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# Arab Countries in Transition:
# Economic Outlook and Key Challenges

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## I. Regional Economic Outlook and Key Challenges

*Political uncertainty in the Arab Countries in Transition (ACT) has continued in recent months, especially as the escalation of the conflict in Syria is creating negative regional spillovers.[1] While transition governments have maintained macroeconomic stability thus far, serious short-term risks continue, and the authorities have made limited progress in building consensus for needed economic reforms. With the exception of Libya, the ACTs' growth in 2012 has remained weak in light of continued policy uncertainty, regional tensions, the deteriorating global economy, and high food and fuel commodity prices. A moderate recovery is expected in 2013. The shrinking of fiscal and reserve buffers over the past year has left very little policy space and heightened vulnerabilities. Prompt policy action and timely and adequate international support are essential to maintain macroeconomic stability and address long-running structural deficiencies, to lay the foundation for inclusive growth and job creation for a young and growing population.*

**Background and recent developments.** In recent months, political uncertainty has receded among most ACTs, reflecting progress that has been made in instituting democratically elected governments and broader political reforms. By contrast, the conflict in Syria has escalated into a civil war and is leading to a serious humanitarian crisis with significant regional spillovers, especially for neighboring countries. Moreover, the recent outbreak of social unrest underscores the continued fragility of the situation in the region.

The external environment has continued to deteriorate: international food and fuel prices have continued to rise, and economic activity in trading partners, both in Europe and key emerging markets, has weakened. As a consequence, exports, which had remained relatively robust in 2011, have declined significantly, while import bills are continuing to grow with escalating food and fuel prices. Tourism receipts are recovering from last year's disruptions but are still much below pre-2011 levels; and FDI inflows have remained subdued. In addition, the disruptions to gas supplies in Jordan and the drought in Morocco are weighing on their growth prospects and expanding external current account deficits.

Fiscal balances are further deteriorating this year, as policymakers' efforts to limit their fiscal imbalances are tested by the adverse external conditions and heightened social demands from populations that have not yet received any tangible economic benefits from the political transitions. In this light, and with limited exchange rate flexibility, international reserves have further declined, leaving few buffers and little policy space going forward.

**Outlook.** 2013 could see a moderate economic recovery in the ACTs, assuming a gradual return of confidence as domestic uncertainties recede. Nonetheless, growth will not be sufficient to tackle the region's high rates of unemployment, especially among women and youth. Fiscal balances are expected to improve, as the diminished buffers leave policymakers with few choices than to adjust, and as the economic recovery increasingly supports fiscal revenues.

[1] The ACTs include Egypt, Jordan, Libya, Morocco, Tunisia, and Yemen.

**Risks.** This outlook is subject to a number of important downside risks:

- The projected economic recovery will only materialize if confidence and private investment pick up. The ongoing political transitions, with short planning horizons for governments in a number of countries and upcoming constitutional changes in many ACTs, are a source of uncertainty and possible setbacks, which would hold back private investment and, more broadly, confidence. Labor strikes or a continuation of the recent uptick in social unrest could also hold back the recovery.

- The conflict in Syria is a key uncertainty for the region, and its further evolution could profoundly reshape regional conditions in the period ahead. Neighboring countries have been welcoming Syrian refugees, but this comes at a fiscal cost to them, particularly for Jordan, which hosts the largest number of refugees.

- Another key risk lies in global economic developments, in particular related to Europe, where some countries in the region have significant real economic links that include trade, tourism, remittances, and FDI.

- The planned fiscal consolidation is contingent on policymakers being able to implement the necessary measures. ACTs have already acted to contain or reduce subsidies, and many have also taken other fiscal adjustment measures. However, more strenuous actions will be required to reach the expected fiscal adjustment, which may prove challenging in the current social and political environment.

- The ACTs are faced with substantial external financing needs. In 2013, these are projected at $33 billion, and could be even higher, especially if international prices for food and fuel remain at present (or even elevated) levels, adding to the import bill. Not all financing will be forthcoming from private capital markets, and it will be important that sufficient support from the international community can be mobilized.

Arab Countries in Transition: Financing Needs[1]
*(Billions of U.S. dollars)*

| | Est. | Projections | |
|---|---|---|---|
| | 2011 | 2012 | 2013 |
| Current account deficit (excl. official transfers) | 28.0 | 30.3 | 24.1 |
| External amortization | 8.9 | 9.2 | 9.3 |
| **External gross financing needs[2]** | **36.9** | **39.6** | **33.4** |
| Budget deficit (excl. grants) | 43.5 | 47.4 | 37.8 |
| Public external amortization | 4.8 | 5.2 | 5.2 |
| **Fiscal financing needs[3]** | **48.3** | **52.6** | **43.0** |
| Public short-term domestic debt | 100.4 | 96.3 | 122.2 |

Sources: National authorities; and IMF staff calculations.
[1]Comprises: Egypt, Jordan, Morocco, Tunisia, and Yemen. Libya does not face financing needs.
[2]Current account deficit, excluding grants, plus amortizartion.
[3]Budget deficit, excluding official grants, plus public external amortization. Assumes full domestic rollover.
[4]Remaining maturity basis.

**Short-term policy challenges.** In the face of reduced fiscal buffers and diminished external reserves, policy action is needed to maintain macroeconomic stability, instill confidence, and help mobilize external financing. Any macroeconomic stabilization program will involve fiscal consolidation, which, if sustained, will not only improve public debt sustainability but also increase the availability of private sector credit and help alleviate any real exchange rate misalignment. Fiscal adjustment is already planned in most ACTs, and will be supported going forward by recent IMF financing facilities in Jordan and Morocco. Mobilizing external support will be important to facilitate and smooth the adjustment path. Monetary policy should aim at containing inflationary second-round effects from rising international food and fuel prices and from subsidy reforms.

To achieve these goals, it will be essential to build broad ownership through clear communication with the public, and to carefully implement consolidation plans, which should include putting in place measures to protect the most vulnerable. To be socially acceptable and successful, the burden of adjustment needs to be spread fairly.

**Medium-term challenges and key reforms.** To tackle lackluster growth and high unemployment, countries need to begin laying out a road map for structural economic reform that will guide the economic transitions and provide a vision for revitalizing the economy and tackling structural unemployment. While strategies will vary, reflecting different starting points and goals, they will be broadly anchored in aiming to achieve higher, sustained, private-sector-led growth, requiring more private investment and higher productivity. Governments will thus need to engineer a business environment conducive to private sector-led growth while ensuring adequate regulation for its smooth functioning, thereby enabling ACT economies to limit the scope for rent-seeking. Labor market and education reforms will be important to ensure adequate skill-building and protection for workers, while business regulation and governance reforms are needed to ensure simple, transparent, and evenhanded treatment for companies. In addition, improving access to finance will help catalyze entrepreneurship and private investment.

**Role of the international community.** While economic stabilization and transformation will need to be driven primarily by the ACTs themselves, the international community needs to strongly support them. Regarding countries' macroeconomic stabilization agendas, the main focus of the international community should be on the provision of adequate external financing and policy advice to support and smooth countries' adjustment efforts. Financing will also be important in supporting countries' economic medium-term transformation agendas; in addition, the international community can help by providing access to export markets and appropriate expertise in helping design suitable policy packages. For its part, the IMF is engaged in financing arrangements with Jordan and Morocco (the latter on a precautionary basis), and is in discussions on a possible arrangement with Egypt and a second arrangement with Yemen. In addition, in all ACTs, the IMF's focus has been on analytical work, policy advice, and capacity building.

## II. Egypt

*Egypt has managed to preserve macroeconomic stability in the period following the revolution, but a broad-based recovery of the economy has yet to set in. Growth has been held back by political and policy uncertainty, security problems, and the global slowdown. Moreover, financial fragilities have risen owing to a decline in international reserves and an increase in the fiscal deficit and domestic t-bill rates. Egypt's medium-term prospects remain favorable, provided the country quickly puts in place a comprehensive economic program that addresses the fiscal and balance of payments deficits and builds foundations for achieving higher and more socially balanced growth.*

**Background**. During the second half of the past decade, Egypt experienced accelerated growth following reforms that stimulated investment. However, social outcomes were unsatisfactory as unemployment remained high, double-digit inflation eroded household incomes, and privatization was perceived to have benefited only a few. Moreover, progress in fiscal consolidation was hindered by the 2008 surge in commodity prices and the global economic crisis, leaving public debt well above 70 percent of GDP.

**Egypt: Selected Economic Indicators, 2009/10-12/13**

| | 2009/10 | 2010/11 | Est. 2011/12 | Proj. 2012/13 |
|---|---|---|---|---|
| GDP growth, percent | 5.1 | 1.8 | 2.0 | 3.0 |
| CPI inflation, percent | 10.7 | 11.8 | 7.3 | 12.3 |
| General government balance, excl. grants, percent of GDP | -8.2 | -10.1 | -11.8 | -10.3 |
| Current account, excl. grants, percent of GDP | -1.7 | -2.3 | -3.0 | -3.0 |
| Fiscal financing needs, excl. grants, US$ billion 1/ | 18.5 | 25.1 | 31.6 | 31.7 |
| External financing needs, excl. grants, US$ billion 2/ | 7.1 | 11.5 | 11.7 | 12.7 |
| Public debt, percent of GDP | 73.2 | 76.4 | 79.7 | 81.1 |
| External debt, percent of GDP | 12.4 | 11.8 | 10.1 | 14.5 |
| Reserves to short-term debt, percent 3/ | 306 | 297 | 326 | 327 |
| Reserves in months of imports of goods and services 3/ | 6.9 | 4.7 | 2.7 | 3.0 |

Sources: Egyptian authorities; and IMF staff estimates.
1/ Budget deficit, excluding official grants, plus public external amortization. Assumes full domestic rollover.
2/ Current account deficit, excluding official grants, plus amortization.
3/ Official reserves including central bank foreign currency deposits held at banks.

**Recent developments**. Egypt's economy has yet to fully recover from the erosion of confidence that triggered a sharp reversal of capital flows, an abrupt decline in tourist arrivals, and a standstill in investment in the aftermath of the January 2011 revolution. Real GDP growth has remained anemic, reaching only about 2 percent in FY2011/12 (July–June), while the unemployment rate has increased to 12.6 percent from about 9 percent before the revolution. Lower revenue collection and higher spending have widened the budget deficit, which reached 11.8 percent of GDP (excluding grants) in FY2011/12. Reliance on the domestic market to finance the deficit has contributed to a sharp increase in domestic t-bill rates, which peaked at nearly 16 percent in August before receding. The balance of payments also deteriorated owing to portfolio capital outflows and lower tourism revenues and FDI. As a result, international reserves (including the central bank's foreign currency deposits in domestic banks) declined to $15.1 billion at end-August, from $43 billion at end-December 2010, notwithstanding some bilateral support and the issuance of foreign currency t-bills. The banking sector appears to have remained relatively stable through this period, but liquidity conditions have tightened, private-sector credit has contracted in real terms, and deposit growth has slowed.

**Short-term outlook**. The political transition has advanced with the transfer of power to civilian rule following presidential elections in May/June. Nonetheless, confidence will take time to recover fully, and the outlook for FY2012/13 remains a gradual recovery of economic activity and continued—albeit narrowing—balance of payments pressures. Real GDP growth is expected to pick up somewhat to 3 percent, held back by the challenging external environment and the negative fiscal impulse from the consolidation embedded in the FY2012/13 budget. Despite the modest growth prospects, inflation is likely to increase somewhat, driven by higher global commodity prices. Unemployment is expected to remain elevated, with job creation still insufficient to cover the structurally large number of labor market entrants (about 750,000 annually). The authorities are in the process of articulating a homegrown economic program that would seek to preserve macroeconomic stability, restore confidence, and protect the vulnerable population. They have requested financial assistance from the IMF and other partners to support program implementation.

**Risks**. While the weak global environment weighs negatively on Egypt's recovery prospects, the main risks to the outlook are domestic in nature. In particular, prolonged political uncertainty, a worsening of the security situation, and/or failure to put in place corrective policies would dampen confidence, delay the economic recovery, and lead to increased pressure on the pound and international reserves. Fiscal risks would also rise in such a scenario. Economic outcomes could exceed expectations if the political transition advances smoothly and the authorities implement a comprehensive and broadly supported economic program that addresses effectively the country's imbalances.

**Short-term policy issues**. The most immediate policy challenges are to contain the large fiscal and balance of payments deficits, support a rapid economic recovery and job creation, and protect the most vulnerable segments of the population. On the fiscal front, upfront measures are needed to put the budget deficit on a credible downward trajectory that will help reduce the government's debt burden over the medium term. Possible measures include expanding targeted social transfers to the vulnerable population while cutting back untargeted and inefficient energy subsidies (which cost the budget more than 6 percent of GDP in FY2011/12); raising revenues through a broadening of the income tax and a transition to a modern value-added tax; and increasing infrastructure, education, and health spending to boost growth and social outcomes, and to create jobs. Allowing the currency to move in line with market forces—while avoiding excessive short-term volatility—would help protect international reserves and competitiveness, while mobilizing foreign financing on favorable terms could bridge temporary balance of payments gaps.

**Medium-term challenges.** Sustaining higher and more socially balanced growth will require policies to leverage Egypt's considerable economic potential and unleash its dynamic private sector. Creating a more transparent and competitive business environment, streamlining burdensome regulations, and improving access to financing, especially for small enterprises, should help boost economic activity and create jobs. Increasing investment in human capital and infrastructure should help provide more equal access to job and business opportunities for all sections of society.

## III. Jordan

*The economy has been suffering from exogenous shocks, including high energy prices and regional unrest, particularly in neighboring Syria. Supported by a Stand-By Arrangement, the authorities have adopted a national reform program to bring fiscal and energy policies back to a sustainable path, while fostering high and inclusive growth.*

**Background**. Jordan experienced a period of robust growth during 2000–09 (averaging about 6½ percent). The economy is among the most open in the Middle East; tourism receipts, remittances, FDI flows, and external grants play an important role. Jordan imports most of the hydrocarbon products and grains that it needs. While the authorities have implemented structural reforms to develop the private sector, unemployment remains high, averaging about 13 percent during 2000–11. Unemployment is particularly high among the young and graduates (estimated at around 31 percent at end-2011).

**Recent developments.** Jordan's economy has been affected by exogenous shocks. Repeated disruptions to the flow of natural gas from Egypt, together with high and rising oil prices, have required imports of expensive fuel products for electricity generation, increasing the operating losses of the electricity company NEPCO. At the same time, regional tensions have increased the fiscal burden of supporting a large number of Syrian refugees.

In response to the negative external shocks, the Jordanian government has adopted a national reform program. It already took significant measures in 2012 to bring back fiscal and energy policies to a sustainable path while providing targeted support to the vulnerable part of the population, but further adjustment is needed over the medium term. A three-year Stand-By Arrangement with the IMF, approved on August 3, will provide liquidity during the next three years to allow the authorities to gradually implement their program.

**Jordan: Selected Economic Indicators, 2010–13**

| | | | Projections | |
|---|---|---|---|---|
| | 2010 | 2011 | 2012 | 2013 |
| GDP growth, percent | 2.3 | 2.6 | 3.0 | 3.5 |
| CPI inflation, end of period, percent | 6.1 | 3.3 | 4.4 | 4.2 |
| Fiscal balance, percent of GDP | -5.6 | -5.7 | -6.5 | -5.5 |
| Fiscal balance excluding grants, percent of GDP | -7.7 | -11.7 | -10.7 | -9.3 |
| NEPCO operating balance, percent of GDP | -0.9 | -4.9 | -5.3 | -3.8 |
| Fiscal balance excluding grants plus NEPCO operating balance, percent of GDP | -8.6 | -16.6 | -16.0 | -13.1 |
| Current account, percent of GDP | -7.1 | -12.0 | -14.1 | -9.9 |
| Current account excluding grants, percent of GDP | -11.3 | -19.0 | -18.9 | -14.2 |
| Gross public debt, percent of GDP | 67.1 | 70.7 | 79.2 | 83.0 |
| External government debt, percent of GDP | 24.6 | 21.9 | 23.3 | 23.2 |
| Gross international reserves, months of imports 1/ | 7.4 | 6.0 | 4.0 | 3.9 |
| Short term debt, percent of international reserves | 5.3 | 1.6 | 2.3 | 2.0 |

Sources: Jordanian authorities; and IMF staff estimates.
1/ Imports adjusted to exclude re-exports.

**Short-term outlook**. Economic growth is projected at 3 percent in 2012, supported in part by a recovery in remittances and tourism. Nonetheless, the external current account deficit is expected to widen to an estimated 14 percent of GDP in 2012, from 12 percent of GDP in 2011, primarily because of a higher energy import bill. The 2012 central government deficit (excluding grants) is projected to narrow by about 1 percent of GDP relative to the 2011 outturn, but the operating losses of NEPCO are higher than in 2011, resulting in a public debt-to-GDP ratio of slightly below 80 percent by end-2012. In line with the authorities' reform program, further fiscal consolidation is expected to be implemented in 2013, aiming for a reduction of the central government deficit (excluding grants) by about 1½ percent of GDP.

**Downside risks**. Higher-than-projected oil prices will drive up the cost of electricity production as well as the fuel subsidies from the budget. The authorities are working on developing alternative and cheaper sources of energy, but this process is likely to take some time. Furthermore, the uncertain regional and global environment could hurt the flow of remittances and FDI, and may also have fiscal implications. In particular, the situation in Syria is disrupting transit trade and introduces significant uncertainty into the government's spending to accommodate refugees' needs. On the political front, forthcoming elections constitute an element of uncertainty for the continuity of policy reforms.

**Short-term policy issues**. The authorities have taken substantial measures since May 2012 to reduce the fiscal deficit, mostly on the expenditure side. Since then, higher oil prices and an acceleration in the inflows of refugees from Syria are putting pressures on the budget, but the authorities are committed to undertake contingency measures to stay within the deficit target. It will be crucial to formulate a sound 2013 budget with measures underpinning further consolidation and a strategy for medium-term energy reforms.

**Medium-term challenges**. To bring the public debt to sustainable levels, fiscal consolidation under the authorities' national program will continue in the medium term through expenditure and tax reforms. At the same time, the burden of reforms on vulnerable groups will need to be minimized through well-targeted assistance. To reduce public debt, NEPCO will be brought back to cost recovery, which to a large extent will hinge on the success of Jordan's strategy to establish transparent and sustainable energy prices and diversify its energy sources. In parallel, the authorities' program envisages fostering high and more inclusive growth, and will include implementing structural reforms aimed at improving the business environment, enhancing transparency, and fostering trade, while improving labor market skills through education and training reform.

## IV. LIBYA

*After a dramatic decline in 2011, the Libyan economy has rebounded in 2012, underpinned by restoration of hydrocarbon production. Delays in normalizing the security situation pose risks to the outlook. In the near term, security must be established, hydrocarbon production restored to pre-2011 levels, fiscal discipline exercised, the banking system revived, and macroeconomic stability maintained. Medium-term efforts should focus on infrastructure renewal, private-sector development, job creation, improving education and health services, and putting in place an effective social safety net, within a framework of transparent and accountable governance. The Fund has been assisting Libya with policy advice and technical assistance.*

**Background**. During 2004–10, average growth was approximately 5 percent, annual consumer price inflation averaged less than 4 percent, and foreign assets increased from $20 billion at end-2003 to $170 billion at end-2010. Although the non-hydrocarbon sectors grew rapidly, led by an ambitious public investment program, the country remained dependent on hydrocarbons, which accounted for over 70 percent of GDP, more than 95 percent of exports, and approximately 90 percent of government revenue. Development of the nascent private sector was constrained by the dominance of the state and by institutional weaknesses. As of end-2010, the authorities estimated unemployment at 26 percent.

**Recent developments**. The prolonged fighting had a far-reaching impact on standards of living, provision of basic services, and employment: economic activity contracted sharply in 2011 and consumer prices increased, primarily due to international sanctions and supply constraints. The current account surplus decreased due to the conflict-induced reduction in hydrocarbon output. Government revenue declined precipitously and expenditure was reduced in light of limited financing and due to constraints on implementing capital spending. The resulting budget deficit was financed by arrears and drawing down of government deposits at the Central Bank. During the conflict commercial banks suffered from a systemic liquidity shortage linked to the slow normalization of the foreign exchange market. The bulk of Libya's foreign assets were unfrozen on December 16, 2011, clearing the way for normalization of the foreign exchange market and commercial banking operations.

**Libya. Selected Economic Indicators, 2011-13**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| | | | Projections | |
| GDP growth, percent | 3.7 | -59.7 | 121.9 | 16.7 |
| Inflation, percent | 2.5 | 15.9 | 10.0 | 0.9 |
| Fiscal balance, percent of GDP | 16.7 | -27.7 | 19.4 | 7.7 |
| Current account, percent of GDP | 19.8 | 1.3 | 21.8 | 10.3 |
| Fiscal financing needs, US$ billion | … | 9.9 | 0.0 | 0.0 |
| External debt, percent of GDP | 7.6 | 15.6 | 6.5 | 5.7 |
| Foreign assets, percent of GDP | 233.0 | 495.6 | 230.1 | 211.1 |
| Foreign assets, US$ billion | | 176.9 | 195.8 | 206.1 |

Source: National authorities; and IMF staff estimates and projections.

**Short-term outlook**. Real GDP is rebounding in 2012, underpinned by the faster-than-anticipated resumption of hydrocarbon output, while consumer price inflation will ease significantly. The current account surplus will increase and the budget will return to surplus. Current spending will increase from 22 percent of GDP in 2010 to 41 percent in 2012, while capital spending, constrained in the short term by limited absorptive capacity, will decline from 26 percent of GDP in 2010 to 9 percent in 2012.

**Downside risks**. Risks to the outlook include delays in normalizing the security situation and lower international prices for oil and gas. Uncertainties in the security environment would constrain private-sector economic recovery and could impede the return of expatriate workers that are needed to alleviate workforce bottlenecks. Intensifying strains in the euro area and fragilities elsewhere have resulted in deteriorating financial conditions and escalated downside risks to global growth. Although hydrocarbon prices remain high, the economy remains vulnerable to a prolonged decline in oil prices.

**Short-term policy issues**. Libya must restore security, bring hydrocarbon production fully online, resuscitate the banking system, exercise fiscal discipline, maintain macroeconomic stability, and manage the sharply higher flow of reserves transparently and with good accountability. While the government needs to respond to short-term pressures to finance post-conflict economic recovery and social cohesion, increased current spending will weigh on fiscal sustainability and incentives for private sector development. Wage increases implemented by the previous regime will raise the wage bill from 10 percent of GDP in 2010 to 17 percent of GDP in 2012. Similarly, an increase in subsidies will raise their cost from 9 percent of GDP in 2010 to 14 percent in 2012. Although Libya can afford elevated current spending in the short term, the level of recurrent expenditure, if continued, is likely to be inconsistent with appropriate budgetary prioritization and fiscal sustainability, and would exert upward pressure on the real exchange rate. It will also be important for the Central Bank, as banking supervisor, to verify that the commercial banks have as clear a picture as possible of the impact of the recent conflict on their balance sheets, and to ensure that they have sufficient capital to cover losses and to continue lending during the reconstruction period.

**Medium-term challenges**. There is a need for a new vision for the Libyan economy. The main challenges are to promote inclusive growth by advancing private sector–led economic diversification, generating productive employment, enhancing competitiveness, improving governance, and strengthening social protection. On the macro-policy front, there is a need to enhance the public financial management (PFM) framework with a consistent fiscal rule that reflects economic objectives and volatility in hydrocarbon-based revenues. The sovereign wealth fund should be fully integrated into this framework. As a part of the PFM reform agenda, there is a need to enhance fiscal policy formulation over the medium term and help make the budget a strategic policy tool that links national policy objectives to economic performance.

## V. MOROCCO

*The short-term prospects remain broadly favorable, although the economic outlook is subject to important downward risks from an uncertain external environment. Negative real growth in Morocco's trading partners and a poor harvest will slow growth in 2012, while high oil and food prices will continue to put pressures on the external and fiscal accounts. The IMF Executive Board approved a US$6.2 billion arrangement for Morocco under the Precautionary and Liquidity Line (PLL) to support the authorities' economic program, which aims at rebuilding external and fiscal buffers and promoting higher and more inclusive growth. The PLL will provide insurance against exogenous shocks, strengthen investors' confidence, and facilitate access to private capital markets.*

**Background.** The political transition has proceeded smoothly, but pressures for reforms continue. A political reform process was initiated in March 2011 following social protests. A new constitution paving the way for broader reforms was adopted in July 2011 and elections were held in November 2011. The head of the Justice and Development Party formed a new coalition government in January 2012.

**Recent developments.** Despite headwinds, real GDP growth accelerated to about 5 percent in 2011, the highest rate in the region, boosted by strong investment and robust private consumption. Unemployment hovered around 9 percent, remaining particularly high among the youth at almost 18 percent. Inflation declined to about one percent, the lowest rate in the region. The current account deficit widened significantly, mainly due to rising oil prices. Higher oil prices also contributed to a widening of the fiscal deficit to about 7 percent, because of the increased cost of the generalized subsidies on fuel products. In June 2012, the authorities increased the price of a number of subsidized oil and food products, in order to contain the cost of the subsidies while making room for better-targeted social programs.

On August 3, 2012, based on Morocco's overall sound economic policies and framework, the IMF approved a two-year arrangement under its PLL in the amount of US$3.5 billion the first year and an additional US$2.7 billion the second year. The arrangement is to support the authorities' program. This program is built on fiscal consolidation, with a medium-term fiscal deficit target of 3 percent of GDP (including grants), to be achieved in part through subsidy reform and better targeting of social protection, and through structural reforms to boost potential growth, competitiveness, and employment.

**Morocco. Selected Economic Indicators, 2010–13**

| | | | Projections | |
|---|---|---|---|---|
| | 2010 | 2011 | 2012 | 2013 |
| GDP growth, percent | 3.7 | 4.9 | 2.9 | 5.5 |
| CPI inflation, percent 1/ | 1.0 | 0.9 | 2.2 | 2.5 |
| Fiscal balance, percent of GDP 2/ | -4.6 | -7.1 | -6.7 | -6.5 |
| Current account, percent of GDP 3/ | -4.6 | -8.4 | -8.6 | -6.8 |
| Fiscal financing needs, US$ billion 4/ | 4.9 | 7.9 | 7.4 | 7.5 |
| External financing needs, US$ billion 5/ | 5.4 | 9.8 | 9.9 | 8.5 |
| Public debt, percent of GDP | 51.3 | 54.3 | 58.1 | 58.9 |
| External debt, percent of GDP 6/ | 24.7 | 23.6 | 25.4 | 24.9 |
| Short term debt, percent of international reserves | 0.02 | 0.02 | 0.02 | 0.02 |

1/ Period average.
2/ Excluding grants.
3/ Excluding official transfers.
4/ Budget deficit excluding grants plus public external amortization. Assumes full domestic rollover.
5/ Current account deficit excluding transfers plus external amoritzation.
6/ Includes external publicly guaranteed debt.

**Short-term outlook.** Negative real growth in Morocco's trading partners and a poor harvest are projected to slow real GDP growth to 2.9 percent in 2012, while high oil and food prices will continue to put pressures on the external and fiscal accounts. Unemployment is expected to remain broadly stable. Average inflation is expected to remain low at about 2.2 percent, despite the effect of the recent increases in administered prices. The fiscal deficit is expected to be reduced to 6.1 percent in 2012 owing to the recent measures to contain the cost of subsidies and the authorities' efforts to increase revenue and contain nonessential expenditure.

**Downside risks.** Morocco faces external risks related to a marked deterioration in economic activity in the advanced trading partners, especially in the euro area, which could have sizeable real spillovers on growth and the balance of payments. Moreover, Morocco is vulnerable to a spike in international oil and food prices. Higher oil prices would also hurt Morocco's trading partners, further increasing the current account deficit and reducing growth. The PLL arrangement will support the authorities' policies by providing insurance against such exogenous shocks. The authorities do not intend to draw upon resources available under the PLL unless Morocco experiences actual balance of payments needs resulting from deterioration in external conditions.

**Short-term policy issues.** High oil prices contributed to a buildup of fiscal and external pressures. Rebuilding the eroded fiscal and external buffers remains crucial. In that context, moving ahead with the subsidy reform, containing the wage bill, and launching the reform of the pension system are crucial to further reducing the deficit and bringing it back to its medium-term target, and to ensuring long term sustainability of the pensions system. At the same time, it is important to put in place a well-targeted social protection program to ensure that those in most need are sheltered from the effects of the gradual withdrawal of generalized subsidies. The planned international bond issuance is a welcome step to help strengthen reserves buffers.

**Medium-term challenges.** A stable macroeconomic and financial environment and the authorities' comprehensive reform agenda are expected to improve competitiveness, increase potential growth, and promote more inclusiveness over the medium term. However, recent regional and domestic tensions have highlighted the importance of steadfast implementation of the planned social and economic reforms. These include: further improving the business climate and economic governance by enhancing transparency, accountability, and the rule of law, strengthening private-public partnerships, facilitating trade, developing infrastructure and alternative energy sources, increasing labor market flexibility, and promoting active labor market programs.

## VI. TUNISIA

*Following a recession in 2011, the 2012 economic outlook remains difficult owing to a deterioration of the external environment and investor wait-and-see attitude. A well-targeted countercyclical fiscal expansion would support short-term growth and job creation. Moreover, a broad set of reforms and prudent macroeconomic policies will be needed to boost private investment and put Tunisia on a higher growth and employment path over the medium term. Addressing pressing issues in the banking sector is an important priority. The Fund has been supporting Tunisia with policy advice and technical assistance.*

**Background**. The political transition is moving ahead, although social and regional tensions remain. The Constituent Assembly, elected in October 2011, is preparing a new constitution, which is expected to be followed by general elections in March 2013. In the interim, power has been shared by a coalition transition government. Political differences within the coalition government, tensions with opposition factions and labor unions, and the possible postponement of the elections have recently increased policy uncertainty.

**Recent developments**. After experiencing a severe recession in 2011, some signs of a rebound have emerged in 2012, with tourism and FDI picking up by 36 percent and 45 percent, respectively, during the first half of the year. Inflation reached 5.6 percent (y/y) in July, reflecting higher food prices and the impact of large liquidity injections. A slowdown in Europe and increasing capital goods imports led to further deterioration of the current account deficit (9 percent of GDP at end-July on an annualized basis), in spite of recovering tourism and remittance receipts. Despite large external disbursements (almost US$1 billion from Qatari loans and a US-backed bond issuance) and gradually rebounding FDI, foreign exchange reserves continued to decline to U$7 billion at end-July 2012 (3.4 months of imports) from $7.5 billion at end-2011. The fiscal balance recorded a slight surplus in the first half of 2012 because of significant delays in the implementation of the sizable growth-supporting public investment plan (a 20 percent execution rate as of end-June). Important financial sector vulnerabilities remain, despite some recent steps toward improving banking supervision and regulation.

**Tunisia: Selected Economic Indicators, 2010-13**

| | | | Projection | |
|---|---|---|---|---|
| | 2010 | 2011 | 2012 | 2013 |
| Real GDP growth (percent) 1/ | 3.0 | 0.0 | 2.7 | 3.3 |
| CPI inflation (percent) | 4.4 | 3.5 | 5.0 | 4.0 |
| Fiscal balance (percent of GDP) 1/ | -1.1 | -3.5 | -7.1 | -5.6 |
| Current Account (percent of GDP) | -4.8 | -7.3 | -7.9 | -7.7 |
| Fiscal financing needs (in US$ billion) 2/ | 1.6 | 2.7 | 3.5 | 3.3 |
| External financing needs (in US$ billion) 3/ | 4.1 | 5.6 | 5.4 | 5.3 |
| Public debt (percent of GDP) | 40.4 | 44.4 | 46.3 | 51.5 |
| External debt (percent of GDP) | 48.8 | 50.2 | 54.6 | 56.7 |
| Short term debt (percent of international reserves) | 52.3 | 68.5 | 64.1 | 67.5 |

1/ Overall fiscal deficit of the central government, excluding grants and privatization
2/ Overall budget deficit (excluding grants) plus public external amortization. Assume full domestic rollover.
3/ Current account deficit (excluding grants) plus amortization on external debt.

**Short-term outlook**. Tunisia's economic recovery remains fragile towing to a worsened external environment, continued social tensions, increasing policy uncertainty ahead of the elections, and the wait-and-see attitude of domestic and foreign investors. Economic activity in the rest of the year is expected to remain timid, with base effects carrying real GDP growth to 2.7 percent for 2012. Growth will be helped by an acceleration of public spending in the latter part of the year, but this will not be enough to make a significant dent in reducing unemployment (currently at 17.6 percent). Inflation will be contained at about 5 percent in the next few months, accompanied by credit growth deceleration as banks strive to improve their liquidity position. The pick-up in capital expenditure to support economic growth and job creation, particularly in disadvantaged regions, and a rising wage bill will widen the fiscal deficit to 7.1 percent of GDP. Tunisia's current account deficit is expected to widen to 7.9 percent of GDP by end-year, with its external financing needs for 2012 (US$5.4 billion) mostly met or already mobilized.

**Risks are still tilted to the downside**. A worse-than-anticipated recession in Europe would sharply hurt Tunisia's short-term growth prospects by further depressing exports, and hampering the rebound in tourism and FDI inflows. An escalation of domestic social tensions, fueled in part by continuing high unemployment, and increasing political uncertainty would impede foreign and domestic investment. On the upside, a rapid stabilization of the domestic social situation and in Libya could bolster trade and investors' confidence.

**Short-term policy issues**. A further rebalancing of the policy mix is needed to support Tunisia's short-term growth while preserving macroeconomic stability. In light of a difficult international environment, a better-targeted countercyclical fiscal expansion, relying more on a pick-up in public investment, could support short-term growth and job creation. Monetary policy should address inflationary pressures and more exchange rate flexibility (recent steps towards this have been initiated by the central bank) would help to stabilize official foreign reserves. Recent policy measures—a modest increase in the central bank's policy rate and retail fuel prices to contain energy subsidies and current expenditures—are helpful steps toward maintaining macroeconomic stability. Loan restructuring—particularly when applying international standards for loan classification—is necessary to limit the rise in nonperforming loans. Public debt would increase to 51½ percent of GDP in 2013, mostly reflecting the anticipated recapitalization of public banks.

**Medium-term challenges**. The key medium-term challenge is to address high structural unemployment, especially among the youth. Real GDP growth could reach 6 percent by 2017 if a broad set of structural reforms to foster private investment is implemented, together with appropriate macroeconomic policies. Needed reforms include improving governance and the business environment, reforming the labor market and the education system, and a comprehensive financial sector reform–including restructuring and recapitalization, bringing supervision in line with international standards, and improving banks' governance. Regional disparities also need to be addressed.

## VII. Yemen

*Despite a difficult political transition and social unrest, the government has been successful in maintaining macroeconomic stability. However, widespread poverty and unemployment, which increased further after the 2011 political crisis, urgently need to be addressed.*

**Background.** Even before the 2011 crisis, Yemen was facing severe economic and security problems. The oil production on which it heavily depends is in decline, its non-hydrocarbon sector is underdeveloped, poverty is widespread, and unemployment is very high. The country experienced a serious political crisis in 2011 that resulted in policy paralysis and shortages of basic commodities. After nearly a year of unrest, a political agreement was brokered by the Gulf Cooperation Council, leading to the formation of a national unity government in December 2011 and the election of a new president in February 2012. The new government has a two-year mandate to implement constitutional reforms and hold parliamentary elections.

**Recent developments.** The economic situation is very difficult. Economic activity fell by over 10 percent and inflation increased to 23 percent (y/y) in 2011, affected by the deterioration of security and shortages of fuel and other commodities. About one million workers lost their jobs, the number of people living in poverty increased to over 50 percent of the population, and child malnutrition increased. Despite these difficulties, the government succeeded in stabilizing the economy: the exchange rate stabilized at pre-crisis levels; foreign exchange reserves slightly increased to over US$4 billion (four months of imports); and inflation fell to single-digit levels in recent months. The IMF provided emergency support earlier this year, disbursing nearly US$100 million under its concessional window in support of the government's efforts to stabilize the macroeconomic situation. Oil grants from Saudi Arabia contributed in an important way to the improved macroeconomic and humanitarian situation, particularly while a key oil pipeline was disabled for most of 2011 and the first half of 2012.

**Yemen: Selected Economic Indicators**

| | | | Proj | |
|---|---|---|---|---|
| | 2010 | 2011 | 2012 | 2013 |
| Real GDP growth (percent) | 7.7 | -10.5 | -1.9 | 4.1 |
| CPI inflation (percent) | 11.2 | 19.5 | 15.0 | 12.7 |
| Fiscal balance (percent of GDP) | -4.0 | -4.3 | -5.7 | -6.0 |
| Current account (percent of GDP) | -4.4 | -3.0 | -2.7 | -4.0 |
| Fiscal financing needs (US$ billions) 1/ | 1.8 | 2.0 | 4.7 | 3.3 |
| External financing needs (US$ billions) 2/ | 2.2 | 2.3 | 3.7 | 2.5 |
| Public debt (percent of GDP) | 40.9 | 42.4 | 44.9 | 45.1 |
| External debt (percent of GDP) | 19.3 | 18.0 | 17.8 | 17.4 |
| Central bank reserves (US$ billion) | 5.1 | 4.0 | 4.1 | 3.6 |
| In months of imports | 6.0 | 3.7 | 4.0 | 3.3 |

1/ excluding grants, assuming full roll over of domestic debt.
2/ excluding grants, including amortization.

**Short-term outlook.** While the government has made strides in restoring normalcy, 2012 will be a difficult year. Economic growth is likely to remain anemic, especially since the oil pipeline was only recently repaired. The fiscal situation continues to be challenging: tax revenues have not recovered to pre-crisis levels, and capital and social expenditures remain very low. Monetary aggregates are showing mild signs of a recovery. Financing needs are large in view of the level of spending on social and investment projects needed for sustained growth and lower poverty and unemployment. Donors recently pledged about US$8 billion in support over the 2012-14 period to help address the many urgent problems facing the people of Yemen.

**Downside risks.** Yemen's economy faces considerable domestic and external risks. Prolonged political uncertainty and/or a worsening of the security situation could jeopardize the recovery. They could result in policy paralysis and undermine needed reforms, dent confidence, and shift resources from priority areas. Delays in translating donor pledges into concrete financial support could also impact the recovery and, possibly, the Government's determination and ability to move forward with economic reforms.

**Short-term policy issues.** The short term policy issues are to strengthen the budget by stopping the fall in tax revenues and reprioritizing expenditures toward pro-growth social and infrastructure projects. On the former, there is a need to move vigorously to stop the slide in tax compliance and widen the tax base. This would require strong political support to enable the tax administration to bring more large taxpayers under the GST net. On the latter, there is the need to gradually streamline fuel subsidies to make room for capital and social expenditures, which are critical for sustained growth and poverty reduction.

**Medium-term Challenges.** The fundamental economic weaknesses of the Yemeni economy are related to heavy dependence on declining oil production, an underdeveloped non-hydrocarbon sector, and a shortage of water resources. Maintaining macroeconomic stability and putting public finances on a sustainable medium-term footing will be challenging but necessary to move to a virtuous cycle where macroeconomic stability and higher investment contribute to sustained growth and employment. Building on macroeconomic stability and underpinned by sustainable public finances, a medium-term program would include a well-targeted social safety net to minimize the impact on the poor; civil service reforms; reprioritizing expenditures; and improving governance and transparency in line with the Government's Transition Plan. Progress in these areas would be instrumental to the recovery of the private sector and the creation of jobs and economic opportunities that Yemen urgently needs.