that will not require a capital injection after the crisis will likely need several years to absorb the shock and bring NPLs back to the precrisis level. In turn, this could imply that credit provision remains impaired in several countries after the crisis abates.

The effect of the foreign exchange depreciation in the stress test is limited at the aggregate level, though its impact could still be disruptive on individual banks and through other channels. The assumed 30 percent foreign exchange depreciation leads to a 1 percent drop in CARs at the MCD level. This is due to most countries having a relatively small net open position, a small pool of foreign exchange loans to the private sector (with some exceptions in highly dollarized countries, mainly in the CCA), and important data gaps

of the established principles on capital requirements stipulates that banks should hold a capital-to-risk-weighted-assets ratio of 8 percent or above. This requirement was increased recently in Basel III with specific additional capital charges.

Figure 4.6. Macro-Financial Responses to COVID-19 in MCD Countries
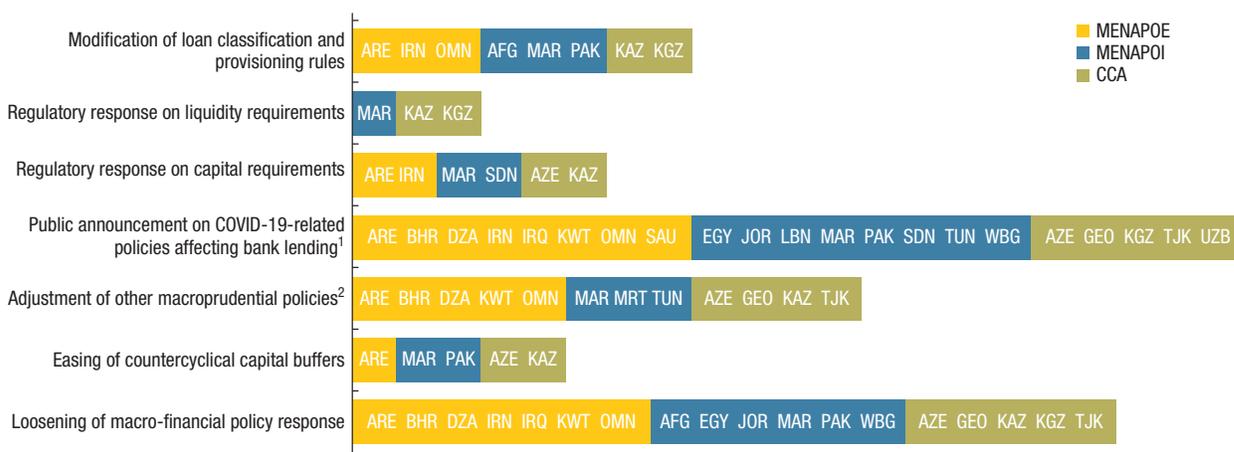
Sources: Announcements of national authorities; IMF Policy Tracker; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; COVID-19 = coronavirus; MCD = Middle East and Central Asia; MENAPOE = Middle East and North Africa oil exporters; MENAPOI = Middle East and North Africa oil importers. Country abbreviations are International Organization of Standardization (ISO) country codes. The size of the bars reflects the number of countries that implemented the policy.
[1]Such announcements vary by country and may refer to restructuring of loan terms, or suspension of any commission.
[2]Other macroprudential measures vary by country and may include changes in cash reserves and loan-to-value and loan-to-deposit ratios.

that prevent the estimation of this shock in several jurisdictions.

Risks to the outlook and this stress test remain tilted to the downside (see Chapter 1). Despite the sobering picture the stress tests paints, the sheer size and persistence of the shock may yet lead to nonlinear shock propagation in the banking system. Some triggers that may escalate the impact on banks could include the following: (1) the sudden removal of emergency support measures, (2) a new pandemic wave and higher persistence of the shock, and (3) large capital outflows accompanied by disruptive foreign exchange depreciations.

A Swift Policy Response

Some of the worst possible outcomes of the stress-testing scenario may have been avoided, at least so far, because of the comprehensive policy responses to the pandemic by the authorities across the region (though lack of recent data makes this hard to assert). Many countries deployed supportive financial sector policies to ease the provision of credit and help banks

absorb the stresses.[6] Policy responses included reducing policy rates in line with lower global rates, lowering reserve requirements, mandating that banks defer loan repayments (often without interest or penalty), supplying liquidity to the banking system, and loosening various regulatory requirements (Figure 4.6).

Slightly fewer than 60 percent of MCD countries have loosened macro-financial policy; the proportion of countries that have done so in the CCA and among MENAP oil exporters is higher, close to that of emerging market and developing economies (Figure 4.7). The share of MCD countries that eased countercyclical buffers exceeded that of emerging market and developing economies (16 percent versus 9 percent). The fraction of countries that loosened liquidity requirements is particularly high in the CCA, about 40 percent versus 22 percent among emerging market and developing economies. Although modification of loan classification and provisioning rules in the CCA was almost as common as within emerging market and

---

[6]The IMF Macroprudential Policy Framework (IMF 2013, 2014) discusses the role of macroprudential policy.

Figure 4.7. Financial Policy Response to COVID-19
(Share of countries implementing measure, percent)
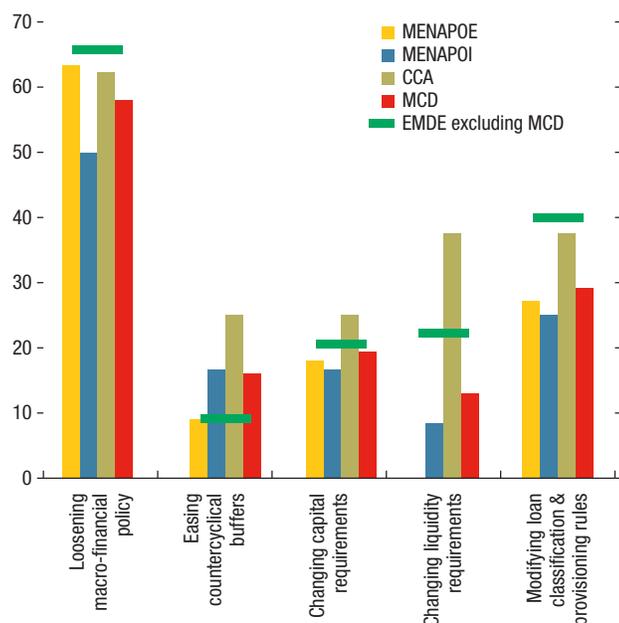
Sources: Announcements by national authorities; IMF Policy Tracker; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; EMDE = emerging market and developing economies; MCD = Middle East and Central Asia; MENAPOE = Middle East and North Africa oil exporters; MENAPOI = Middle East and North Africa oil importers. Ratio is calculated as the number of countries that implemented the measure, divided by number of countries in the relevant region.

Figure 4.8. Credit Growth
(Month over month, percent change, weighted average, January 2019 = 100)
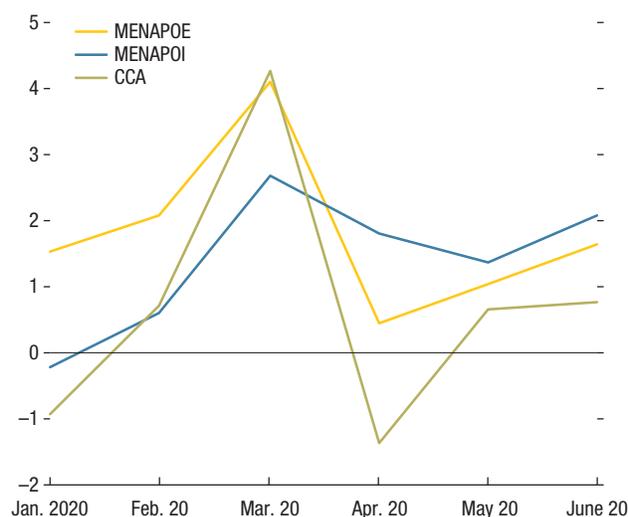
Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAPOE = Middle East and North Africa oil exporters; MENAPOI = Middle East and North Africa oil importers. MENAPOE consists of Iran, Oman, Qatar, Saudi Arabia; MENAPOI consists of Afghanistan, Egypt, Jordan, Morocco, Lebanon, Pakistan; CCA consists of Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, and Uzbekistan, based on limited data availability in 2020:Q2.

developing economies, it does not appear to have been used as much among MENAP countries. Some country-specific measures included reinforcing the monitoring of banks' liquidity risks (*Djibouti*), developing pandemic-specific stress tests (*Pakistan*), postponing the implementation of the International Financial Reporting Standard-9 (*Afghanistan*), and alleviating a temporary shortage of liquidity by introducing foreign exchange currency swaps and broadening the existing collateral base for refinancing operations (*Georgia*). Several financial supervisors suspended provisioning requirements for loans, benefiting from a temporary payment moratorium (*Algeria, Morocco*), and some others proactively asked banks to preemptively provision for losses from the pandemic (*Georgia*). The size of packages announced by central banks to support financial stability varied, with some as large as 20 percent of GDP (*United Arab Emirates*). Furthermore,

most MCD countries have implemented a wide range of policies to support SMEs, including moratoriums on debt repayments, direct lending through public institutions, and extension of guarantees (Box 4.2).

An assessment of implemented policies remains preliminary at this juncture because the data have yet to fully manifest their effects. Based mainly on anecdotal evidence, macroprudential relaxation and liquidity provision measures that authorities have adopted (Figure 4.6) may have helped slow a procyclical cut in credit in the MENAP and CCA regions (Figure 4.8),[7] supported economic activity, and as a result, helped mitigate the risk of sudden asset impairment. Liquidity support to firms and households, together with payment deferrals, helped postpone or prevent some short-term financial risks from materializing, including an increase in NPLs. In response to supportive policies in both the region and worldwide,

[7]This is based on limited credit data available across MCD countries from the second quarter of 2020.

Figure 4.9. Financial Conditions

1. Financial Sector Stock Indices
(December 2, 2019 = 100)
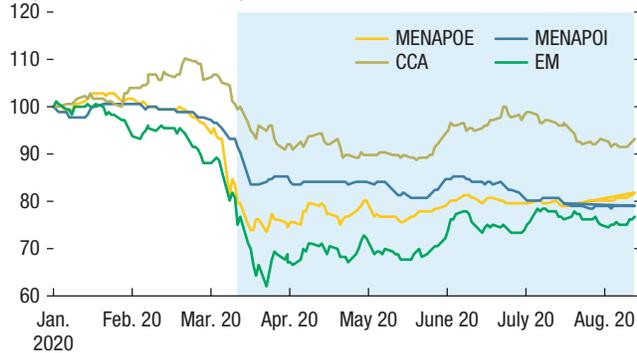
Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; EM = emerging market economies; MENAPOE = Middle East and Central Asia oil exporters; MENAPOI = Middle East and Central Asia oil importers. Country abbreviations are International Organization for Standardization (ISO) country codes. MENAPOI averages the financial sector stock indices of EGY, JOR, and TUN. MENAPOE averages the financial sector stock indices of BHR, KWT, OMN, QAT, SAU, and UAE (Dubai and Abu Dhabi). CCA is the average stock price of banks in the Kazakhstan Stock Exchange Index and Georgian banks in the London Stock Exchange. EM is the MSCI Emerging Markets Financials Index.

2. Sovereign Bond Spreads
(Median, basis points)
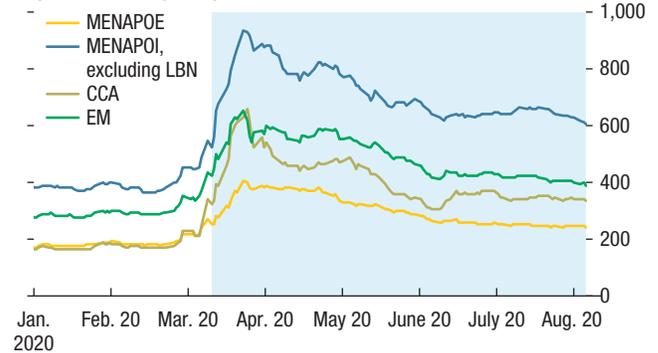
Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; EM = emerging market economies; LBN = Lebanon; MCD = Middle East and Central Asia; MENAPOE = Middle East and North Africa oil exporters; MENAPOI = Middle East and North Africa oil importers.

3. Cumulative Capital Outflows
(Millions of US dollars)
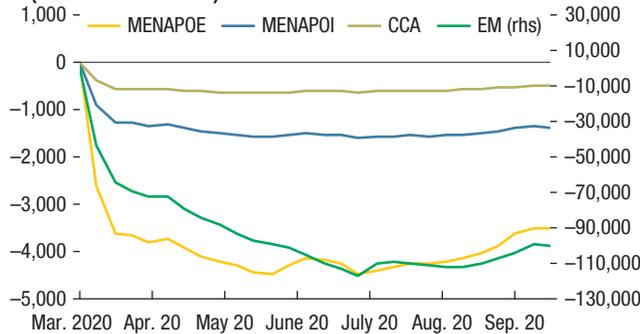
Sources: Haver Analytics; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; EM = emerging market economies; MCD = Middle East and Central Asia; MENAPOE = Middle East and North Africa oil exporters; MENAPOI = Middle East and North Africa oil importers; rhs = right-hand scale.

4. Capital Outflows
(Weekly, millions of US dollars)
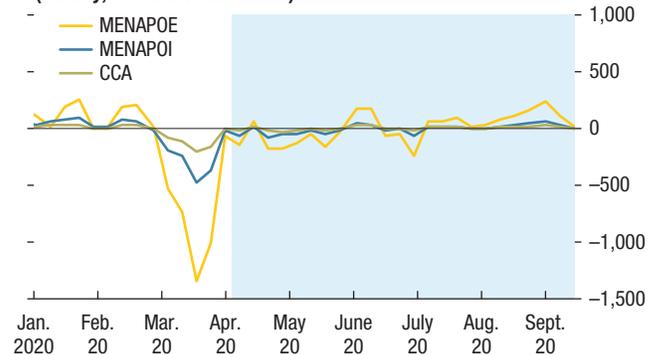
Sources: Haver Analytics; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; EM = emerging market economies; MCD = Middle East and Central Asia; MENAPOE = Middle East and North Africa oil exporters; MENAPOI = Middle East and North Africa oil importers.

financial conditions appear to have stabilized—in line with emerging markets—after initial tightening at the onset of the crisis (Figure 4.9).

That said, policymakers need to take into account that utilizing buffers now inevitably means reduced capacity to absorb potential future shocks, for example, if the impact of the pandemic is

greater or more persistent than anticipated. These risks are discussed in the next section.

Securing Financial Stability

The financial sector policy agenda should strike a careful balance between supporting the recovery

through sustained provision of credit and preserving financial stability.

- The medium- and long-term financial stability repercussions of macroprudential relaxation should be carefully assessed to account for banking sector risks, including those identified in the stress-testing exercise. These risks may stem from (1) further exacerbation of some of the pre-COVID-19 vulnerabilities to banks' balance sheets (discussed in the first section), including stronger bank-sovereign nexuses, as MENAP countries are expected to increase domestic financing in 2020 (Chapter 3); (2) state-owned banks' large and increased exposure to poor quality loans of state-owned enterprises (*Algeria*, *Iran*, *Iraq*); (3) potential evergreening of asset quality problems and increased NPLs in the future; (4) lending to lower-quality borrowers and excessive credit risk taking, including through credit to sectors most affected by COVID-19 (leisure, airlines, auto, oil and gas) with muted prospects for recovery; and (5) easing of countercyclical capital buffers and capital and liquidity requirements in many countries (Figure 4.7). Even so, some banking systems in MCD countries—particularly in MENAP oil importers—entered the pandemic with limited capital buffers and might encounter large losses and potential recapitalization costs if credit and foreign exchange risks materialize, as the stress-testing exercise showed. Hence, governments should carefully calibrate the timing of any unwinding of financial sector support, including regulatory forbearance.

- Authorities may implement further relaxation of macro-financial policies where capital and liquidity buffers still allow it, while encouraging appropriate loan provisioning or restructuring by banks.

- The trade-offs associated with macroprudential relaxation should be carefully considered on a case-by-case basis, taking into account the uncertainty about the economic outlook and the importance of avoiding procyclical effects. On the latter, for example,

if financial indicators point to lending or prudential constraints becoming binding, macroprudential relaxation may need to speed up to avoid drying up of credit.

- A more supportive macro-financial policy would be more effective if coordinated with other policy initiatives and if its prudential and financial stability implications are communicated clearly. Close tracking of external and exchange rate sustainability implications of supportive policies should continue, especially in highly dollarized banking systems (*Armenia*, *Georgia*, *Kyrgyz Republic*, *Tajikistan*, *Uzbekistan*) and in countries with fiscal dominance.

- It is critical to record NPLs transparently and to set aside sufficient provisions immediately, reflecting the effective riskiness of exposures, to preserve the credibility of supervisory frameworks. Any further support to borrowers should be transparent, temporary, and most important, targeted: to avoid funding insolvent borrowers—with careful assessments made of sectors permanently shrunk by the pandemic—and to align incentives with best credit risk management practices (*Afghanistan*, *Algeria*, *Armenia*, *Azerbaijan*, *Georgia*, *Iran*, *Kazakhstan*, *Kyrgyz Republic*, *Pakistan*).

- Undercapitalized banks (*Algeria*, *Azerbaijan*, *Iran*, *Lebanon*, *Libya*, *Mauritania*, *Pakistan*, *Tunisia*) should be considered on a case-by-case basis. Banks with eroded capital and liquidity buffers may be assisted with a mix of private and official support—including capital injections, emergency liquidity assistance, and guarantees—considering fiscal space (see Chapter 3),[8] contagion risks, and enhanced supervision. If needed, they could be ring-fenced with a precise communication strategy to prevent contagion and maintain central banks' and regulators' credibility.

---

[8]Government intervention should be the last resort, only to preserve financial stability. Where possible, recapitalization should be based on private sector investments to minimize moral hazard, and the authorities should reverse public sector injections as soon as market conditions allow it.

After the crisis abates, authorities should turn their efforts to strengthening institutions for medium-term financial stability and access to finance.

- Regulators should continue to monitor developments and stand ready to preserve financial stability as public emergency support is removed, beginning with less-effective programs. They should encourage banks to repair their balance sheets progressively by strengthening liquidity and other financial soundness indicators, to comply with pre-COVID-19 regulatory requirements, and to rebuild their buffers (*Iraq*, *Iran*, *Pakistan*) as the resolution of unviable, nonsystemic banks starts and the delayed reform of large state-owned banks advances (*Iraq*, *Iran*).

- The experience of the pandemic may prime some MCD policymakers to strengthen risk-based supervisory frameworks (*Algeria, Armenia, Georgia, Iran, Pakistan, West Bank and Gaza*) and their bank resolution frameworks (*Georgia, Iran, Pakistan, West Bank and Gaza*).

- Frameworks for resolving insolvency have been improving in recent years, but there is room for streamlining insolvency proceedings to facilitate NPL resolution (Figure 4.10).

- Increasing access to financial services could enhance the capacity of banks and other financial institutions to channel savings to productive uses. Public support may further boost household and SME financial inclusion in the MCD region to build on the authorities' continued efforts in this area, but the benefits of such support should be balanced with fiscal space. Increasing

Figure 4.10. Resolving Insolvency
(Index, 0–100, 100 is best)
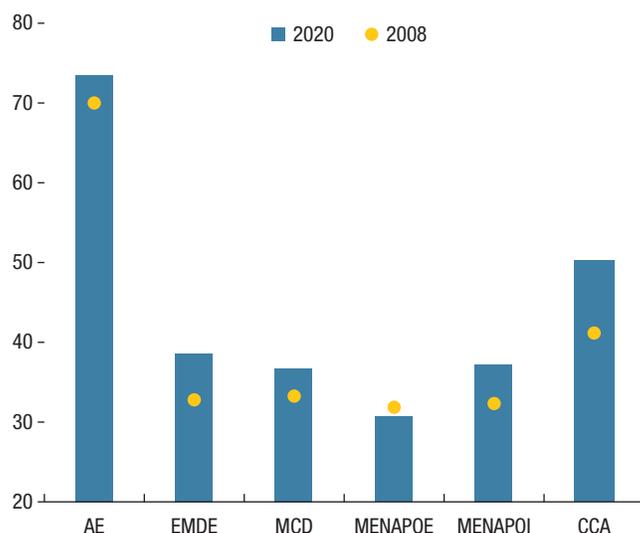
Source: World Bank Doing Business Indicators 2020.
Note: The Resolving Insolvency Index measures the time, cost, and outcome of domestic insolvency proceedings, as well as the strength of legal frameworks applicable to judicial liquidation and reorganization proceedings. AE = advanced economies; CCA = Caucasus and Central Asia; EMDE = emerging market and developing economies; MCD = Middle East and Central Asia; MENAPOE = Middle East and North Africa oil exporters; MENAPOI = Middle East and North Africa oil importers.

financial inclusion should remain a priority for policymakers during and after the pandemic (Box 4.2).

The IMF continues to provide financial policy advice and capacity development to countries in the region. In this context, delivery of remote technical assistance has recently increased markedly to help countries address financial stability issues raised by the crisis. Since April 2020, COVID-19-related technical assistance requests and delivery have focused on central bank risk management, top-down stress testing, and development of securities markets, among others.

Box 4.1. Macro-Level Stress Test Assumptions

The stress test is performed as a sensitivity analysis based on aggregate balance sheets for each Middle East and Central Asia (MCD) country.[1] All else equal, the test's scenario studies the cumulative balance sheet and capital adequacy implications of two shocks:

- **Asset impairment.** A severe deterioration in the macroeconomic outlook (including as a result of a decline in hydrocarbon revenue for oil exporters) requires additional provisioning for existing exposures, including through the application of the expected credit loss model or equivalent supervisory standards. In addition to increases in riskiness of exposures, disruptions to firms' cash flows (including of small and medium-sized enterprises) and household incomes could trigger outright bankruptcies and losses. The asset impairment shock in the stress test is calibrated as a one-off reclassification of 15 percent of *performing loans* into the *nonperforming loan (NPL)* category. However, countries with weaker asset quality and significant related-entity lending could face a larger shock. It is further assumed that the new NPLs should be provisioned at an average rate of 50 percent, which is slightly below the current MCD average to account for a gradual increase in provisioning of new NPLs.

- **Foreign exchange (FX) depreciation.** FX depreciation could affect banks in the following ways: (1) directly with an impact on their profit and loss that depends on their net open FX positions; and (2) indirectly through a further increase in NPLs for FX loans to unhedged borrowers. This shock is calibrated as a one-off depreciation of 30 percent from the exchange rate level at the end of 2019 and is applied to all MCD countries, regardless of their FX regime. The indirect channel is calibrated as an increase of 6 percent in FX NPLs, also provisioned at 50 percent, as in the credit risk shock.

- **Scenario plausibility.** The shocks calibration produces a post-shock NPL ratio for the MCD region of approximately 16.5 percent, or a tripling of the aggregate NPL ratio. The calibrated shock is lower than what some countries experienced after the global financial crisis and, more generally, the scenario outcome is also lower than the 22 percent ratio that a recent paper (Ari, Chen, and Ratnovski 2019) finds as the NPL average in crisis episodes with elevated NPLs. Still, in some countries, a shock tailored to specific circumstances not examined in this regional overview may be more realistic. Given that the pandemic's macroeconomic shock is several standard deviations worse than previous shocks, this scenario may still have considerable downside risks and prove optimistic. On the upside, the shock scenario's FX component is less likely to materialize in countries with a fixed FX regime and stable fundamentals to sustain it.

---

[1]Results exclude Iraq, Libya, Mauritania, Syria, Turkmenistan, and Yemen because of data limitations. Aggregate ratios in the stress test can be interpreted as weighted averages across banks.

Box 4.2. Public Interventions to Support Small and Medium-Sized Enterprises' Financial Inclusion

Small and Medium-Sized Enterprises' Financial Inclusion in the Middle East and Central Asia Region

The Middle East and Central Asia (MCD) region lags most other regions in financial inclusion of small and medium-sized enterprises (SMEs). In line with world averages, SMEs represent about 95 percent of all registered firms and employ about half of the region's total labor force (the other half is employed by large firms), yet SME access to finance is the lowest in the world, with only 7 percent of total bank lending (Figures 4.2.1 and 4.2.2; for details see IMF 2019).

A reduction in the SME financial inclusion gap could bring several macroeconomic benefits to MCD countries. As argued in IMF (2019), improving SME financial inclusion can help increase economic growth and job creation. It may also enhance the effectiveness of fiscal and monetary policy and, under adequate supervisory and regulatory frameworks, could contribute to financial stability. Capital markets and fintech could facilitate greater SME financial inclusion, either by providing the supply of bank credit or by offering new financing channels (for details see IMF 2019).

Supporting SME Financial Inclusion before the Pandemic

MCD countries have implemented several policies to support SME financial inclusion. These include direct interventions to enhance access to bank credit, such as through public credit guarantee programs (PCGs), state-owned or development banks, interest rate regulations, and tax incentives.

Figure 4.2.1. SME Lending by Region
(Percent of total lending)
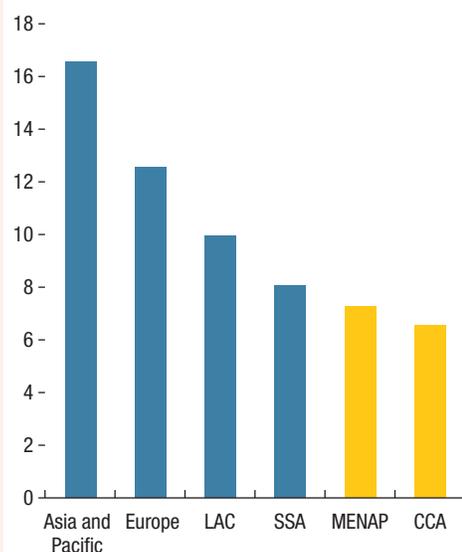
Sources: Financial Access Survey; World Bank, World Development Indicators; World Bank Enterprise Surveys; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; LAC = Latin America and the Caribbean; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; SME = small and medium-sized enterprise; SSA = sub-Saharan Africa.

While our analysis shows that the best solution to promoting SME financial inclusion requires a broad policy approach that would strengthen institutions, the business environment, and macro fundamentals (IMF 2019), certain public interventions could serve as an intermediate solution by helping address some market failures:

- Well-designed PCGs may help reduce collateral requirements and credit risk for lenders. Best practice underscores that PCGs should have sound governance and accountability mechanisms in place, including transparent reporting. While PCGs help increase SME financial inclusion, they also raise risks if not designed adequately. These include possible misallocation of resources and moral hazard (for principles of PCG design, see World Bank and FIRST Initiative 2015). There are also transfer risks to the public sector. Therefore, fiscal risks related to PCGs should be closely monitored and assessed by authorities. PCGs are funded by public institutions, including state banks or foreign donors (*Algeria, Jordan, West Bank and Gaza*) or by public and private institutions (*Egypt, Lebanon, Morocco, Tunisia*) (OECD, EU, and ETF 2018).

Box 4.2 *(continued)*

**Figure 4.2.2. SME Financial Inclusion Index for Emerging Markets**
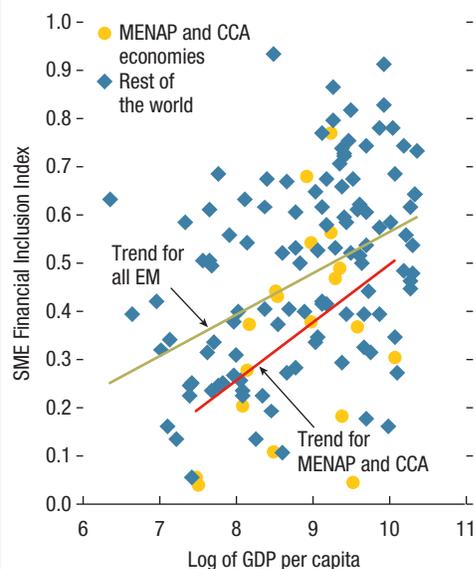
Sources: Financial Access Survey; World Bank, World Development Indicators; World Bank Enterprise Surveys; and IMF staff calculations.
Note: The Financial Institution Depth index is a composite index, which measures the depth of the banking system, pension and mutual funds, and the insurance sector. The higher the index number, the better the financial inclusion. For details on the calculation, see IMF (2019). CCA = Caucasus and Central Asia; EM = emerging market economies; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; SME = small and medium-sized enterprise.

- Development banks play a significant role in allocating credit to SMEs, including in *Jordan* (Governorate Development Fund), *Tunisia* (Bank for Financing Small- and Medium-Sized Enterprises), and *Armenia* (Armenian Development Fund) (OECD, EU, and ETF 2018). International experience with these types of banks raises serious concerns, however, with risks emerging from their lack of diversification, poor asset quality, and regulatory forbearance.

- Experience shows that interest rate caps can reduce SME lending instead of making it more affordable. Interest rates, in principle, should be set on a commercial basis but could be subsidized using fiscal resources where fiscal space is available.

- Relaxing prudential requirements, for example by changing risk weights used to determine regulatory capital ratios, is discouraged because it may jeopardize financial stability, while the effectiveness of such measures is not established.

Supporting SME Credit Supply during the COVID-19 Crisis

The COVID-19 shock has severely affected SMEs. SMEs tend to have lower cash buffers and frequently operate in the informal sector, which makes them more vulnerable than large firms during the pandemic. Given uncertainties about the pandemic's path, even illiquid (though not yet insolvent) SMEs may be compelled to close. However, the same uncertainties make it very difficult to identify ex ante viable firms and calibrate solvency support.

Given the magnitude of the crisis, the policy support needs to be broader if fiscal space is available. Analysis suggests expanding the pre-pandemic framework to ease financing constraints on SMEs through the following main channels. *First*, there is a case to **expand PCGs**. Amid increased credit risk, lenders—even with available funding and ample capital buffers—can be reluctant to lend to firms facing financial difficulties. Governments in many countries (*including* emerging markets) have responded by providing or extending credit guarantees (either directly or indirectly through existing public programs, including public banks)—to help limit lenders' potential credit losses (Jeasakul 2020). *Second*, timely, temporary, and targeted fiscal measures can help viable firms, including in informal sectors. Support may be channeled to these firms by working with existing institutions that serve these groups, such as microcredit institutions and informal sector organizations (Shang, Brooks, and An 2020). *Third*, for programs that rely on lenders' balance sheets, central banks can provide **term funding** to eligible financial institutions at a cost consistent with policy rates (potentially below market funding costs) (Jeasakul 2020). *Fourth*, for programs that operate through special purpose vehicles, central banks can finance the government-backed special purpose vehicles' acquisition of loans (taking the vehicles as collateral) (Jeasakul 2020). *Fifth,* combining grants with a temporarily higher future corporate tax rate (to cut

Box 4.2 *(continued)*

Figure 4.2.3. SME Policy Responses in MCD Countries

Sources: Announcements by national authorities; IMF Policy Tracker; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAPOE = Middle East and North Africa oil exporters; MENAPOI = Middle East and North Africa oil importers. Country abbreviations are International Organization for Standardization (ISO) country codes. The size of the columns reflects the number of countries that implemented the policy.

costs and induce self-selection of firms) would act as an equity injection for SMEs (Blanchard, Philippon, and Pisani-Ferry 2020). As the crisis abates, this additional support could be withdrawn smoothly.

Many MCD countries responded with specific programs to help SMEs cope with the pandemic and boost their financial inclusion. These measures include a deferral of taxes (*Algeria, Kazakhstan, Kyrgyz Republic, Qatar*), a moratorium on debt repayments (*Djibouti, Iran, Iraq, Kuwait, Oman, Qatar, West Bank and Gaza*), and extended provision of loan guarantees (*Bahrain, Kazakhstan, Pakistan*), among others (Figure 4.2.3). Overall, most of these measures go in the right direction and are in line with the experience of many other countries. All of these policies would require new expenditures or may generate contingent liabilities; thus, they have to be temporary, targeted, and transparent, and careful consideration of fiscal space is warranted (see Chapter 3).

To support the economic recovery, MCD countries should continue to implement reforms aimed at expanding SME financial inclusion. Building on the progress made so far, the authorities should further develop *adequate* institutions and improve the business environment to boost SME financial inclusion. Lasting SME financial inclusion could be a key source of sustainable and inclusive growth over the medium term.

References

Ari, Anil, Sophia Chen, and Lev Ratnovski. 2019. "The Dynamics of Non-Performing Loans during Banking Crises: A New Database." IMF Working Paper 19/272, International Monetary Fund, Washington, DC.

Blanchard, Olivier, Thomas Philippon, and Jean Pisani-Ferry. 2020. "A New Policy Toolkit Is Needed as Countries Exit COVID-19 Lockdowns." PIIE Policy Brief 20–8, Peterson Institute for International Economics, Washington, DC.

International Monetary Fund (IMF). 2013. "Key Aspects of Macroprudential Policy." Washington, DC.

International Monetary Fund (IMF). 2014. "Staff Guidance Note on Macroprudential Policy." Washington, DC.

International Monetary Fund (IMF). 2019. "Financial Inclusion of Small and Medium-Sized Enterprises in the Middle East and Central Asia." IMF Middle East and Central Asia Departmental Paper 19/02, Washington, DC.

Jeasakul, Phakawa. 2020. "Considerations for Designing Temporary Liquidity Support to Businesses." Monetary and Capital Markets COVID-19 Special Series Note (May 8), International Monetary Fund, Washington, DC.

Organisation for Economic Co-operation and Development, European Union, and European Training Foundation (OECD, EU, and ETF). 2018. *SME Policy Index—The Mediterranean Middle East and North Africa: Interim Assessment of Key SME Reforms.* Paris: OECD Publishing.

Shang, Baoping, Evans Brooks, and Zhiyong An. 2020. "Expenditure Policies in Support of Firms and Households." Fiscal Affairs COVID-19 Special Series Note (April 20), International Monetary Fund, Washington, DC.

World Bank and FIRST Initiative. 2015. *Principles of Public Credit Guarantee Schemes for SMEs.* Washington, DC.

MENAP Region: Selected Economic Indicators, 2000–21
(Percent of GDP, unless otherwise indicated)

	Average 2000–16	2017	2018	2019	Projections 2020	2021
MENAP[1]						
Real GDP (annual growth)	4.6	2.4	1.8	0.9	−4.4	2.9
of which non-oil growth	5.6	2.8	2.4	2.4	−3.9	2.7
Current Account Balance	7.3	−0.6	3.1	0.9	−3.6	−2.6
Overall Fiscal Balance	2.2	−5.6	−2.7	−4.1	−10.3	−7.6
Inflation (year average; percent)	6.8	7.2	8.9	7.3	9.5	9.9
MENAP oil exporters						
Real GDP (annual growth)	4.8	1.5	0.4	−0.3	−6.6	3.4
of which non-oil growth	6.0	2.0	1.3	2.1	−5.8	3.4
Current Account Balance	10.7	1.8	6.6	3.2	−3.4	−2.0
Overall Fiscal Balance	4.8	−5.2	−1.2	−3.0	−11.2	−7.7
Inflation (year average; percent)	6.5	3.5	8.0	6.6	7.5	8.4
MENAP oil exporters excl. conflict countries and Iran						
Real GDP (annual growth)	5.2	−0.3	1.6	1.1	−6.5	2.4
of which non-oil growth	6.8	1.8	2.0	2.7	−6.1	3.2
Current Account Balance	12.6	1.3	6.9	3.9	−3.7	−2.3
Overall Fiscal Balance	6.0	−5.5	−1.0	−2.3	−10.7	−7.4
Inflation (year average; percent)	3.5	0.9	2.2	−0.9	1.7	2.8
Of which: **Gulf Cooperation Council (GCC)**						
Real GDP (annual growth)	4.7	−0.2	1.9	0.7	−6.0	2.3
of which non-oil growth	6.4	2.1	1.7	2.4	−5.7	2.9
Current Account Balance	14.3	2.8	8.6	5.8	−1.8	0.4
Overall Fiscal Balance	7.6	−5.6	−1.5	−2.0	−9.2	−5.7
Inflation (year average; percent)	2.9	0.2	2.2	−1.5	1.5	2.9
MENAP oil importers						
Real GDP (annual growth)	4.3	3.9	4.1	2.8	−1.0	2.2
Current Account Balance	−2.6	−6.8	−6.7	−5.8	−4.1	−4.4
Overall Fiscal Balance	−5.9	−6.6	−6.9	−7.3	−7.9	−7.3
Inflation (year average; percent)	7.3	14.1	10.3	8.6	12.6	12.3
MENA[1]						
Real GDP (annual growth)	4.6	2.0	1.2	0.8	−5.0	3.2
of which non-oil growth	5.7	2.4	1.9	2.5	−4.4	3.0
Current Account Balance	7.9	−0.3	4.0	1.3	−3.9	−2.7
Overall Fiscal Balance	2.7	−5.6	−2.3	−3.7	−10.6	−7.7
Inflation (year average; percent)	6.7	7.7	9.7	7.5	9.4	10.1
Arab World						
Real GDP (annual growth)	4.8	1.6	2.4	2.0	−5.0	3.2
of which non-oil growth	6.0	2.0	2.6	2.7	−4.4	2.8
Current Account Balance	8.8	−0.9	3.7	1.4	−4.8	−3.5
Overall Fiscal Balance	3.1	−6.4	−2.4	−3.3	−10.8	−7.9
Inflation (year average; percent)	4.7	7.3	6.2	2.7	6.2	7.1

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

[1]2011–21 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.

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

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

CCA Region: Selected Economic Indicators, 2000–21
(Percent of GDP, unless otherwise indicated)

	Average 2000–16	2017	2018	2019	Projections 2020	Projections 2021
CCA						
Real GDP (annual growth)	7.3	4.1	4.3	4.8	−2.1	3.9
Current Account Balance	0.2	−2.3	0.2	−1.5	−4.1	−3.8
Overall Fiscal Balance	1.6	−2.8	1.9	0.5	−4.9	−3.3
Inflation (year average; percent)	9.0	9.1	7.9	6.6	7.6	6.4
CCA oil and gas exporters						
Real GDP (annual growth)	7.5	3.8	4.2	4.6	−1.6	3.5
of which non-oil growth[1]	7.9	3.1	3.9	5.6	−1.6	3.6
Current Account Balance	1.5	−1.9	1.4	−0.9	−3.3	−3.2
Overall Fiscal Balance	2.4	−2.7	2.5	0.7	−4.6	−3.1
Inflation (year average; percent)	9.4	9.8	8.8	7.0	7.9	6.8
CCA oil and gas importers						
Real GDP (annual growth)	6.0	5.9	5.1	6.1	−5.0	5.8
Current Account Balance	−8.8	−4.6	−8.1	−5.6	−10.0	−8.3
Overall Fiscal Balance	−3.0	−4.0	−1.9	−1.4	−7.1	−4.6
Inflation (year average; percent)	6.7	4.4	2.6	3.8	5.3	3.9

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

[1]Aggregate for Azerbaijan, Kazakhstan and Turkmenistan. Uzbekistan data for non-oil GDP is not available.

CCA oil and gas exporters: Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.

CCA oil and gas importers: Armenia, Georgia, the Kyrgyz Republic, and Tajikistan.