May 2023 REO: Middle East and Central Asia

Key Messages

- Economic activity is expected to slow in 2023, following a year of resilient growth despite global shocks.
- Russia’s war in Ukraine and geo-economic fragmentation are major sources of uncertainty.
- Financial sector instability in advanced economies has increased risks.
- Restoring price stability and preserving debt sustainability are key policy priorities.
- The 2023 World Bank-IMF Annual Meetings in Marrakech will provide a platform for wide ranging policy discussions on challenges facing the region and the world.

Economic growth surprised in 2022 despite a series of global shocks.

- **Real GDP growth for 2022 has been revised up** to 5.3 percent in the Middle East and North Africa (an upgrade of 0.3 percentage point from October), reflecting strong domestic demand and a rebound in oil production, and 4.8 percent in the Caucasus and Central Asia (1.0 percentage point), reflecting spillovers from the war in Ukraine.
- **Inflation surged in 2022** to 14.8 percent in MENA and 13 percent in the CCA, as the war in Ukraine spurred global food and energy prices. Headline inflation eased in the final months of 2022, but core inflation remains high.
- **Central banks across ME&CA tightened monetary policy** in response to high inflation and exchange rate pressures. While the monetary policy stance was appropriately tight in many countries in early 2023, it may need to tighten further to stabilize inflation in Egypt, Pakistan, and Tunisia.
- **Fiscal positions were mixed.** Most GCC, MENA emerging markets, and CCA countries maintained a prudent stance, but some MENA oil exporters ran a procyclical fiscal policy.

Growth will decelerate this year, and inflation will remain persistent.

- In **MENA**, GDP growth is forecast to slow to 3.1 percent in 2023 before rising to 3.4 percent in 2024, reflecting tight policies to restore macroeconomic stability, agreed OPEC+ oil production cuts, and the fallout from the recent deterioration in financial conditions. Headline inflation in MENA is set to remain unchanged at 14.8 percent before declining to about 11 percent in 2024.
- Growth is also forecast to decelerate in the **CCA** in 2023, slowing to 4.2 percent, as the impact of the initial spillovers from the war in Ukraine fade, before rebounding slightly in 2024. Inflation is projected to ease—reflecting the lagged impact of monetary tightening and easing global commodity prices—but to remain in the double digits (11.8 percent) this year before slowing to 8.5 percent in 2024.

Risks to the outlook are large and tilted to the downside. **Financial sector instability** in advanced economies could rise, leading to contagion and more adverse credit conditions, depressing global growth, and exacerbating financial market volatility and debt sustainability concerns for many EM&MIIs. **Tighter-for-longer global financial conditions** would also prompt investors to reassess debt sustainability and push the most vulnerable economies to the brink of debt distress. This could spur a flight to safety and capital outflows, fueling exchange rate depreciation pressures and leading to financial stress. **An escalation of the war in Ukraine** could lead to high volatility in commodity markets, shortages, and renewed price increases for energy, food, and fertilizers, fueling additional inflationary pressures across ME&CA, and amplifying the risks of social unrest.

Policy tradeoffs remain complex, and striking the right policy balance will be critical. Amid continued uncertainty, policymakers should stay the course to safeguard macroeconomic stability through tight monetary and fiscal policies while
being mindful of financial stability risks. At the same time, they should accelerate structural reforms to bolster potential growth and enhance resilience, inclusion, and social safety nets.

**Monetary policy: Focus on regaining price stability.** Inflation is estimated to have peaked in 2022 but remains elevated in many countries. While tight monetary policy stances continue to work through their lags, additional policy rate increases in advanced economies might lead to depreciation pressures. In this context, monetary policy should be driven by the following principles:

- In countries where inflationary pressures continue and the stance is loose, a tighter monetary policy should be considered.
- Where inflation has peaked and the stance is tight or neutral, central banks should remain data dependent and not start loosening prematurely (before there are clear signs that core inflation is on a downward trajectory).

**Financial stability: Be mindful of risks.** Amid heightened global financial stress, policymakers should closely monitor financial system vulnerabilities that could arise from continued monetary tightening. Bank supervisors should ensure that banks have governance and risk management commensurate with their risk profile, including adequacy of capital and liquidity stress tests.

**Fiscal policy: Preserve debt sustainability, build buffers, and be supportive of monetary tightening.** In the near term, when fiscal space permits, countries should prioritize targeted and temporary support to protect the most vulnerable from still-high food and energy prices with cash transfers.

- **Oil exporters** should carefully manage oil revenues, avoid expanding current expenditures, improve budget transparency, and strengthen medium-term fiscal frameworks.
- In **emerging markets**, fiscal consolidation should continue to be anchored on a downward debt path, supported by revenue mobilization and expenditure containment measures, while strengthening social protection.
- In **low-income countries** and **fragile and conflict-affected states**, the lack of fiscal space to protect the vulnerable demands the support of the international community and global cooperation.

**The Fund’s commitment to the region is unwavering.** Since 2020, the IMF has supported ME&CA members with $29.7 billion in new financing commitments—including recent Fund arrangements for Armenia, Egypt, Mauritania, and Morocco—and allocated $49.3 billion special drawing rights to boost the region’s reserve assets. The Fund has also increased its presence on the ground by expanding Resident Representative offices, opening/reopening our regional technical assistance offices (METAC, CCAMTAC), and setting up a new regional office in Riyadh, which will strengthen our partnership with the region. The upcoming World Bank-IMF Bank Annual Meetings in Marrakech in the fall will also provide a platform for wide ranging policy discussions on challenges facing the region and the world.