North Africa Economic Outlook 2021

Debt Dynamics: The Path to Post-COVID Recovery

AFRICAN DEVELOPMENT BANK GROUP

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ISBN 978-9938-9986-1-0

ACKNOWLEDGEMENTS

The North Africa Economic Outlook 2021 was prepared in the Vice Presidency for Economic Governance and Knowledge Management, under the supervision and general direction of Rabah Arezki, Vice President and Chief Economist.

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The report highly benefited from the contributions of Dr. Hinh Dinh, President of the consulting firm Economic Growth and Transformation, LLC. Professor Djaobélé Lokna and Konan Raphaël N'Guessan served as peer reviewers. The document was also reviewed internally by Lacina Balma, Linguère Mbaye, Anthony Simpasa, and Mustafa Yasin Yenice.

The data appearing in the report were compiled by the Statistics Department, led by Louis Kouakou, Manager, Economic and Social Statistics Division.

The cover of the report is based on a general design by the Bank's External Relations and Communications Department. Editing was provided by Paul Holtz, President, Next Partners, and layout support by Yasso Creation (Tunisia). The Bank's Language Services Department translated the report into French.

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EXECUTIVE SUMMARY

In 2020 North African economies experienced three shocks: the COVID-19 pandemic, a collapse in oil prices, and a steep drop in tourism. Growth was also cut short due, in part, to sharp contractions in the region's main European trade partners. Real GDP growth was negative in 2020, at –1.1 percent—a 5.1 percentage point drop over 2019. Still, this output loss was less severe than projected thanks to governments' prompt interventions to mitigate the impacts of the pandemic. Egypt even managed to achieve positive growth, among the few countries in the world to do so.

Though growth performance varied by country, by and large, macroeconomic variables deteriorated in 2020 for North Africa. The average fiscal deficit nearly doubled, from 5.7 percent of GDP in 2019 to 11.6 percent in 2020, and the current account deficit increased from 4.9 to 8.8 percent of GDP. Between 2015 and 2020 external debt soared 88 percent, from 17 percent of GDP to 32 percent. Moreover, the structure of the region's debt has shifted from official bilateral and multilateral creditors to private sources.

The pandemic has exacerbated several structural weaknesses in North Africa's social and economic landscape. In Algeria, Libya, and Mauritania these include a commodity-driven growth model, heavy dependence on natural resource extraction, undiversified economic activities, and external trade concentration. In all North African countries structural issues encompass long-term unemployment, widespread informality, skills mismatches, and weaknesses in fiscal and financial management. The pandemic has also disproportionately affected poor people—reversing the region's hard-won progress in reducing poverty and inequality, and likely putting the 2030 goal of eliminating extreme poverty beyond reach.

Conditional on global risks and uncertainties, the region is expected to recover quickly to pre-pandemic levels. The African Development Bank projects that growth will reach 4.0 percent in 2021 and 6.0 percent in 2022. The speed of recovery is partly expected to come from the rebound in oil prices (Algeria, Libya) and tourism (Egypt, Morocco, Tunisia), better vaccine production and distribution, and strong recovery in the region's European trade partners.

COVID-19 has increased the external vulnerabilities of North African countries and markedly reduced their external buffers. The crisis has also significantly eroded fiscal space. Amid prospects for a protracted recovery in key sources of income for the region (oil and tourism), oil exporters faced a double impact brought about by lockdowns and severe oil market fluctuations. Countries that are fragile or in postconflict situations, such as Libya, experienced more severe economic impacts.

North African countries have accumulated external debt very quickly since 2010. Egypt, Morocco, and Tunisia have increasingly relied on sovereign Eurobond markets to meet their external financing requirements. Other countries in the region have relied on domestic debt (Algeria, Libya) or official development assistance (Mauritania) for this purpose. The Eurobond market typically has shorter debt maturities, higher interest rates, and higher risk of a foreign currency crisis (in case of a devaluation) relative to loan terms from official Paris Club creditors. Meanwhile, excessive domestic borrowing can lead to money creation (and therefore rising inflation pressures), crowding out of private investment, or both. Algeria, Egypt, Morocco, and Tunisia also face the additional risk of contingent liabilities incurred by state-owned-enterprises. For instance, before COVID, these contingent liabilities were estimated at 13 percent of GDP in Egypt and 16 percent in Morocco (AfDB 2020).

If the pandemic continues into 2022 and beyond, some countries will likely face liquidity problems in servicing debt payments. No international mechanism exists to deal with debt workouts for lower-middle-income countries, though the African Development Bank has proposed one for African countries: the African Financial Stability Mechanism, which would help avoid liquidity crises.

As countries in the region begin to reopen, policymakers will be tasked with mitigating the ongoing public health threat while also taking steps to rebuild their economies and ensure that adequate social safety nets are in place. Over 2021–23 North Africa's financing needs are estimated to exceed $180 billion to adequately respond to the crisis and support the recovery. With weak fiscal positions severely constraining government support measures in many countries, much more emphasis will be put on the need for ambitious reforms to rekindle robust, sustainable, equitable growth while avoiding further deterioration of fiscal and debt situations.

Short-term policy recommendations for damage management include:

- Limiting the spread of the virus, providing relief for vulnerable populations, and overcoming vaccine-related challenges.
- Developing capacity for debt sustainability analyses.
- Preparing debt workout schemes should the pandemic last longer and hit harder.
- Assessing the full stock of sovereign actual debt and contingent liabilities.
- Strengthening coordination among fiscal, monetary, and exchange rate policies to monitor the direction, speed, and magnitude of capital flows and their effects.
- Conducting public expenditure reviews to protect investment projects needed to restore economic growth.

The May 2021 Paris Summit on Africa financing ended with the decision to reallocate $33 billion in International Monetary Fund (IMF) Special Drawing Rights to African countries. This additional funding could provide fiscal space for North African countries but has not yet been delivered.

Among the medium-term measures to stimulate post-pandemic economic recovery are:

- Investing in digitalization.
- Providing support to small and medium-size enterprises, notably access to finance and managerial skills.
- Enhancing domestic resource mobilization.
- Deepening domestic bond markets.
- Monitoring governments' contingent liabilities with a view to mitigating their impact on public debt.
- Restructuring state-owned enterprises and using debt efficiently and transparently to finance productive investments and avoid debt traps. External financing should favor long maturities on reasonable borrowing terms.

Over the long term, policy reforms to foster economic and market diversification, technological innovation, and large-scale job-creation include:

- Promoting economic and export diversification.
- Investing in public goods needed to ease regional disparities and foster inclusive growth.
- Deepening regional integration in the context of the African Continental Free Trade Area (AfCFTA) agreement.

CHAPTER 1

ECONOMIC PERFORMANCE AND OUTLOOK

Though Africa has been relatively spared from the health consequences of the Covid-19 pandemic, the socioeconomic costs have been very high. In 2020, 30 million Africans were pushed into extreme poverty and an estimated 39 million could be made poorer in 2021 (AfDB 2021). The crisis has hit all African regions hard, leading to the continent's recession in 2020 for main two reasons: the decline in commodity prices and the collapse of tourism and foreign investment. In 2021 Africa's growth is projected at 3.4 percent after a contraction of 1.8 percent in 2020—the continent's worst recession in half a century. The pandemic has significantly increased countries' financing needs, with unfavorable consequences for public finances and debt levels. To respond to the crisis, Africa needs an estimated $154 billion in additional financing in 2020–21 (AfDB 2021).

In 2020 three shocks hit North Africa hard: COVID-19, an oil price collapse in oil-exporting countries such as Algeria and Libya, and tourism declines in Egypt, Morocco, and Tunisia. The oil blockade in Libya worsened the negative impact of the oil price shocks on the country, with regional ramifications on growth. Growth also declined sharply due, in part, to a sharp contraction in North Africa's most important European trading partners.

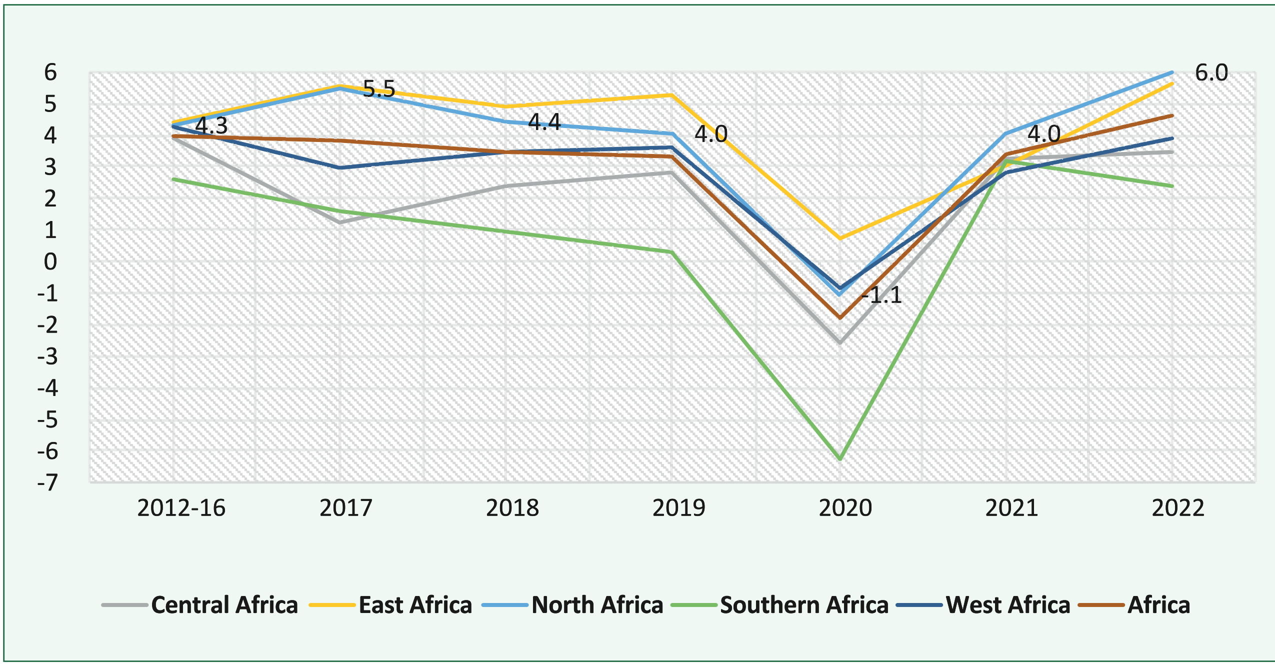
Still, at –1.1 percent, North Africa's output loss in 2020 was much less severe than had been projected. It was also substantially lower than in all other African regions except East Africa. This chapter analyzes North Africa's economic fundamentals amid the COVID-19 crisis. The first section reviews the region's recent growth performance. Because prospects vary, it also assesses the pandemic's effects on each country in the region: Algeria, Egypt, Libya, Mauritania, Morocco, and Tunisia. The second section describes measures taken to mitigate the pandemic and their costs. The final section appraises prospects for recovery, which are conditioned on risks and uncertainties.

1.1 MACROECONOMIC PERFORMANCE

1.1.1 North Africa's output loss in 2020 was relatively low, and its prospects for recovery are better than those in other African regions

Before the pandemic, North Africa was in a favorable economic position, with annual GDP growth averaging 4.6 percent in 2017–19 (figure 1.1). Then COVID–19 struck Egypt in mid–February 2020 and spread rapidly across the region. The loss of lives and livelihoods, sharp drop in oil and other commodity prices, and collapse of tourism dealt a harsh blow to the regional economy. COVID has also had massive impacts on vulnerable groups including women, young people, the poor, and informal sector workers.

Figure 1.1: GDP growth in North Africa and other African regions, 2012–2022 (Percent)



Source: African Development Bank statistics.
Note: Data are estimates for 2020 and projections for 2021–22.

In October 2020 the World Bank (2020d) estimated that the collapse in oil prices would lower government revenues in the Middle East and North Africa by $116 billion for the year, implying major economic damage for Algeria and Libya. But given rising oil prices since November 2020, this economic cost will likely be revised.

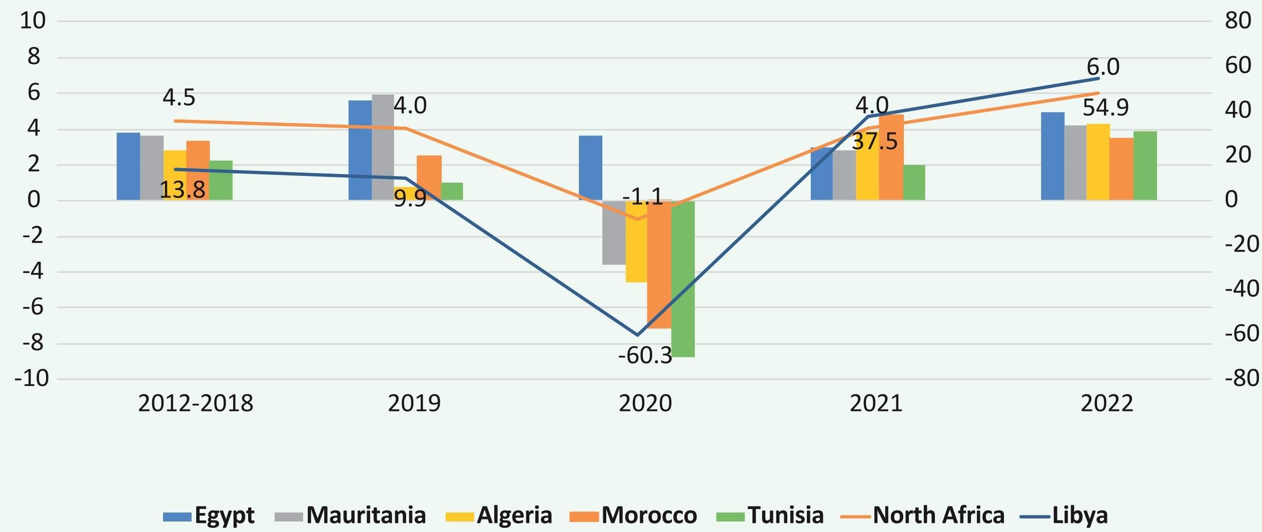
Moreover, thanks to the relative success in containing the damages of the pandemic in 2020, North Africa's GDP growth contraction of 1.1 percent was substantially lower than the African average (1.8 percent; see figure 1.1).

North Africa's GDP growth is projected to rebound to 4.0 percent in 2021—the same level as in 2019— then rise to 6.0 percent in 2022. This projected recovery is better than that for all other regions of Africa.

1.1.2 Growth performance and prospects vary significantly by country

In 2020 the North African countries hit hardest by the pandemic were Algeria, Libya, Morocco, and Tunisia; impacts were milder in Egypt and Mauritania (figure 1.2). In addition to the fall in tourism revenues, the collapse in oil prices and demand had a fiscal ripple effect on the region's three oil-exporting countries: Libya, Algeria, and Egypt, in descending order. A drop in prices and demand for nonoil commodities (phosphate rock, urea, manganese ore) also lowered revenues in Mauritania, Morocco, and Tunisia. Unemployment—already high before COVID-19—worsened, exacerbating poverty and inequality. Because COVID's impacts on growth performance and prospects have and will vary significantly, a brief assessment for each country is provided below.

Figure 1.2: GDP growth in North Africa by country, 2012–2022 (Percent)



Source: African Development Bank statistics.
Note: Libya, an outlier, is shown on the right Y axis. Data are estimates for 2020 and projections for 2021–22.

Algeria. In 2020 the pandemic, coupled with the significant decline in hydrocarbon exports, shocked the Algerian economy. The country's 4.6 percent contraction in real GDP growth (compared with a positive rate of 0.8 percent in 2019) was more than four times the regional average. This sharp drop was due to the collapse in fuel export revenues, which in 2019 accounted for more than 96 percent of merchandise exports.

As a result, Algeria developed large fiscal and current account deficits. The fiscal deficit more than doubled, from –5.6 percent of GDP in 2019 to an estimated –12.6 percent in 2020. The current account balance (including grants) rose from –10.0 percent of GDP to –14.8 percent. Financing these deficits increased the country's external vulnerabilities. Gross international reserves held by the Central Bank of Algeria fell from more than $61.5 billion in 2019 to $44.6 billion in 2020, and $21.9 billion in 2021.

In 2020 Algeria took steps to tame the adverse fiscal effects of the crisis. The Additional Finance Act, issued in June 2020, aimed to boost foreign direct investment. The government also announced structural reforms to move away from commodity dependence (a rent-seeking economic model) and toward a diversified, self–sustaining economy that is expected to attract foreign investors (Haraun and Djerba 2020).

As oil prices and demand recover, Algeria's economic growth is forecast to rebound to 3.9 percent in 2021 and 4.3 percent in 2022. The main driver of economic growth will be substantive recoveries in investment spending and in hydrocarbon production and exports.

Egypt. Egypt was the first African country in Africa to be hit by COVID 19, in February 2020, before it spread to the continent's 53 other countries. The crisis undermined the country's return to a more stable macroeconomic environment, characterized by strong growth, improved fiscal accounts, and a comfortable level of foreign exchange reserves. Still, Egypt managed to achieve GDP growth of 3.6 percent in 2020—a better outcome than in most countries around the world.

Thanks to its commitment to continue structural reforms that began under the International Monetary Fund's Extended Fund Facility (IMF 2021a), Egypt was able to mobilize sufficient external financing. This included a $2.8 billion stopgap loan issued under the IMF's Rapid Financing Instrument, a $5.2 billion Stand-by Arrangement, a $5 billion sovereign Eurobond, a $0.75 billion sovereign "green" bond (see chapter 2), and a $2 billion loan from a United Arab Emirates–led consortium of commercial banks (World Bank 2020g). Consequently, the country's foreign exchange reserves were at a comfortable level of $40 billion as of February 2021 (Trading Economics 2021).

Egypt's growth is projected to be 3.2 percent in 2021 and 4.7 percent in 2022 (AfDB 2021). Medium-term growth prospects depend on the progress of the ongoing fiscal reforms, strengthening of the private sector, and continued provision of stimulus to the economy.

Libya. In 2020 Libya suffered several shocks in addition to the pandemic. Beyond the deleterious effects of the oil sector shocks, it experienced serious impediments related to the civil conflict. In January 2020 Libya was subjected to a nine-month blockade that cut oil output to 228,000 barrels per day (World Bank 2021e). The country's exports—mainly crude oil, refined petroleum products, natural gas, and chemicals—fell more than 80 percent in 2020. Due to oil dependence, Libya experienced enormous volatility in its export prices and demand. For instance, the price of Brent crude fell to $22.58 a barrel at the end of March 2020, the lowest level since 2002.

Libya's 2020 growth rate was estimated at –60.3 (AfDB 2021). Its currency continues to suffer in the parallel market because of political uncertainty and macroeconomic instability. In mid-December 2020 Libya devalued its currency for the first time in five years, decreasing its value from 1 Libyan dinar (LYD) to 0.5175 Special Drawing Right (SDR) to LYD 1 to SDR 0.156 (equivalent rate to the USD of LYD 4.48), effective January 3, 2021 (Reuters, December 16, 2020).

Given the extreme volatility and unpredictability surrounding the economic environment, reliable forecasts for Libya are only possible for the short term (World Bank 2021e). But given the recent progress in Libyan peace negotiations and rapid opening of oil fields, along with rising oil prices, growth can be expected to recover faster. The African Development Bank projects GDP growth of 37.5 percent in 2021 and 54.9 percent in 2022 based on the assumption of a postconflict recovery with significant capital inflows. Such growth would help Libya make up more than half of its loss in 2020.

Mauritania. Mauritania's main trade partner is China. When the Chinese economy contracted in the first half of 2020, demand for Mauritanian exports plummeted. In addition, the pandemic reduced foreign direct investment. Social distancing measures, closures of the border, restaurants, and markets, and lingering uncertainty led to a sharp reduction in consumption (World Bank 2021f). As a result, GDP growth is estimated to have fallen from 5.9 percent in 2019 to –3.6 percent in 2020. Strong fiscal pressures increased the risk of debt distress.

As the country's recession worsened, domestic and international tax revenues continued to decrease, while current spending escalated significantly as the government increased social transfers to protect vulnerable households and grant tax exemptions for firms—particularly small and medium-size enterprises experiencing financial difficulties. Consequently, the deficit is estimated to have reached an unprecedented 4.1 percent of GDP, the highest level recorded since 2005. Large financing needs increased Mauritania's public debt rose from 56.7 percent of GDP in 2019 to 62.6 percent in 2020, exacerbating the country's already high risk of debt distress (averaging 63 percent of GDP during 2015–18).

Mauritania's economic outlook partly depends on the government's ability to stem the ongoing crisis. Strong recovery in China is expected to lead to a resumption in demand for Mauritania's exports, and growth is projected to rebound to 2.8 percent in 2021 and 4.2 percent in 2022.

Morocco. The automobile sector, which accounts for 27 percent of exports, was most affected by the sharp decline in Morocco's exports. According to the country's High Commission for Planning (2021), 97 percent of car exports are destined for the European market. Declines in foreign demand for and prices of phosphates and derivatives—which account for 17 percent of exports—led to a 40.1 percent drop in their exports in the first quarter of 2020. After a resurgence of COVID-19 during the summer and fall of 2020, the number of new infections started to decline in December (World Bank 2021h). The pandemic took a severe toll on the Moroccan economy, abruptly pushing it into a severe recession for the first time since 1995. The pandemic-triggered shocks to supply and demand were compounded by the underperformance of the agricultural sector due to an unusually dry winter.

Real GDP is estimated to have contracted 7.1 percent in 2020, mainly because of the combined effects of the pandemic and drought. Consequently, Morocco's fiscal balance is estimated to have worsened from –4.1 percent of GDP in 2019 to –7.7 percent in 2020, partly due to $2.6 billion in additional spending to mitigate the impacts of the pandemic. Together with the recession, this substantially increased the debt-to-GDP ratio from 33.1 percent in 2019 to 39.2 percent in 2020.

A disruption in supply chains hurt most major export sectors including automotive, aeronautics, and textiles. Yet in 2020 the current account deficit improved by 2.2 percentage points of GDP to reach –1.5 percent of GDP, supported by a decrease in imports that exceeded the fall in exports, as well as grants from the European Union. Unemployment rose from 9.2 percent in 2019 to 12.5 percent in 2020 and is projected to reach its highest level since 2001. In addition, foreign direct investment declined, from 29.4 billion Moroccan dirham (MAD) in 2019 to MAD 24.4 billion in 2020 (from about $267 million to $222 million; World Bank 2020f).

Morocco's GDP growth is expected to rebound to 4.8 percent in 2021 and 3.5 percent in 2022, which will help shrink the fiscal and current account deficits. In October 2020 King Mohammed VI announced a roadmap for economic recovery complemented by a major universal social security program (Abouzzohour 2020). The authorities have also focused on how to revive and prioritize key sectors—such as tourism, transport, hospitality, and the private sector—that were harshly affected in 2020. The New Development Model for Morocco, released in June 2021, provides a vision for the country by 2035 aimed at achieving skills development, social justice, and sustainable growth.

Tunisia. About 60 percent of Tunisia's export revenues come from France, Germany, and Italy. In 2020 exports dropped 18.7 percent and imports 11.7 percent. Though all subsectors engaged in foreign trade saw declines, the largest were in clothing and textiles (45 percent) and mechanical and electrical industries (34 percent). Other manufacturing industries dropped by 30 percent, energy by 12 percent, and mining, phosphates, and derivatives by 17.5 percent (IFPRI 2020). The pandemic struck at a weak point in Tunisia's economic history. Due to persistent political instability, the economy has struggled to garner investor confidence. Unemployment has remained stubbornly high, rising from 14.9 percent at the end of 2019 to 18 percent in the second quarter of 2020, a level last reached during the 2011 revolution (World Bank 2021g).

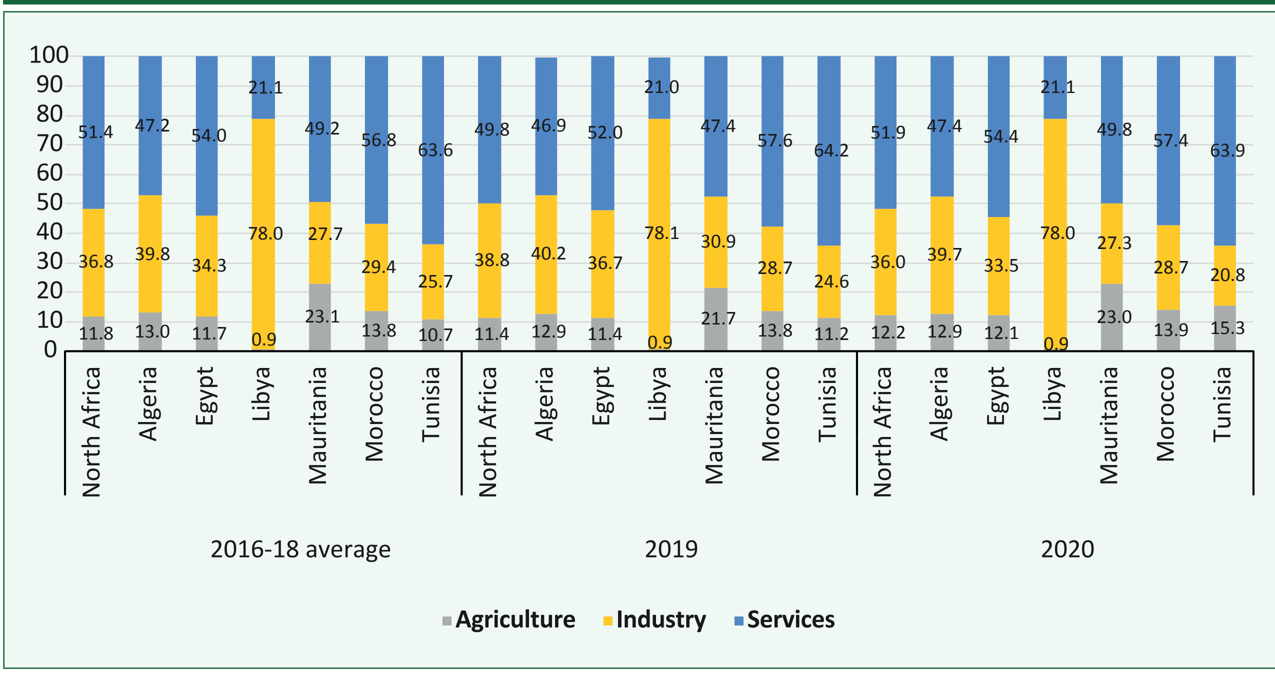
Tunisia's GDP contracted an estimated 8.8 percent in 2020. In the second quarter of the year, GDP contracted 21 percent year-on-year because lockdowns suppressed domestic supply and demand. GDP growth is expected to rebound to 2.0 percent in 2021 and 3.9 percent in 2022. In line with these trends, the current account deficit is expected to improve as export industries start to recover, though at a sluggish pace given persistent structural constraints and political uncertainties. But current structural reforms—affecting state-owned enterprises, the pension system, food and energy subsidies, and the informal sector—are expected to improve the country's macroeconomic fundamentals.

1.1.3 Economic contraction has been driven by services on the supply side and investment spending on the demand side

Structural weaknesses were inherent in most North African economies before COVID-19, including some countries' high dependence on natural resources for exports and low economic productivity, resulting in pervasive informality. The region's recent contractions in GDP can be explained in terms of supply and demand.

Supply side. The structure of output suggests that the contraction was largely driven by a decline in services, reflecting the collapse of tourism and transportation as roads, railroads, airports, and ports were closed and border crossings were prohibited. Except for Libya, North African countries are heavily dependent on services. In 2020 services accounted for 47.4 percent of GDP in Algeria, 54.4 percent in Egypt, 49.8 percent in Mauritania, 57.4 percent in Morocco, and 63.9 percent in Tunisia (figure 1.3).

Figure 1.3 Sector shares of nominal GDP in North Africa by country, 2016–20 (Percent)



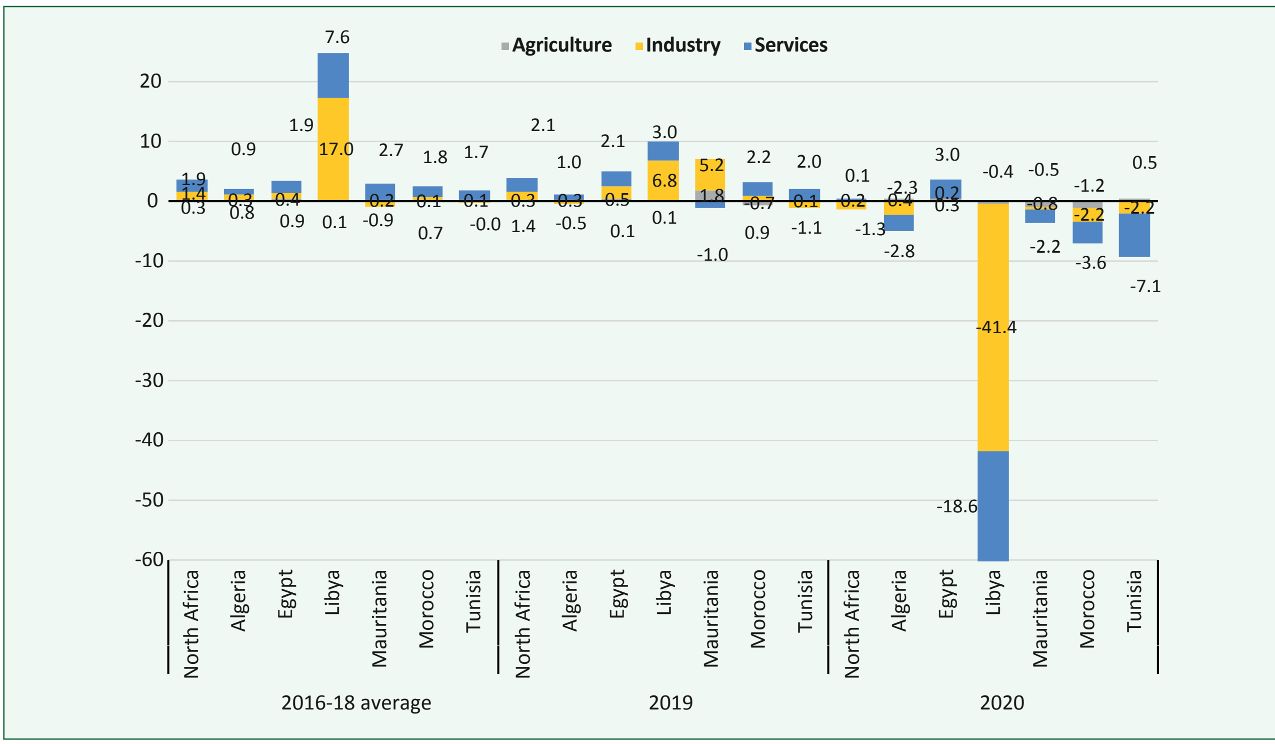
Source: African Development Bank statistics.
Note: Data for 2020 are estimates.

Within services, tourism—including related establishments such as hotels, restaurants, bars, and entertainment venues—is most important for Egypt, Tunisia, and Morocco. In 2018 tourism's value added to GDP was estimated at 10.0 percent in Egypt, 13.8 percent in Tunisia, and 6.5 percent in Morocco (AfDB 2020). Tourism is the third largest source of foreign revenue in the region, second only to remittances and nonoil exports (UNECA 2020).

In March 2020 the number of tourist arrivals in North Africa dropped by 18 percent relative to March 2019, or about 900,000 people (UNECA 2020). The Egyptian government estimated that tourism receipts fell by about $1 billion a month over the first half of 2020. Tourist cancellations crossed 80 percent in mid–March 2020 (year on year), putting 138,000 jobs at risk. The drop in tourism jobs is expected to affect at least another 1.4 million people. Such a decline would represent 10 percent of employment (UNECA 2020).

In 2020 services accounted for –2.8 percentage points of the –4.6 percent contraction in GDP in Algeria; –3.6 points of the –7.1 percent contraction in Morocco; and –7.1 points of the –8.8 percent contraction in Tunisia (figure 1.4). By contrast, services contributed 3.0 points to Egypt's GDP growth of 3.6 percent in 2020. The decline in services masks heterogeneity across subsectors. Though tourism and transport have declined, telecommunications, banks, and insurance providers have remained active during the pandemic.

Figure 1.4: Sectoral contributions to GDP growth in West Africa by country, 2016–20 (Percent)



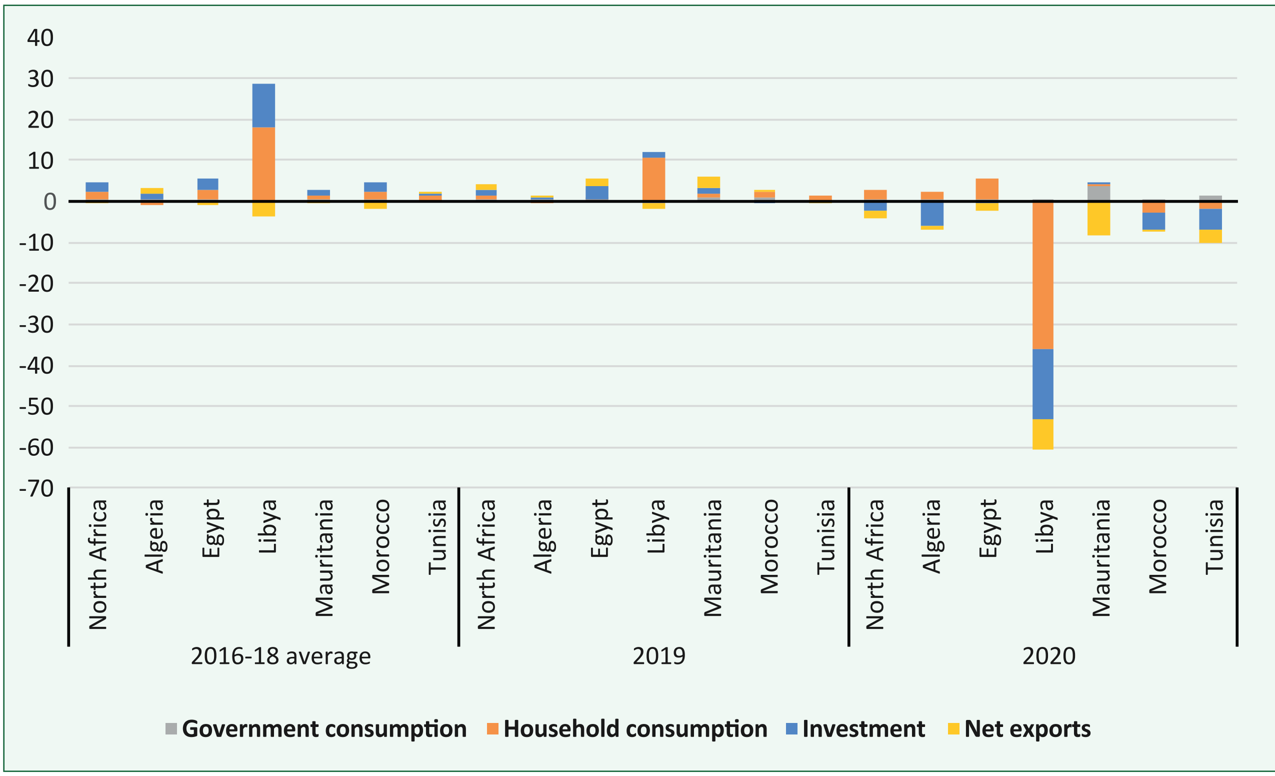
Source: African Development Bank statistics.
Note: Data for 2020 are estimates.

Demand side. The sharp pandemic-induced contraction in demand was largely driven by declines in fixed investment spending and net exports, as opposed to government and household consumption (figure 1.5). In 2020, compared with the average 28 percent of GDP for investment in lower–middle-income countries, countries in North Africa belonging to the same income group had shares as high as 46 percent in Algeria, 44 percent in Mauritania, and 32 percent in Morocco (IMF 2020d).

Investment accounted for –2.3 percentage points of North Africa's 2020 GDP growth rate of –1.1 percent. The severity of the fall in investment for each country is shown in figure 1.5. For example, in Algeria investment accounted for –6.0 points of the –4.6 percent GDP growth rate and in Tunisia for –5.1 points of the –7.3 percent rate.

The drivers of growth in North Africa reversed in 2020. In 2019, for the first time in a decade, investment contributed more (1.7 percentage points) to regional GDP growth (4.0 percent) than did total consumption (1.2 points). But in 2020 total consumption contributed more (2.3 percentage points) to GDP growth—at 2.3 points in Algeria, 5.7 points in Egypt, 4.3 points in Mauritania, –2.9 points in Morocco, and 0.1 point in Tunisia.

Figure 1.5: Demand-side contributions to GDP growth at market prices in North Africa by country, 2016–18 (Percent)



Source: African Development Bank statistics.
Note: Data for 2020 are estimates.

1.2 RESPONSES TO MITIGATE THE CRISIS

1.2.1 Emergency spending was initiated across the region

In response to COVID-19, all North African economies have, to varying degrees, boosted spending on healthcare, provided emergency spending to support affected workers and companies in strategic sectors, adopted temporary tax payment reliefs and holidays, and extended government guarantees for loans from banks or central banks in favor of strategic sectors. Major fiscal measures that North African governments implemented in 2020 in response to COVID-19 are summarized in table 1.1. These discretionary measures supplemented existing stabilizers such as automatic insurance mechanisms and social safety nets, which differ across countries in breadth and scope.

Table 1.1: Key economic responses to COVID-19 in North Africa by country, 2020

Type	Algeria	Egypt	Mauritania	Morocco	Tunisia
Additional spending on and forgone revenue from the health sector	• Medical supplies • Bonus payments for health workers • Allowances to the unemployed • Transfers to poor households	• Medical supplies • Higher wages for public health staff • Meal subsidies for poor households	• Emergency funds for urgent procurement of medical supplies and equipment	• Creation of a special fund for management of the pandemic (about 3 percent of GDP)	• Equipment for public hospitals • Waiver of value-added taxes for businesses selling medicines
Additional spending on and forgone revenue from other sectors and areas		• Lower energy costs for factories • Subsidies for xporters • Support to pensioners and irregular workers • Lower interest rates to encourage spending • Six-month grace period on insurance premiums for small and medium-size enterprises. • Lower stamp duty on transactions and tax on dividends for investors • Postponement of capital gain taxes		• Affected businesses can defer income tax and social contribution payments • Cash transfers to about 1 million workers • Social transfers extended to the temporary unemployed • Deadline postponed for personal income tax filing	• Monthly cash transfers for low-income households, disabled and homeless people • Temporary support for the unemployed and self-employed • Special programs to support social work • Suspension of penalties for delayed tax returns and customs payments • Measures for the private sector (faster value-added tax refunds, postponement of other taxes and social contributions, rescheduling of tax arrears)
Equity injections, asset purchases, loans, debt assumptions				• Creation of a fund for strategic investments to finance investment projects and sustain the capital of firms needing equity injections	• Creation of fund for public donations to the health sector • Investment fund to finance strategic private companies • Bridging fund to repurchase shares of strategic private companies

Guarantees on loans, deposits, and the like		• New fund to guarantee mortgages and consumer loans made by banks • Temporary real estate tax relief for industrial and tourism sectors • Guaranteed low- interest Central Bank loans to tourism sector			• State guarantees for new credits from banks
Quasi-fiscal operations (of public corporations on behalf of government)		• Stock purchase by the Central Bank. • Loan subsidies to tourism, agriculture, industrial and housing.			

Source: IMF 2021c.
Note: Detailed information for Libya was not available.

1.2.2 Countries faced the challenge of raising spending to fight COVID and protect people while receiving lower external financing

Most North African countries have adopted supplementary budgets to deal with COVID-19. In addition, Mauritania, Morocco, and Tunisia have created dedicated COVID extra-budgetary funds. These funds have allowed expenditures to be programmed and disbursed more quickly than would be possible under the conventional budget process. Tunisia's fund is mostly financed by private contributions, while the funds in Mauritania and Morocco pool resources from private donations and contributions, public resources, and external sources of finance. The fund in Tunisia is off budget while those in Mauritania and Morocco are under the budget system and fully integrated with budget execution and control procedures (Fazeer and others 2020).

These above-the-line measures consist of additional spending and/or forgone revenue in health and other relevant sectors. Below-the-line measures represent liquidity support such as equity, loans, and guarantees. These contingent liabilities have different implications for public finances and need closer monitoring, including setting of sunset clauses.

Combined, North African governments committed about $15 billion to discretionary measures to mitigate the impacts of the pandemic. Among the region's middle-income countries the additional spending ranged from 0.4 percent of GDP in Algeria to 8.8 percent in Morocco. At 4.9 percent of GDP, the additional spending by Mauritania put it in the upper range of interventions by low-income countries. For the other North African countries, additional spending was consistent with that in other emerging market and middle-income countries.

Fiscal measures have included:

- Exempting or postponing rent payments on property, and land taxes (Egypt).
- Deferring or exempting tax declarations and payments (Algeria, Egypt).
- Suspending or reducing various government fees and penalties (Algeria, Tunisia).
- Strengthening or broadening unemployment benefits (Algeria, Morocco).
- Expanding cash transfers to low-income households (nearly all countries in the region).
- Providing subsidized loans to small and medium-size enterprises, businesses in hard-hit sectors, and low-income households (Egypt, Tunisia).

Monetary policies measures have included:

- Cutting policy interest rates (Algeria, Egypt, Mauritania, Morocco, Tunisia).
- Injecting liquidity into the banking system (Morocco, Tunisia).
- Expanding access to lending tools, including cutting reserve requirements and extending loan maturities (Algeria, Morocco, Tunisia).
- Lowering capital adequacy requirements (Morocco).
- Relaxing loan classification and provisioning (Morocco).

Details on the policy instruments applied are summarized in box 1.1.

Box 1.1: Fiscal and monetary policy responses to COVID in North Africa

Algeria
The government allocated DZD 70 billion ($545 million) to mitigate COVID's health and economic impacts. These efforts included postponing tax payments, providing allowances and cash transfers to vulnerable households, cutting the reserve requirement ratio to 6 percent, lowering the main policy rate by 0.25 percentage point to 3.0 percent, and cutting imports by at least $10 billion.

Egypt
The government cut gas and electricity prices for industry, lowered stamp taxes, exempted capital gains from taxation, reduced taxes on dividends, and gave factories and tourist facilities a six-month grace period for paying real estate taxes. The central bank cancelled EGP 9.9 billion ($628 million) of loans, provided EGP 20 billion ($1.3 billion) to support the stock market, and cut the policy rate by a cumulative 3.0 percentage points.

Libya
A LYD 500 million ($364 million) emergency spending package was introduced to support the health system, expand COVID testing, and respond to a possible surge in infections, along with a 20 percent pay cut for civil servants. According to the central bank, funds to combat COVID totaled LYD 847 million ($616 million).

Mauritania
A national solidarity fund of nearly $60 million was created to strengthen health infrastructure for vulnerable populations and workers affected by the economic slowdown and unemployment. In addition, the IMF disbursed $130 million through its Rapid Credit Facility to support priority health spending and assist the most vulnerable households and economic sectors.

Morocco
The government expanded employment benefits, deferred tax payments, cut the policy rate by a cumulative 0.75 percentage point, created a fund dedicated to managing the pandemic, financed a lending facility for micro, small, and medium-size enterprises, and established a post-crisis facility for businesses that will provide financing for working capital at subsidized interest rates.

Tunisia
The government delayed tax payments (including for small and medium-size enterprises), postponed loan repayments for low-income workers, provided financial assistance to poor households, and cut the policy rate.

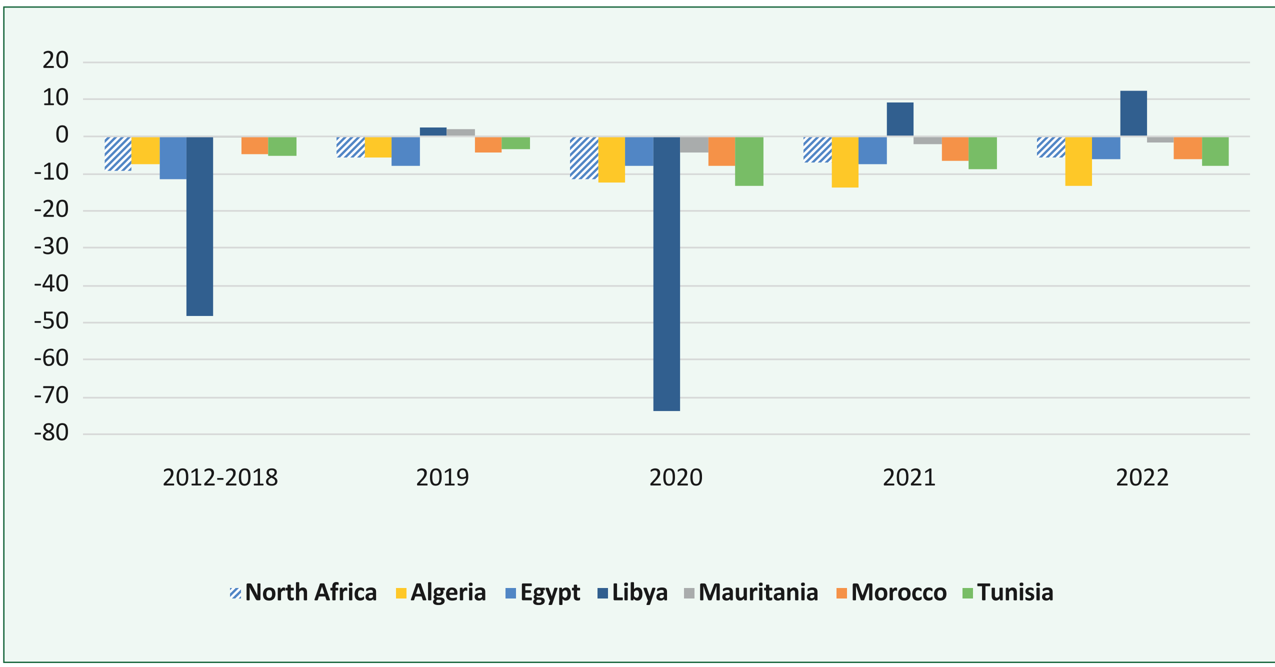
Source: World Bank 2020d; UNECA 2020.

1.2.3 Fiscal deficits deteriorated

In 2020 budget imbalances in North Africa ballooned because of pandemic-related spending and sharply declining revenues from oil, tourism, and shutting down of economic activities. Despite reductions in investment spending on public projects, declining revenues aggravated fiscal deficits in all North African countries (figure 1.6). Between 2019 and 2020 the region's fiscal deficit more than doubled, from 5.7 percent of GDP to 11.6 percent.

Libya suffered the most, moving from a fiscal surplus of nearly 2.2 percent of GDP in 2019 to a deficit of 73.8 percent in 2020. In addition, three countries provided businesses with below-the-line budget guarantees totaling $8.0 billion. Morocco led with $7.3 billion in guarantees, while Egypt provided $0.5 billion and Tunisia $0.2 billion. Budget deficits also widened due to rising debt service.

Figure 1.6: Fiscal balances in North Africa by country, 2012–22 (Percentage of GDP)



Source: African Development Bank statistics.
Note: Data are estimates for 2020 and projections for 2021–22.

1.2.4 Monetary and external accounts saw further imbalances

Current account deficits. Between 2019 and 2020 the region's average deficit in current account balances (including grants) widened from 4.9 percent of GDP to 8.8 percent (table 1.2). The two oil exporters, Libya and Algeria, as well as Mauritania, suffered the highest deficits, at 59.8 percent, 14.8 percent, and 17.6 percent of GDP . Morocco's and Egypt's current account deficits were the lowest, at 1.5 percent and 3.1 percent of GDP. The deficit in Tunisia was 8.1 percent of GDP. The shrinking of tourism receipts exacerbated the current account deficits. But given the recent recovery in oil and commodity prices, current account deficits for the region are projected to be much lower in both 2021 (4.9 percent of GDP) and 2022 (1.3 percent of GDP).

Table 1.2: Current account balances in North Africa by country, 2018–22 (Percentage of GDP)					
	2018	2019	2020	2021	2022
North Africa	**-5.3**	**-4.9**	**-8.8**	**-4.9**	**-1.3**
Algeria	-9.5	-10.0	-14.8	-13.8	-11.1
Egypt	-2.4	-3.6	-3.1	-3.6	-2.3
Libya	1.8	9.3	-59.8	31.2	61.3
Mauritania	-13.8	-10.9	-17.6	-14.3	-13.7
Morocco	-5.3	-3.8	-1.5	-3.1	-4.3
Tunisia	-11.2	-8.5	-8.1	-4.1	-3.6
Africa	**-3.5**	**-4.0**	**-5.5**	**-4.1**	**-2.7**

Source: African Development Bank statistics.
Note: Includes grants. Data are estimates for 2020 and projections for 2021–22.

Exchange rates, interest rates, and inflation. The effects of fiscal deficits—including the high cost of debt service—and the banking system's sharp increase in government credit through direct advances and holding of more treasury bills and bonds, combined with shrinking foreign exchange reserves, affected current account deficits and exerted pressure on exchange rates. High external debt service obligations, dwindling foreign reserves, and rising fiscal concerns haveresulted in depreciation pressures for most African currencies (AfDB 2021). In Morocco exchange rates have been less stable after the global lockdowns. In early April 2020 the dirham's value to the dollar stood at a historic MAD 10.27, compared with MAD 8.8 in January 2021. For the first time in five years, Libya devalued its dinar in mid-December 2020, from LYD 1.35 to the dollar to LYD 4.48 (effective January 3, 2021).

Interest rate policy is one of a central bank's most important monetary instruments to support the economy. Algeria cut interest rates from 3.75 percent in 2019 to 3.0 percent in December 2020; Egypt from 12.25 percent to 8.5 percent in November 2020; Morocco from 2.25 percent to 1.5 percent in June 2020; and Tunisia from 7.75 percent to 6.75 percent in June 2020 and 6.25 percent in October 2020.

The risk of high inflation due to expansionary monetary policies and large fiscal deficits is low because of the decline in overall demand in North Africa. In fact, the region as a whole experienced deflation between 2019 and 2020 as consumer prices dropped by nearly half, from 8.1 percent to 4.1 percent (table 1.3). In Egypt inflation fell from 13.9 percent to 5.7 percent.[1] Libya experienced the opposite, moving from

[1] Egypt changed its method of measuring inflation in the fall of 2020.

−2.2 percent to 1.5 percent, partly due to the blockade. But in the immediate term, inflation is likely to rise across the region due to higher costs for food and energy (that is, cost push inflation).

Table 1.3: Inflation in North Africa by country, 2018–22 (Percent)

	2018	2019	2020	2021	2022
North Africa	**13.4**	**8.1**	**4.1**	**5.0**	**6.1**
Algeria	4.3	1.9	2.4	4.5	4.1
Egypt	21.6	13.9	5.7	6.4	7.5
Libya	13.6	-2.2	1.5	10.5	17.4
Mauritania	3.1	2.3	2.7	3.9	3.0
Morocco	1.6	0.2	0.7	0.1	0.7
Tunisia	7.3	6.7	5.9	5.7	4.3

Source: African Development Bank statistics.
Note: Data are estimates for 2020 and projections for 2021–22.

Rising debt. Debt and debt service have risen significantly in the face of the sharp deterioration in fiscal performance. This is a serious concern for the region because the debt burden will crowd out resources needed to support healthcare and economic recovery. Between 2015 and 2020 North Africa's external debt increased more than 14 percentage points—from 17.9 percent of GDP to 32.0 percent—and in a number of countries a shift in debt structure from official bilateral and multilateral to private creditors raised the costs of debt servicing. Still, in Egypt and Morocco the reliance on international capital markets could imply a drop in debt servicing costs relative to domestic financing at higher interest rates. And not all North African countries face similar debt situations. In 2020 the region's two main oil exporters, Algeria and Libya, were are almost external debt free. But heavy external debt burdens (public and private) remained in Tunisia (97.2 percent of GDP) and Mauritania (62.6 percent of GDP). Morocco's external debt is modest at 39.2 percent of GDP (AfDB 2021).

1.2.5 Recovery in tourism will take time

Tourism, North Africa's largest source of service-related export revenues, was hit hard by the pandemic. Between January and October 2020 international arrivals in North Africa plummeted 76 percent (UNWTO 2020). With the closing of borders, airports, and ports, the implementation of travel restrictions, and the extensive losses of full- and part-time jobs of North Africans working abroad, the sharp deterioration in tourism receipts has lowered services balances and current account balances.

Tourism will experience some recovery in the near future. But it will be slow due to travelers' reluctance to travel. An August 2020 survey by the International Air Transport Association found that over half of respondents would wait 6–12 months or more before traveling again, even after travel restrictions are lifted.

1.2.6 Remittances increased in some countries

Remittances account for about 6 percent of North African GDP on average, ranging from about 1 percent in Algeria and Mauritania to 5 percent in Tunisia, 6 percent in Morocco, and more than 8 percent in Egypt (AfDB 2020). Most Moroccan and Tunisian migrants are in European countries (France, Germany, Italy, and Spain, countries hit hard by COVID-19).

In 2020 remittances to North Africa fell the most in Algeria, by $104 million (a 5.8 percent drop from 2019), and Mauritania, by $3 million (4.9 percent drop; table 1.4). But in other countries remittances actually increased.

Table 1.4: Remittances to North Africa by country, 2015–20 (Millions of U.S. dollars)

Country	2015	2016	2017	2018	2019	2020	Change, 2019–20	Change, 2019–20 (percent)
Algeria	1,997	1,989	1,792	1,985	1,786	1,682	-104	-5.8
Egypt	18,325	18,590	24,737	25,516	26,781	29,603	2,822	10.5
Mauritania	-	-	77	60	64	61	-3	-4.9
Morocco	6,904	6,383	6,823	6,919	6,963	7,419	456	6.5
Tunisia	1,971	1,821	1,890	1,902	2,050	2,100	50	2.5

Source: African Development Bank statistics based on KNOMAD data, https://www.knomad.org/data/remittances (May 2021).
Note: Data for 2020 are estimates. Information on Libya's remittances was not available.

1.2.7 Grants and foreign aid shrank

COVID caused a drop in grants and international assistance to North Africa because donors were also struck by fiscal and debt difficulties. Key donors, such as the United Kingdom, cut foreign aid budgets. Between 2019 and 2020 bilateral donors slashed aid commitments by 17 percent, including a 5 percent decline in commitments of official development assistance (Development Initiatives 2020).The scale of these cuts at a time when bilateral aid is falling for certain sectors may start to shift the nature of the financing structure used to support the delivery of critical human development resources, especially human capital services.

Donor countries have indicated that they would strive to protect their budgets for official development assistance. Yet in the first five months of 2020, bilateral aid commitments which were reported to the International Aid Transparency Initiative were about 30 percent lower than during the same period in 2019 (Observer Research Foundation 2020).

It is crucial that the United States and other advanced countries increase foreign aid to help North African and other developing nations recover (Borgen Project 2020). Between 2019 and 2020 aid from developed countries fell sharply: in Germany, from $6.2 billion to $2.25 billion, in Spain from $0.29 billion to $0.23 billion, and in the United Kingdom from $11.9 billion to $6.4 billion (Development Initiatives 2021).

In 2020, as of July, lending from the World Bank rose by $14.1 billion and from the African Development Bank by $1.8 billion—both representing increases of more than 40 percent over the same period in 2019. But together with the falling amount of bilateral aid delivered as grants, the concessional aspect of aid (the "grant element") was reduced (Development Initiatives 2020).

1.2.8 The pandemic will have lasting effects on poverty

Services account for most employment in North Africa's formal and informal sectors. They are also the domain of small and medium-size enterprises, household businesses, and self-employed individuals. As such, the pandemic's most serious impacts fell on vulnerable groups. Unemployment was already stubbornly high in the region, and the pandemic intensified it. In Algeria unemployment rose from 11.4 percent in 2019 to 13.7 percent in 2020, in Morocco from 9.2 percent to 12. 5 percent, and in Tunisia from 14.9 percent to 17.4 percent (IMF 2020d). Accordingly, poverty increased.

Poverty. In combination with North Africa's economic contraction, COVID-19's most severe impact was a significant increase in poverty across the region due to job losses, business closures, disruptions in government services, and food insecurity. Because all six North African countries are classified as lower-middle-income, it is appropriate to use the poverty line of $3.50 a day for measurement. The poverty line of $5.50 a day significantly increases poverty rates because most of the region's population lives on a daily income ranging from $3.50–5.50 (table 1.5). Applying this measure to compare poverty headcounts (as a percentage of the population) before and during COVID indicates that poverty increased most in Tunisia (albeit from a low base), from 2.4 percent to 4.2 percent, followed by Algeria (2.2 percent to 3.3 percent), and Morocco (4.9 percent to 6.2 percent; table 1.5). Egypt is unique in North Africa, with a very high poverty headcount that rose from 24.1 percent to 30.5 percent.

Table 1.5: Projected changes in poverty due to GDP contractions and COVID in selected North African countries, 2020 (Percent)

Country	Poverty headcounts before COVID		Poverty headcounts during COVID	
	$3.20 a day	$5.50 a day	$3.20 a day	$5.50 a day
Algeria	2.2	20.8	3.3	26.5
Egypt	24.1	68.9	30.5	73.8
Morocco	4.9	23.4	6.2	27.5
Tunisia	2.4	15.0	4.2	22.0

Source: World Bank 2020d.
Note: Data for Libya and Mauritania were not available.

Several factors explain the large increase in poverty. First, economic dualism is widespread across North Africa, as reflected in formal and informal sectors. Formal labor markets— dominated by employees of government and state-owned enterprises—have better-paying jobs than informal ones. Moreover, work in the informal sector offers little job security and virtually no social protection. When measured as the percentage of the workforce not contributing to social security, informality rates are 31.5 percent in Libya, 44.9 percent in Egypt, 51.4 percent in Tunisia, 63.3 percent in Algeria, and 76.2 percent in Morocco (Gatti and others 2014). Second, lack of access to medicine, healthcare, and food increased the likelihood of poor nutrition and infection. Third, poor people are more likely to have preexisting health problems and usually reside in crowded environments (say, with two or three generations under the same roof), making transmission of the virus more likely (OECD 2020).

1.3 PROSPECTS FOR RECOVERY

North Africa's prospects for recovery in the near term seem bright (see figures 1.1 and 1.2). But the near-term outlook is clouded with uncertainties emanating from tailwind and head-wind factors. Moreover, the projected recovery will not be strong enough to absorb new entrants into labor markets, and faces additional risks over the medium and long term.

1.3.1 Tailwind factors support the idea that North Africa can thrive as COVID-19 abates

- With the pandemic beginning to be brought under control in some North African countries, governments are easing lockdowns and mobility restrictions. Vaccine production and distribution are moving forward much faster than expected. And testing and treatment have improved. Still, better COVID-related regulation is crucial.
- Access to vaccines is increasing. In 2021 COVAX—the global initiative aimed at equitable access to COVID-19 vaccines—plans to provide Algeria with 2.2 million and Egypt 5.1 million (WHO 2001). Several countries have also placed orders directly with vaccine companies such AstraZeneca, Socopharm, and Sputnik V. Egypt has ordered 100 million doses, Morocco 2.5 million, and Algeria 500,000 (Aktas 2021).
- Successful pandemic control experiences of countries within and outside the region are being shared. As a result, health protection equipment (masks), treatment (medicine), and health services (hospitals, doctors, nurses) are becoming more widely available.
- Oil prices have recently risen significantly—reflecting growing demand, especially in the United States by the end of the first quarter of 2021—with the price of Brent crude hitting more than $64 a barrel. That compares with World Bank (2021b) forecasts of $44 a barrel for 2021 and $50 for 2022.
- Policy support for the health sector continues in all North African countries.

1.3.2 But headwind factors could imperil a rapid recovery

- COVID-19's impacts are lasting longer than expected, and new variants of the virus have emerged. North Africa's economic recovery depends on successful containment of the pandemic. In mid-April 2021 Africa had registered 4,346,813 COVID-19 cases. Of the five countries reporting the most, three are in North Africa: Morocco (502,102), Tunisia (271,861), and Egypt (182,424). The other two are South Africa (1,558,456) and Ethiopia (228,996; ECDC 2021).
- Threats persist from new variants of the virus, with the Alpha and Delta variants more transmissible than the predominant COVID-19 strain. The two variants have wreaked havoc in many countries including India, the United Kingdom, and the United States.
- Limited access to or delays in vaccine distribution risk COVID-19 becoming a long-term concern. Vaccines must be manufactured in large quantities and be distributed worldwide. Yet Africa may have to wait years before getting enough vaccines for its people (Aktas 2021).
- Though oil prices have rebounded, continuation of this trend depends on increasing world demand—which, in turn, depends on continued global recovery and decisions by the Organization of the Petroleum Exporting Countries and their partners (OPEC+) on whether to increase oil production.
- Weaknesses in the recovery of consumer and business confidence may cause protracted domestic and external demands. Consumers may also require a period of recovery, like producers after long periods of unemployment and financial loss.
- Because the pandemic disrupted human capital accumulation, it could induce a decline in productivity. Productivity is essential for long-term growth.
- Simmering geopolitical tensions are reflected in North Africa's social and political landscape, which is vulnerable to Libya's fragile political transition to peace, Mauritania's anticorruption campaign, Morocco's strikes and protests against unemployment and social inequality, and Tunisia's persistent economic and political dissatisfaction.
- Given the sharp deterioration in fiscal performance and need to extend pandemic relief measures and related public expenditures into 2021 and possibly 2022, debt burdens and debt service will continue to rise in most North African countries. This is a serious concern because debt burdens will either overcrowd demand for resources for healthcare and recovery support or result in defaults (see chapter 2).

1.3.3 Medium- and long-term risks abound

The 2020 economic crisis exacerbated several structural weaknesses in North African economies, suggesting that even if growth bounces back in the near term, the persistence of the pandemic or development of future external shocks will jeopardize the sustainability of growth in the medium to long term.

First, COVID-19 magnified the hazards of a commodity-driven growth model and heavy dependence on natural resources—as in Algeria and Libya, where oil revenues account for more than 96 percent of exports. Resource dependence subjects an economy to commodity price volatility. When commodity prices are high, a "Dutch disease" effect creates distortions in the economy, leading to rising input costs and contraction in tradable sectors such as manufacturing. The experiences of Algeria and Libya contrast sharply with that of Egypt, where in 2020 economic diversification nurtured by the ongoing Economic Transformation Program dampened the negative impacts of the oil shocks. Iron-dependent Mauritania and, to a lesser extent, Tunisia and Morocco (dependence on iron ore and phosphate) would also benefit from nurturing private sectors not based on extractives. Egypt's moves to liberalize tariff and nontariff barriers and allow duty-free zones to sell in the domestic market offer valuable lessons for first steps in accelerating diversification.

Second, COVID-19 revealed the perils of excess concentration in North Africa's export destination markets. More 65 percent of African exports to the European Union are primary goods, while almost 70 percent of its EU imports are manufactured goods. Given that intraregional trade in North Africa accounts for less than 5 percent of the region's total trade, its proximity to the rest of Africa makes regional markets a natural starting point. Access to Africa's low-income countries—especially through the African Continental Free Trade Area (AfCFTA) agreement, covering a market of 1.2 billion people—presents a low entry bar and could be an attractive trade opportunity for all kinds of products. In addition, North Africa's multi-language advantage would further lower the entry bar for exports of services to francophone Africa.

Third, the ensuing instability and insecurity in postconflict Libya constrain any initiative for economic diversification, making governance reforms a prerequisite. Instability is inevitable when the benefits of oil revenues are not inclusive. Similarly, widening regional disparities hamper efficient resource allocation and could erode social stability, threatening a smooth, sustained economic recovery in the medium term.

Finally, in recent decades the deleterious effects of climate change in North Africa have created another hurdle to sustained economic recovery. Water scarcity and desertification pose significant risks for agricultural sustainability and food security, and so warrant public investments in low carbon industries, desalination projects, and solar energy.

CHAPTER 2

DEBT DYNAMICS AND FINANCING ISSUES

This chapter analyzes the debt dynamics of North African economies. The first section provides an overview of trends in external financing—foreign direct investment, portfolio investment, official development assistance, and remittances—and how the COVID-19 pandemic affected these flows. The second section assesses general government indebtedness, with detailed analyses of external debt and debt sustainability. The third section covers efforts by various North African governments to develop domestic bond markets. The final section examines emerging debt vulnerabilities, including contingent liabilities of state-owned enterprises and the outlook for debt in North Africa.

2.1 RECENT DEVELOPMENTS IN EXTERNAL FINANCING

2.1.1 Before the pandemic, external financing increased only slightly

During 2014–19 North Africa's combined financial inflows from all sources—remittances, net debt inflows, foreign direct investment, official development assistance, and portfolio investment—rose slightly, led by remittances and net debt inflows (figure 2.1). Foreign direct investment was fairly stable, in the range of $10–13 billion a year. Except in Mauritania, official development assistance accounted for less than 1 percent of GDP for North Africa. Portfolio investment also played a minor role, though limited reliable information on such investment makes it difficult to make any definitive assessment of trends.

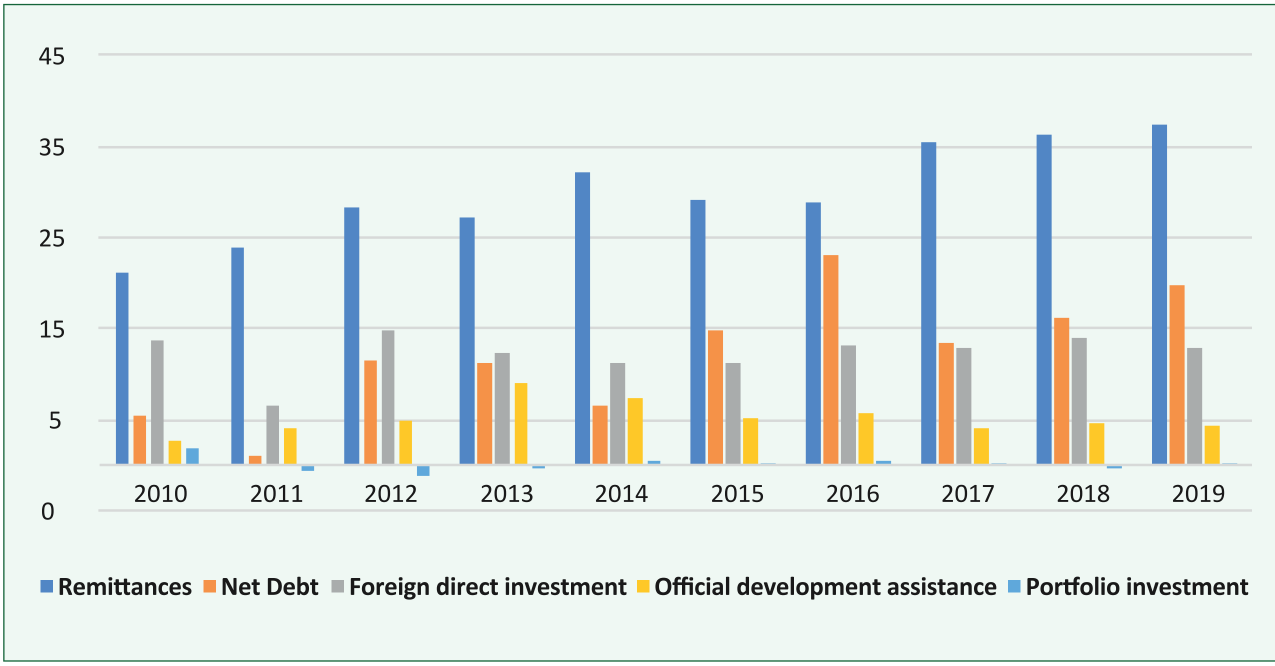
2.1.2 The pandemic caused a sharp drop in foreign direct investment

In 2020 COVID-19 severely curtailed foreign direct investment in Africa, mirroring global trends (UNCTAD 2021). This downturn was exacerbated by lower commodity prices. Foreign direct investment in North Africa fell 25 percent, to about $10 billion in 2020, down from $13 billion in 2019. Although Egypt remained the largest recipient in Africa, it registered a 35 percent reduction in foreign direct investment in 2020, to $5.9 billion.

Due to the widespread economic uncertainty and restrictions on the movement of people, goods, and services, many announced and planned investment projects were shelved or put on hold. As noted, the pandemic hit services disproportionately—with the biggest impacts on tourism and related industries like aviation, hospitality and leisure.

Global trends in foreign direct investment suggest that the pandemic could have lasting effects on investment policies in North Africa. It could solidify the shift toward more restrictive admission policies for foreign investment in strategic industries. In addition, it could trigger increased competition for investment as economies seek to recover. At the international level the pandemic will likely accentuate the need to reform international investment agreements, as government responses to the health crisis and its economic fallout—through subsidies and guarantees—created numerous frictions with obligations under these agreements.

Figure 2.1: Financial flows to North Africa by type, 2010–19 (Billions of U.S. dollars)



Source: World Bank 2021c; UNCTAD 2021; OECD 2019.

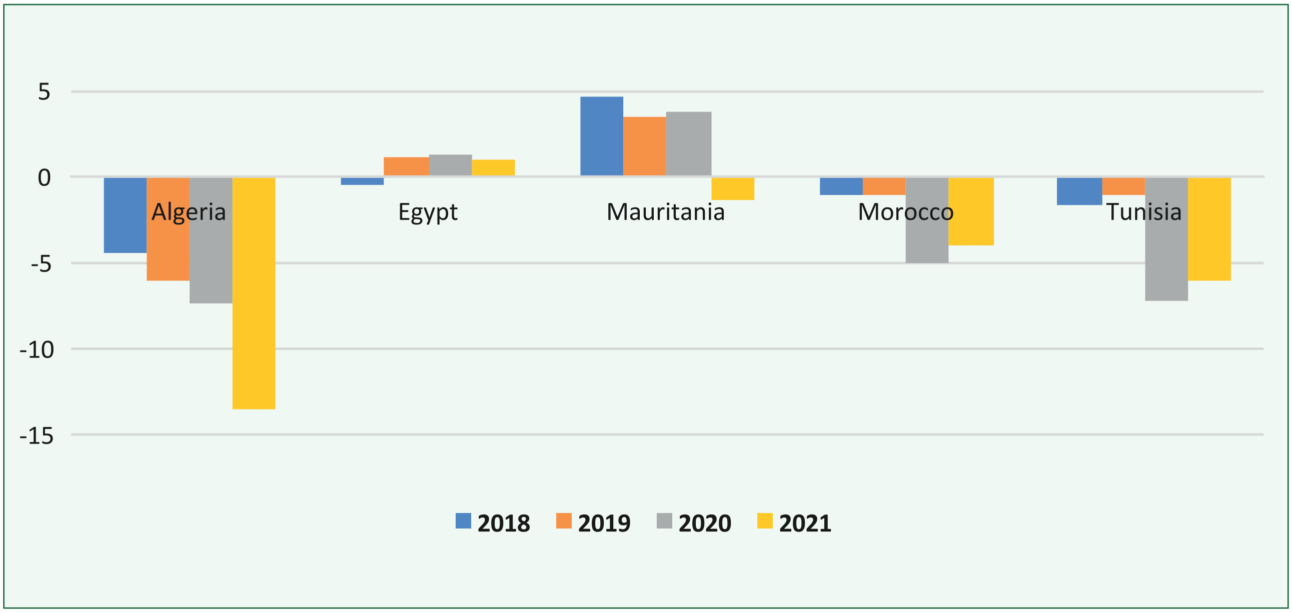
2.2 CHANGING STRUCTURE AND DRIVERS OF DEBT

2.2.1 Increased fiscal and current account deficits have forced countries to incur more debt, domestically and externally

COVID compelled North African governments to take on more domestic and external borrowing in 2020 (figure 2.2). As a result, general government debt as a share of GDP rose in all North African countries, reversing trends toward more stable or lower public debt that had been achieved in recent years in Egypt, Mauritania, Morocco, and Tunisia. In 2021 public debt in North African countries is expected to rise further as a share of GDP (IMF 2021h).

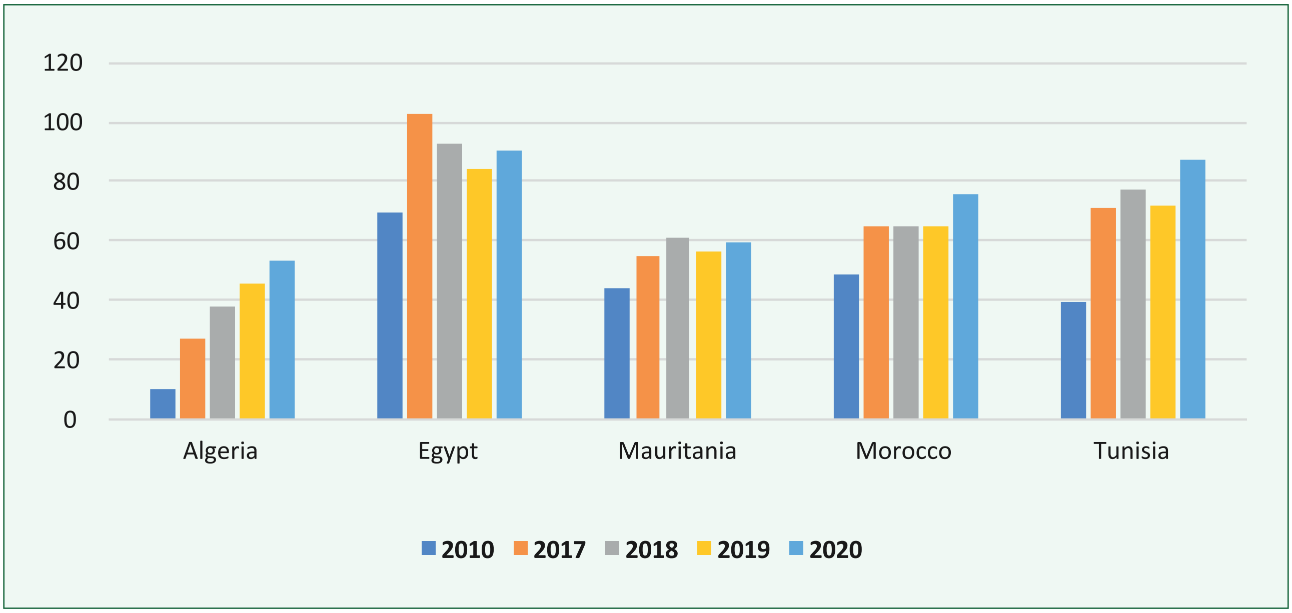
Across the region, general government debt rose rapidly between 2010 and 2020—especially in Algeria, where public debt as a share of GDP more than quintupled (figure 2.4). Some countries have tried to reduce public debt: Egypt managed to reduce it from 103.2 percent of GDP in 2017 to 83.8 percent in 2019. But because of large expenditures in response to the pandemic and lower levels of nominal GDP, in 2020 public debt as a share of GDP rose across the region, surpassing 80 percent in Egypt and Tunisia.

Figure 2.2: Central Government Net Borrowing (-) as a Share of GDP, 2018-21 (Percent)



Source: IMF 2021h.
Note: Includes both domestic and external debt.
Information for Libya was not available.

Figure 2.3: General government debt in North Africa by country, 2010–20 (Percentage of GDP)



Source: IMF 2021h; World Bank 2021c.
Note: Includes both domestic and external debt.
Information for Libya was not available.

2.2.2 Dynamics of rapid public debt accumulation have varied by country

North African countries have taken different approaches to funding their larger financing requirements.[2] Because the authorities have decided against borrowing externally, Algeria's public debt is essentially domestic. During 2010–19 it spiked to finance a deficit borne of rising spending and falling hydrocarbon prices. By the end of 2019 external public debt represented less than 2 percent of GDP—but domestic debt, including guarantees, was 44 percent (table 2.1).

Tunisia's heavy reliance on external borrowing is largely due to the profile of its debt, which has low average interest rates, relatively long maturities, a substantial concessional share (with a predominance of multilateral creditors), and a large grant element on new external debt. These features make Tunisia's external debt relatively robust to shocks apart from a large real exchange rate depreciation, which would sharply increase external debt in local currency. The long debt maturity profile also limits rollover risks. Still, the country's high debt service burden (equal to about 15 percent of exports) may become an issue over the short to medium term.

Among the remaining North African countries (with the exception of Mauritania, which relies much more on official development assistance), Egypt and Morocco have managed to lengthen the maturities of their sovereign debts. In addition, Egypt's 2016 liberalization of its capital account and high real interest rates have attracted foreign investors who have pumped billions of dollars into the domestic debt market. The share of foreign ownership of outstanding treasury bills went from less than 1 percent in 2016 to 19 percent in 2019. Large fluctuations in these investments have imposed new challenges on the government about how to minimize the large flows of "hot" money in and out of the country. Morocco is facing similar challenges about flows of hot money invested in domestic treasury bills.

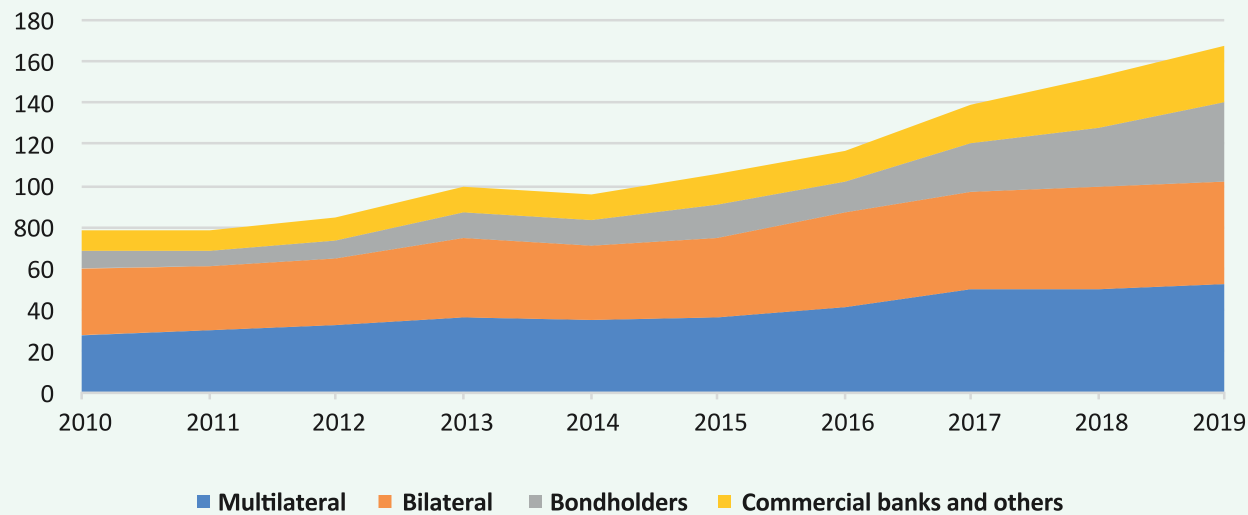
[2] The country information in this section was drawn from AfDB (2021).

Table 2.1: Debt in North Africa by country, 2010–19 (Percentage of GDP)						
Algeria	**2010**	**2015**	**2016**	**2017**	**2018**	**2019**
General government gross debt	10.5	8.7	20.5	26.8	37.2	45.8
External	2.7	1.5	2.0	2.0	1.8	1.8
Domestic	7.8	7.2	18.5	24.8	35.4	44.0
Total external debt	4.5	2.8	3.4	3.4	3.3	44.0
Egypt						
General government gross debt	69.6	88.3	96.8	103.0	92.5	84.2
External	14.4	13.6	17.1	30.9	35.7	34.2
Domestic	55.2	74.9	79.7	72.1	56.8	50.0
Total external debt	16.0	15.0	20.8	35.8	40.0	38.1
Mauritania						
General government gross debt	43.9	58.7	56.5	55.1	61.4	56.5
External	46.9	63.2	63.1	61.9	59.2	56.4
Domestic	-3.0	-4.5	-6.4	-6.8	2.2	0.1
Total external debt	63.1	80.8	79.2	77.3	74.1	70.7
Morocco						
General government gross debt	49.0	63.7	64.9	65.1	65.2	65.2
External	23.6	31.5	31.2	32.4	29.0	31.4
Domestic	25.4	32.2	33.7	32.7	36.2	33.8
Total external debt	29.3	43.9	46.1	46.6	42.7	46.4
Tunisia						
General government gross debt	39.2	55.4	62.3	70.9	77.5	71.8
External	33.9	45.6	48.9	60.8	62.0	66.5
Domestic	5.3	9.8	13.4	10.1	15.5	5.3
Total external debt	51.3	64.3	69.1	85.5	88.3	97.3

Sources: IMF 2021h; World Bank 2021c.
Note: Information for Libya was not available.

The external debt of North African countries more than doubled between 2010 and 2019, from $79.1 billion to $168.2 billion (figure 2.4). External debt accumulation rose even faster for the region's three emerging economies: Egypt, Morocco, and Tunisia.

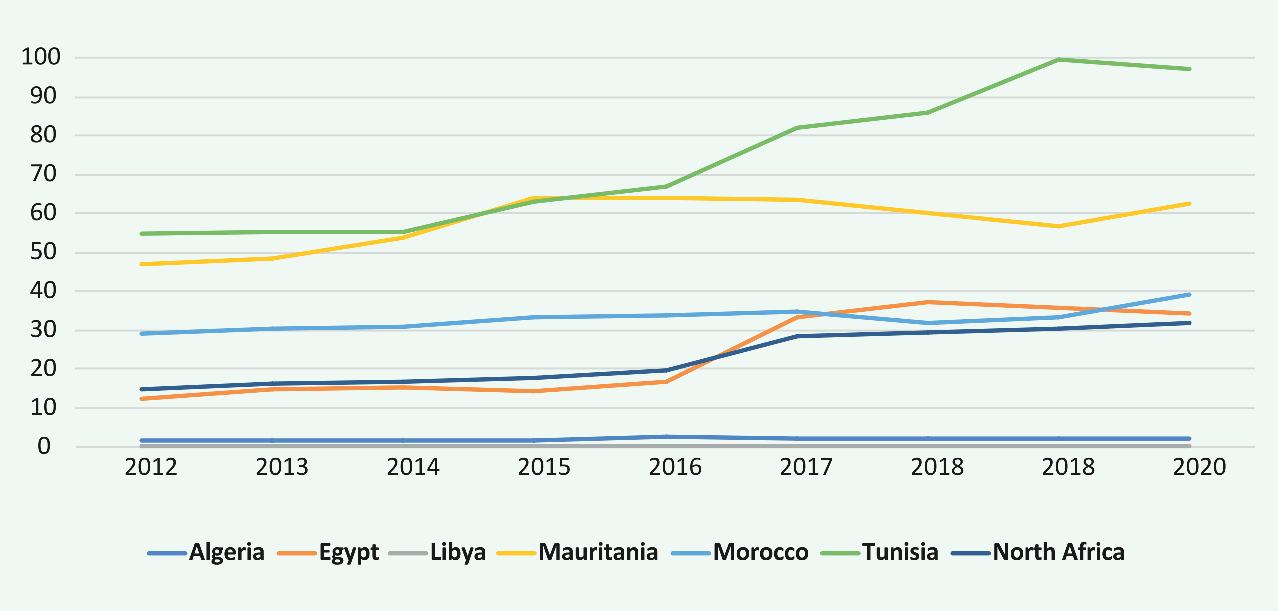
Figure 2.4: Long-term external debt in North Africa by creditor type, 2010–19 (Billions of U.S. dollars)



Source: World Bank 2021c.

Between 2012 and 2020 total external debt as a percentage of GDP rose by 10.1 percentage points in Morocco, 42.4 points in Tunisia, and 22.1 percentage points in Egypt (figure 2.5). Estimates for 2020 indicates that external debt is quite high in Tunisia (97.2 percent of GDP) and Mauritania (62.6 percent). The average increase in external debt was about 60 percentage points of GDP for emerging and developing economies between 2010 and 2020—the largest, fastest, broadest increase in debt in these economies in the past 50 years (Kose and others 2020).

Figure 2.5: Total external debt in North Africa by country, 2012–20 (Percentage of GDP)



Source: World Bank 2021c.
Note: Data for 2020 are estimates.

Though all financing sources have participated in the rapid growth of North Africa's debt, funding from bondholders, commercial banks, and others has become much more important (see figure 2.4). In 2010 these private sources accounted for 23.8 percent of the region's long-term external debt; by 2019, 39.0 percent. And because most short-term external debt is owed to private sources, in 2019 they accounted for just under 45 percent of total external debt in North Africa.

Egypt. As noted, the 2016 liberalization of the capital account attracted foreign investors to the domestic debt market. But COVID-19 caused a significant reversal in capital flows, putting pressure on reserves and the current account. The pandemic also exacerbated Egypt's already large refinancing needs, with 60 percent of the country's public debt at a maturity of one year or less. To bridge the financing gap, Egypt accessed funding from the COVID-related facilities of international financial institutions. In May 2020 the country also tapped international capital markets, issuing a $5 billion bond—its largest issuance to date. These moves boosted foreign exchange reserves to $40 billion at the end of 2020. External debt rose to 36 percent of GDP, but the new borrowing helped lengthen its average maturity.

Libya. Though Libya's external debt is among the lowest in the world, estimated at 5.8 percent of GDP in 2017, domestic debt reached 155.0 percent of GDP in 2020. Historically, Libya had limited need for external borrowing thanks to its abundant foreign earnings and reserves from hydrocarbons. But the political and security crisis significantly cut government revenue, and foreign direct investment (FDI) has not flowed into the country since 2014.

Mauritania. A primary surplus of 3.5 percent of GDP in 2018 and 1.7 percent in 2019 made it possible to reduce Mauritania's public debt from 65 percent of GDP in 2018 to 62 percent in 2019. Yet total public debt, almost all external, remains high and vulnerable to shocks. Public external debt is projected to rise to 69 percent of GDP in 2020 and 70 percent in 2021, then decline slightly to 68 percent in 2022—well above the 40 percent threshold that is considered sustainable.

Morocco. To mitigate the impacts of the pandemic, Morocco has accessed emergency funding from donors, including $3 billion from the IMF and $460 million from the African Development Bank. In September 2020 Morocco also issued a €1 billion Eurobond. These inflows bolstered foreign exchange reserves, which are sufficient to cover 8.1 months of imports and three times the debt due in the short term. General government debt carries an average maturity of more than six years, and more than half of Morocco's external debt is owed to multilateral institutions.

Tunisia. Tunisia's public debt, 70 percent of which is external, exceeded 80 percent of GDP in 2020, continuing the rapid upward trend that began in 2011. Debt servicing costs absorb 28 percent of the budget, constraining other development spending. The financial difficulties of public enterprises are another concern. At the end of 2019 the debt of public enterprises represented 13 percent of GDP. Because of its high reliance on external debt, Tunisia is more vulnerable to exogenous shocks than other North African countries.

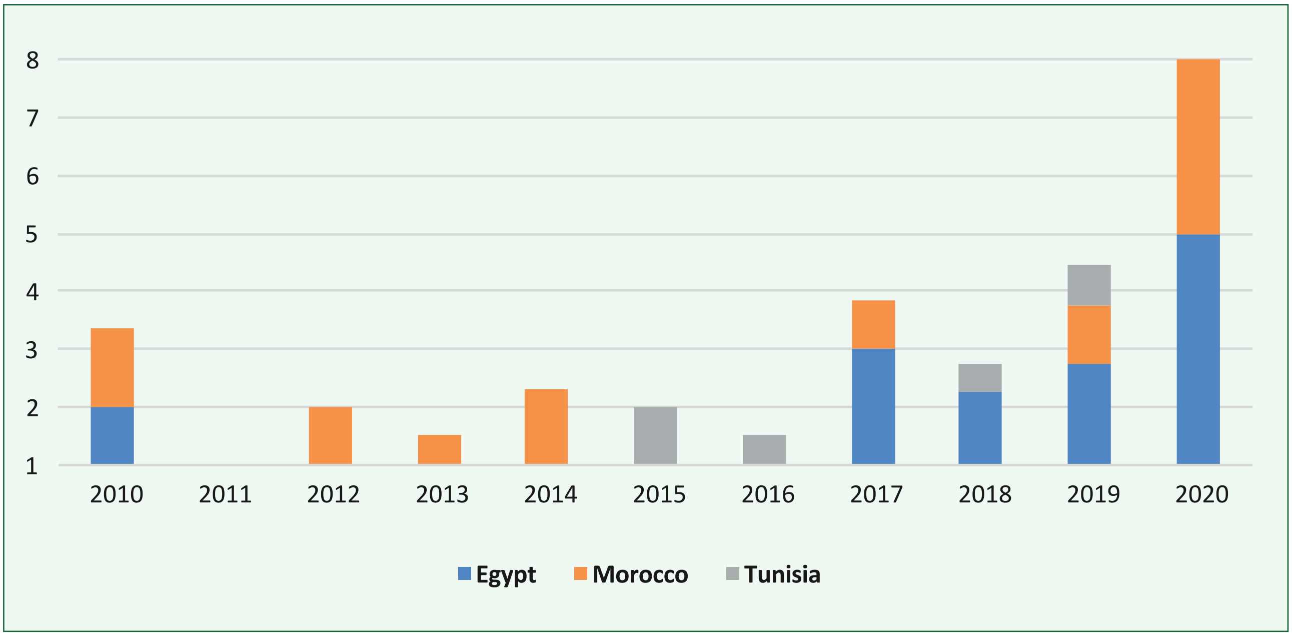
2.3 BOND MARKETS

2.3.1 Egypt, Morocco, and Tunisia have increasingly issued Eurobonds to raise external financing

North Africa's three emerging economies—Egypt, Morocco, and Tunisia—have been active participants in Eurobond issuances. Between 2010 and 2020 Egypt and Morocco each raised about $7 billion through such bonds, most of which were denominated in U.S. dollars (figure 2.6). Among African countries, Egypt ranked first in cumulative Eurobond issuances over 2000–19 with more than $30 billion, just ahead of South Africa (AfDB 2021). Morocco and Tunisia ranked 7th and 9th, with less than $8 billion in combined issuances over the same period.

In 2020, reflecting their efforts to extend the maturity of their debt profiles, Egypt and Morocco managed to extend the maturities of their Eurobonds to 30 years. In its last issuance, Egypt was able to extend the maturity to 40 years, making it the longest maturity bond not only in North Africa but also in the Middle East. In 2020 Egypt also pioneered the region's first issuance of a "green" bond (box 2.1). All the recent Eurobond issuances from North African countries were heavily oversubscribed.

Figure 2.6: Eurobond issuances in North Africa, 2010–20 (Billions of U.S. dollars)



Source: African Development Bank statistics; Bloomberg.

Since 2016 African Eurobonds have traded at a premium, and these higher yields have made possible the sharp increase in Eurobond issuances from the continent. But because interest rates play an important role in assessing debt sustainability, North African governments should adopt policies to address their large and rising interest burdens and to avert falling into debt traps (see chapter 3).

Box 2.1: More innovative issuance: Egypt's sovereign green bond

In 2020 Egypt entered the "green" bond market through a $750 million, five-year issue with a 5.25 percent yield, joining a small but growing group of emerging market economies that have recently issued sovereign green bonds (Chile, Fiji, Hungary, Indonesia, Poland) or broader social, sustainable, and pandemic bonds (Ecuador, Guatemala, Mexico).

Egypt's green bond is part of the country's innovative debt management strategy, which aims to diversify its investor base while shifting to longer-term borrowing. The bond also confirms the government's intention to improve environmental outcomes. The $750 million raised, plus that from planned green issuances, will directly contribute to the financing of $1.95 billion in public investment projects tagged as green by the government. These projects are split across six categories—pollution prevention and control, sustainable water and wastewater management, clean transportation, renewable energy, energy efficiency, and climate change adaptation—each aligned with one or more of the UN's Sustainable Development Goals. The finance ministry, with World Bank support, has developed a framework for identifying and tracking green financing.

The green bond issuance:

- Nurtures a sustainability narrative for Egypt, which could have positive effects not only for lending and portfolio flows but also for foreign direct investment and private equity.
- Includes a clear, overarching environmental goal that can be used to assess whether green plans become reality. The goal is to ensure that renewable sources generate 20 percent of electricity by 2020 and 42 percent by 2035.
- Helps further define the country's green framework. Vigeo Eiri—a company that provides guidance on environmental, social, and governance (ESG) investing to investors and issuers—provided an independent verification of the framework. An external reviewer will assess green investments every year, with reporting made public.

A lot of hard work went into Egypt's green framework, which with experience can be further improved. The framework's clear environmental goals will strengthen Egypt's ESG credentials and provide a good example for other African countries to follow.

Source: Authors based on Smith 2020.

2.3.2 Domestic bond markets have deepened

Though significant relative to domestic debt, North Africa's bond markets are considered underdeveloped. The region's bond markets are also characterized by low volumes, low liquidity, and a strong tendency to "buy and hold."

In recent years Egypt has been one of the region's most active countries in promoting its domestic financial markets. The country has initiated several rounds of reforms to support the development and availability of a wider range of products for participants in the financial sector. Financial instruments are also being used for debt management. To lower borrowing costs by extending maturities and diversifying funding sources, the government aims to lengthen the average maturity of domestic and foreign debt to 4.0 years by the end of fiscal 2021 and 4.5 years by fiscal 2022. That will be achieved by offering larger and longer-dated bonds to reduce rollover and refinancing risks while helping to consolidate the yield curve. In addition, the government has set a target to raise the share of tradable debt instruments to 70 percent of the total by the end of fiscal 2021 and to limit the maximum share of short-term debt trades to 50 percent.

The government is also considering diversifying sources of financing by issuing the first sukuk (Islamic) bonds in both domestic and Gulf markets to finance development projects and expand the investor base to retail investors and more nonbank financial institutions. Yields on sukuk bonds are expected to be lower than those on traditional bonds. With real interest rates of more than 5 percent, Egypt's bonds attracted significant inflows. Sharp selloffs when the pandemic struck have since reversed, with large inflows into local currency bonds, which carry a 6.8 percent return. (The average for emerging markets is close to zero.)

The main features of Morocco's domestic bond market are described in table 2.2. The government is also using the local currency bond market as part of its policy options to reduce the cost of government debt by promoting arbitration between domestic and external resources (75 percent/ 25 percent).

Tunisia's goal is to reach a slightly larger share (30 percent) of domestic debt. The curve supervision committee—made up of the Central Bank of Tunisia, Financial Markets Council, and Tunisian Ministry of Economy and Finance—launched the new version of the yield curve in March 2020.

Table 2.2: Features of domestic bond markets in North Africa, 2020				
Type	Algeria	Egypt	Morocco	Tunisia
Indicative size (domestic debt/GDP)	45.6%	79.5%	45.9%	35.0%
Secondary market?	No, except for treasury bonds	Yes, but not very active	Yes, but not very active	Yes, but not very active
Treasury bond maturities	6 months	3, 6, 9, and 12 months	3, 6, and 12 months	
Bond maturities	1.5, 3, 5, 10, and 20 years	3, 5, 7, and 10 years	5, 10, 15, 20, and 30 years	4, 7, 10, and 15 years
Regular issuance?	No	Yes, every other week to avoid crowding out competing maturities	Yes, using auctions	Yes, using auctions and reopening methods.
Yield curve	Used as a reference for the market	Implied curve based on the Nelson-Siegel model	Used as a reference for the market. Generated daily. Available in two electronic platforms (a domestic bank and Bloomberg)	The curve generated by the Conseil des Marchés Financiers is weekly. The one by Tunisie Clearing is daily
Foreign ownership allowed?	No	Yes	Yes	Yes

Source: https://www.africanbondmarkets.org/.

Mauritania initiated its public finance consolidation and debt management policy in 2016 and pursued it until the outbreak of COVID-19. Primary balance surpluses in 2018 (3.5 percent of GDP) and 2019 (1.7 percent) helped put gross public debt on a downward trajectory, from 65 to 62 percent of GDP. Similarly, debt service fell from 17.4 percent of exports in 2018 to 14.1 percent in 2019. But total public debt, which is almost exclusively external, remains high and vulnerable to exogenous shocks. According to a debt sustainability analysis published by the IMF in September 2020, the risk of external and public debt distress remains high in Mauritania. Public external debt as a share of GDP is projected to rise to 69 percent in 2020 and 70 percent in 2021 (before shrinking to 68 percent in 2022)—well above the sustainable debt target of 40 percent.

Algeria's nascent bond market has grown since 2015. The country's domestic public debt consists of treasury bills and bonds as well as outstanding debt purchased from state-owned enterprises. In 2017 the Bank of Algeria became authorized to purchase securities issued by the treasury on an exceptional basis and for a maximum of 5 years. Between November 2017 and April 2019 the Bank of Algeria provided funding of nearly $55 billion (equivalent to 32 percent of GDP) to cover the fiscal deficit, government repayment of debt to key public enterprises, government borrowing through the issuance of bonds to finance growth-related activities, financing of social housing, and other structural investments.

In 2018 Libya had proven crude oil reserves of 48 billion barrels, the ninth-largest reserves in the world. Oil revenues have provided the country with ample financial leverage and low external debt. In 2019 Libya had the second-largest foreign exchange reserves in Africa, estimated at $84 billion. Thus the country has limited needs for external borrowing, with external debt equivalent to 5.8 percent of GDP in 2017 (the most recent year with available data). But the political and security crises have significantly reduced government revenues, causing domestic debt to burst to 155 percent of GDP in 2020.

2.4 DEBT VULNERABILITIES

A prolonged pandemic poses enormous risks to North Africa. Though the outlook for the global economy has improved, North African economies face a highly uncertain recovery. Vaccination to the point of herd immunity is unlikely until at least mid-2022. Financial flows continue to be adversely affected. Tourism prospects will not rematerialize until air travel and the economies of Europe have fully recovered. And no debt relief is in sight for lower-middle- and middle-income countries. Debt sustainability analyses conducted by the IMF and World Bank since the start of the pandemic project a range of possible outcomes for the region's countries, described below. The potential risks are made even more worrisome by the large contingent liabilities of state-owned enterprises.

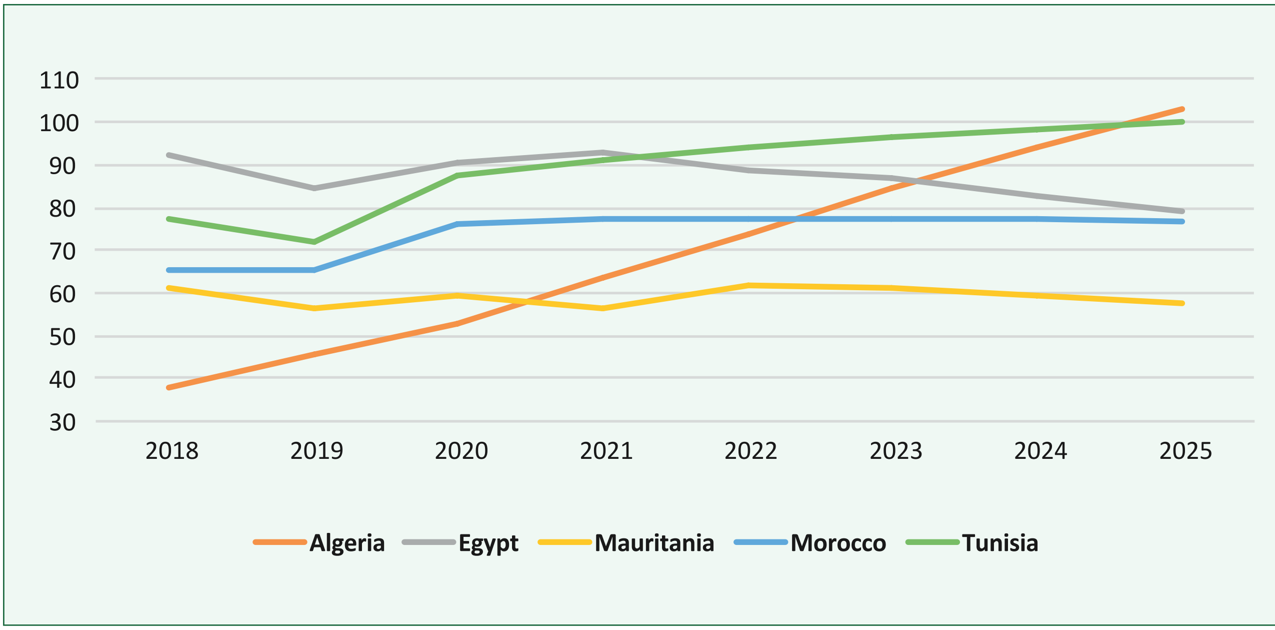
2.4.1 Country risks vary considerably

Egypt's debt sustainability analysis, published in January 2021, indicates that the country faces a high probability of debt difficulties. The main risks are slower than expected recovery from COVID-19 resulting in less ambitious fiscal consolidation, lower GDP growth, and a sustained increase in interest rates due to tighter financial conditions for emerging markets. Total debt is projected to increase to 93 percent of GDP in fiscal 2021 before steadily declining to 79 percent by 2025. But the debt-to-GDP ratio could hit 108 percent in 2022 if a macro-fiscal shock—with additional contingent liabilities in the range of 13 percent of GDP—were to materialize.

The debt sustainability analysis for Morocco concludes that central government debt will remain sustainable. Though the central government's debt-to GDP ratio is estimated to have risen 11.3 percentage points in 2020, elements of the country's debt continue to limit potential vulnerabilities. These include its relatively long maturity (weighted average maturity of 7.5 years), the relatively low share denominated in foreign currencies (about 25 percent), and the investment base made up mostly of local investors, many of whom are long-term investors. Thanks to such features, as well as to its solid track record and favorable ratings, Morocco's government has maintained steady access to international capital markets at favorable terms for the past decade. Gradual fiscal adjustment and continued implementation of structural reforms should help the debt-to GDP ratio return to a downward trajectory over the medium term.

Tunisia's public debt will become unsustainable unless strong and credible reforms are adopted with broad support. Debt sustainability risks are compounded by financing risks, real effective exchange rate overvaluation, and state-owned enterprises' contingent liabilities and guarantees. In the absence of a credible medium-term framework, gross government debt is projected to reach nearly 100 percent of GDP over the medium term (figure 2.7). Gross public financing needs would stay in an elevated range of 14–18 percent of GDP on an annual basis. In addition, public debt sensitivity to shocks has increased, with the most significant risk coming from exchange rate depreciation.

Figure 2.7: Gross government debt in North Africa by country, 2018–25 (Percentage of GDP)



Source: IMF 2021h.
Note: Data are estimates for 2020 and projections for 2021–25.
Data for Libya were not available.

Though Libya's external debt is among the lowest in the world, domestic debt has increased significantly in recent years—reaching 155 percent of GDP in 2020. The Ministry of Finance (representing the government of national accord) covers its financing needs with borrowing from the Central Bank. But such borrowing, combined with the depletion of foreign reserves, is not sustainable and carries potentially serious macro¬economic consequences. A strong debt management policy should be implemented to handle the recent increase in domestic debt.

Mauritania's medium-term outlook is broadly positive and public debt is sustainable, yet debt vulnerabilities remain. The risk of external debt distress and the overall risk of public debt distress remain high, as the net present value of public external debt relative to GDP will continue to breach its threshold in 2020–22 under baseline projections, and the debt service-to-revenue ratio will breach its threshold in 2020–25. Projected export, growth, fiscal, and debt trajectories are highly uncertain and vulnerable to stronger impacts from the pandemic, reversals in metal and oil prices, regional security developments, and climate hazards. The 2020 debt sustainability analysis calls for prudent policies including avoiding nonconcessional borrowing and relying instead on grants and concessional financing taken up at a moderate pace consistent with absorptive capacity.

Algeria's domestic public debt mainly consists of treasury securities and restructured debt purchased from public enterprises. One of the advantages of having mostly domestic debt is that when export earnings decline, pressures on the exchange rate and on the risk of depleting international reserves are less severe—allowing the country to continue to borrow without undue concerns about external debt servicing capacity. On the other hand, in many developing economies inflationary pressures could lead to financial repression, with adverse consequences for inequality and growth.

Given the need for short-term support in response to the pandemic, there are high risks that continued monetization of the budget will lead to higher inflationary pressures, larger current account deficits (putting pressure on foreign reserves and the exchange rate), and a sharp rise in the ratio of domestic debt to GDP. While emergency expenditures may justify continuing this policy for the next year or two, seigniorage exceeding 2–3 percent of GDP will begin to cause inflationary pressures. The sharp decline in economic activity due to the pandemic may have alleviated these pressures for the time being. The partly controlled economy may also have reduced inflation. On the external side, to control the worsening of the current account deficit, the government has imposed import controls. Again, this may work in the short term but will introduce significant economic distortions in the longer term.

For the time being, the most important impact has been a sharp rise in gross government debt. In most other North African economies such debt is expected to stabilize after the COVID-induced jump in 2020 . But Algeria's debt ratio is forecast to more than double over 2020–25 to exceed 100 percent of GDP (see figure 2.7). Large credit to the government will also crowd out credit to the private sector, undermining prospects for recovery once the pandemic is under control. The situation is similar in Libya, where domestic debt is growing fast.

2.4.2 State-owned enterprises have amassed enormous contingent liabilities

Sound public debt management requires monitoring and mitigating contingent government liabilities. With support from international financial institutions, North African governments have been aware of the risks posed by contingent liabilities, and some are considering or implementing risk mitigation tools. Contingent liabilities may be justified in certain circumstances: for example, in Morocco credit guarantee schemes launched by the government in response to COVID-19 imply new contingent liabilities of up to 6.5 percent of GDP. But a more systematic risk mitigation approach may be needed, such as creating reserve accounts or setting strict exposure limits on contingent liabilities.

Egypt's state-owned enterprises are supervised by the Directorate of Public Corporations and Privatization, which undertakes good practices including the publication of a comprehensive report on state enterprises as an appendix to the budget. But fiscal risks related to state-owned enterprises remain to be identified and assessed on a more systematic basis. In response, the government is moving on multiple fronts. To strengthen the budget process, the new Public Finance Law will include a fiscal responsibility provision and accounting rules for all budget entities. Budget details will be published throughout the process, including fiscal risks and contingent liabilities. The Ministry of Finance recently established a unit for fiscal transparency and citizen engagement. Egypt's scores at the International Budget Partnership and ranking in the Open Budget Index have continued to rise and are expected to improve further in 2021, reflecting progress on citizen engagement.

Morocco's government is changing the management framework for sovereign guarantees. To better manage the sovereign guarantees extended to state-owned enterprises—estimated at about 16 percent of GDP (AfBD 2020)—the government is launching an agency that will monitor all enterprises with state participation to improve governance and limit contingent liabilities. As noted, credit guarantee schemes launched in response to the pandemic have added contingent liabilities estimated at about 6.5 percent of GDP. Those extended in response to COVID will be transferred to a new financial institution, under central bank supervision, that will absorb the first layer of losses from potential activation of guarantees.

In Tunisia state-owned enterprises with large outstanding guarantees pose significant fiscal and financial risks. Though complete data are not available for all such enterprises, partial data for 30 show a debt stock of almost 40 percent of GDP, with 20 percent of GDP due to banks and suppliers and the rest to social security funds, other state enterprises, and the government. In addition, partial data show that state enterprises benefit from government guarantees estimated at 15 percent of GDP in mid-2020. Adding the debt of state-owned enterprises to central government debt would push total public debt well above 100 percent of GDP. Additional details on the country's state-owned enterprises and measures under government consideration to address their contingent liabilities are provided in box 2.2.

Box 2.2: Challenges of state-owned enterprises in Tunisia

State-owned enterprises play a dominant role in Tunisia's economy. The country has more than 100 such enterprises, 55 of which are commercial. The government owns 7 of the country's 10 largest firms. Available data indicate that most state-owned enterprises are in poor financial shape. They have large arrears and cross-arrears with the government, social security funds, and other entities. In mid-2020 arrears from state-owned enterprises to the state totaled 5.5 percent of GDP, while arrears from the state to such enterprises totaled 7.9 percent. In recent years transfers from the budget to state-owned enterprises have been large and stable, in the range of 7–8 percent of GDP.

In addition to their direct burden on the budget, state-owned enterprises pose significant fiscal risks because their weak financial performance generates high debt. State enterprises are highly indebted, with the total debt of the 30 largest reaching almost 40 percent of GDP in 2019 (and expected to have increased further in 2020). Almost half that debt is to banks, with the balance due mainly to the state, other state enterprises, and social security funds. Furthermore, a significant part of state enterprise debt to domestic banks and multilateral and bilateral lenders—estimated at 15 percent of GDP in mid-2020—is covered by government guarantees. These guarantees are a significant contingent liability for the government, estimated at 6.3 percent of 2020 GDP.

The Tunisian authorities have been receiving technical and financial support from various partners to improve the governance and financial performance of state-owned enterprises. A new law on the enterprises being reviewed by the authorities will provide the legal foundation to implement comprehensive reforms aimed at increasing efficiency, improving service delivery, strengthening oversight and accountability, and boosting competition and investment. Key measures include clearing the cross-arrears, developing and implementing a strategic plan to reform the enterprises, improving financial information about them, centralizing their monitoring, and strengthening their governance.

Source: Authors.

CHAPTER 3

POLICY RECOMMENDATIONS

The COVID-19 pandemic has worsened macroeconomic imbalances in North Africa and exacerbated structural weaknesses, including a heavy reliance on commodities, undiversified economic activities, external trade concentration, and weaknesses in fiscal and financial management. Recovery will further be hindered by a rising debt burden. This chapter proposes policy recommendations for the short, medium, and long terms to deal with this situation. Among the key policies:

- Over the short term, limit the spread of the virus, provide relief for vulnerable populations, and overcome vaccine-related challenges.
- Strengthen coordination among fiscal, monetary, and exchange rate policies to closely monitor the direction, speed, and magnitude of capital flows and their effects.
- Over the medium term, conduct public expenditure reviews to protect core investment projects needed to restore economic growth.
- Over the long term, manage public debt and enhance domestic resource mobilization through sound debt management, high debt transparency, and thorough monitoring of contingent liabilities.
- Promote economic and export diversification through trade policy reforms and government investments in public goods.

North Africa's debt dynamics will be shaped by the global recovery, which will determine prospects for tourism and exports, and by international interest rates, which might rise due to larger budget deficits in developed economies. Moreover, it is not clear if the world can reach herd immunity by 2022 so that the global recovery can take hold promptly. These factors are beyond the control of North African governments. But debt dynamics also depend on each country's economic growth, a factor that governments can help enable. So, from a policy perspective, North African countries should manage debt prudently while restoring economic growth as soon as possible.

As countries in the region begin to reopen, policymakers will be tasked with mitigating the ongoing public health threat while also taking steps to rebuild economies and ensuring that adequate social safety nets are in place. In the medium and long term these governments need to balance continued support for economic recovery with investments that help them reduce the fiscal costs of coping with future pandemics (such as maintaining inclusive health systems and investments in the public goods needed for structural transformation—meaning, diversification from natural resource dependence toward industries that create jobs for all.

The medium- and long-term policy agenda will pose tough fiscal challenges for North African governments. That may tempt them to postpone critical investments needed for structural change. For example, investments in skills development—which have long-term payoffs—might be delayed in favor of expenditures with larger short-term political payoffs. Similarly, new investments in health systems, including universal health insurance to cope with future pandemics, may be deemed low priority in the immediate aftermath of COVID-19 even though such investments will reduce future fiscal burdens. In countries with mounting debt, like Tunisia, debt servicing costs may preempt early investments in diversification and structural change altogether.

Unlike most low-income African countries, which are in dire need of debt resolution, North African countries can cope with the pandemic and current debt levels as well as finance diversification and inclusive growth. But that can only happen if they adopt timely and prudent fiscal, financial, and debt management policies. All North African governments should explore their options for creating fiscal space to support diversification and inclusive growth.

To be efficient, reforms and investments must be properly sequenced. North African governments could initiate critical investments and policy reforms for small and medium-size enterprises and workers—including formalization, education, skills development, and digitalization—that have a longer gestation period. Over the longer term, modern workforces and larger formal sectors will raise the productivity of North African governments' investments in large public goods projects and deep structural reforms. Such efforts are crucial to creating decent and sustainable jobs, fostering inclusive growth, and achieving upper-middle-income status.

3.1 SHORT-TERM PRIORITIES FOR DAMAGE MANAGEMENT

Short-term priorities include:

- ***Protecting lives and livelihoods*** by extending safety nets and social protection programs through cash transfers, food aid, unemployment assistance, and free treatment to informal workers, women, young people, and the poor. Initiatives that Egypt introduced in 2020 in response to the pandemic include policies to curtail food inflation, increases in strategic food reserves to aid the most vulnerable 30 percent of the population, and targeted cash transfer programs. In Mauritania a special social solidarity fund collected $5.4 million to help fight COVID. Efficiency requires that social protection programs be flexible to better target the most vulnerable populations over time. Community-based targeting has proven more efficient than individual targeting.
- ***Building preparedness for timely detection and treatment*** of the coronavirus and monitoring the situation. For example, by establishing an organization to take charge of this responsibility and making it fully operational and effective, such as Tunisia's National Observatory of New and Emerging Diseases. In Morocco an emergency committee chaired by the minister of finance is in charge of monitoring the situation as long as the pandemic or its negative impacts exist.
- ***Ensuring liquidity of the financial system.*** Most North African central banks have reduced their reserve requirement ratios and policy interest rates to avoid liquidity constraints in coping with the crisis. Morocco has also granted interest-free loans to the self-employed and sovereign guarantees to loans taken by small and medium-size enterprises until economic activities return to normal.
- ***Extending the 2020 interventions to provide direct financial support*** so that small and medium-size enterprises can retain employees, cover necessary costs, and survive the pandemic. In Morocco a special fund totaling 3 percent of GDP—financed by the government and voluntary tax-deductible contributions—supported businesses, including in the informal sector. Egypt imposed a new 1 percent tax on public and private sector salaries and 0.5 percent on state pensions to support small and medium-size enterprises.
- ***Avoiding unsustainable debt.*** COVID-19 has exacerbated pressures on public debt while raising the need for large additional and unplanned fiscal spending. Instituting efficient debt management systems focused on debt reprofiling or restructuring will be important to long-term debt sustainability.
- ***Harnessing digital technology to restructure state-owned enterprises*** to hive off contingent liabilities and combat illicit financial flows, while potentially boosting domestic revenues. In North Africa fiscal subventions to state enterprises have crippled central governments' ability to stimulate private sector growth. For instance, in Morocco

the debt owed by state-owned enterprises accounts for 16 percent of GDP.

- ***Developing capacity for debt sustainability analyses*** that allow debt reports to be issued at fixed intervals. More North African countries should adopt this practice, working with multilateral institutions and bilateral and private creditors to promote prudent decisionmaking by borrowers and lenders alike.
- ***Seeking more liquidity to meet financial obligations*** if the pandemic lasts longer than expected or the global economic economy is delayed. The G20's Debt Service Suspension Initiative (DSSI) is only a temporary fix for the debt problems of low-income countries, and no debt workout framework exists for middle-income countries. The African Development Bank's proposed creation of an African Financial Stability Mechanism aims to avoiding liquidity crises in all African countries, including those in North Africa (box 3.1). Such a framework would require efforts from all sides. From creditors, there is a need for continued support to help North Africa overcome the pandemic—including, where relevant, debt relief linked to growth recovery through investment programs. The May 2021 Paris Summit on Africa financing reallocated IMF Special Drawing Rights totaling $33 billion to the continent. This funding could provide fiscal space for North African countries.

Box 3.1: The African Financial Stability Mechanism: an initiative from the African Development Bank

The African Financial Stability Mechanism (AFSM), expected to be established in early 2022, could help African countries experiencing or threatened by severe financial difficulties such as balance of payments disequilibria and external financing problems, with a focus on both preventing and resolving crises. Assistance would take the form of financial assistance conditioned on the implementation of macroeconomic and fiscal reforms and prudent policies that favor a stable, enabling environment for private investors.

This financing arrangement could help Africa avoid spillovers from global pandemics or external shocks. The common framework would provide a much-needed financial safety net for African economies. It could help countries with temporary balance of payments misalignments avoid illiquidity-driven defaults by offering financing on beneficial terms. Other advantages could include the ability to offer a platform for orderly debt restructuring and the capability to limit spillover effects associated with debt distress. It could also bolster domestic financial markets and prevent future debt accumulation. Hence it would provide countries with the means to promote resilient development. AFSM lending, like IMF loans, would be issued based on ex ante and ex post conditions. Debt sustainability analyses could be systematically conducted to balance countries' needs for funds, inform them about risks of debt distress, and ensure that debt relief is used for sustainable development.

For resources, the AFSM might draw on the experiences of the European Stability Mechanism, which funds its loans by borrowing on capital markets—providing an important degree of maturity transformation at the cheapest rates available. Contributions by member countries to the AFSM could be determined by their economic weight or size, using criteria such as population or GDP. Members would commit to providing capital within their agreed contribution. Given the currently limited financial resources and thin tax bases of African countries, the raising of capital could be done on a partial basis. Consequently, borrowing should be as cheap as possible, while maintaining a reliable investor base. The lending instruments that the AFMS could consider would vary depending on the circumstances.

Many African countries already have extensive experience coordinating financial issues under regional financing arrangements. Obtaining sufficient capital for the AFSM may prove challenging in the current context. Yet the recent reallocation of IMF Special Drawing Rights offers an opportunity for resources to fund the AFSM. Sovereign wealth funds and Arab funds could also provide capital.

Source: Authors.

- ***Structuring debt management agencies with clear powers and governance ability*** to improve recording of sovereign actual and contingent debt liabilities, enhance transparency about key financial commitments, and overcome governance failures caused by lack of proper processes and structures. Such challenges are complicated by the entrance of nontraditional creditors and new commodity-based (collaterized) commitments with rules that may not be clear. Creditors, including international financial institutions such as the African Development Bank, World Bank, and IMF, should support transparent and sustainable lending practices—such as through more proactive implementation of the IMF's fiscal transparency code.
- ***Strengthening coordination among fiscal, monetary, and exchange rate policies*** to closely monitor the direction, speed, and magnitude of capital flows and their effects. Over the past decade some North African economies have relied heavily on private creditors, mainly Eurobond and commercial sources, to finance their budget and current account deficits. As a result, their debt burdens have become highly sensitive to interest rate and exchange rate movements and the risk of balance of payments crises has increased.
- ***Conducting thorough public expenditure reviews*** to establish core, protected groups of investment projects needed to restore economic growth. Such reviews should focus on making capital projects more efficient through procedures that enhance project identification and implementation..

3.2 MEDIUM- AND LONG-TERM MEASURES FOR STRONG, SUSTAINABLE, INCLUSIVE GROWTH

3.2.1 Medium term measures

- ***Making new investments in healthcare systems*** to cope with future pandemics and ease burdens on governments. Unlike most low-income countries, where affordability and implementation are critical constraints, North African governments could consider universal health insurance to reduce government spending.
- ***Providing fiscal support and policy reforms to formalize the informal sector*** through training for workers and businesses to close skills gaps. Public investment in active labor market policies to train informally employed or unemployed workers (especially women and young people) and entrepreneurial training for owners of informal small and medium-size enterprises could accelerate private investment in industries constrained by the availability of skilled labor. North Africa could incentivize the private sector to engage in sectors that foster economic diversification (including low-carbon industries), ease regional disparities, and shrink the region's high female and youth unemployment. Though formalization will be resource-intensive in the medium term, over the long term it will expand tax bases, generate new streams of tax revenues, and contribute to fiscal stability.
- ***Investing in digitalization and in science, technology, engineering, and mathematics and problem-solving skills*** to groom the workforce for the future. Such investments will also trigger the adoption of new technologies and the emergence of new service industries to support diversification.
- ***Investing in network infrastructure that facilitates digital transformation*** by expanding internet connectivity economywide to ensure that everyone—children, adults, workers, businesses—can benefit from online learning. Doing so will also boost managerial and production productivity in small and medium-size enterprises through technological and financial innovation, and more efficient trade through ecommerce and financial inclusion across all sectors. It will also create large-scale employment and could disproportionately benefit women and young people. Digital transformation is already a hallmark of most upper-middle-income countries. North African countries could invest in it to leapfrog and catch up.
- ***Improving access to finance for small and medium-size enterprises,*** which remains a critical impediment to business development in Africa. Over the medium term an accelerator program that helps small business owners strengthen their leadership, management, and capacity skills to run their businesses can enhance access to finance. New legal frameworks for alternative collateral

requirements would allow credit institutions to obtain collateral both on movable and immovable assets, enabling small businesses to obtain loans or improve borrowing terms. Fiscal incentives could also be used to provide training to small businesses. Access to sustainable financing should be conditional on formalization of small and medium-size enterprises, with fiscal stimulus oriented toward firms with potential for creating wealth and employing women and young people.

- ***Promoting financial inclusion.*** Despite its mostly middle-income status, North Africa lags other African regions in digital finance and financial inclusion. Only 15 percent of Egyptians have a bank account. Investing in financial inclusion would deliver high financial payoffs even in the medium term by increasing domestic savings and enabling lower interest rates, which could increase profits by directly reducing the cost of private investments, individual loans, and sovereign borrowing on local currency debt markets.
- ***Improving public debt management and enhancing domestic resource mobilization.*** Governments in North Africa need to develop mechanisms and institutions that enable them to strike the proper balance between the benefits and costs of additional debt. These efforts include sound debt management, high debt transparency, and thorough monitoring of contingent liabilities. Restructuring state-owned enterprises and using debt efficiently to finance productive investments are important measures to avoid debt traps. External financing—which is quite high in Mauritania, Morocco, and Tunisia—should favor concessional terms and long maturities.
- ***Deepening domestic bond markets.*** Policymakers need to take into account the risks of foreign ownership of treasury bills and bonds, since the "on and off" impacts of market sentiment can lead to capital flight under changing market conditions such as interest rate changes in advanced countries. Thus there is a need to carefully manage capital flows. In Egypt foreign purchases account for 40 percent of outstanding government securities, most of which are short-term treasury bills. COVID-19 led to major portfolio outflows in early 2020. These flows have recently stabilized and reversed thanks to higher yields following interest rate hikes in Egypt. Support by creditors—including international financial institutions and bilateral donors—could help promote more comprehensive techniques and facilitate South-South dialogue and collaboration.
- ***Strengthening monitoring and mitigation of contingent government liabilities.*** Governments and debt managers need to carefully review the financial liabilities of state-owned enterprises, subnational debt, guarantees, and other contingent debt. Guarantees and other legally committed liabilities must be closely monitored in case the commitment of a sovereign to pay is triggered or even if it is not legally obliged to support it. The inability of state-owned enterprises and subnational governments to roll over maturing principal debt obligations may require central governments to step in.
- ***Mitigating environmental and social risks in investment decisions.*** Investors are increasingly focused on environmentally sustainable development. Systematic, proactive engagement with investors on such efforts can make a difference. Egypt's successful recent issuance of a five-year, $750 million sovereign green bond is a case in point. The bond was five times oversubscribed and has broadened Egypt's investor base.
- ***Deepening regional integration in electricity markets and investing in renewable energy.*** This will also contribute to greener economic growth. In Tunisia, for example, the trade deficit is driven by the energy trade deficit, which accounts for about 40 percent of total.
- ***Introducing fiscal consolidation reforms and reducing subsidies***. In North Africa public wages, debt service, and subsidies represent a high share of current public expenditures—impeding public investment in public goods, especially infrastructure. In Tunisia subsidies and debt service account for 68 percent of the 2021 budget. In Egypt corporate taxes raise less than 6 percent of GDP. And in Mauritania the tax burden is only 17 percent of GDP. Reducing subsidies will free resources for needed public investments.

- ***Making public investments more efficient and productive.*** Debt-financed public investment should be guided by efficiency. The limited fiscal space of North African governments suggests that they should finance more public goods by tapping capital markets and public-private partnerships. That said, fiscal risks from public-private partnerships and other instruments should be rigorously scrutinized, quantified, and mitigated. In addition, debt-financed public infrastructure projects should be self-liquidating, supported by strong institutional frameworks that allow for the channeling of resources into sectors with the potential for higher revenue streams and labor absorptive capacity. Thus policies to improve public expenditure efficiency and rationalize public spending should be consistent with existing legislation to enhance oversight and accountability through better investment monitoring and evaluation.
- ***Reforming institutions to support sustained long-term growth and move from middle-income status.*** Such reforms include improving the quality of judicial systems, protecting investors, enforcing laws and supporting the rule of law in general, enhancing the flexibility of labor markets, making public procurement more open and transparent, controlling corruption, and ensuring level playing fields for public and private enterprises in education, health, and transport.

3.2.2 Long term measures

- ***Promoting economic and export diversification*** through trade policy reforms and fiscal investments in public goods and industrial clusters for non-extractive goods and services. Such efforts are key to inclusive, sustainable growth and large-scale job creation in natural resource–dependent Algeria, Libya, and Mauritania. Their low industrialization suggests that concerted public investments in industrial clusters—especially for greenfield export-oriented investments—could fast-track linking firms in the clusters to national and regional value chains, fostering diversification. Morocco provides a shining example of industrial clusters that have facilitated high-value manufacturing and exports. Enhancing competitive local production in the clusters through innovation-driven manufacturing can nurture new sectors, including by supporting downstream production by small farmers and small and medium-size enterprises. This will widen sources of key products and raw materials outside traditional import markets while creating much-needed jobs across the entire production value chain.
- ***Improving economic resilience to exogenous shocks and future challenges*** in food security, water security, and especially climate change. All of North Africa is susceptible to high water stress and desertification. The Nile Delta will be affected by rising sea levels. In the past decade Morocco has addressed these issues with agricultural policies to curb the adverse impacts of variable rainfall on crops and decrease the volatility of growth. Each Northern African country should identify the climate-related risk that most jeopardizes its economic stability and adopt mitigating measures. There is also an opportunity for governments to prioritize climate change adaptation and mitigation measures by promoting green economic activities.
- ***Investing in public goods needed to ease regional disparities and foster inclusive growth.*** The formalization of informal businesses, expansion of digitalization, and development of a skilled workforce in the medium term will begin to bridge disparities among North African countries. In the longer term, North African governments could invest in public goods, especially large infrastructure (including water desalination and renewable energy projects), to shrink regional disparities further. This could be especially valuable in stemming gender disparities and nurturing women's economic empowerment in areas with a concentration of unemployed or poor women.
- ***Undertaking water desalination projects.*** These projects can be coupled with renewable energy projects.
- **Deepening regional integration in the context of the African Continental Free Trade Area (AfCFTA) agreement.** To reduce the risks of overdependence on a few trade partners in Europe, North African countries could strategically benefit by opening more to trade with Sub-Saharan Africa, especially after implementation of the AfCFTA. They could also benefit from deep preferential trade agreements with European partners. Such agreements demand much larger commitments in areas that are part

of the World Trade Organization's rulebook and cover topics that fall outside its current mandate and are often not directly related to trade.

- ***Developing the skills needed to be more proactively involved with lead issuance advisers*** in managing bond negotiations for lower interest rates. Governments should also be more actively involved in exercising their choice of accepting or rejecting investors' bids.
- ***Reviewing the overall debt maturities of Eurobonds and other external debt, as well as foreign-owned domestic debt amortization schedules*** to smooth their overall debt maturities, reduce spikes in debt service costs, and reduce repayment risks. The 2018 selloff of frontier Eurobonds underscored the volatile nature of global debt markets and demonstrated that the window for issuance can shut when market sentiment deteriorates.
- ***Preparing for debt restructuring should the need arise, given the shift to Eurobonds as a financing source.*** A collective action clause is needed that allows for a supermajority of bondholders to agree to debt restructuring that is legally binding on all holders of the bond—including those who vote against the restructuring. Bondholders generally opposed such clauses in the 1980s and 1990s, fearing that it gave debtors too much power. But in light of the experiences of Argentina and Ecuador, collective action clauses have become more common because they are now seen as potentially warding off more drastic action while enabling easier coordination among bondholders. In this context, sharing of experiences aimed at developing a collaborative process and a voluntary exchange of information with creditors is critical.

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