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

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I. REGIONAL ECONOMIC OUTLOOK AND KEY CHALLENGES

In an environment of heightened socio-economic tensions, regional insecurity, and strained public finances, the Arab Countries in Transition (ACTs)¹ face the difficult task of delivering on the expectations for jobs and growth. Despite patchy improvements in some countries, economic growth remains subdued, private investment is weak, and external and fiscal buffers are running low. Fostering social cohesion and avoiding a downward spiral of economic and political malaise calls for urgent implementation of economic reforms and coordinated support from the international community.

A. Background and recent developments

Three shocks undermine sentiment. The economic situation in the ACTs has become increasingly difficult amid a still weak external environment, rising regional tensions stemming largely from the civil war in Syria, and heightened domestic political uncertainty in many countries, at times accompanied by violence. As a result, private sector sentiment has worsened, private sector activity remains subdued, and private investment, particularly foreign direct investment, has slowed.

Growth is low and unemployment is rising. Average growth (excluding Libya) is expected to inch up to 3 percent in 2013 from 2½ percent in 2012, with the marginal pick-up reflecting a nascent recovery of tourism and exports, increased post-crisis capacity utilization, and a post-drought rebound of agriculture in Morocco. This moderate growth is not generating the jobs needed to stem the rise in the number of unemployed, which has increased by more than 1 million people since early 2010.

Progress with reforms has been uneven, further straining public finances. Budget deficits remain elevated, averaging 9 percent of GDP in 2012 (excluding Libya) owing to weak revenue collection and weaker-than-expected fiscal consolidation efforts. In Egypt and Jordan, high levels of public debt (more than 80 percent of GDP) further limit fiscal space. Meanwhile, inflation pressures have begun to ease in most ACTs helped by lower food and energy prices and weak demand. Foreign exchange reserves have stabilized for now, reflecting a gradual narrowing of current account deficits and, notably in Egypt, external financial support. Nevertheless, reserve buffers remain low relative to the underlying vulnerabilities.

B. Short-term outlook

Private investment and growth are anemic. The current challenges faced by the ACTs are likely to persist over the near term. Revitalizing private sector activity will require political stability and strong policy efforts to improve the business climate. This will take time. Meanwhile, we expect only a gradual recovery in 2013–14, with average GDP growth at about 3 percent.

¹ The ACTs are Egypt, Jordan, Libya, Morocco, Tunisia, and Yemen.

Inflation is expected to stabilize in the upper single digits and the current account and fiscal deficits could begin to narrow gradually, but will remain elevated. Consequently, public debt and unemployment in most countries are likely to continue creeping up.

Significant downside risks. Risks to this already sobering outlook are significant, and mostly to the downside. The Syrian crisis, recent domestic political tensions, and incidences of increasing violence have the potential to intensify further and bring growth to a halt. This would have strongly negative consequences for labor markets in the region. First, an increased flow of refugees could overburden budgets of Syria's neighboring countries, while damaging trade, confidence, and growth in the region more broadly. Equally damaging could be setbacks to the political transitions as well as an escalation of violence in Libya, Tunisia, Egypt, or Iraq, which would further delay economic reforms and deter investment. In some countries, new disruptions to energy supplies (for example, oil production in Libya or Jordan's gas imports from Egypt) would take a toll on fiscal and external positions. Finally, and with somewhat lower probability, weaker global—notably European—growth could slow recovery of exports and foreign inflows.

C. Short-term policy issues

The employment imperative. Social cohesion and public support for the ACTs' economic transitions depend to a large extent on the authorities' ability to reduce unemployment—a key source of social tensions. With the private sector still on the sidelines, temporarily scaling up public spending on infrastructure and basic services could provide a much-needed short-term boost to growth and stabilize unemployment in the short run.

The fiscal conundrum—finding fiscal space in spite of budget shortfalls. Identifying the fiscal space for such scaling up in the face of high budget deficits and mounting public debt is the key challenge for policymakers. In practice, the strategy will need to rely on three pillars:

- *Reallocating public expenditure.* This entails phasing out poorly targeted and costly subsidies, and directing the savings toward public investment and better-targeted safety nets for the poor. These reforms are advancing markedly in Jordan, Morocco, and Tunisia, but they are yet to achieve significant progress in some other countries.
- *More gradual fiscal consolidation.* A more gradual pace of fiscal adjustment could be warranted in the short run if: a) it does not compromise medium-term fiscal targets anchored on maintaining macroeconomic stability; and b) adequate financing is available. In most cases, there will be little room to rely on additional domestic financing without a further increase in interest rates and thus worsening financing conditions for the private sector.
- *Obtaining additional affordable external finance.* Even with continued fiscal reforms, scaled-up external financing on affordable terms will have to be an important element of the funding package for any increase in public spending.

Need to maintain macroeconomic stability. Turning to the broader macroeconomic agenda, governments in the region will have to navigate carefully over the next two years along a narrow path of often conflicting objectives. In particular, policies will have to aim at reducing fiscal deficits and debt; enhancing the quality of spending; supporting domestic demand in the context of weak private sector activity; rebuilding external reserve buffers and facilitating external adjustment through increased exchange rate flexibility and saving some external receipts; and containing inflation through sterilizing some of the government expenditure and avoiding monetization of budget deficits. This calls for country-specific policy configurations which reflect these trade-offs, prioritization of the authorities' goals, and the available set of policy instruments.

D. Medium-term challenges

Structural reforms to ignite private sector-led growth. The economies of the ACTs have a vast potential for strong and sustainable private sector-led growth. They represent a large market with a young population and a large labor force, with many on the job market having attained secondary or tertiary education levels. Realizing this potential requires reforms across a multitude of areas to create better conditions for entrepreneurship and achieve higher living standards (text chart). Many reforms will take several years before affecting economic outcomes; they should be initiated without delay.

Quick wins. Early actions that generate “quick wins” would strengthen confidence in the authorities' dedication to the reform process. For example:

- Greater transparency of the budget process, public hiring and procurement, as well as project selection for public investment would help to demonstrate the authorities' commitment to accountability while improving economic opportunities and raising efficiency of public spending.
- Safety nets for the most vulnerable groups could be strengthened by improving targeting of social assistance. To this end, poorly targeted and costly subsidies could be phased out to enable scaling up of means-tested social assistance. And mechanisms should be put in place to quickly and in a transparent manner identify and reach out to the ones most in need.
- Initiation of a dialogue with the business community to identify and streamline the most binding business regulations, including those affecting labor markets, would encourage investors.

Arab Countries in Transition: Structural Reform Agenda



- Fostering partnership with large investors to reform vocational training and develop training programs, particularly for women and the youth, could help tackle persistent unemployment while improving productivity.
- Bankruptcy, provisioning, and collateral regulations could be strengthened, credit bureaus developed, and market infrastructure improved to reduce risk premia and improve access to credit.
- Alongside, the authorities should work to strengthen anti-monopoly regulations and institutions to facilitate market development and seek deepening trade integration to open up new business opportunities.

E. Role of the international community

Countries are in the drivers' seat. National dialogues on a way forward—facilitated by active and open communication and outreach by the authorities—need to focus on broader growth-promotion strategies through deep structural reforms with clear, realistic, and tangible policy commitments and outcomes. Consensus on and speedy implementation of these country-specific agendas are urgently needed. Common elements of such strategies could include targeting quality and efficiency gains in the provision of public services, enhanced social protection, better transparency and governance in the public sector, education reforms, and other structural measures to upgrade the business climate.

Vital role for external support. The ACTs' external partners should continue to support the economic transformations through actions in the following areas:

- *Scaling-up external financial support.* External official disbursements since the onset of the Arab Spring (totaling around US\$38 billion) have covered only a small share of the transition countries' financing gaps, notwithstanding significant contributions from the Gulf Cooperation Council (GCC) countries. Going forward, more financial support, most urgently for increased public spending on infrastructure and basic services as well as for smoother fiscal consolidation, will be critical for economic recovery and socially acceptable transitions.
- *Facilitation of trade and FDI.* Most importantly, progress with agreements to promote trade, regulatory convergence, and FDI will be needed to help build market-based recoveries and sustained growth for the ACTs. Early progress would help build public confidence in the process of negotiating such agreements and in the long-term sustainability and adequacy of support from the international community.

Arab Countries in Transition: Financing Needs¹
(Billions of U.S. dollars)

	Est.		Projections	
	2011	2012	2013	2014
Current account deficit (excl. official transfers)	26.5	31.9	28.0	29.4
External amortization	14.3	14.3	14.8	22.7
External gross financing needs²	40.8	46.3	42.8	52.1
Budget deficit (excl. grants)	37.1	46.9	55.7	61.1
Public external amortization	5.4	5.4	6.0	8.3
Fiscal financing needs³	42.5	52.2	61.6	69.4

Sources: National authorities; and IMF staff calculations.

¹Comprises: Egypt, Jordan, Morocco, Tunisia, and Yemen. Libya does not face financing needs.

²Current account deficit, excluding grants, plus amortization.

³Budget deficit, excluding official grants, plus public external amortization.

- *Technical assistance.* The reform process in the ACTs suggests a number of potential areas for further technical assistance and capacity building, including public finance management, reform of social safety nets, civil service reforms, financial sector reforms to improve access to finance for small- and- medium-scale enterprises, tax and customs policy and administration, pension, education and other social sector reforms. The Deauville Partnership's Transition Fund (Box 1) has started to play an important role in this regard.

IMF engagement. For its part, the IMF is ready to engage with the country authorities and other donors on these matters, building on the analysis, policy advice, and capacity building support it has been providing to all ACTs and other countries in transition. As regards financing support, the IMF has committed about \$10 billion in financing arrangements with Jordan, Morocco, Tunisia, and Yemen; and is in discussions on a possible medium-term arrangement with Yemen.

Box 1. The Middle East and North Africa (MENA) Transition Fund (TF)

The MENA TF, with a total envisaged endowment of US \$250 million, was established in 2012 by the Deauville Partnership as a joint venture among the G-8 countries, Gulf partner countries and Turkey, and international and regional financial organizations. Its objective is to support the ACTs in formulating policies and programs and implementing reforms that aim to bring about sustainable, inclusive growth over the medium-term, while strengthening transparency and accountability in governance.

The TF's Steering Committee has so far approved 24 projects for all ACTs. They cover such areas as support to micro, small, and medium enterprises (Egypt, Jordan, Libya, Morocco, Yemen), energy sector reform (Egypt, Tunisia), access to water (Jordan), targeted social assistance (Jordan, Tunisia), labor market policies (Jordan), public-private partnerships (Tunisia), civil society dialogue (Yemen), leadership development and governance (Morocco, Tunisia, Yemen) and regional integration through trade and transport (Egypt, Jordan, Morocco, Tunisia).

Over the past nine months, the TF has evolved into a key vehicle to support the ACTs' capacity-building efforts in the areas of structural reforms identified in the main text. It is particularly suited for this role: it was designed to be rapid, flexible, and responsive in providing grant support for technical cooperation; and it facilitates coordination and prioritization of work programs across donors and the ACTs governments. Perhaps most importantly, the TF can stay involved long enough to help with the implementation of reforms, not only with their design.

TF projects have focused in particular on the following priorities in response to the countries' key development needs and should continue to do so:

Building strong institutions to help establish improved accountability and governance. Specific efforts are expected to focus on reforms in the areas of public financial management (budgeting, budget execution and cash management, and reporting), public procurement (transparency in awards, increased competition, improved public service delivery and better public funds management), and financial sector strengthening (banking supervision and financial sector stability and capital market development). Strengthening the quality of statistics could become another key component of this work program.

Promoting trade integration. Specific efforts could focus on measures that have the potential to show immediate effects, to bridge the time until the ACTs will reach or upgrade free trade agreements with their major trading partners.

Helping policies become more equitable and inclusive. Specific efforts could concentrate on reducing untargeted subsidies to create room for targeted social safety nets and on putting in place a more efficient and fairer tax system to ease distortions, improve revenue administration, and thereby increase long-term growth prospects.

Lowering the cost of doing business. This agenda would require focus, inter alia, on removing impediments to entry and exit and streamlining business regulations.

The impact of the TF on the ACTs' reform efforts depends on the quality of its project pipeline, as well as on its capacity to meet currently strong project demand with its financial resources. At present, \$103 million have already been committed in less than six months. There is clearly strong demand from the ACTs, which represents ample opportunity for donors to engage. Effort will continue to be made to ensure that the projects financed by the TF are demand- rather than supply-driven.

II. EGYPT

Political uncertainty and social unrest have kept growth low for a third straight year, impacted policy performance, and clouded the economic outlook. Financial fragilities have continued to build up with rising fiscal deficits, arrears, inflation, and debt, as well as low external buffers. Recent financial support, mainly from the GCC, bolstered reserves and provided a window to tackle fiscal and external imbalances, including through subsidy reforms. Structural reforms are also needed to create strong inclusive growth and higher employment.

Background. The political transition that started two and a half years ago continues to be difficult. In July, widespread dissatisfaction with government performance, which culminated in massive demonstrations, led to the overthrow of the recently elected president, the suspension of the constitution, and the installation of an interim government. The latter announced a new political roadmap that aims at revising the constitution and holding parliamentary and presidential elections during the next year. This said, the political environment remains polarized and sometimes violent unrest continues. Meanwhile, fiscal reforms have slowed and social tensions remain high.

Recent developments. Real GDP growth slowed further in 2012/13, in part due to political turmoil toward the end of the fiscal year, and the unemployment rate has remained above 13 percent. Inflation doubled to 10 percent in August 2013 in the eight months since December 2012. The budget sector deficit in 2012/13 is estimated at 14.1 percent of GDP and the public debt at 90 percent of GDP. The worsening fiscal position and rising energy subsidies have led to the accumulation of substantial external arrears by the public oil company (EGPC), weighing negatively on foreign investment in the energy sector. The ensuing slowdown in energy production has further increased the budgetary cost of energy subsidies. Due to limited access to international financial markets, the government has increased its recourse to bank financing including central bank overdraft facilities, thereby crowding out the private sector. Operational restrictions in the foreign exchange market and limited exchange rate flexibility are reflected in a parallel market premium. Substantial financial disbursements and in-kind grants (oil and LNG shipments) from partner countries (Kuwait, Libya, Qatar, Saudi Arabia, and UAE) in 2013 have helped to rebuild international reserves, which now stand at around three months of imports, and more recently have produced some decline in domestic T-bill rates.

Egypt: Selected Economic Indicators, 2010/11 - 2013/14
(Percent of GDP, unless otherwise indicated)

	Projections			
	2010/11	2011/12	2012/13	2013/14
GDP growth, percent	1.8	2.2	1.8	2.8
CPI inflation, period average, percent	11.1	8.6	6.9	10.3
Budget sector balance	-9.8	-10.8	-14.1	-13.1
Current account balance, excl. grants	-2.9	-3.3	-2.9	-3.6
Fiscal financing needs, (excl. grants), US\$ billion ¹	25.4	31.2	39.9	47.9
External financing needs (excl. grants), US\$ billion ²	11.9	13.4	12.8	22.7
Public debt	76.6	80.6	89.5	91.8
External debt	14.8	13.4	16.2	18.8
Reserves in months of imports	4.7	2.7	2.6	3.0

Sources: National authorities; and IMF staff calculations.

¹Budget sector deficit, excluding official grants, plus public external amortization.

²Current account deficit, excluding grants, plus amortization.

Short-term outlook. The pledged financial support from Kuwait, Saudi Arabia, and UAE (about \$ 12-15 billion) would help Egypt meet its financing needs during the next year or so. It has also created some fiscal space allowing the interim government to announce in August a fiscal stimulus package consisting of 1.2 percent of GDP in additional investment spending to support

growth and create jobs. Nonetheless, because of the disruptions in the manufacturing and tourism sectors, growth is expected to remain subdued in FY 2013/14. The budget deficit will remain elevated, unless the authorities move ahead quickly with their plans to reform subsidies and implement other fiscal measures. Inflation is projected to rise further, reflecting persistent supply-side bottlenecks and continued money expansion.

Risks. The main risk is that heightened political uncertainty and further escalation of violence would reduce confidence and increase external and budgetary pressures. Also, the rise in regional turmoil, in particular the conflict in Syria, could delay the resumption in FDI and tourism and can potentially affect Suez Canal revenues. Higher food and energy prices would place an additional burden on the budget and worsen the external position. On the other hand, a rapid emergence of a broad and inclusive political process would restore confidence and accelerate the return of private investors.

Short-term policy issues. The immediate priority is to restore macroeconomic stability by strengthening public finances, steadying the foreign exchange market, and reducing inflation while preserving competitiveness. Stimulus spending should be efficient and reversible to avoid exacerbating underlying economic vulnerabilities. Shifting budgetary resources towards infrastructure, education and health spending, as well as defining a clear strategy for settling domestic and external arrears will be important to improve growth prospects. Designing and announcing a credible medium-term fiscal framework will help anchor expectations and support confidence in the fiscal solvency. Removing the restrictions to price discovery in the foreign exchange market would help preserve competitiveness of the economy and address external imbalances.

Medium-term challenges. The medium-term priorities should be achieving higher and inclusive growth while rebuilding fiscal and external buffers. Promoting the role of the private sector would unleash Egypt's underexploited economic potential. Egypt has lost significant ground to its peers in terms of business climate and competitiveness. The immediate task is to streamline burdensome regulations, improve access to financing, and modernize insolvency and land management laws. At the same time, increasing investment in human capital and removing bottlenecks to investment in the electricity and transport sectors would help boost economic activity and provide more equal access to job and business opportunities for all segments of society. Over the medium-term, bringing the budget balance back on a sustainable path is essential. This requires regaining control of public expenditures, including reforming energy subsidies and containing the wage bill, and mobilizing additional revenue. Further external financial-support could provide the breathing room necessary to smooth the fiscal consolidation and develop well-targeted social safety nets. Potential areas for further technical assistance from Egypt's external partners include: public finance management; subsidies and social safety nets; civil service reform; and access to finance for small- and- medium-sized enterprises (SMEs).

III. JORDAN

Jordan's economy continues to suffer from exogenous shocks. These include regional unrest, especially in neighboring Syria and Egypt, and energy supply problems. Nevertheless, fiscal and external balances are gradually improving and the macroeconomic situation has remained stable. The authorities are implementing a national reform program to correct domestic and external imbalances through fiscal and energy policies, while fostering higher and more inclusive growth. The first review under Jordan's program with the IMF, supported by a Stand-By Arrangement, was completed in April 2013.

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 some structural reforms to develop the private sector, unemployment remains persistently high, averaging 13.7 percent during 2000–12. Unemployment is largely a youth phenomenon—29 percent of young people (ages 15 to 24) were out of jobs in 2012 and accounted for almost half of total unemployment. Political reform has been gradually progressing. The election law was amended in 2012, to support the move toward a multi-party political system, and the new parliament elected in January 2013 is playing a more visible role.

Recent developments. Despite a challenging environment, the macroeconomic situation remained broadly stable through mid-2013. Growth increased slightly to 2.6 percent in the first quarter, while inflation eased somewhat to 5 percent in August, as the impact of the fuel price liberalization in late 2012 faded. Gas inflows from Egypt increased in the first half of the year, reducing expensive fuel imports for electricity generation. In July, however, gas delivery was again interrupted following an attack on the pipeline, and has not yet resumed. This, together with high global oil prices and a growing number of Syrian refugees in Jordan (over 530 thousand as of mid-September, according to the United Nations) put pressure on fiscal and external accounts. Nonetheless, the authorities' IMF-supported program has stayed broadly on track owing to tight management of the central government budget. An increase in electricity tariffs for most economic sectors on August 15 (households were exempted) is expected to reduce the electricity company's (NEPCO) losses. The Central Bank of Jordan (CBJ) managed well the temporary pressures on reserves in late-2012, which, since then, have been rebuilt, helped by significant reduction in the trade balance, sizeable grants from the Gulf Cooperation Council countries, and two successful U.S. dollar-denominated domestic bond issuances.

Jordan: Selected Economic Indicators, 2011 - 2014
(Percent of GDP, unless otherwise indicated)

	Projections			
	2011	2012	2013	2014
GDP growth, percent	2.6	2.8	3.3	3.5
CPI inflation, period average, percent	4.4	4.8	5.9	3.2
General government balance, excl. grants ¹	-11.7	-10.3	-13.3	-11.3
Current account balance, excl. grants	-19.0	-22.8	-16.9	-14.2
Fiscal financing needs, (excl. grants), US\$ billion ²	3.8	3.7	5.2	4.7
External financing needs (excl. grants), US\$ billion ³	6.0	7.6	6.4	5.8
Public debt	70.7	79.6	83.8	87.0
External debt	21.9	23.4	25.4	25.6
Reserves in months of imports	5.9	2.9	3.9	4.9

Sources: National authorities; and IMF staff calculations.

¹Starting in 2013, the government balance includes direct transfers to NEPCO.

²Budget deficit, excluding official grants, plus public external amortization.

³Current account deficit, excluding grants, plus amortization.

Short-term outlook. Real GDP growth is expected to gradually accelerate to about 3.3 percent in 2013 and 3½ percent in 2014, reflecting an increase in government capital spending and domestic consumption, as well as improved performance of the tourism and financial sectors. Inflation is expected to decline to about 3 percent by end-2013. The external current account deficit, while remaining sizable, is projected to improve significantly because of higher grant financing and lower energy imports. In combination with a pickup in confidence and a stronger capital account, this will allow the CBJ to maintain a strong reserve position. The central government deficit (excluding grants) is projected to narrow by about 2 percent of GDP in both 2013 and 2014—helped mostly by the elimination of nearly all fuel subsidies and by the planned implementation of revenue-generating measures.

Risks. Jordan is exposed to spillovers from neighboring Syria. An escalation of the civil war could lead to a further inflow of refugees, adding pressure on public finances. It could also affect FDI and private sector confidence. Furthermore, a continued disruption in gas supplies from Egypt would weaken the current account and increase NEPCO losses (by as much as 1.3 percent of GDP in 2013 and 2 percent of GDP in 2014). Other risks stem from lower growth, higher global oil prices, and any delays in implementing the energy strategy designed to bring NEPCO back to cost recovery. Any decrease in confidence could translate into renewed pressure on reserves.

Short-term policy issues. Steadfast implementation of the authorities' reform program is needed to keep the fiscal and external balances on a sustainable path. On the fiscal front, consolidation will remain gradual to prevent jeopardizing growth prospects and social cohesion. The envisaged measures in 2014 include an increase in government investment and cuts in less productive spending, as well as improvements in tax administration and public financial management. On the energy front, the strategy to return NEPCO to cost recovery includes the implementation of announced electricity tariff increases and the completion, by end-2014, of a liquefied natural gas terminal in Aqaba that would make Jordan less dependent on gas supplies from Egypt. To help maintain international reserve buffers, monetary policy will remain focused on maintaining the attractiveness of dinar-denominated assets. Furthermore, with fiscal and external buffers running low, mobilizing upfront additional grant financing will continue to be critical to ensure macroeconomic stability.

Medium-term challenges. To strengthen debt sustainability, fiscal consolidation should continue in the medium-term through tax and expenditure reforms. At the same time, the burden of reforms on vulnerable groups needs to be minimized through well-targeted social assistance and creation of quality jobs. Public debt would be reduced by bringing NEPCO back to cost recovery through the implementation of Jordan's strategy to establish transparent and sustainable energy prices, diversify energy sources, and increase energy efficiency. In parallel, fostering high and more inclusive growth will require implementing structural reforms aimed at improving the business environment and enhancing access to finance, while improving labor market skills through education and training reforms. This agenda offers opportunities for possible technical assistance, including in the areas of tax administration and public financial management.

IV. LIBYA

After a brief period of calm following the February 2011 revolution, Libya is experiencing a new wave of instability and turmoil. The resulting drop in oil exports is undermining the already poor fiscal outlook. Containing the large fiscal pressures requires restraining current spending, including through streamlining general subsidies and putting a lid on public sector employment. Implementation of structural reforms to enhance transparency and accountability, and building effective state institutions in the areas of public finances and the monetary authority are key priorities. In the long term, economic and political stability will hinge on reducing dependency on oil and building a broad-based high-employment economy.

Background. Restoration of hydrocarbon output underpinned economic recovery following the 2011 revolution, resulting in a doubling of real GDP in 2012. Consumer price inflation fell, with a year-on-year rate of -3.7 percent in December 2012. The overall budget balance moved to a surplus of 20.8 percent of GDP in 2012, from a deficit of 18.7 percent in 2011. Similarly, the current account surplus widened to 36 percent of GDP, from 9 percent in 2011. Broad money increased by 11.5 percent, with a modest shift from currency into deposits, and credit to the private sector rose by 24 percent.

Recent developments. Attacks on oil production and export facilities across Libya nearly halted oil production during the summer of 2013. As of end-September, reports suggest that output was approximately 40 percent of capacity, at about 0.6 million barrels per day (bpd), significantly lower than the envisaged 1.7 million bpd. In the year through end-June, base money increased by 6 percent with a shift from currency to deposits; currency decreased by 11 percent while deposits increased by 16 percent. Nevertheless, the boom in private-sector deposits, triggered by the removal in June 2012 of restrictions on withdrawals introduced during the revolution, has come to an end. As of June, deposits had declined by 12 percent relative to peaks reached in February 2013. Meanwhile, growth in central bank reserves has moderated as oil export receipts have declined.

Libya: Selected Economic Indicators, 2011 - 2014
(Percent of GDP, unless otherwise indicated)

			Projections	
	2011	2012	2013	2014
GDP growth, percent	-62.1	104.5	-5.1	25.5
CPI inflation, period average, percent	15.9	6.1	3.6	9.4
General government balance, excl. grants	-9.2	19.3	-7.4	-5.9
Current account balance, excl. grants	8.4	28.6	-5.5	-5.3
Fiscal financing needs, (excl. grants), US\$ billion ¹
External financing needs (excl. grants), US\$ billion ²
Public debt	0.0	0.0	0.0	0.0
External debt	16.1	6.8	7.9	5.9
Reserves in months of imports of imports	35.6	35.0	26.2	21.5

Sources: National authorities; and IMF staff calculations.

¹Budget deficit, excluding official grants, plus public external amortization.

²Current account deficit, excluding grants, plus amortization.

Short-term outlook. The oil output forecast for 2013 has been reduced to 1 million bpd. This implies a contraction of about 5 percent in the real economy during 2013. This revision will also bring forward the onset of budget and balance of payment deficits. Staff projects collected revenue to increase to 61 percent of GDP in 2014, which would lead to a budget deficit of 6 percent of GDP. The deficit will be financed by drawing down on government deposits at the central bank, of about \$60 billion.

Risks. Turmoil in Libya is intertwined with weak state institutions, and their inability to deliver basic services, particularly law and order. Trust in government is eroding on the backdrop of interregional tensions, further weakening the state and creating a vicious circle of declining legitimacy and effectiveness. Uncertainty is keeping investors away and prompting those who are active to scale down their activities. Lack of necessary maintenance and investment in oil infrastructure, will further reduce output and export capacity for the medium-term. Bottlenecks, and political and security challenges are likely to place an upward pressure on inflation.

Short-term policy issues. The rapid deterioration of the fiscal outlook adds urgency to the need to contain current spending and improve the quality of the budget process. Public expenditure should be reoriented from wages and subsidies to service delivery and institution building. Strengthening public finance management, with a focus on enhancing transparency, accountability and the efficiency of public spending is necessary to restore both fiscal sustainability and trust in government. It is also necessary to continue to build capacity at the central bank to improve the management of public wealth and facilitate the development of the financial sector as a key driver for private-sector led growth.

Medium-term challenges. For Libya to move away from total dependency on oil, to a sustainable and inclusive path, it would be necessary to create the conditions for diversified, private-sector led growth. This will require, among others, enhancing the business environment, upgrading the skills of the workforce through better education and training, fostering financial intermediation, and investment in physical, regulatory and institutional infrastructure.

V. MOROCCO

Morocco faces a difficult environment for reforms, with high expectations and a challenging socio-political context. Buoyed by an exceptional agricultural output, overall economic activity is expected to register a healthy increase this year. But nonagricultural activity has slowed, dragged down by weak external demand. Inflation has remained low. After widening significantly in 2012, the fiscal and current account deficits are expected to decline in 2013, even though fiscal performance is being hampered by the detrimental impact on revenue of the underlying slowdown in activity. The authorities have taken steps to reduce fiscal and external vulnerabilities. In particular, in an effort to shield the budget from international oil price fluctuations, they recently introduced a mechanism to partially index the prices of some subsidized petroleum products to international prices. The second review under the IMF's Precautionary and Liquidity Line (PLL) was completed in July 2013.

Background. A political reform process was initiated in March 2011 following social protests. A new constitution was adopted in July 2011, followed by elections and the formation of a coalition government in January 2012. Tensions within the coalition led to the resignation of ministers from the main junior party, Itsiqlal. Negotiations to form a new coalition have been protracted. The challenge for the authorities has been to sustain difficult reforms in a context of high expectations, a challenging political landscape, and an unfavorable regional and global environment.

Recent developments. Non-agriculture activity slowed in the first half of 2013 while inflation remained low at 2.3 through August 2013. Unemployment has remained at about 9 percent since 2012 and is particularly elevated among the youth (about 18 percent). Lower-than-expected tax revenue due to lower income tax receipts from some large corporations and a fall in customs tax inlays have negatively affected public finances through July 2013. On August 29, the authorities introduced a partial indexation of some subsidized fuel products to international prices, which resulted in price increases between 5 and 15 percent. While this led to some protests especially from the transportation sector, these have been relatively limited. The trade balance has improved thus far in 2013, notably on account of lower fuel and food imports although the situation in the Euro zone, Morocco's main trade partner, continues to weigh on export performance. International reserves have stabilized at about four month of imports. The second review under the two-year PLL arrangement (\$6.2 billion) with the IMF was concluded in July 2013. The authorities do not intend to draw upon resources available under

Morocco: Selected Economic Indicators, 2011 - 2014
(Percent of GDP, unless otherwise indicated)

	Projections			
	2011	2012	2013	2014
GDP growth, percent	5.0	2.7	5.1	3.8
CPI inflation, period average, percent	0.9	1.3	2.3	2.5
General government balance, excl. grants	-6.9	-7.7	-6.5	-6.2
Current account balance, excl. grants	-8.4	-10.2	-8.2	-7.4
Fiscal financing needs, (excl. grants), US\$ billion ¹	8.3	9.0	8.5	8.8
External financing needs (excl. grants), US\$ billion ²	9.8	11.4	10.5	10.3
Public debt	54.4	60.5	61.8	63.1
External debt ³	25.1	29.8	31.3	31.3
Reserves in months of imports	5.0	4.2	4.3	4.1

Sources: National authorities; and IMF staff calculations.

¹Budget deficit, excluding official grants, plus public external amortization.

²Current account deficit, excluding grants, plus amortization.

³Includes external publicly guaranteed debt.

the PLL unless Morocco experiences actual balance-of-payments needs resulting from a significant deterioration in external conditions.

Short-term outlook. Growth is expected to accelerate to about 5 percent in 2013 on account of an exceptionally strong harvest and despite slower nonagricultural growth. Growth is expected to slow to 4 percent in 2014 as agriculture growth normalizes. Inflation is projected to remain at about 2½ percent in 2013-14, notwithstanding recent increases in the prices of some energy products. The current account deficit is expected to contract as a result of the planned reduction in the fiscal deficit; lower global energy prices; lower food imports resulting from the recovery in agriculture; weaker domestic demand; and exports from newly developed sectors resulting from recent foreign investments.

Risks. A persistent spike in international oil prices would add pressure to the already high fiscal and external deficits. In addition, a protracted period of slower growth in the advanced trading partners, especially in the euro area, could have sizeable spillover to growth and the balance of payments. Pressing social demands, ongoing tensions in the region and a shifting political context may slow the pace of implementation of the necessary reforms.

Short-term policy issues. Ensuring macroeconomic stability by rebuilding fiscal and external buffers and moving ahead with difficult but necessary reforms in a challenging environment remain crucial. In particular, the authorities' plan for fiscal consolidation needs to be pursued and the fiscal framework strengthened. The costly universal subsidies should be replaced by well-targeted social programs that benefit those most in need. In a difficult context, effective communication will be important to adhere to the medium-term path, show citizens the benefits of the planned reforms, and ultimately protect policy credibility.

Medium-term challenges. Preserving fiscal sustainability is the key challenge. To this end, the authorities need to meet their medium-term targets on the wage bill, reform the pension system, and strengthen the tax system by broadening the base and reducing tax evasion. To improve competitiveness and achieve more inclusive growth, there is a need to accelerate structural reforms aimed at job creation to reduce high unemployment especially among the youth, and further improve the business climate and economic governance by enhancing transparency, accountability, and the rule of law. Morocco would also benefit from moving toward greater exchange rate flexibility to enhance external competitiveness and strengthen the economy's ability to absorb shocks. This agenda presents substantial needs for further technical assistance, particularly in the areas of taxation, the budget monitoring process, as well as on further strengthening the monetary policy framework and exchange rate management.

VI. TUNISIA

Renewed domestic political tensions, increased security incidents, and a subdued international economic environment are weighing on Tunisia's economic performance and, in particular, the government's ability to progress with important economic reforms. Economic activity has slowed and inflation remains high, even after having been contained, while both the current account and fiscal deficits have widened further. The composition of external financing has recently shifted to more short-term flows and donor financing for the year is expected to fall short of amounts envisaged. The government has adopted a national economic program focused on preserving macroeconomic stability and supporting growth and social cohesion. The IMF is supporting Tunisia with a two-year Stand-By Arrangement approved in June (US \$1.75 billion).

Background. The assassination of an opposition politician in July has led to a protracted political crisis that is delaying the transition and weighs on the economic outlook. Discussions between members of the ruling coalition, the opposition, and civil society are ongoing on the possible dissolution of the current government and the formation of a technocratic government. Agreement on a timetable for finalizing the constitution and organizing the elections are also part of the discussions. Implementing the economic reform agenda enjoys broad political support, but the associated legislation is delayed by the current political impasse and the priorities of the National Constituent Assembly, which has just resumed its activities. Lack of clarity in the political transition and setbacks in the security situation have led to further rating downgrades and reinforced investors' "wait and see" attitude.

Recent developments. Preliminary data indicate that growth has reached 3 percent y-o-y for the first half of 2013, driven by a strong resumption of chemical and mining activities, and despite a sharp decline in agricultural production. Unemployment declined to 15.9 percent (from 16.7 percent at end-2012), but remains high among the youth and female graduates. Declining food prices pushed headline inflation down to 6 percent y-o-y in August. Lower imports of raw materials and capital goods kept the current account deficit for the first half of 2013 at about 4 percent of GDP (in line with program projections), while the composition of external financing has shifted to more short-term flows than anticipated. Nevertheless, pressures on the foreign exchange market persisted, and the exchange rate has depreciated by about 7 percent vis-à-vis the euro and the U.S. dollar since the beginning of the year.

Short-term outlook. With the prospect of elections in the first half of 2014 and relatively subdued growth in Tunisia's trading partners, economic growth is likely to average 3 percent in 2013 and 3.7 percent in 2014. Inflation is

Tunisia: Selected Economic Indicators, 2011 - 2014¹
(Percent of GDP, unless otherwise indicated)

	2011	2012	Projections	
			2013	2014
GDP growth, percent	-1.9	3.6	3.0	3.7
CPI inflation, period average, percent	3.5	5.6	6.0	4.7
General government balance, excl. grants	-3.4	-5.3	-7.7	-6.8
Current account balance	-7.9	-8.7	-8.5	-7.1
Fiscal financing needs, (excl. grants), US\$ billion ²	3.0	3.6	4.7	4.5
External financing needs (excl. grants), US\$ billion ³	10.7	11.1	11.0	10.7
Public debt	44.0	44.0	45.5	49.7
External debt	47.6	51.4	52.1	55.2
Reserves in months of imports	4.3	3.8	3.9	4.2

Sources: National authorities; and IMF staff calculations.

¹Figures may differ from WEO data as they reflect updates by recent missions.

²Budget deficit, excluding official grants, plus public external amortization.

³Current account deficit, excluding grants, plus amortization.

likely to decrease further towards 5.3 percent by end-2013 on the back of a large negative output gap, and declining food price inflation. Tunisia's current account deficit would remain high at about 8 percent of GDP in 2013, expected to be financed mostly by official external financing flows, thereby keeping foreign exchange reserves broadly stable at close to 4 months of imports.

Risks. A deterioration of the security situation, an escalation of domestic social tensions and a continuation of the political stalemate would increase policy uncertainty, impede foreign investments and tourism receipts, and further undermine the economic recovery. Delaying crucial structural reforms may also lead to a significant shortfall in the associated official external financing expected in 2013. Re-emerging financial stress in the euro area and/or a deeper than expected slowdown in EMs would add another drag on growth and the external position.

Short-term policy issues. The most immediate challenge for Tunisia is to maintain macroeconomic stability while moving ahead with the reform agenda in a difficult political environment. Fiscal policy will need to be geared towards preventing the crowding out the private sector, preserving external stability, and safeguarding debt sustainability. The weakened economic outlook and the likely shortfall in anticipated official external financing, call for new fiscal measures to curb the widening of the central government fiscal deficit and external imbalances. A tight monetary policy will be needed to contain pressures on inflation and the exchange rate arising from widening external imbalances and shortfalls in official foreign financing. Greater exchange rate flexibility would contribute to improving Tunisia's external position and rebuild foreign exchange buffers. The two-year Stand-By Arrangement with the IMF is expected to provide Tunisia with a financing cushion in case of an adverse shock. Key reforms include mobilizing resources for recapitalizing public banks, repaying arrears, completing the audit of public banks and formulating their new strategic orientation, adopting the investment code, and moving ahead with energy subsidy reform.

Medium-term challenges. Generating higher and more inclusive growth to absorb high unemployment and reduce social and economic disparities across regions remains the key economic challenge for Tunisia. A stronger banking sector and a deeper domestic financial market will be important to finance the investment activities in this respect. Additionally, reforms should focus on: (i) a more transparent and competitive environment for doing business (ii) progress towards better-targeted social safety nets; (iii) fiscal reforms creating a more level playing field for the on-shore and offshore sectors, strengthening revenue collection, improving equity and raising transparency; (iv) enhancing the functioning of the labor market and (v) the governance of public enterprises. This agenda offers opportunities to deepen technical assistance provided, including in the areas of banking, revenue administration, public financial management and expenditure policy.

VII. Yemen

Yemen continues to face serious challenges. The political transition has advanced at a slower pace than planned, and security remains weak. Nevertheless, the economy has been gradually recovering, and progress has been made in restoring macroeconomic stability, although poverty and unemployment remain very high. Delays in reforms, shortfalls in donor support, and continued sabotage activities pose serious risks, which could undermine these stabilization gains. Consolidation of these gains and boosting growth and job creation will hinge on the government's ability to successfully conclude the national dialogue conference, strengthen security, and begin to implement priority fiscal and other pro-growth reforms. The IMF provided financial support for Yemen's reform efforts through the Rapid Credit Facility (RCF) in 2012. Discussions on a successor arrangement are underway.

Background. Yemen experienced a serious political crisis in 2011 that resulted in a decline in economic activity. A political agreement brokered by the Gulf Cooperation Council enabled the formation of a national unity government in December 2011 and the election of a new president in February 2012. A national dialogue started in March 2013 and is expected to conclude with some delay in the coming weeks, paving the way for the drafting of a new constitution. The presidential and parliamentary elections, initially planned for February 2014 are expected to be postponed by a few months. Despite progress on the political front and a major restructuring of the army, the security situation remains difficult.

Recent developments. Following a contraction in real GDP and surge in inflation in 2011, Yemen has made progress in returning to macroeconomic stability and growth thanks to renewed government efforts at reforms and substantial financial support from the Friends of Yemen, especially Saudi Arabia. In 2012, output started to recover, inflation decelerated substantially, foreign exchange reserves increased, and the exchange rate appreciated to its pre-crisis level. However, the fiscal deficit widened to 6.3 percent of GDP (12.3 percent of GDP before grants) mainly due to higher subsidies and wages, as well as revenue loss caused by frequent sabotage of the key oil pipeline. In the first half of 2013, the macroeconomic situation has remained manageable, although inflation has been rising. Overall fiscal discipline has been largely maintained, but lower oil revenue has been offset by reducing much needed public investment. There is an urgent need to implement key reforms, including a gradual reduction in the large energy subsidies, in order to facilitate an increase in targeted transfers and infrastructure investment that would better benefit the poor and promote job creation and growth. The authorities have advanced

Yemen: Selected Economic Indicators, 2011 - 2014¹
(Percent of GDP, unless otherwise indicated)

	Projections			
	2011	2012	2013	2014
GDP growth, percent	-12.7	2.4	6.0	3.4
CPI inflation, period average, percent	19.5	9.9	12.0	12.0
General government balance, excl. grants	-5.6	-12.4	-6.9	-7.3
Current account balance, excl. grants	-6.5	-7.1	-4.6	-5.3
Fiscal financing needs, (excl. grants), US\$ billion ²	2.0	4.6	3.3	3.4
External financing needs (excl. grants), US\$ billion ³	2.3	2.7	2.1	2.6
Public debt	45.2	47.8	48.1	50.2
External debt	18.3	17.9	16.7	17.0
Reserves in months of imports	3.9	5.6	4.6	3.6

Sources: National authorities; and IMF staff calculations.

¹Figures may differ from WEO data as they reflect updates by recent missions.

²Budget deficit, excluding official grants, plus public external amortization.

³Current account deficit, excluding grants, plus amortization.

other reforms, including improving compliance of large tax payers and implementing efficiency and governance-enhancing reforms, notably the unification of diesel prices while compensating the electricity sector to avoid tariff increases.

Short-term outlook. Looking forward, a successful conclusion of the national dialogue and improved security would help improve the macroeconomic situation. Non-hydrocarbon growth is expected to pick up reflecting increased utilization of idle capacity and the rekindling of private sector activity. Oil production is projected to recover gradually with reduced attacks on the pipelines. However, inflation is expected to remain in low double digits and the external position to worsen unless the exceptional balance of payments support of 2012 is repeated. Donors have pledged about \$8 billion over 2012–14, but disbursement has been lagging and there is a need to increase budget financing in the context of a sound macroeconomic framework.

Risks. The main downside risk is a further deterioration in the political and security situation—related particularly to the outcome of the national dialogue, heightened social unrest, and shortfall in donor support. Additional risks could arise from the unfolding of events elsewhere in the Middle East. On the upside, a breakthrough in the national dialogue, an acceleration of donor disbursements, including for budget support to buttress reforms, and higher oil and gas prices including a potential revision of LNG contracts in line with international prices, would reduce pressures on the fiscal and external positions.

Short-term policy issues. The short-term policy priority is to strengthen macroeconomic stability and lay the foundation for fiscal and external sustainability, and high and inclusive growth. This will require a gradual restructuring of the budget, through increasing tax revenues, containing the wage bill, and reducing the large fuel subsidies, while increasing targeted transfers and infrastructure investment. There is also scope for improving financial intermediation while strengthening bank supervision to facilitate lending to the private sector. Increased exchange rate flexibility would also help protect foreign exchange reserves and support diversification.

Medium-term challenges. The key medium-term challenge is to sustain high growth and job creation, and diversify the production and export structure from hydrocarbon exports and put public finances on a more sustainable medium-term footing. In addition to the critical fiscal reforms described above, there is a need to address inefficiencies in oil refining, electricity generation and state enterprises in general. Improved business environment, strengthened bank supervision, and continued prudent monetary policy will also be critical for spurring private sector credit growth and job creation. Further improvements are needed in governance and transparency in line with the Government's Transition Plan. This agenda requires further technical assistance by Yemen's external partners, including in the areas of public financial management, financial and capital market development, monetary operations, banking supervision, payment system, economic and financial statistics, and judicial reforms.