What China's Rebalancing Means for the Middle East and Central Asia

By Pritha Mitra

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China, the second largest economy in the world, is shifting its growth model from an export- and investment-driven economy to one centered on consumption. With this shift in its growth model contributing to a slowdown in China's economy, the impact is being felt around the world.

With only moderate links to China—mainly through trade—that impact, however, is likely to be relatively minor for the Middle East and North Africa (MENA) and the Caucasus and Central Asia (CCA). In fact, our recent study suggests there may even be some upside potential.

China's economy is so large that spillovers will manifest in one of two ways: through China itself—which we'll call *direct links*—and through China's impact on overall global growth—which we'll call *indirect links*.

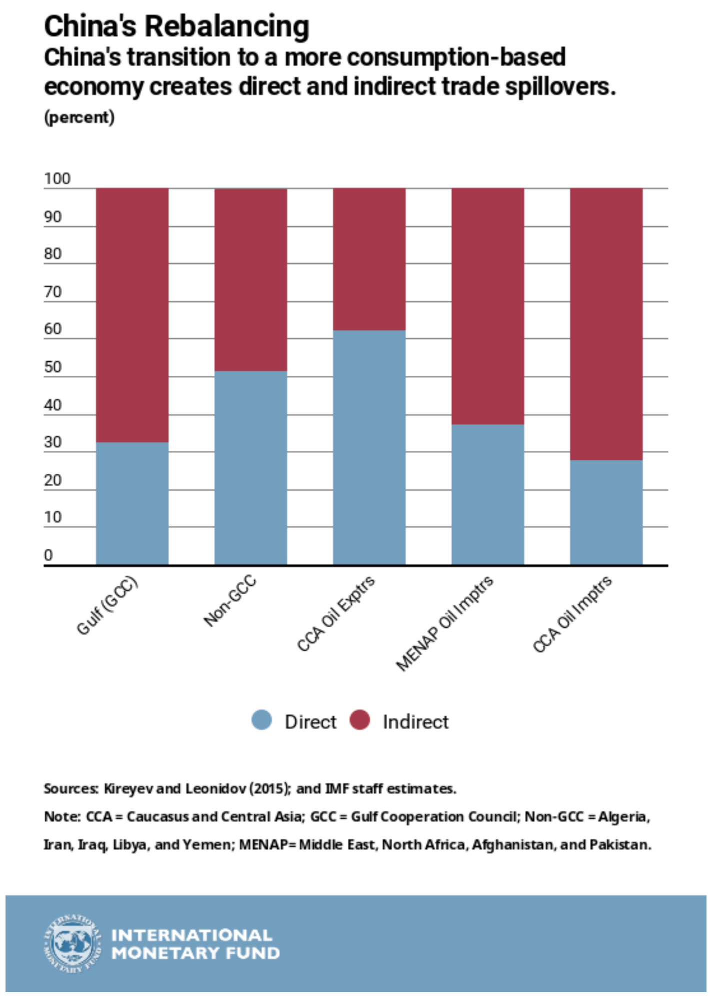
Let's start with the direct links.

The economies of the Middle East and North Africa and Caucasus and Central Asia regions are still heavily reliant on commodities, some of which are exported to China. As China transitions to a more consumption-based economy, its demand for oil and natural gas is likely to remain broadly steady, and may even rise with increased consumption. So that trade won't be negatively impacted by China's rebalancing.

It's a different story for metal exporters. China's transition away from manufacturing accounts for about 40 percent of the recent global decline in metal prices. That has particularly affected Middle East and North Africa countries like Mauritania and Lebanon, and Caucasus and Central Asia countries like Armenia and Georgia, whose commodities of copper, iron, and basic metals make up the bulk of their exports to China.

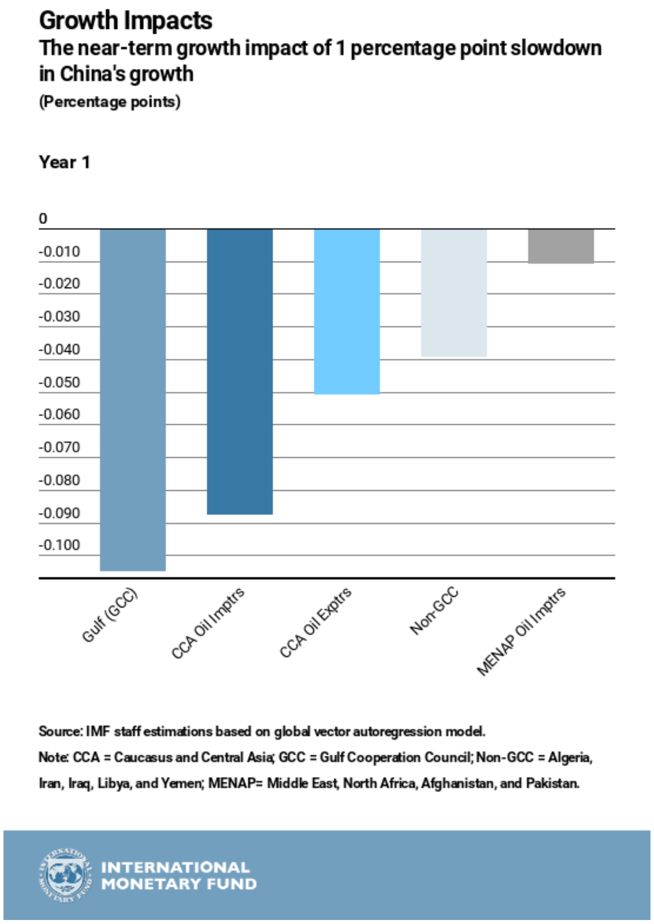
Now to the indirect links.

Given China's size, an economic slowdown is likely to spill over to the rest of the world through trade, commodity prices, and confidence. For example, a drop in China's growth by 1 percentage point would reduce Group of 20 (G20) growth by ¼ percentage point, which will have inevitable spillovers for Middle East and North Africa and the Caucasus and Central Asia, particularly with regards to trade. Slower global growth will reduce global demand for oil, impacting the oil-exporting countries of Middle East and North Africa and the Caucasus and Central Asia. Overall, the majority of the trade spillovers from China's rebalancing for the Gulf countries— Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—and the Middle East and North Africa and Caucasus and Central Asia oil importers will come from these indirect links (see Figure).



What are the overall growth impacts of China's rebalancing?

Across the two regions, the countries of the oil-exporting Gulf Cooperation Council (GCC) will be impacted the most, largely through indirect trade links. However, the effect is likely to be limited to a 0.1 percentage point decline in growth for each percentage point decline in China's growth (see Figure). For example, that is about half of the impact on Southeast Asia, the region expected to be hit the hardest. The Middle East and North Africa oil importers will be affected the least—a 0.01 percentage point decrease for every 1 percentage point slowdown in China—as the lower cost of oil improves overall terms of trade, disposable incomes, and input costs.



So what are the potential upsides?

Exposure to China's rising consumption growth could boost consumption-related imports, including tourism. As part of the rebalancing process, China's exports are also moving up the value chain and exiting some sectors. This creates opportunities (notwithstanding competition from Southeast Asia) for Middle East and North Africa and Caucasus and Central Asia economies to enter those sectors to both satisfy China's increased consumption demand and replace some of China's exports to the rest of the world—boosting the region's growth and employment. As well, the Caucasus and Central Asia region is expected to benefit from China's *One Belt One Road* (OBOR) initiative, which seeks to raise connectivity and cooperation across Eurasia. Under current plans, it could raise investment (mostly infrastructure) in the Caucasus and Central Asia by up to 2 percent of GDP annually for the next five years. Even if China slows the pace of investment, the region would still reap substantial gains. Increased transit across the OBOR corridor will provide an opportunity for countries to increase their sales of transit-related services, such as restaurants, hotels, and fuel stations. A slowdown in OBOR-related investments would slow this effect but, nevertheless, continue to raise productivity, exports, and employment.

So what should policymakers in the Middle East and North Africa and Caucasus and Central Asian countries be doing in response to China's rebalancing?

First, greater exchange rate flexibility would, in some cases, ease adjustment to shocks and help increase competitiveness, which is crucial for increasing exports to China and the rest of the world. And second, structural reforms targeted at boosting productivity and the competitiveness of consumption and tourism-oriented industries could, over time, help raise the regions' share of trade with China and the rest of the world. The success or failure of this, though, will hinge on improving the business environment, increasing labor market efficiency, boosting worker talent, improving access to financing (especially for small and medium enterprises), and better infrastructure.

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Pritha Mitra is a senior economist in the IMF's Middle East and Central Asia Department. She leads regional surveillance work for the Middle East and North Africa (MENA) oil importing countries, and the development of fiscal policy advice and medium-term growth potential for the overall MENA region. In previous positions at the IMF, she worked on several crisis countries in emerging Europe and on low-income and emerging market economies in Asia and Africa, as well as on low-income country policy design. She has also worked as a senior transfer pricing expert for Arthur Andersen in New York and holds a PhD in Economics from Columbia University.