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MENA: North Africa And Levant Economies Will Suffer The Most From Russia's Invasion Of Ukraine

18 Mar 2022 | MENA (Region) | Country Risk

Key View

- At Fitch Solutions we expect that the Russia-Ukraine war will significantly accelerate inflation in net oil importers in the Middle East and North Africa, weighing on economic growth and social stability. We expect that governments will respond by raising subsidies, which will deepen fiscal imbalances.
- Higher energy and food prices will increase the import bill for net oil importers, widening their current account deficits.
- Oil exporters, by contrast, will benefit from higher energy prices. Higher oil prices will trigger investment (offsetting the inflationary impact), and will bolster their fiscal and external positions.

At Fitch Solutions we anticipate that Russia's invasion of Ukraine will have significant negative implications for net hydrocarbon importers in the Middle East and North Africa (MENA), while net hydrocarbon exporters will see their macroeconomic conditions improve. Even though rising commodity prices will fuel inflationary pressures across MENA, inflation in net oil importers will pick up at a faster pace than in most oil exporters, causing greater headwinds to growth.

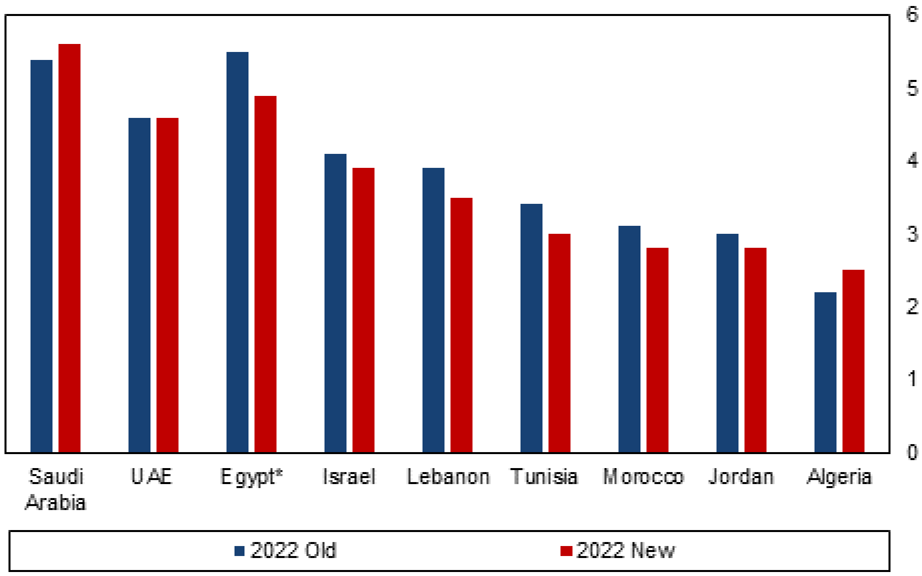
Net oil importers will see additional pressure on their public finances and external positions, which are already stretched because of the Covid-19 shock. In contrast, oil exporters will see their fiscal and external positions strengthen, while higher oil prices will likely trigger more investment in some cases, supporting even higher economic growth this year.

Growth Gap Between Oil Importers And Exporters Will Widen

We have revised down our 2022 growth forecast for most MENA oil importers. Higher inflation, tighter monetary policy and limited room to significantly increase subsidies and/or expand the social safety net, will weigh on private consumption in these economies. In Morocco, we cut our growth forecast for 2022 from 3.1% to 2.8%, as we think that lower agricultural output due to a drought will compound the impact of inflationary pressures on private consumption. In Tunisia, we have also revised down our 2022 growth forecast from 3.4% to 3.0% to account for the repercussions of the war on private consumption - through higher inflation and lower remittance inflows - and on the recovery in the tourism sector.

Mixed Growth Impact

Selected MENA Economies – Real GDP Growth, %



* Growth in FY2022/23 Source: Fitch Solutions forecasts

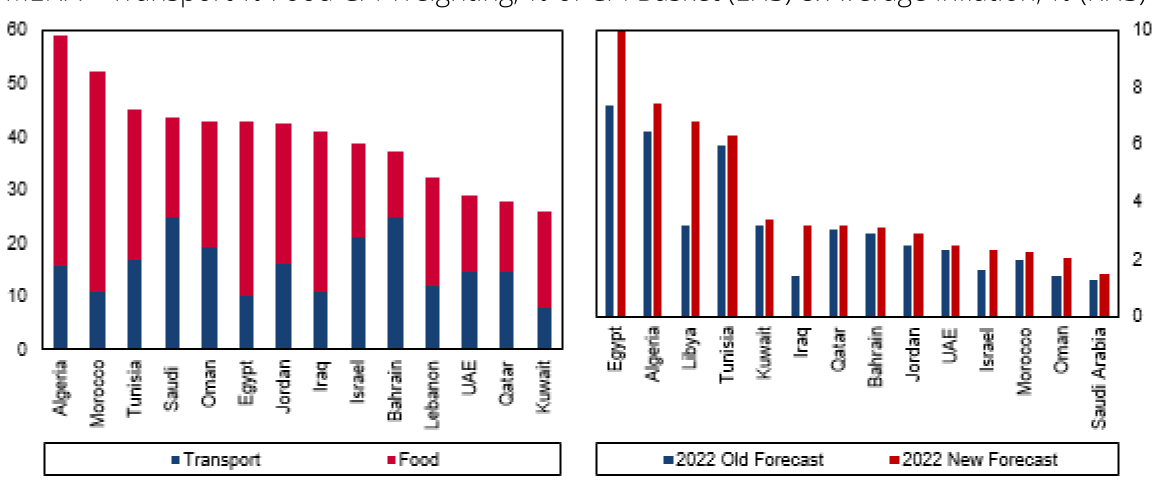
Meanwhile, higher oil prices will likely trigger more investment in some oil exporters, prompting us to revise our growth forecasts up for some of these economies (*see chart above*). This is particularly true for Saudi Arabia, where we increased our 2022 growth forecast from 5.4% to 5.6%. Similarly, in Algeria, we expect growth to come in at 2.5% (up from 2.2%). This is because we believe that higher oil-related revenues will allow for greater investment spending, which will more than offset the inflationary impact on private consumption. In the UAE, we maintained our growth projection at 4.6% in 2022, as we think that Russia's invasion of Ukraine presents both upside and downside risks to the economy.

Higher Energy And Food Prices Will Compound Inflationary Pressures In MENA...

We have revised up our 2022 forecast for average inflation in MENA from 14.0% to 15.6%. Russia's invasion of Ukraine has triggered a rally in commodity prices, with Brent prices sitting at slightly below USD100 per barrel (/bbl) compared to an average of USD71.0/bbl in late 2021. Additionally, wheat prices are nearly 50.0% higher than their 2021 average. Sticky global inflation and lingering supply chain bottlenecks will also add to inflationary pressures in MENA countries. North African economies will be the most affected given the large weighting of food in their CPI baskets (*see chart below, left*). This informs our elevated forecasts for average inflation in these states in 2022 (*see chart below, right*).

Across The Board Upward Revisions

MENA – Transport % Food CPI Weighting, % of CPI Basket (LHS) & Average Inflation, % (RHS)



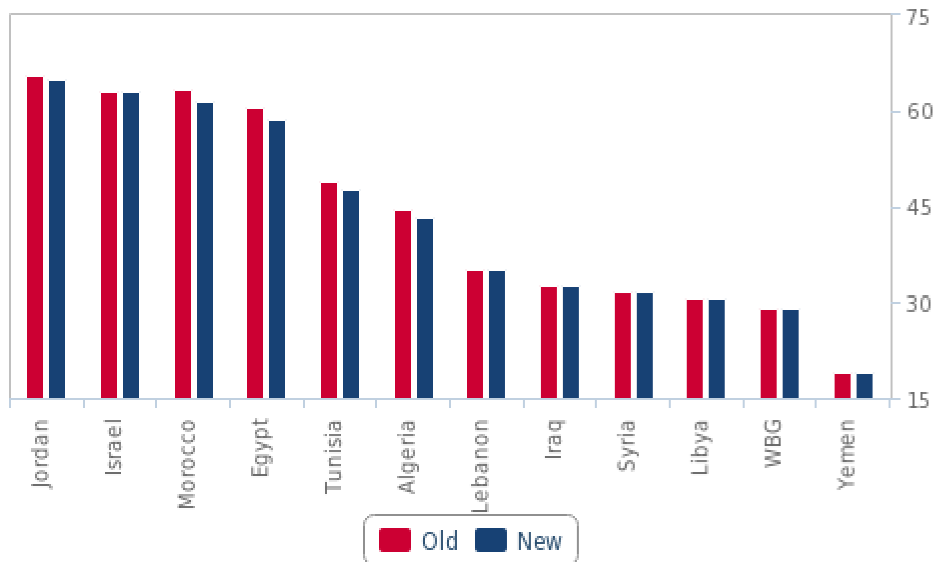
Source: National Sources, Fitch Solutions

...And Will Heighten Social Discontent in North Africa and Most Of Levant

As a result of higher inflation, we have lowered our Short-Term Political Risk Index score for several countries in North Africa and Levant, but particularly in Morocco and Egypt (*see chart below*). We believe that higher inflation, especially food inflation, will increase risks to social stability. This is particularly true for North Africa, where average inflation will rise from 4.8% in 2021 to 7.9% in 2022, and which has been historically more vulnerable to rising food prices than elsewhere in MENA.

Higher Risk To Social Stability In North Africa And Levant

Selected MENA Markets - Short-Term Political Risk Index Score



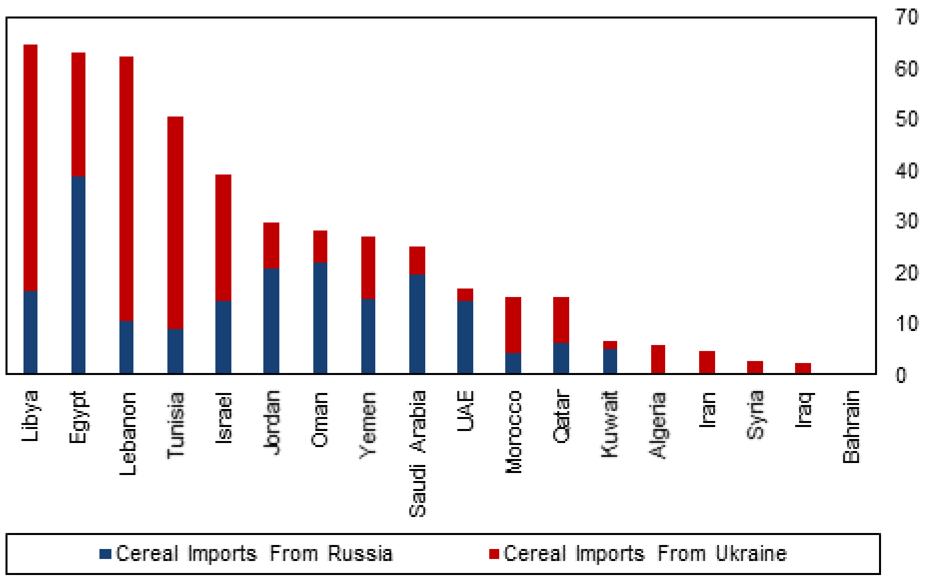
Note: STPRI score is out of 100, lower score indicates higher risk. Source: Fitch Solutions

Mixed Impact Through The Trade Channel

While MENA's total exports to Russia and Ukraine are worth less than 1.0% of the region's GDP, many countries are highly dependent on cereal imports from the two countries. This dependence is highest in Lebanon and North Africa, which source over 50% of their cereal imports from Russia and Ukraine (*see chart below*).

High Dependency On Russia And Ukraine For Cereal Imports

MENA – Cereal Imports From Russia & Ukraine, % of Total Cereal Imports



Note: Values are for 2019. Source: Trade Map, Fitch Solutions

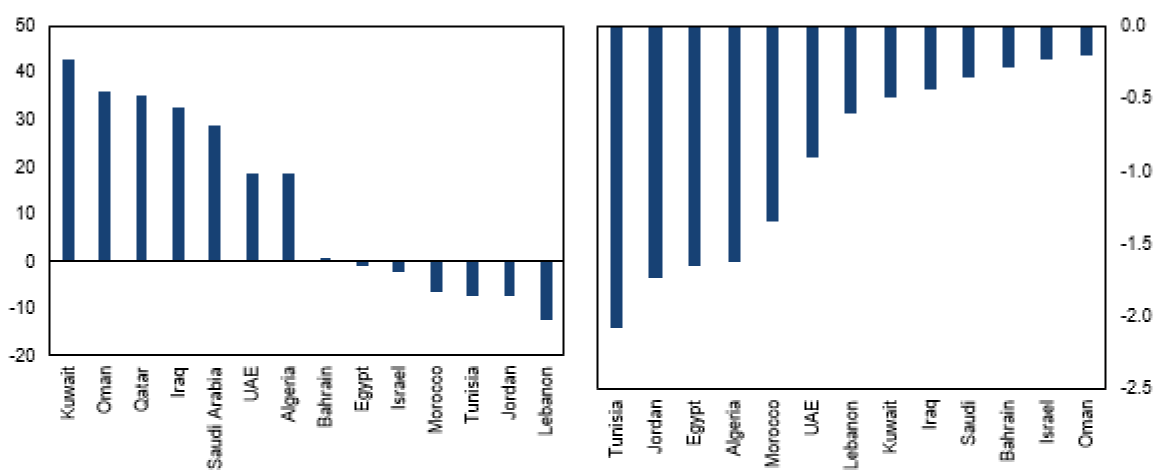
Countries with a high share of wheat imports from Ukraine, such as Libya, Lebanon, Tunisia and Egypt, have to find alternative import markets after Ukraine's decision to ban wheat export until end-2022. Egypt (the world's largest wheat importer) and Algeria have also imposed export restrictions on some agricultural products in order to preserve local supplies. While Egypt has five months' worth of grain stored, Lebanon has just one month's worth on hand.

Losers And Winners From Higher Commodity Prices

The external position of most economies in North Africa and the Levant will be particularly hit by higher energy and food prices. This is because they have relatively large deficits in their net oil and cereal trade balances (*see charts below*). Egypt, however is a notable outlier as it has as very small deficit in its energy trade oil balance, while Morocco has a relatively well-developed local grain sector, limiting its import needs. That said, we anticipate a weak harvest in Morocco this year due to a severe drought, which will likely increase its grains imports needs.

North Africa And Levant Most Affected

Selected MENA Countries – Oil (LHS) & Cereal (RHS) Trade Balance, % of GDP

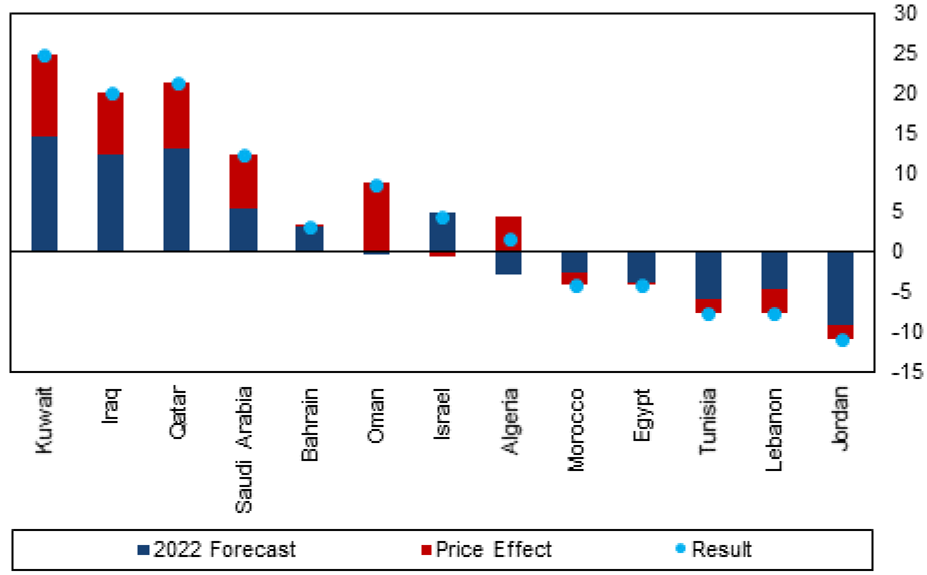


Note: Values are for 2019. Source: Trade Map, National Sources, Fitch Solutions

If oil prices remain elevated, this will widen energy exporters' current account surpluses and energy importers' deficits. For instance, Kuwait will see its current account surplus approaching 25% of GDP, while Jordan's deficit will be close to 10% of GDP (*see chart below*).

A Broad Range Of Impact

Selected MENA Countries – Current Account Balance, % of GDP

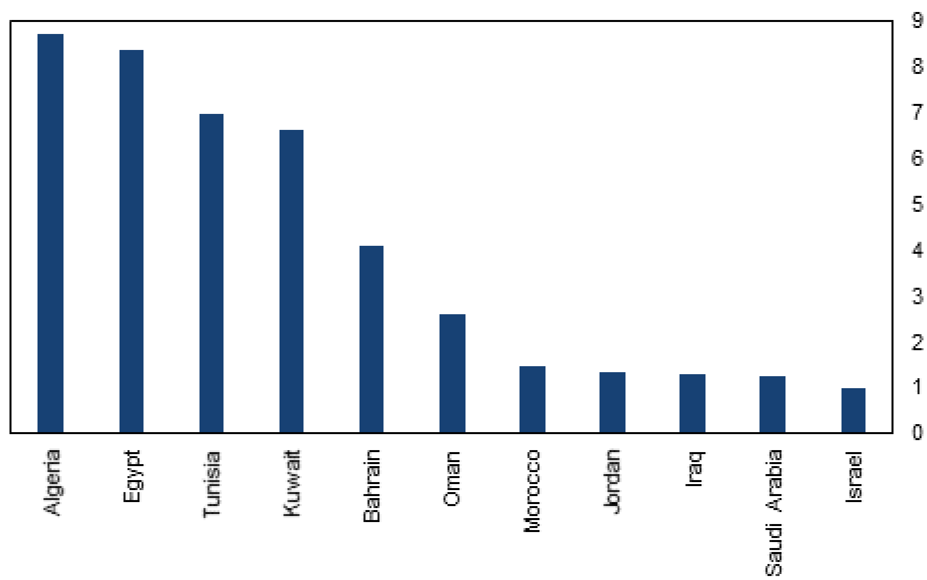


Note: Simulation assuming oil prices average USD125 per barrel in 2022. Source: Fitch Solutions

Higher energy and food prices will also weigh on the fiscal position in MENA countries through rising subsidy bills. Even oil exporters, such as Algeria, Kuwait, Bahrain and Oman, will see their subsidy bill increase, partially offsetting some of the gains from higher hydrocarbon prices and exports. In contrast, among the region's oil importers, Egypt, Morocco and Jordan will be the most affected (*see chart below*). This will lead to wider fiscal deficits and higher debt loads in these economies.

Subsidy Bills Set To Rise

Selected MENA Countries – Subsidies, % of GDP



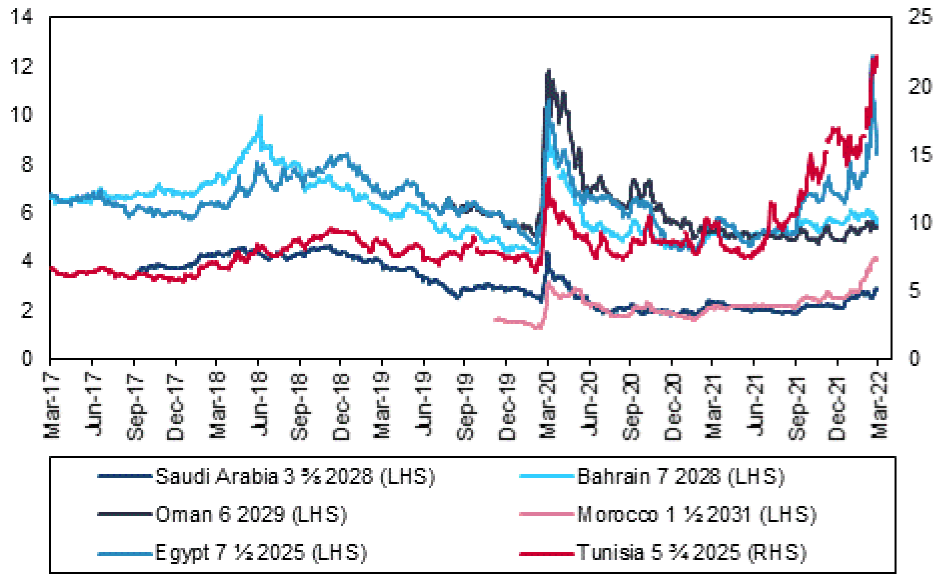
Note: Subsidies include fuel, food and others. Source: National Sources, Fitch Solutions

Limited Impact On Currencies, Upward Pressures On Yields

Currency pegs and central banks' intervention have helped to limit the impact of the Russia-Ukraine crisis on most MENA currencies. The Moroccan dirham, Tunisia dinar and the Israeli shekel, however, have weakened by 4.1%, 2.4% and 1.5% against the US dollar since the start of the Ukrainian crisis. Several factors have contributed to the weakening, such as the strengthening of the US dollar, risk off sentiment towards emerging markets, tightening global financing conditions and/or rising pressure on the external positions. Moving forward, we expect these factors will continue to impact the trajectory of these currencies, albeit to a smaller extent. We thus expect weakness in these currencies will persist, as they will not recover all of their lost value in the short term.

Pickup In North Africa's Government Bond Yields

Selected MENA Countries - Government Yields, %



Source: Bloomberg

Meanwhile, bond yields have risen sharply in North African economies but have remained broadly stable in Gulf Cooperation Council countries (*see chart above*). The Ukraine crisis has worsened risk off sentiment towards emerging markets and we expect this trend to continue in coming quarters, especially as global financing conditions keeps tightening. This has hurt Egypt's financing position which has been reliant on portfolio inflows and has exacerbated existing pressures on Tunisia and to a lesser extent on Morocco. Talks between Tunisian authorities and the IMF over a funding programme are advancing (in line with our view), which will likely shore up confidence. In Egypt, we think that the Russia-Ukraine war has exacerbated external vulnerabilities that will weigh on its currency. Recent media reports said that Egyptian authorities are in contact with the IMF over an arrangement, confirming our view on Egypt. We think Egyptian authorities will reach an IMF agreement that would reassure investors, resulting in a devaluation of the pound by between 5.0% to 7.0%.