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Middle East and North Africa: Economic Outlook and Key Challenges

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I. Regional Economic Outlook and Key Challenges

Economic risks in the Middle East and North Africa (MENA) region have risen as the uncertainties inherent in the political transition in a number of countries persist and social unrest continues. Oil importers are facing a significant economic downturn, with limited fiscal room and rising borrowing costs. The immediate challenge for oil importers is to fulfill peoples' expectations while preserving macroeconomic stability. In 2012, their external and fiscal financing needs are projected at about $50–55 billion and, with capital markets providing only a small part of these funds and at a higher cost, official financial support will be essential. Now is also the time to begin formulating a broad reform agenda and embedding it in a medium-term macroeconomic policy framework to build confidence, anchor expectations, and provide the basis for sustained inclusive growth.

Background. The Arab Spring has resulted in a prolonged political transition, with governments still in the process of defining a clear and credible roadmap toward political and economic reform. Heightened uncertainty has had economic fallout as activity has been disrupted, investment has weakened, and foreign direct investment (FDI) inflows and tourism receipts have plummeted, leading to a sharp decline in growth in many countries in 2011. At the same time, surging global commodity prices have fed into higher import costs in oil-importing countries, pushing governments to respond by increasing spending, including on wages and food and fuel subsidies, to mitigate the impact of the downturn and higher import prices. More generally, rising sovereign credit default swap (CDS) spreads, together with weakening investor sentiment, have increased borrowing costs in international markets. Financial sector balance sheets are deteriorating, reflecting the downturn's adverse impact on the quality of loan portfolios as well as on regional stock markets.

Short-term outlook. The protracted political transition and deteriorating global environment are expected to result in a long, drawn-out economic recovery and strain macroeconomic balances:

- *Growth, inflation, and unemployment*. Forecasts of economic activity in 2011 are being revised down compared with previous projections, with conflict taking a big toll on the economies of Libya, Syria, and Yemen. Inflation is projected to remain high in oil importers, driven by a mix of domestic and structural factors, as well as ongoing pass-through of international food and commodity prices. Unemployment is likely to rise further with the sharper-than-anticipated economic slowdown, leading to a deterioration in social outcomes. The outlook for 2012 is clouded by the security situation in conflict countries and the prolonged political transition in Egypt and Tunisia. Early conflict resolution in Libya, Syria, and Yemen, and timely transitions in Egypt and Tunisia will likely have a positive economic impact.

- *Fiscal balances*. Fiscal positions are projected to deteriorate as governments continue to expand subsidies, transfers, and public-sector wages to meet higher social demands and reduce unemployment. With the average fiscal deficit in 2011 likely to exceed 8 percent of GDP, and remaining high in 2012, public finances will be strained in oil-importing countries. Estimates of fiscal financing needs in the baseline scenario for 2012 have increased to almost $55 billion. In light of the difficult access to international capital markets, governments are relying on credit from domestic banks and crowding out the already weakened private sector.

Financing Needs, Middle Income MENA Oil Importers 1/
(in billions of U.S. dollars)

	Est.	Projections			
	2010	2011	2012	2013	2011-13
Current account deficit (excl. official transfers)	21.2	29.2	28.3	27.9	85.4
External amortization	23.0	22.1	23.1	26.3	71.5
External gross financing needs	**44.3**	**51.3**	**51.4**	**54.2**	**156.9**
Budget deficit (excl. grants)	36.7	44.3	45.7	41.7	131.7
Public external amortization	7.2	7.9	8.3	7.7	23.8
Fiscal financing needs 2/	**43.9**	**52.2**	**54.0**	**49.4**	**155.6**
Public short-term domestic debt 3/	96.1	93.3	111.0	128.6	

Sources: National authorities, and IMF staff estimates and projections.
1/ Comprises Egypt, Jordan, Lebanon, Morocco, Syria, and Tunisia.
2/ Assuming full domestic rollover, zero external rollover.
3/ Remaining maturity basis. Excludes Syria as data on short-term public domestic debt are unavailable.

- *External positions*. Despite stable remittances and exports, higher food and commodity prices and declines in tourism are contributing to a worsening of current account balances. Concurrently, a substantial decline in capital inflows is putting pressure on exchange rates and external reserves. Since the beginning of the year, external reserves have fallen by 40 percent in Egypt, and between 5–10 percent in Jordan, Syria, and Tunisia. External financing needs in 2012 are currently projected to exceed $50 billion.

Downside risks. The biggest downside risk at this juncture is domestic in nature. Hurdles in the political transition in some countries, prolonged conflict in others, as well as delays in defining a comprehensive medium-term macroeconomic policy framework to anchor expectations would adversely affect investor sentiment, launching a self-perpetuating downward economic spiral. Regional spillovers from prolonged conflict in Libya and Syria—via remittances, trade, and confidence effects—would also adversely affect many countries in the region. Risks from the external environment have increased recently, reflecting the weakening of the global outlook, though spillovers from turmoil in the European periphery have been limited thus far. In the event that the European debt crisis spreads to the global arena, MENA oil importers would face contagion via real sector linkages in trade, tourism, FDI, and remittances, also possibly through financial sector linkages, including higher costs of external financing. The Maghreb countries would be particularly affected by adverse developments in Europe.

Short-term policy issues. *Increased public spending is necessary to preserve social cohesion, but it is important that countries avoid measures that will have long-term fiscal consequences or be difficult to unwind later*. In this context, developing a comprehensive medium-term sustainable fiscal framework is necessary. Such a framework can guide the annual budget planning process and allow for a transparent discussion between policymakers and the population as to how policy priorities and tradeoffs are reflected in the budget.

Better targeting of subsidies and transfers can help free up resources for investments in infrastructure and education and support the neediest. Subsidies and transfers across the region are untargeted, high relative to GDP and to peers, inefficient, and inequitable. Work needs to begin urgently to move to a more efficient and more equitable targeted social transfer system that could be introduced in the medium term. In parallel, eliminating inefficient tax exemptions and privileges that narrow the tax base, as well as broadening the coverage of the tax system to better include high-income and high-wealth taxpayers, could both boost revenue and improve fairness.

Mobilizing external support is needed to help MENA oil importers finance the fiscal deficit, stabilize reserves, and restore investor confidence. Governments can rely on domestic banking sectors for part of their financing needs, but at the risk of crowding out private-sector lending. Regional and international partners can provide the financing to help countries respond to fiscal pressures while maintaining macroeconomic stability and support much-needed social spending targeted to the neediest. In addition, they can help countries formulate and monitor home-grown reform agendas.

Medium-term challenges and key reforms. Longstanding challenges of high unemployment and low productivity growth demand a comprehensive and bold reform strategy to deliver significant improvements in growth and social outcomes. Regional demographics portend a large increase in working-age populations over the next decade. Significant improvements in the business climate, labor markets, public-sector service delivery, transparency, and governance are essential to increasing competitiveness and raising growth rates. Greater access to economic opportunities and finance, better education systems, and institutional reforms in the legislative and judicial areas will help address inequity among the population.[1] Revisiting trade agreements with the European Union to obtain greater market access for MENA's exports (e.g., agriculture, textiles, and services) would boost the region's output. A piecemeal approach is likely to prove inadequate to the people's aspirations. Strong leadership is required from within the region to build ownership and stakeholder participation. Partnership with regional and international donors and institutions can help support their agenda.

[1] See IMF Staff Note "*Economic Transformation in the MENA: Delivering on the Promise of Shared Prosperity, May 27, 2011"* for a discussion of how reforms in these areas can help jump-start growth.

II. Egypt

The Egyptian economy is expected to recover only modestly in 2011/12, with growth being held back by political uncertainty, a restrictive fiscal stance, and the difficult external environment. Absent external financing, the official reserves of the central bank could drop by $9 billion. However, medium-term prospects are positive as the economy's underlying potential remains intact.

Background. During the second half of the past decade, Egypt experienced a period of accelerated growth following reforms to stimulate investment. However, despite the relatively strong growth performance, social outcomes were unsatisfactory as unemployment remained high—particularly among the youth, double-digit inflation eroded household incomes, and privatization was perceived to have benefited only a few. Progress in fiscal consolidation was slow, with public debt remaining above 70 percent of GDP and mainly financed domestically.

Recent developments. Following a near stand-still in some sectors during the peak of popular protests earlier this year, economic activity began to recover gradually during the second quarter. Real GDP growth is estimated to fallen to just over 1 percent for fiscal year 2010/11 (July–June), reflecting a decline of about 3 percent during the first half of 2011. Unemployment rose to almost 12 percent, from about 9 percent at end-2010. Lower revenue collections and emergency spending led to a widening of the 2010/11 fiscal deficit to just below 10 percent of GDP. The banking sector remained stable, despite a brief closure, with deposits broadly unchanged and dollarization increasing only slightly. However, the balance of payments worsened considerably due to a sharp drop in tourism revenues, FDI, and portfolio outflows. International reserves declined from $43 billion to $26½ billion (about 5 months of imports) during the first half of 2011.

Short-term outlook. The outlook for 2011/12 suggests a slow recovery of economic activity and continued balance of payments pressures.

- Real GDP growth is expected to pick up only gradually, reaching about 1¾ percent in 2011/12 given the political uncertainty, a negative fiscal impulse of more than 2 percent of GDP implied in the budget, and a difficult external environment. Sectors most hit by the unrest earlier this year (tourism, manufacturing, construction, trade) are expected to

Egypt. Selected Economic Indicators, 2010/11–12/13

	2010/11	2011/12	2012/13
		Projections	
GDP growth, percent	1.2	1.8	4.0
Inflation, percent	11.8	11.0	10.5
Fiscal balance, percent of GDP, excl. grants	-10.3	-9.4	-9.0
Current account, percent of GDP, excl. grants	-2.3	-2.7	-2.5
Fiscal financing needs, US$ billion 1/, excl. grants	82.2	90.3	112.4
External financing needs, US$ billion 2/, excl. grants	9.6	10.1	2.2
Public debt, percent of GDP	76.2	76.6	75.5
External debt, percent of GDP	15.1	13.8	13.0
Reserves to short-term debt, percent 3/	295.2	259.4	174.2

1/ Gross financing requirement.
2/ Current account deficit excluding official grants plus capital account deficit.
3/ Official reserves.

contribute to the recovery. With modest growth and a rising negative output gap, inflation is expected to ease somewhat, but unemployment is likely to increase further. However, the public debt-to-GDP ratio would remain broadly stable, reflecting a lower fiscal deficit and negative real interest rates on domestic debt.

- Following the Supreme Council of the Armed Forces' decision to refrain from official foreign borrowing—including from the IMF—to finance the budget, a drawdown of international reserves of about $9 billion may be needed to cover the estimated balance of payments shortfall in 2011/12.
- Prudential data provided by the Central Bank of Egypt suggests that the banking sector should be able to withstand the currently projected environment for 2011/12. As of end-December 2010 (latest available data), non-performing loans declined to 11 percent and were largely provisioned, and capital adequacy reached 16 percent.

Downside risks. Continued political uncertainty, a protracted transition process, and/or a worsening of the security situation would dent confidence further, which, in turn, could depress growth, lead to higher dollarization and lower bank deposits, trigger further capital outflows, and ultimately increase pressures on the pound and international reserves. Risks to the fiscal outlook also prevail, as social spending may need to rise in light of high unemployment, and banks may be unable or unwilling to finance the large fiscal deficit and debt rollovers. The turmoil in global financial markets poses some risks to Egypt, mainly via real channels as the sovereign is not planning to tap international markets any time soon.

Short-term policy issues. Meeting large fiscal financing needs solely from domestic sources, while maintaining macroeconomic stability and a comfortable international reserves cover, is a major challenge. While the budget for 2011/12 signals the authorities' commitment to fiscal consolidation, it entails risks for the recovery and the financing outlook that need to be carefully managed. Allowing the pound to move in line with market forces—while avoiding excessive short-term volatility—will also be important to limit the use of international reserves and maintain external sustainability going forward.

Medium-term challenges. Leveraging the Egyptian economy's potential to return to rapid—but also more inclusive—economic growth to provide sufficient employment for the fast-growing labor force will be key. This can be achieved by creating a more transparent and competitive economy, improving the business environment—especially for small enterprises, and generally providing more equal access to opportunities for all sections of the society. Sustained inclusive growth will also require a stable macroeconomic environment. For this, fiscal consolidation will be key to reducing government debt and making room for countercyclical policy when needed. This can be achieved by strengthening tax revenues, including through a transition to a modern value-added tax (VAT), and improving the quality of public spending, including by replacing the large, inefficient, and inequitable system of generalized subsidies (8½ percent of GDP in 2010/11) with a better-targeted social safety net.

III. JORDAN

Economic activity in Jordan will remain subdued in 2011, due largely to continuing high commodity-import prices and lingering political uncertainties. While budgetary and external financing needs for 2011 appear manageable, fiscal and external sustainability in 2012 and beyond will remain reliant on external grant support.

Background. Following a period of robust growth during 2000–09 (averaging about 6½ percent) supported by a favorable external environment, economic activity slowed sharply in 2010 as global economic conditions deteriorated. The Jordanian economy is among the most open in the Middle East, and remains highly dependent on commodity imports and external grants. While the authorities have implemented an ambitious program of structural reforms to develop the private sector, unemployment remains high, particularly among the young and graduates.

Recent developments. Regional and domestic social turmoil and a difficult global environment (high imported food and fuel prices and rising sovereign financing costs) adversely affected the Jordanian economy in 2010–11. Because of a larger import bill, declining remittances, sharply-lower tourism receipts, and lower FDI inflows, international reserves dropped to $11.8 billion (equivalent to 7 months of imports) at end-July 2011. Budgetary grants from Saudi Arabia in late-July of $1 billion (about 3½ percent of GDP), in addition to the $0.4 billion (about 1½ percent of GDP) provided in late-May, will help Jordan meet the high cost of food and fuel subsidies and rising social demands in 2011.

Short-term outlook. Real GDP is expected to grow at a slow pace of 2½ percent in 2011, led by the mining and financial sectors. Unemployment edged up by ½ percent to 13¼ percent during the first half of 2011 and will rise further given the slow forecast growth. Due largely to an increase in food and fuel subsidies and transfer payments, the fiscal deficit (excluding grants) is expected to reach 10 percent of GDP in 2011. However, in light of the grants from Saudi Arabia, public debt will decline to just below the legislated ceiling of 60 percent of GDP in 2011. The external current account deficit (excluding grants) is projected to increase to about 13½ percent of GDP in 2011.

Jordan. Selected Economic Indicators, 2010–12

	2010	2011	2012
		Projections	
Real GDP growth (percent)	2.3	2.5	2.9
CPI inflation (percent)	5.0	5.4	5.6
Fiscal balance (percent of GDP)	-5.4	-3.5	-5.5
Fiscal balance excluding grants (percent of GDP)	-7.5	-10.0	-8.2
Current account (percent of GDP)	-4.9	-6.3	-8.8
Current account excluding grants (percent of GDP)	-9.4	-13.5	-12.0
Fiscal financing needs (in US$ billions) 1/	7.6	6.4	6.8
External financing needs (in US$ billions) 2/	-0.9	2.9	1.5
Public debt (percent of GDP)	61.1	59.5	59.1
External debt (percent of GDP)	24.6	23.6	20.6
Short term debt (percent of international reserves)	5.5	5.4	6.0

1/ Sum of T-bill and T-bond amortization, interest repayment and primary deficit excluding grants
2/ Sum of current account deficit and external short term and MLT debt repayment, less FDI and other capital inflows, and excluding official transfers.

For the remainder of 2011, budgetary financing needs (excluding grants) are estimated to reach $2.84 billion (9.5 percent of GDP), and external financing needs (after FDI, new borrowing, other capital flows, and excluding official transfers) to $1.0 billion (3.9 percent of

GDP). For 2012, total financing needs (excluding grants and official transfers) are estimated at about $8.2 billion (26 percent of GDP), of which $6.8 billion (21 percent of GDP) are related to budgetary financing.

Real GDP growth is projected to pick up modestly to 3 percent in 2012 as business confidence gradually improves. The overall fiscal deficit (excluding grants) is expected to decline to about 8⅓ percent of GDP in 2012, mainly due to a reduction in military spending and food subsidies. As grants are expected to revert to pre-2011 levels, the fiscal deficit (including grants) is projected to increase to 5½ percent of GDP in 2012. The current account deficit (excluding grants) is expected to remain sizeable at about 12 percent of GDP in 2012, mostly due to continuing high expenditure on commodity imports.

Downside risks. Higher commodity-import prices and a fragile domestic and regional political situation would generate lower economic growth and higher fiscal and external deficits than the abovementioned projections. For example, a $10 per barrel increase in international oil prices (from current levels) would result in an expansion in both the fiscal and external current account deficits by about 0.9 percentage points of 2011 GDP.

Short-term policy issues. For the second half of 2011, fiscal financing needs can be financed by local banks, without crowding out the private sector, given large excess reserves in the banking system; and external financing needs can be financed by drawing down foreign reserves, which would still leave international reserves at a comfortable level (at about 6½ months of imports). Such a strategy, however, cannot be replicated on an ongoing basis in the absence of additional external support. Beginning in 2012, the authorities intend to reduce the fiscal deficit to about 3 percent of GDP over the medium term. Further tightening of the monetary stance is appropriate to increase the attractiveness of Jordanian dinar-denominated assets and contain inflationary expectations.

Medium-term challenges. The key medium-term policy challenges are to reduce Jordan's vulnerabilities by reining in large fiscal and current account deficits and dependence on external grants; and creating jobs and providing social protection by achieving faster, more inclusive, growth, including by reducing generalized subsidies and building targeted transfers and social safety nets. Absorbing new labor-market entrants (about 40,000 persons a year), while also reducing unemployment, calls for a more vibrant private sector, with efforts focused on supporting small- and medium-sized enterprises and the underperforming tourism sector. The passage of the public-private partnership law in June 2011 is an important step toward boosting infrastructure investment. In this context, and given the high debt burden and limited fiscal space, the government should refrain from issuing any form of debt guarantees for borrowing by public agencies in connection with prospective mega-projects (in rail transportation, nuclear power, and water infrastructure), while such loan guarantees could be extended by donors. Instead, higher public investment should focus on improving infrastructure for the tourism industry.

IV. Morocco

The short-term economic outlook remains favorable. While sufficient fiscal space in 2011 has allowed for spending in support of the political reform process and address social demands, beginning in 2012, Morocco would need to adopt vigorous fiscal measures to ensure macroeconomic sustainability. The government is committed to improve the targeting of subsidies and to bring the deficit back to about 3 percent of GDP over the medium term.

Background. Thanks to sound macroeconomic policy and political reforms, Morocco was well-equipped to address the 2008 international crisis and to respond to the uprisings that have emerged across the MENA region since early 2011. Economic growth has continued to recover, inflation has remained moderate, and unemployment has declined to about 9 percent. However, unemployment among the young and graduates, at about 17 percent, remains high and has proven more difficult to tackle.

Recent developments. In response to social demands, the Moroccan government has embarked on significant constitutional reforms and increased spending, including subsidies, wages and pensions. GDP growth accelerated during the first quarter of 2011 (4.9 percent year-on-year, compared with 2 percent during the previous quarter). Inflation remains moderate and unemployment has declined to 8.7 percent. Export growth remains robust while import growth has accelerated. Growth in bank credit to the economy has slowed down during the first five months of 2011.

Short-term outlook. Despite the economic difficulties in the euro zone (Morocco's main trading partner), overall GDP is expected to grow between 4½–5 percent in 2011–12, owing to good agricultural production and the strong performance of the nonagricultural sector, including the tourism sector. Unemployment is broadly stable and average inflation is projected at 1½ percent in 2011.

Morocco. Selected Economic Indicators, 2010–12

	2010	2011	2012
		Projections	
Real GDP growth (percent)	3.7	4.6	4.6
CPI inflation (percent) 1/	1	1.5	1.7
Fiscal balance (percent of GDP)	-4.6	-5.7	-5.3
Current account (percent of GDP)	-4.3	-5.2	-4.0
Fiscal financing needs (in US$ billions) 2/	11.9	14.6	15.6
External financing needs (in US$ billions) 3/	5.2	6.8	6.2
Public debt (percent of GDP)	51.1	54.2	55.5
External debt (percent of GDP)	24.6	24.8	24.4
Short term debt (percent of international reserves)	441	515	557

1/ Period average.
2/ Defined as the sum of amortization of medium and long-term debt and fiscal deficit.
3/ Defined as the sum of amortization of medium and long-term, short-term debt and current account deficit.

For fiscal year 2011, the authorities increased public spending in some areas to address social demands and political pressures. Maintaining food and fuel prices unchanged in the context of rising international commodity prices will require spending on food and fuel subsidies of about 5½ percent of GDP in 2011. At the same time, the authorities took counterbalancing measures, which will allow for containing the budget deficit at about 5¾ percent of GDP compared with 4½ percent in 2010. Domestic debt financing is expected to

increase to 5.9 percent of GDP, compared with 1.5 percent of GDP in 2010. In the absence of corrective measures, the budget deficit may reach 6½–7½ percent of GDP in 2012, and public debt will continue to rise.

The current account deficit may increase to about 5 percent of GDP by end-2011 in light of higher fuel prices. Gross international reserves are expected to decline slightly, while remaining comfortable, at above 5 months of imports of goods and services at end-2011. The current account deficit is expected to narrow in 2012, as oil prices decline. Bank credit to the economy is expected to continue to grow against a backdrop of declining liquidity.

Downside risks. Near-term downside risks to the economic outlook are related uncertainties associated with regional developments and spillovers from sluggish growth in European partners, which could affect economic activity and the balance of payments through lower tourism receipts, FDI, and trade. The government could also announce further social spending measures beyond those already under way, which could further adversely affect public finances, debt dynamics, and liquidity.

Short-term policy issues. Following a contained fiscal expansion in 2011, a firm consolidation plan is required for 2012 and over the medium term to ensure fiscal sustainability. In line with Article 77 of the new constitution and the draft organic budget law, which lay down the principle of safeguarding fiscal stability, the authorities intend to bring the deficit back to about 3 percent of GDP over the medium term. This would be in line with a debt-to-GDP ratio converging to about 50 percent of GDP in the medium term.

Medium-term challenges. The favorable economic performance recorded over the past decade—largely attributed to reforms in key economic sectors (e.g., the financial sector and public enterprises) and authorities’ efforts to improve the business climate—needs to be strengthened further. Accelerating structural reforms is necessary to promote inclusive growth and improve social indicators. In this context, the authorities have established a committee to enhance the business environment to improve productivity and increase job creation. In addition, fiscal policies need to be reoriented to provide more leeway for raising health and education spending. Moreover, reforms aimed at reducing minimum wages and hiring costs are critical to reducing youth unemployment.

V. TUNISIA

The short-term economic outlook has worsened since the beginning of the year mainly due to lingering domestic political uncertainty and spillovers from Libya. The financing gap for 2011 still appears manageable. However, the authorities are preparing a development plan and a package of reforms to boost private investment and put Tunisia on a higher growth path over the medium term, which will require large external financing, beginning in 2012.

Background. Tunisia entered the period of popular uprising from a relatively solid macroeconomic and financial position, but with high unemployment rates and serious governance shortcomings. In 2010, economic growth was recovering, inflation remained moderate, and gross official reserves were at a relatively comfortable level. Prudent fiscal policy contributed to a significant decline in public debt over the past few years. Nevertheless, unemployment remained high at 13 percent, especially among young graduates, and significant economic and social disparities exist across regions.

Recent developments. Economic activity was significantly affected during the uprising and following the conflict in Libya. Real GDP declined by 3.3 percent (year-on-year) during the first quarter of 2011. Tourism receipts contracted by more than half during January–July, while export growth remained robust and agriculture output rebounded. Inflation remains moderate (3 percent) and the nominal effective exchange rate has been broadly stable. After declining by about $2 billion during January–July, external reserves increased to $8.6 billion in August following the disbursement of external support. In view of the decline in systemic liquidity, the central bank stepped up its refinancing to the banking sector, cut the reserve requirement ratio, and lowered its key interest rate to 4 percent in June.

Short-term outlook. Remaining political uncertainties, coupled with the repercussions of the ongoing conflict in Libya, will negatively impact the Tunisian economy in 2011.[2] In a scenario with tourism receipts and FDI inflows declining along current trends, real GDP would stagnate. The full implementation of a fiscal stimulus—a large increase in food and energy subsidies and social transfers and an expansion of public investment—would partially mitigate the negative repercussions on real growth. Unemployment may increase substantially, owing to the economic slowdown and the return of Tunisian workers from Libya. The quality of banks' assets will likely deteriorate with the economic downturn. After having mobilized $2 billion of external financing, a budgetary financing gap of $0.5 billion and an external financing gap of $1.1 billion remain to cover the budget deficit and public debt repayments and to maintain external reserves at their end-2010 level ($9.5 billion).

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[2] Political parties are preparing for the elections of a Constituent Assembly scheduled in October but uncertainties remain for the period beyond the elections. The conflict in Libya has pushed a large number of refugees to the south of Tunisia and the security situation at the border remains a source of concern.

Economic activity could begin to recover in 2012 depending on the political transition. In a baseline scenario, real economic growth could reach about 4 percent in 2012, with tourism and FDI rebounding gradually, and sustained public investment plan envisaged by the authorities supporting the recovery. Nevertheless, fiscal and external financing needs would remain substantial in 2012, at $3.6 and $2.8 billion, respectively.

Tunisia. Selected Economic Indicators, 2010–12

	2010	2011	2012
		Projections	
Real GDP growth (percent)	3.0	0.0	3.9
CPI Inflation (percent)	4.4	3.5	4.0
Fiscal balance (percent of GDP)	-1.3	-4.5	-4.6
Current account (percent of GDP)	-4.8	-5.7	-5.5
Fiscal financing needs (in US$ billion) 1/	2.3	3.3	3.6
External financing needs (in US$ billion) 2/	2.4	3.7	2.8
Public debt (percent of GDP) 3/	40.4	41.7	48.0
External debt (percent of GDP) 3/	48.8	49.2	50.6
Short term debt (percent of international reserves)	186.6	158.5	162.3

1/ Budget deficit (excluding grants) plus amortization.
2/ Current account deficit and amortization on external debt, net of FDI and other capital flows.
3/ Assumes that the fiscal gap of about $650 million in 2011 will be covered with external loans.

Downside risks. Significant downside risks remain. A larger decline in tourism and FDI inflows, along with weak government capacity and financing constraints in implementing the envisaged fiscal expansion, could deteriorate the outlook for growth and employment in 2011. A lingering unstable situation in Libya, a difficult political transition and internal social tensions could significantly weaken the outlook for tourism and FDI, undermining the economic recovery. A weakening of the banking sector could also hamper credit growth and the recovery. Tunisia's financing needs could be larger than expected if the downside risks materialize. However, a quick stabilization in Libya could impact Tunisia positively.

Short-term policy issues. The implementation of the planned fiscal stimulus is key to avoiding a recession and further weakening of employment in 2011. Mobilizing additional external financing is, in turn, necessary to implement the envisaged spending plans for 2011 and 2012 and support economic activity and job creation. Monetary policy can continue to be supportive absent inflationary pressures and as long as the financial sector remains stable.

Medium-term challenges. The medium term outlook is potentially very favorable. Real growth could reach 7 percent by 2016, if external financing of about $5 billion per year (10 percent of GDP in 2012, including private) is mobilized and appropriate policies are implemented. The authorities are preparing a development plan and a package of reforms to boost private investment and put Tunisia on a higher growth path. In this context, improving governance, transparency, and the business environment; stepping up infrastructure; restructuring banks; and reforming the labor market and education system are crucial to fostering private investment, growth, and job creation. In case of a shortfall in external financing, the Tunisian economy would recover, but would remain on a lower growth path, which would result in higher unemployment and possible social tensions.