Global Developments: Implications for the Middle East and Central Asia Region

Global developments continue to impact the Middle East and Central Asia (MCD) region. Average growth worldwide has once more been revised down and is anticipated to reach 3 percent in 2019, and 3.4 percent in 2020 versus projections one year ago of 3.7 percent for both of these years (see October 2019 *World Economic Outlook*). Although the reduction in global demand may be partly offset by the recent loosening of global monetary policy, concentration of the slowdown among key trading partners (especially Europe and China) has amplified the impact on the MCD region. Despite rising geopolitical tensions, including those related to Iran, recent disruptions to Saudi Arabia's oil production, and ongoing conflicts in the region (Libya, Yemen), global oil prices have remained low and financial conditions relatively loose.

Real GDP Growth, 2018–24

	2018	2019	2020	2021–24
World	3.6	3.0	3.4	3.6
Euro area	1.9	1.2	1.4	1.4
United States	2.9	2.4	2.1	1.6
China	6.6	6.1	5.8	5.7
Russia	2.3	1.1	1.9	2.0
MENAP	1.6	0.5	2.7	3.1
MENAP oil exporters	0.2	−1.3	2.1	2.1
of which: non-oil GDP growth	0.4	1.1	2.6	2.5
MENAP oil importers	4.3	3.6	3.7	4.8
CCA	4.2	4.4	4.4	4.5
CCA oil and gas exporters	4.1	4.3	4.4	4.5
of which: non-oil GDP growth	3.0	5.1	4.6	4.2
CCA oil and gas importers	5.2	4.9	4.5	4.5

Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, Pakistan.

The outlook for the MCD region is driven by a large contraction in Iran in the short term (see Chapter 1) followed by a rebound in 2020. The risks around the forecast are skewed to the downside and are highly dependent on global factors.

- Ongoing *trade tensions* represent a substantial risk to the region. In September, the United States introduced additional tariffs on Chinese goods, with more scheduled for December. Regional trade links to China are concentrated in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) oil exporters and Central Asia. Yet the spillovers from a China-focused slowdown may not be solely concentrated in these countries. Export shares capture only the direct effects of an external slowdown, so can underestimate exposure to a given country through indirect channels. For example, even countries with few direct sales to China may be impacted considerably by increased competition from redirected trade, as countries with large exports to China seek new markets. Figure 1 addresses this, comparing two measures of export elasticity to a reduction in Chinese demand: one assuming the effect of displaced competition is zero, and one that it is spread equally across all exporters to China. When these competitive spillovers are considered, the likely impact of a China-focused slowdown is more uniform across MCD countries.[1]

- *Oil price volatility* has risen, while remaining below the highs of 2018. The overall level, however, remains similar to that expected in the spring (Figure 2). This is likely a function of both increasingly elastic global oil supply—due to expanded US shale production—and shocks to geopolitical tensions

[1]The goods-weighted export share to China for country i is $\sum_m w_m^i \omega_m$, in which w_m^i is the share of good m in country i's exports, and ω_m is China's share of all imports of good m. This measure captures at least some of the spillovers as other exporters adjust. For example, one of Georgia's main exports is metal ore, particularly copper. China is a very large purchaser in this market, constituting nearly half of global demand. A reduction in Chinese demand will likely increase competition for Georgian copper exports as other producers seek to find new markets. Although direct exports to China are very small (about 6 percent of total in 2018), the impact through competitive spillovers may be larger, and is captured at least in part by the goods-weighted exposure.

Figure 1. MCD Exposure of Exports to China, 2017
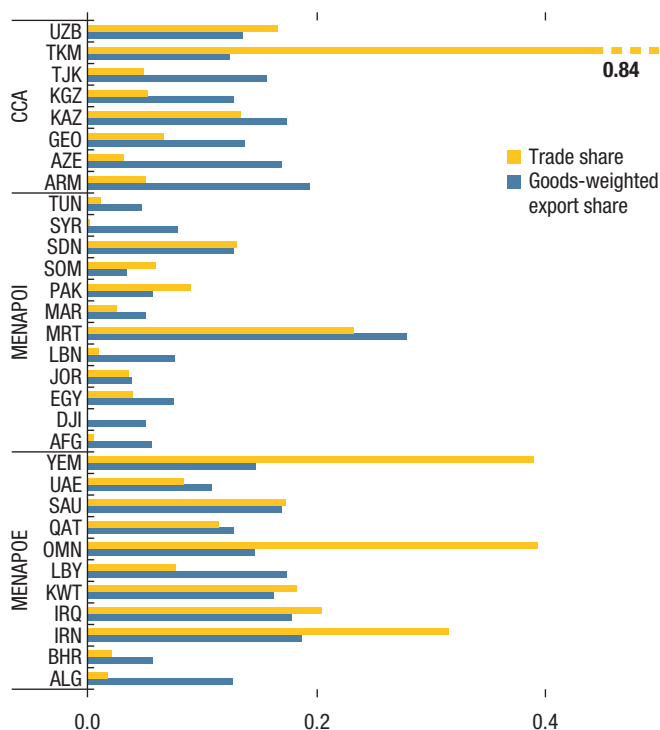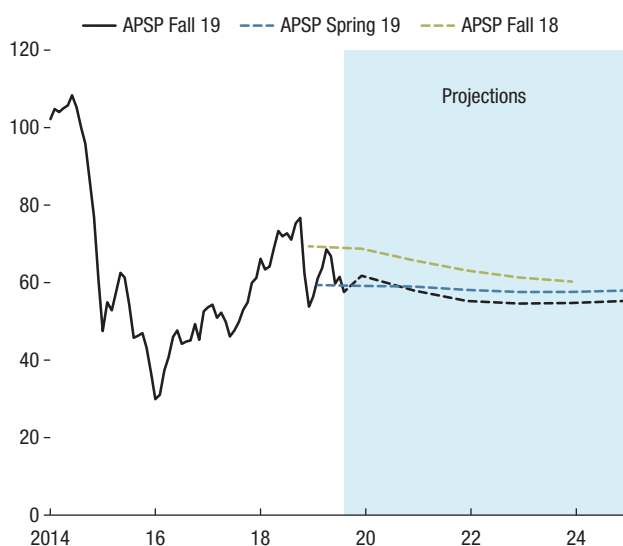*(Share of exports)*

Figure 2. Evolution of Oil Prices
(APSP, US dollars a barrel)

Sources: National authorities; and IMF staff calculations.
Note: APSP = average petroleum spot price. APSP is the average of UK Brent, Dubai Fateh, and West Texas Intermediate crude oil prices.

Sources: BACI International Trade database; Centre d'Etudes Prospectives et d'Informations Internationales; and IMF staff calculations.
Note: The goods-weighted export share for each country is the sum of the product of exports in 4-digit harmonized system goods categories with Chinese import shares of each good. It thus measures the elasticity of exports to a goods-neutral reduction in Chinese demand assuming that exporters' shares of global goods markets remain fixed. CCA = Caucasus and Central Asia; MENAPOE = Middle East, North Africa, Afghanistan, and Pakistan oil-exporting countries; and MENAPOI = Middle East, North Africa, Afghanistan, and Pakistan oil-importing countries. Country abbreviations are International Organization for Standardization (ISO) country codes.

and global demand (Box 1). Yet recent events in the Gulf have highlighted the sensitivity of the global oil market to disruptions in oil shipments and facilities.

- A *disorderly Brexit* could also significantly impact the region. A general slowdown across Europe from Brexit will reduce external demand in countries with tight trade links to the continent, such as Morocco and Tunisia. Yet the direct spillovers from a sharp contraction in the UK economy are likely to be much more acute and more unpredictable. Financial channels could be particularly important, as the UK is the largest banking counterparty for the MCD region, and several countries have considerable exposure to the pound sterling (Kuwait, Oman, Pakistan).

- Finally, *social tensions* across the region remain elevated. Protests earlier this year in Algeria and Sudan have been accompanied by those in Georgia and Kazakhstan (Box 2). The evolution of these events highlights the urgent need for reforms to deliver higher and more inclusive growth, and will shape policymakers' options for addressing the economic challenges faced by the region.

In the longer term, even larger risks loom. Foremost among these are *demographic changes*, which are already straining labor markets and demand for public services, and *climate change*, which will most likely impact the region through more adverse weather events, oil price uncertainty, and tension over scarce resources, particularly water.

Given this environment, regional governments' ***policy objectives*** should, in the near term, stabilize macroeconomic conditions and build resilience by addressing unsustainable fiscal policies while protecting the most vulnerable, and in the medium term, promote inclusion and raise growth by tackling impediments to jobs and investment. More accommodative policies should be considered if there is further slowdown in countries where growth is already too low and when there is policy space.

To achieve these objectives, country authorities will face ***three key policy challenges***, highlighted in this report. First, fundamental reforms to the *conduct and institutions of fiscal policy* are essential to tackle high public debt and inefficient government services. This will include the adoption of policies to promote fiscal transparency *and* predictability, such as credible medium-term fiscal frameworks. Second, the composition of *capital flows* to the region has changed, becoming less conducive to growth. Foreign direct investment (FDI) has been replaced by portfolio flows, especially in MENAP countries; policies to promote deeper markets, reduce restrictions on investment, and improve macroeconomic stability can help attract FDI. Third, *structural reforms* are essential for boosting growth and employment throughout the region. A failure to deliver higher and more inclusive growth may fuel already-elevated social tensions, threatening regional stability.

Box 1. Decoupling of Regional Geopolitical Tensions and Oil Prices

Although global oil prices used to rise sharply and remain elevated for long periods in response to major geopolitical tensions in the MENAP region, more recent episodes of heightened geopolitical tensions have had a much less severe impact. For example, oil prices rose by nearly 60 percent, from $22 a barrel in November 2002 to $35 a barrel in March, in the lead-up to the 2003 Iraq war. However, they only rose by 8 percent from $71 in August to $77 in October following the reimpositions of US sanctions on Iran, which was much milder than expected given the fact that Iran is a large oil producer.

This subdued response of oil prices to geopolitical tensions can be explained by a combination of key factors. First, increased risks of an adverse demand shock, most recently owing to the rising uncertainties in global trade, have been a major dampening force on oil prices. Second, supply-side considerations matter. The oil market structure has changed with US shale oil producers playing an increasingly important role. US shale oil production increased from slightly less than 7 percent of the total US crude oil production in the early 2000s to more than 60 percent in 2018.

A regression analysis using monthly data confirms these relations (Table 1). There is a positive and significant relationship between political risks in the MENAP region and real oil prices. However, this effect is dampened by the rise of shale oil since 2010, when US shale oil production started to accelerate (Box Figure 1.1).[1] The increased shale oil production has also contributed to crude oil inventory in the United States, which has remained at historically high levels since 2015, exerting further downward pressure on oil prices. Trade uncertainty, captured by recent spikes in the Chicago Board Options Exchange Volatility Index (VIX), is associated with a further negative impact on oil prices.

Table 1. Selected Determinants of Oil Price

Variables	Δ Real oil price
Δ Political risk in MENAP	0.96**
	(0.59)
Δ Political risk in MENAP * Shale dummy	−0.87*
	(0.63)
Δ VIX	−0.12***
	(0.03)
Δ US crude inventory	−0.31***
	(0.16)

Sources: Haver, International Energy Agency (IEA); PRS Group; IMF Research Department; and IMF staff calculations.

Note: Sample period is from January 1999 to June 2019. Real oil price is calculated by deflating the monthly average petroleum spot prices using the US consumer price index. Political risk in MENAP is proxied using median political risk ratings of all MENAP countries by Political Risk Service Group—transformed so a higher number indicates increased risks. Shale dummy is set to 0 before year 2010, and 1 from year 2010 onward. All time-series variables are in percentage changes from previous month to ensure stationarity. 11-(month) lagged dependent variables are included as additional controls to alleviate omitted variable bias and reduce serial correlations (Durbin-Watson test confirms no serial correlation). Constant term and coefficients of shale dummy and lagged dependent variables are omitted in the table to save space. Robust standard errors in parentheses. ***$p < 0.05$, **$p < 0.1$, *$p < 0.2$. VIX = Chicago Board Options Exchange Volatility Index.

Prepared by Ling Zhu.

[1]Political risks in the MENAP region are proxied using MENAP countries' median political risk ratings, as calculated by the Political Risk Service Group. This measure accounts for political stability of a country on a comparable basis with other countries by assessing risk points for each of the component factors of government stability, socioeconomic conditions, investment profile, internal conflict, external conflict, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability, and bureaucracy quality. Original ratings range from a high of 100 (least risk) to a low of 0 (highest risk); data for this analysis were transformed—subtracting the index from 100—to imply a higher number indicating increased risks.

Box 1 *(continued)*

Box Figure 1.1. US Shale Oil Production
(Percent of global oil production; million barrels)

Shale production
(percent of global oil production)

Crude inventory
(million barrels, right scale)
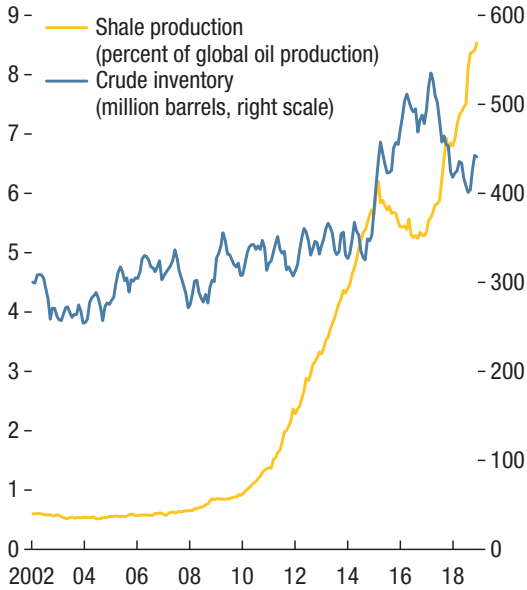
Sources: US Energy Information Administration; Haver
Analytics; and IMF staff calculations.

The muted response of oil prices to changes in perceptions of political risk seems driven by two factors: First, the increasing importance of the US shale oil, especially its role as a major swing producer, has weakened the link between oil prices and geopolitical tensions in the MENAP region. Given the secular nature of the rise in US shale oil, the link between geopolitical tensions and oil prices is likely to remain subdued. Second, trade uncertainty appears to play a large role in keeping oil prices from rising. A protracted trade dispute, increasing the risk of a further global slowdown on top of an already slowing world economy, is expected to keep oil prices low despite geopolitical tensions in the region.

Box 2. Monitoring Social Unrest in the Middle East and Central Asia

Social unrest is growing throughout the Middle East and Central Asia. The Reported Social Unrest Index (RSUI), which counts media reports of social unrest in member countries, shows that reported social unrest has risen to highs not seen since 2014 (Box Figure 2.1).[1]

This recent trend is widespread. Unrest earlier this year had been concentrated in Algeria and Sudan. More recently, though, protests have flared in Georgia and Kazakhstan—albeit in a very different social and political context to that in North Africa (Box Figure 2.2). Still, this contrasts with previous bouts of unrest; prior to 2017 social unrest was relatively more prevalent in countries in the Middle East, North Africa, Afghanistan, and Pakistan region (Box Figure 2.1).

Social unrest constrains policymakers' choices. For example, urgent reforms to Tunisia's public sector wage bill were postponed earlier this year due to fear of widespread protests. And major demonstrations last year led to policy changes in both Armenia and Jordan (Box Figure 2.2). Yet policymakers cannot shy away from reform. Authorities are faced with persistent structural shortcomings, which are limiting jobs and opportunities for their citizens, likely risking further instability.

Box Figure 2.1. Reported Social Unrest Index
(12-month rolling average, 2014–present = 100)
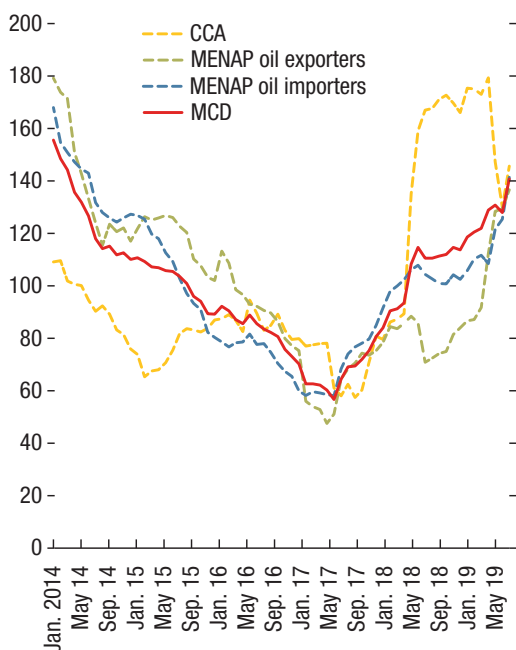
Sources: Factiva; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MCD = Middle East and Central Asia Department; MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

Box Figure 2.2. Reported Social Unrest Index
(Average, 2018–present = 100)
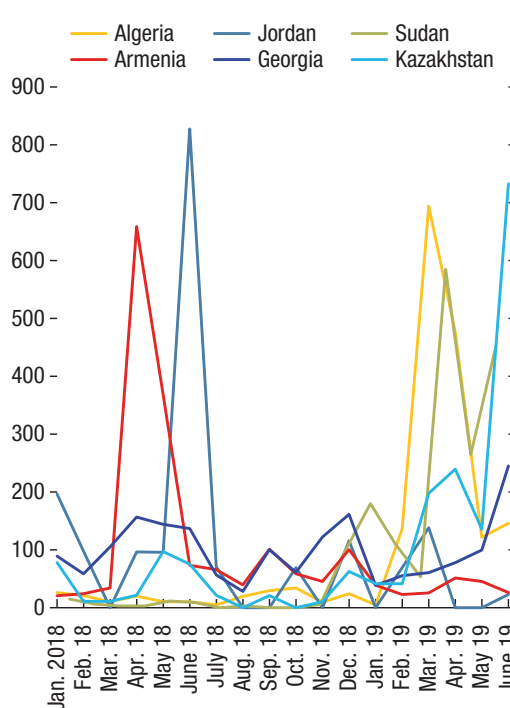
Sources: Factiva; and IMF staff calculations.

Prepared by Philip Barrett.
[1]See Box 1 in the April 2019 *Regional Economic Outlook: Middle East and Central Asia* and associated online annex for further discussion about the construction of this index. Previously computed only for 7 MENA countries, this index is now calculated for the 27 MCD countries for which there are sufficient data.