

April 2022 Middle East and Central Asia Regional Economic Outlook

Key Messages

Recovery before the war. Growth surprised on the upside in 2021 and maintained its momentum entering 2022, despite surging inflation and a temporary pandemic-induced slowdown in January.

- **Real GDP growth for 2021 has been revised up** to 5.8 percent in the **Middle East and North Africa (MENA)** and to 5.6 percent in the **Caucasus and Central Asia (CCA)**, primarily driven by strong domestic demand.
- **Inflation surged in 2021**, to 14.8 percent in **MENA** and 9.2 percent in **CCA**. Higher food prices have been the main driver, except in Gulf Cooperation Council (GCC) (contributing about 60 percent of the increase in MENA excluding GCC). Domestic energy prices were mostly contained due to energy subsidies/administered prices.
- The region dealt with a **temporary increase in COVID-19 (Omicron) infections** in early 2022, but countries reported far fewer deaths, especially those with high vaccination rates. Many countries still struggled to hit vaccination targets: half of MENA and CCA countries did not meet the 40 percent target by the end of 2021.

The war in Ukraine is impacting the region significantly through a **multitude of global and direct channels**, with differentiated impact across country groups.

- **CCA countries** are the most exposed, given close trade and financial linkages with Russia, reliance on remittances and tourism, and exchange rate and cross-border payment spillovers. In addition, they are exposed to global spillovers, in particular from higher commodity prices in the context of already high domestic inflation.
- **MENA oil importers** are being hit by higher commodity prices and tightening financial conditions, fueling inflation and worsening external and fiscal accounts. Some countries are also directly exposed, given their heavy reliance on wheat and energy imports from Russia and Ukraine.
- In contrast, **oil and gas exporters, particularly in MENA**, will benefit from higher energy prices, more than offsetting the impact of tightening financial conditions and lower tourism revenues.
- Higher food prices and potential supply shortages are challenging both the **affordability and availability of basic food** staples like wheat. Higher wheat prices alone can increase ME&CA's external financing needs by up to \$10 billion in 2022. Supply shortages originating from Russia and Ukraine can endanger food security, particularly for **low-income countries (LICs)**, as they may also suffer from potential aid diversion.

Divergences in recoveries. The war in Ukraine will be the dominant factor shaping the outlook, compounding global headwinds from faster-than-expected normalization of monetary policy in advanced economies (AEs), China's slowdown, and a lingering pandemic. The recovery is set to lose steam for oil importers, with increasing divergence across countries, while most countries will also continue grappling with elevated inflation.

- **The outlook for the CCA region is being driven by the multifaceted impact of the war in Ukraine.** Real GDP growth is projected to slow from 5.6 percent in 2021 to 2.6 percent in 2022 (a 1.5-percentage-point downgrade from October). Oil importers will be hit even harder (a 2.4-percentage-point downgrade). Inflation is expected to rise to 10.7 percent, a result of depreciation pressures and commodity price surges.
- **The recovery in MENA is expected to be uneven.** Real GDP growth is forecast at 5 percent in 2022 (a 0.9-percentage-point upgrade from October), down from 5.8 percent in 2021. This masks marked differences across countries: with growth in oil exporters projected at 5.4 percent, versus 4.4 and 1.1 percent in EM&MI countries and LICs, respectively. Inflation is projected to remain elevated at 13.9 percent due to higher food and energy prices and, in some cases, exchange rate depreciation and lax monetary and fiscal policies.
- **EM&MI economies across MENA and CCA face worsening prospects,** given limited policy space amid elevated debt and inflation. For many countries, debt is expected to increase further in 2022 and stay above pre-pandemic levels over the medium term. Public gross financing needs are expected to increase from \$537 billion over 2020-21 to \$584 billion over 2022–23. By 2024, the impact from faster-than-expected normalization of monetary policy in AEs is projected to increase EM&MI countries annual budgetary interest expenses by about 4½ percent of fiscal revenues.
- **LICs face a particularly challenging outlook** given rising food prices, low vaccination rates, and underlying fragilities and conflict in some countries.
- **Meanwhile, oil exporters face brighter prospects,** as the windfall from higher oil prices and successful vaccination campaigns are expected to improve fiscal and external balances and support recovery. On average, oil revenues and external current account balances are projected to increase by 5.3 and 7.2 percentage points of GDP, respectively, in 2022 compared to 2021.

High uncertainty surrounds the outlook and downside risks dominate, including primarily:

- **A prolonged war in Ukraine and further sanctions on Russia,** which would lead to sustained trade disruptions, higher commodity prices, and prolonged supply shortages of vital food items. This will weigh on commodity importers, raise food security concerns—particularly in LICs—and risks of social unrest.
- **Tighter-than-expected global financial conditions** amidst higher uncertainty and volatility, triggering capital outflows as investors fly to safety and raising financing needs, which would push countries to rely even more on domestic financing, thereby leading to even tighter bank-sovereign links.
- **Stubborn inflation resulting in de-anchoring of inflation expectations** could lead to a vicious circle of higher inflation expectations and second-round effects—typically a 1 percentage point increase in five-years-ahead inflation expectations is associated with a 0.21 percentage point increase in core inflation.
- A materialization of these risks and additional ones, stemming from a more pronounced slowdown in China and new COVID-19 outbreaks, could imperil **debt stabilization**.

Near-term policy trade-offs have become increasingly complex, particularly for oil-importing countries, given diminished macro policy space, elevated inflation and debt, in the context of a fragile recovery and tightening global financial conditions. Priorities include:

- **Bringing inflation under control** by adjusting monetary policy without derailing the recovery. Tightening is needed where there are clear risks of de-anchoring inflation expectations or broadening price pressures. Relatedly, countries should avoid FX interventions except to prevent disorderly conditions in the FX market.
- **Mitigating the impact of high commodity prices on the vulnerable.** While allowing the pass-through of higher global food and energy prices to domestic prices, countries should compensate vulnerable households and firms via transparent, temporary, and targeted transfers rather than resorting to subsidies and price controls. Where social safety nets are weak, a gradual adjustment of domestic prices could be considered.
- **Calibrating fiscal policy to safeguard debt sustainability.** Oil exporters have the opportunity to rebuild fiscal buffers, whereas EM&MI countries with limited fiscal space need to implement growth friendly fiscal adjustment, re-prioritizing spending towards, health, social spending and investment.
- **Carefully coordinating fiscal, monetary, and financial policies.** In situations where a tighter monetary stance is needed to combat inflation and where macroeconomic policy space is limited and/or recovery is fragile (e.g., Egypt, Tunisia) medium-term policy frameworks should be strengthened to ease trade-offs and fiscal adjustment plans should be carefully calibrated to minimize any adverse effects on growth.
- **Garnering international cooperation** to prevent a food crisis that could exacerbate the already-dire conditions facing LICs as well as providing equitable access to a comprehensive COVID-19 toolkit.

Accelerating structural reforms has become even more urgent, to mitigate the impact of tighter macroeconomic policies on growth, address long-term scarring from the pandemic and the war, and improve resilience ahead. Priorities include: 1) Rethink the scope and nature of public spending as support measures are withdrawn by reallocating expenditures toward expanded and better-targeted safety nets; 2) Increase revenue-generating capacity to ensure fiscal sustainability and equity, and help achieve development goals; 3) Undertake governance and structural reforms to promote private activity, boost productivity, and reduce informality; and 4) Adjust to climate change through adaptation, which is urgently needed as part of a comprehensive strategy.