4. How Will China's Rebalancing Affect the Middle East and Central Asia?

Weaker commodity prices, slower global growth, and higher global risk aversion are the channels through which the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) and the Caucasus and Central Asia (CCA) economies could be most affected by China's rebalancing, especially if the rebalancing leads to a hard landing. Overall, the impact on the MENAP and CCA regions is likely to be small—between 0.01 percent and 0.1 percent for each 1 percentage point slowdown in China's growth—given the limited bilateral trade and financial linkages with China. Within the regions, commodity exporters would be impacted the most. On the positive side, China's One Belt One Road (OBOR) investments, mainly in infrastructure, could help increase growth in the CCA and Pakistan—even if this investment is less than originally planned. China's rebalancing also presents an opportunity for the region to increase consumption-oriented exports, for example, tourism, agricultural products, and clothing, while creating jobs. To reap these benefits, however, countries need to step up structural reforms to improve their business environment and boost productivity and competitiveness.

Global Spillovers from China's Rebalancing

The Chinese economy is undergoing a substantial structural change. It is moving toward a model in which consumption and services increasingly drive growth rather than public investment and exports (also known as rebalancing). In the long term, the rebalancing should be beneficial for the global economy, as it reduces the risk of a collapse in unsustainable investment and a hard landing in China. In the near term, however, the transition (which began in 2012) entails China's growth gradually slowing to a more sustainable pace. Since China is the world's second-largest economy (at market exchange rates), its slowdown is expected to lower global growth (IMF 2016).

Given China's size, high investment rate, and high import content of its investment and exports, an economic slowdown in China is likely to spill over to the rest of the world through trade, commodity prices, and confidence. Growing financial linkages with the rest of the world, especially with ongoing internationalization of the renminbi and China's gradual capital account liberalization, may also impact currency valuations and increase global financial market volatility—as exemplified by market turbulence triggered by concerns about China's growth in 2015. China's rebalancing away from investment is also contributing to a slowing in demand for many commodities—especially metals, for which it accounted for about 40 percent of total global demand—and their prices, which have fallen by about 60 percent since 2011 (April 2016 *Regional Economic Outlook: Asia and Pacific* [APD REO]).

Global macroeconomic modeling suggests that a 1 percentage point (investment-driven) drop in China's output growth would reduce Group of Twenty (G20) growth by ¼ percentage point (April 2016 *World Economic Outlook*). How other countries would be affected by China's rebalancing depends on the extent and nature of their bilateral exposures to China and their exposure to countries with heavy bilateral exposures to China (April 2016 APD REO). Countries exporting investment-related goods to China, such as those in Southeast Asia, would be hit hardest: a 1 percentage point slowdown in China's growth rate is expected to lead to a 0.15–0.30 percentage point slowdown in that region's growth (Duval and others 2014; Cashin, Mohaddes, and Raissi 2016). Financial spillovers, especially in equity and foreign exchange markets, are likely to be higher for economies with stronger trade linkages to China—for example, Korea, Singapore, and Taiwan Province of China—and countries that

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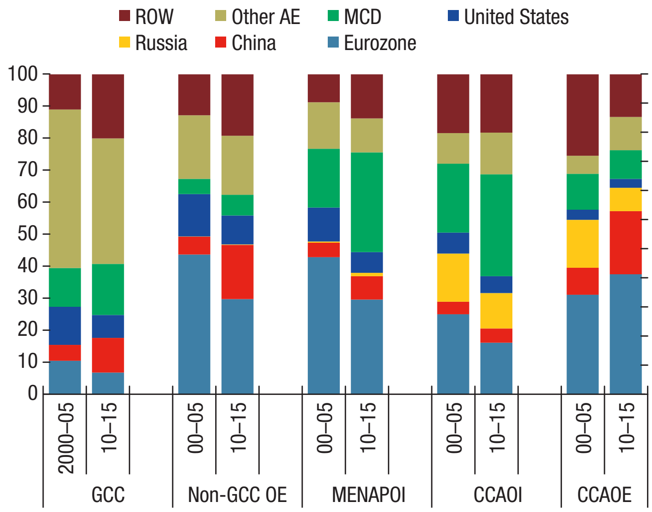
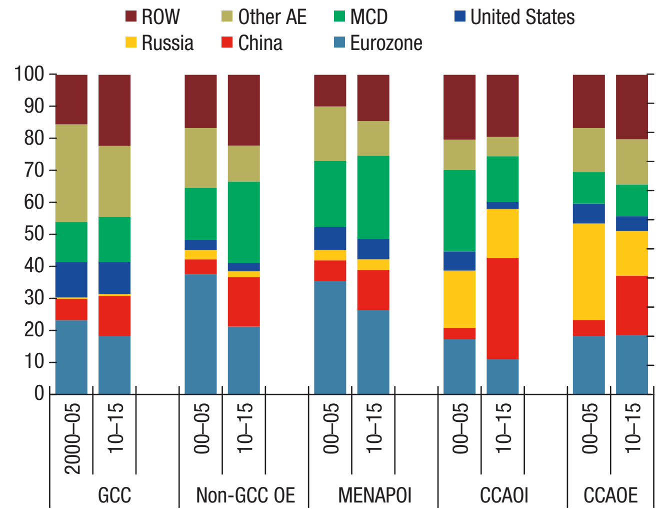
Figure 4.1. Share of Exports by Destination
(Percent, period averages)



Sources: IMF, Direction of Trade database; and IMF staff calculations.
Note: AE = advanced economy; CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers; ROW = rest of the world.

Figure 4.2. Share of Imports by Destination
(Percent, period averages)



Sources: IMF, Direction of Trade database; and IMF staff calculations.
Note: AE = advanced economy; CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers; ROW = rest of the world.

are sensitive to changes in global risk aversion (April 2016 APD REO). Slowing trade and financial inflows would reduce investment and consumption, hurting both near- and long-term global growth prospects. Lower inflows would increase exchange rate pressures, though the effect would be partly offset by import contraction.

Moderate Linkages Between MENAP and CCA Regions and China

MENAP and CCA countries' links to China, primarily through trade, have grown substantially yet remain moderate (Figures 4.1 and 4.2). Trade links are strongest with Europe and Russia, and within the regions.[1] However, since 2000, China has gained importance as an export destination: exports to China have grown tenfold for MENAP oil exporters ($100 billion in 2015) and CCA oil exporters ($15 billion in 2015) and nearly quadrupled for the rest of the region ($6 billion for MENAP oil importers; $400 million for CCA oil importers). The pattern is similar for imports. In the early 2000s, the region had virtually no imports from China. Over the next 15 years, imports picked up pace rapidly and grew almost 10 times—except MENAP oil importers, for which imports grew by about half as much.

The regions' exports to China are varied, ranging from natural resources to electronic components, with commodities accounting for the bulk of exports. MENAP and CCA oil exporters sell hydrocarbons to China (Figure 4.3)—now a top-five export market destination for the CCA. China is a large export market for iron ore from Mauritania (more than 40 percent of total exports) and Tajikistan (about 10 percent of total exports), as well as copper from Armenia (about 5 percent of total exports). The rest of the regions' exports to China are mainly consumption-oriented goods (or inputs for them; well below 10 percent of total exports), including cotton from Pakistan and electronic components from Morocco. The presence of Chinese tourists has been growing

[1]Transit trade within MENAP and CCA countries may understate export shares to other destinations in Figure 4.1.

across the region but remains well below 5 percent of the overall total.

Imports from China have driven a large trade deficit with China. Mostly textiles, electronics, and machinery (Figure 4.4), these imports have continued growing—and at a faster pace than exports—despite the various economic shocks recently faced by the region. Consequently, they have contributed to a rising trade deficit with China for MENAP oil importers and a consistently large deficit for CCA oil exporters, as well as shrinking surpluses for MENAP oil exporters (along with lower oil export revenues) and CCA oil importers (along with lower metal export revenues).

Financial linkages among the CCA, Pakistan, and China are substantial, and they are strengthening owing to the One Belt One Road Initiative (OBOR). China's official lending to CCA countries has risen from $300 million (0.1 percent of GDP) in 2007 to $4.4 billion (1 percent of GDP) in 2014. Over the next five years, as part of OBOR (Box 4.1), China is expected to invest an additional cumulative $35 billion (2 percent of GDP) in the CCA, mainly in infrastructure and mining. As a part of this initiative, China is also investing $28 billion (2 percent of GDP) in Pakistan (mainly energy and infrastructure) over the same period and another $16.5 billion over the longer term. In the rest of MENAP, China contributes less than 5 percent of total foreign direct investment, mainly for energy and transport infrastructure. In Egypt, China's direct investment would rise if it moves forward with financing energy projects worth $15 billion (totaling 0.9 percent of GDP over the next five years). Otherwise, financial links between China and the MENAP region are modest. Foreign direct investment, banking flows, remittances, and portfolio flows are mainly from Europe and the Gulf Cooperation Council (GCC) (Figure 4.5).

What Does China's Economic Transition Mean for MENAP and CCA?

On the upside, exposure to China's rising consumption growth could boost its consumption-related imports. As part of the rebalancing process, China's exports are also moving up the value chain and exiting some sectors. This creates opportunities for developing economies to enter those sectors to both satisfy China's rising consumption demand and replace some of China's exports to the rest of the world (April 2016 APD REO).[2]

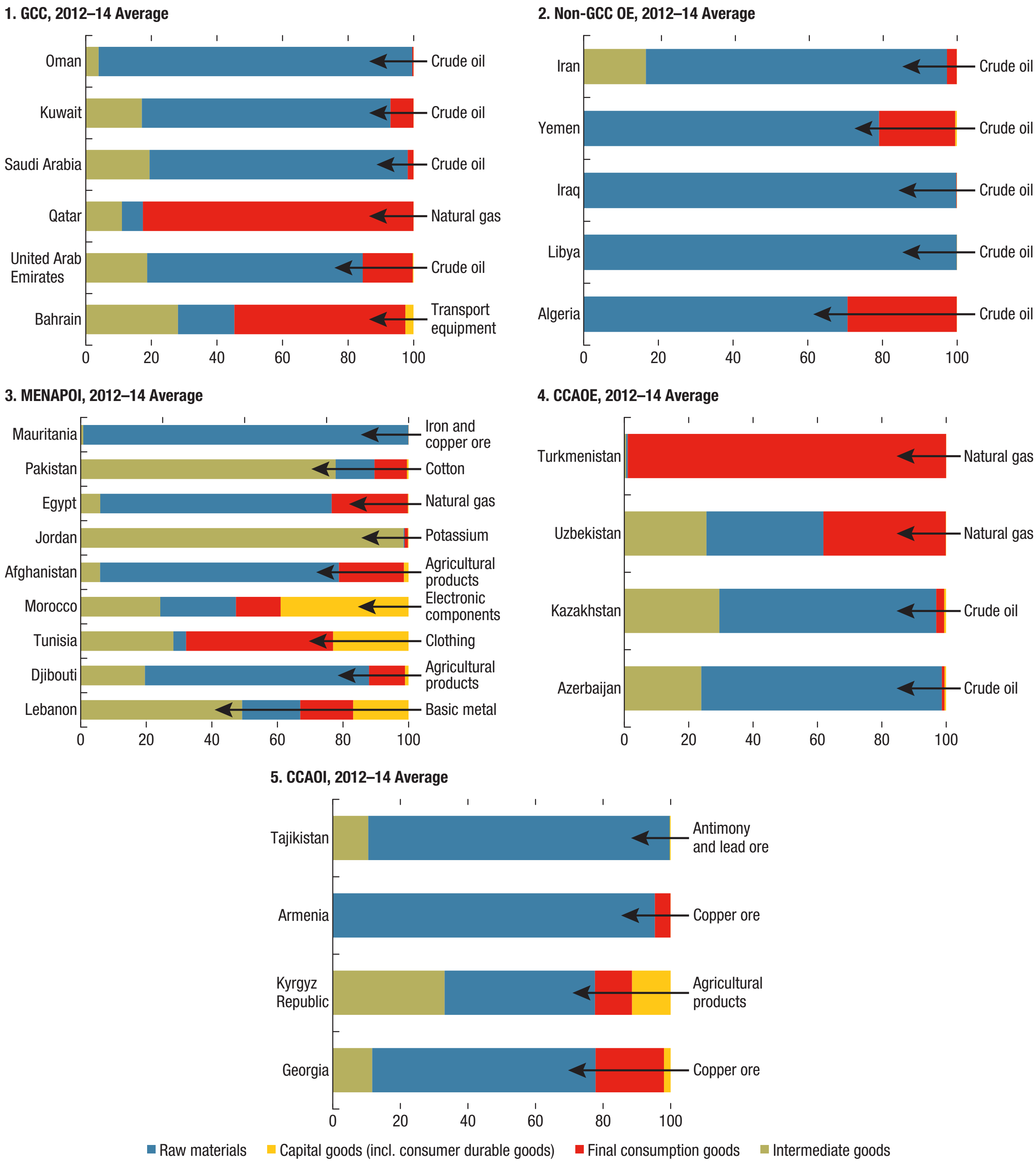
The impact of China's rebalancing could be large for MENAP and CCA oil exporters due to reduced oil exports. So far, China's demand for oil has only marginally declined and is expected to rise with increased consumption. However, China's lower import demand and its adverse effects on global growth are weighing on global oil demand—accounting for about one-third of the past two years' oil price decline (April 2016 APD REO). This price decline, combined with lower oil demand from MENAP and CCA oil exporters' main trading partners, weakens their export revenues and economic growth.

Spillovers from China's rebalancing to the MENAP and CCA regions are estimated using a global vector autoregression (GVAR) model. The model analyzes interactions in the global economy, applying a long time series on more than 30 countries taking into account trade and financial linkages.[3] A 1 percentage point decline in China's growth is estimated to reduce GCC growth by 0.1 percentage point in the near term (Figure 4.6)—about one-half of the impact on the region expected to be hit hardest, Southeast Asia—and would mainly occur through the decline in global oil demand and prices. The impact on non-GCC oil exporters is smaller due to sanctions on Iran

[2]China's move up the value chain has increased competition for some advanced economies (Germany, Japan, Korea, and the United States).

[3]For simplicity, the rebalancing in China is modeled as a negative growth shock in China.

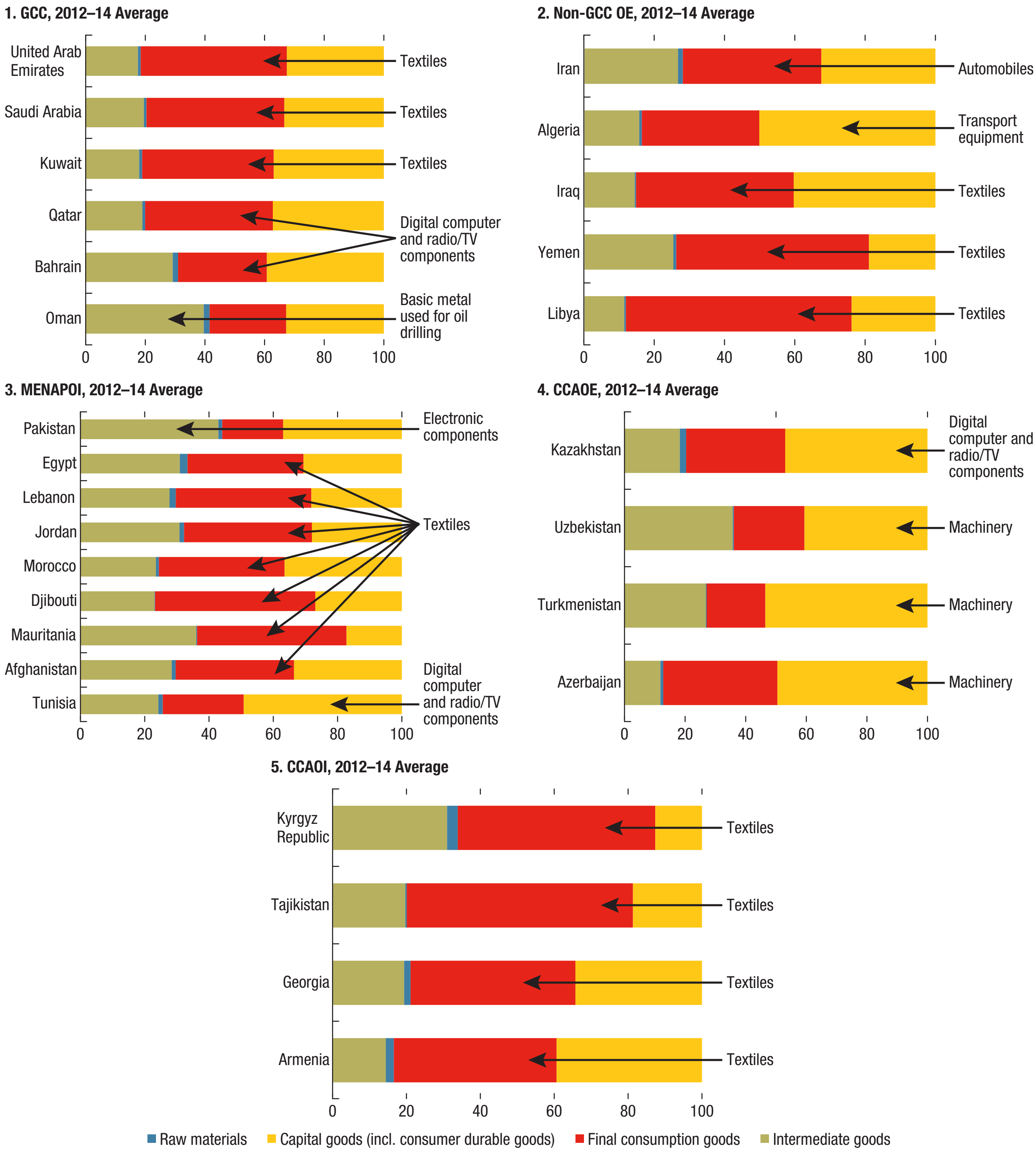
Figure 4.3. Exports to China
(Percent of total exports to China)



Sources: Centre d'Etudes Prospectives et d'Informations Internationales BACI International Trade database; and IMF staff calculations.
Note: Classifications based on UN Stage of Processing in which natural gas is classified as a final consumption good although it may also be used as an intermediate good. CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.

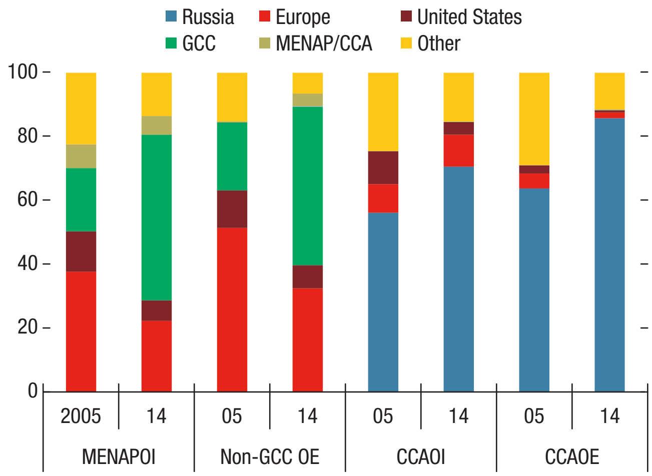
Figure 4.4. Imports from China

(Percent of total imports from China)



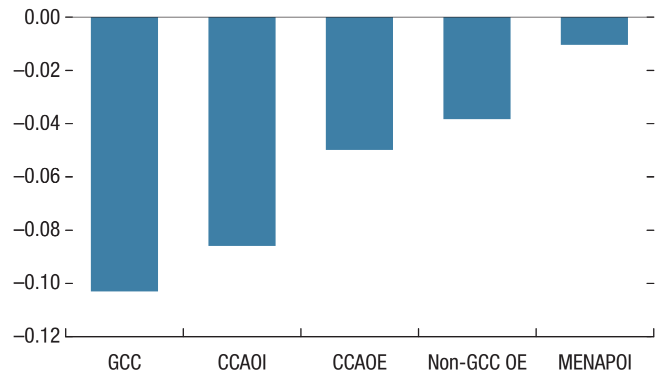
Sources: Centre d'Etudes Prospectives et d'Informations Internationales BACI International Trade database; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.

Figure 4.5. Remittance Inflows by Region, 2014 vs. 2005
(Percent)



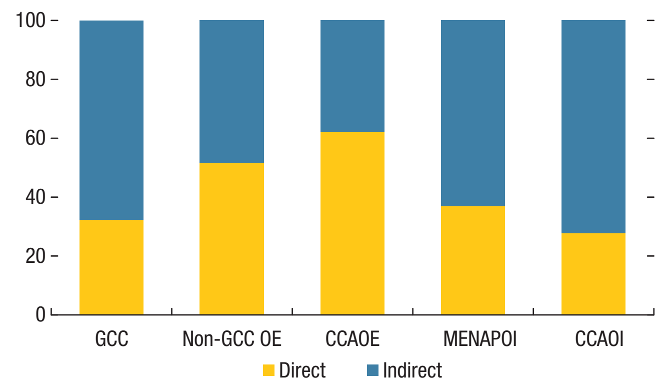
Sources: World Bank; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.

Figure 4.6. Near-Term Growth Impact of 1 Percentage Point Slowdown in China's Growth
(Percentage points)



Source: IMF staff estimates based on global vector autoregression model.
Note: CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.

Figure 4.7. Direct and Indirect Trade Spillovers from China's Slowdown
(Percent)



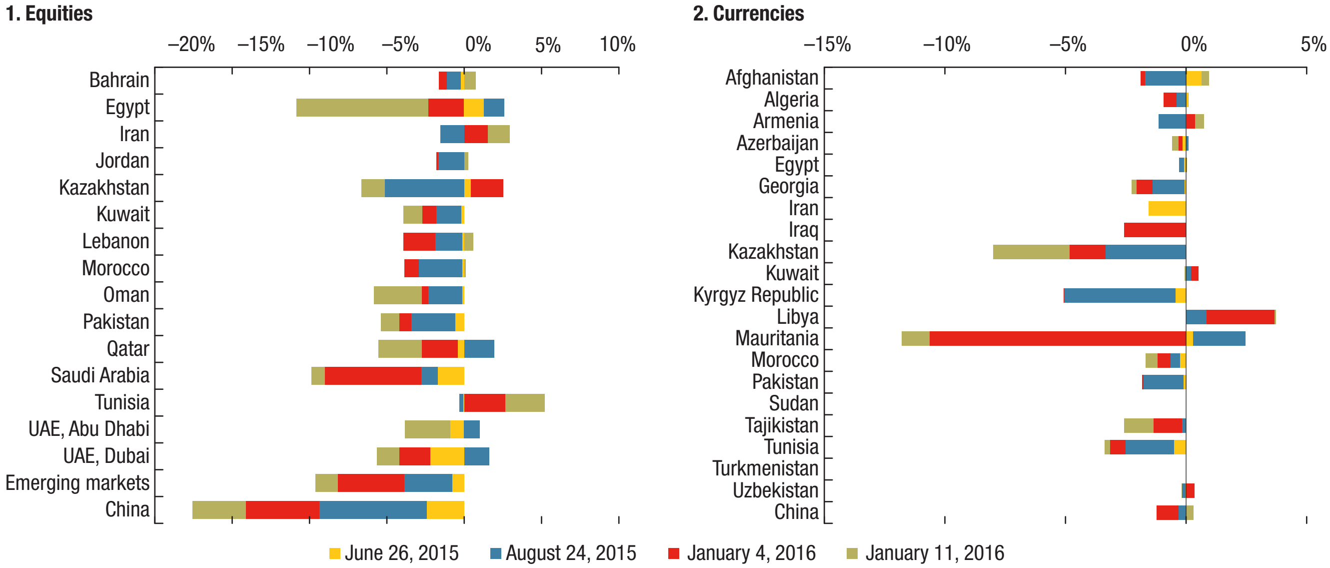
Sources: Kireyev and Leonidov (2015); and IMF staff estimates.
Note: CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.

having lowered the sensitivity of its total exports to changes in oil prices. (With the recent removal of the sanctions, the impact might increase.) CCA oil exporters are also expected to have a lower impact because they export a significant amount of natural gas directly to China and we assume China's gas demand will continue to be relatively stable (Figure 4.7 highlights the large direct trade links of the CCA oil exporters with China).

Other commodity exporters in the MENAP and CCA regions are also likely to be affected. Globally, about 40 percent of the recent decline in metal prices is attributable to China. In 2015, Mauritania's growth fell to one-third of what it was the previous year, largely due to iron exports losses to China—which have declined by $180 million. Similarly, Armenia's copper exports fell by $16 million over the past year. Further declines in metal prices could force the closure of some of the region's mines.

MENAP and CCA oil importers' exposures to China reflect their strong links to China's trading partners: Europe, the GCC, and Russia. Lower Chinese demand for imports reduces economic growth in its trading partners. Lower oil prices partly mitigate the impact by improving their (and Europe's) terms of trade, disposable incomes, and input costs. The latter effect dominates for the MENAP oil importers (directly and indirectly by softening the impact of China's rebalancing on Europe) where a 1 percentage point decline in China's growth has almost no impact on growth in the near term (Figure 4.6). In contrast, the CCA oil importers are almost as affected as the GCC, reflecting spillovers from lower Russian growth in

Figure 4.8. Financial Market Response to Sharp Drops in Chinese Equities
(Percent change, during three days after event)



Sources: Bloomberg L.P.; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; UAE = United Arab Emirates. Country abbreviations are International Organization for Standardization (ISO) country codes.

response to China's rebalancing, including lower remittances and foreign direct investment.

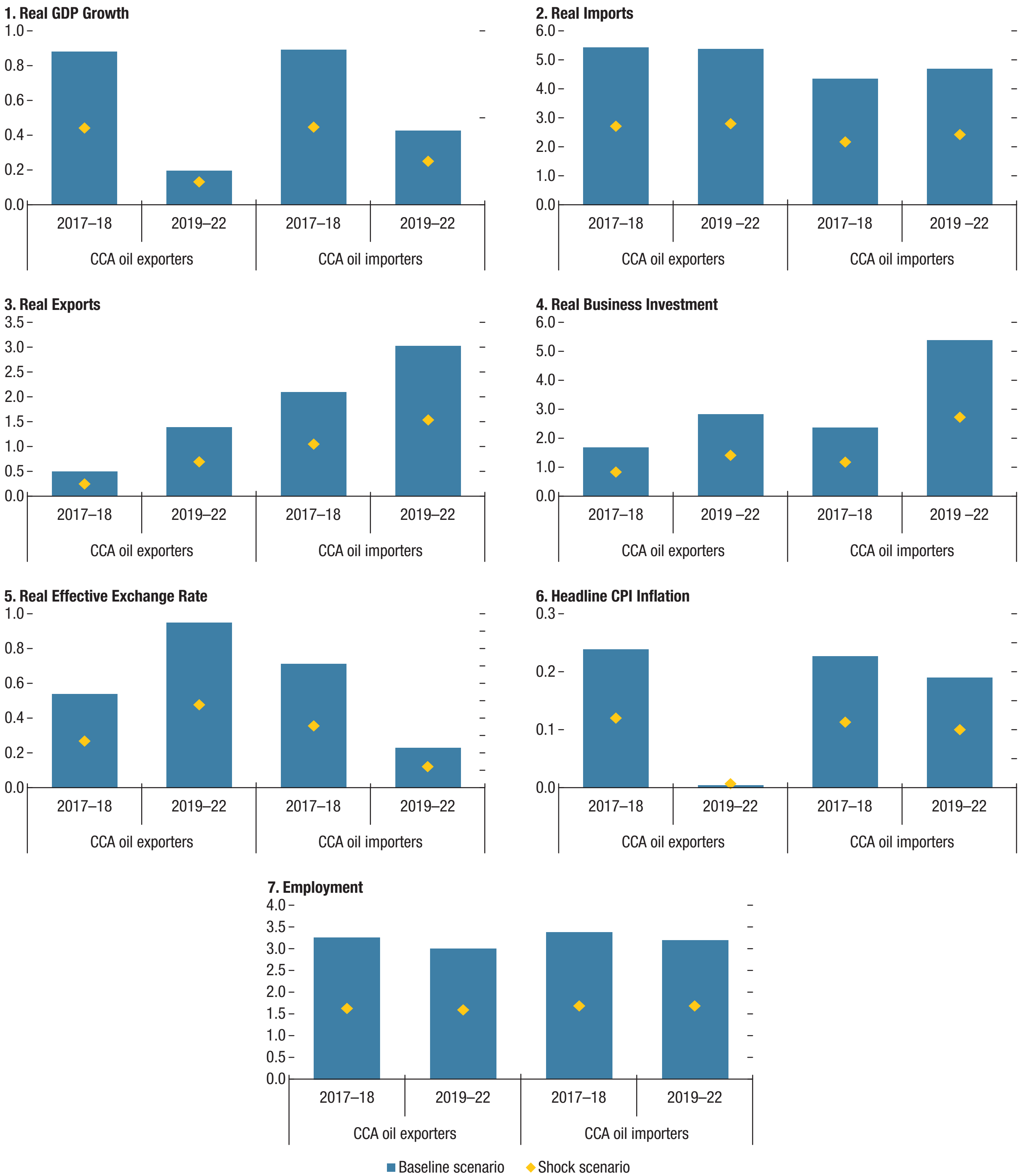
In addition to spillovers through commodity prices and trade, the MENAP and CCA regions have been sensitive to increases in global risk aversion—as evidenced by financial market reactions during recent risk-off episodes related to China. However, the financial market impact has been short-lived and smaller than in other regions that are more integrated in global financial markets (Figure 4.8).

Looking ahead, the CCA could benefit the most from China's OBOR investments. According to the authorities from countries involved in OBOR, it could potentially raise CCA investment (mostly infrastructure) by nearly 2 percent of GDP annually for the next five years. Under these assumptions, simulations using a global dynamic stochastic general equilibrium model—notwithstanding significant uncertainty surrounding such estimates—suggest that the anticipated increase in productivity growth would boost exports and employment (net of any increase in investment-related imports of goods, services, or labor) with annual economic growth rising by 1½ percentage points in the near term and by 0.3 in the long term (Figure 4.9). However, initially, increased investment demand would raise price pressures (possibly hurting competitiveness) and imports, eroding some of the benefits to growth. Half as much OBOR investment would dampen the net positive impact on growth, exports, and employment by about one-half in the near term and by about one-third in the long term (shock scenario, Figure 4.9).

Policies To Help MENAP and CCA Respond to China's Rebalancing

How can the regions mitigate against adverse economic spillovers from China's rebalancing? If policy space and/or buffers are available, fiscal policy could be used to help smooth adjustment to the growth and commodity price shocks that may accompany China's transition. Where financing constraints are tight, raising

Figure 4.9. Model-Based Estimates of One Belt One Road Impact
(Percentage points)



Source: IMF staff estimates.
Note: Estimates are based on simulations from a dynamic stochastic general equilibrium model. CCA = Caucasus and Central Asia; CPI = consumer price index.

the efficiency of public spending and revenue collection may help create savings that can be channeled toward growth-enhancing spending, supporting demand over the near term and raising potential growth. Greater exchange rate flexibility would also facilitate adjustment to shocks in some cases. If global risk aversion starts to weigh on the regions' financial systems, prudential policies could be applied to safeguard financial stability by increasing liquidity and mitigating risks to asset quality.

If MENAP and CCA countries implement appropriate supporting policies, China's rebalancing can offer them an opportunity to expand exports and create jobs. The shift toward a consumption- and services-driven economy in China is likely to boost China's demand for tourism and consumption goods, as well as demand for services along the OBOR corridor.

- This shift creates an opportunity for the region (especially commodity importers) to expand exports to China—notwithstanding competition from Southeast Asia—since most of the MENAP and CCA non-commodity exports to China are already consumption-oriented or inputs to consumption goods (including, for example, agricultural products, cotton, and clothing). Although so far there is no evidence that China's rebalancing has had any significant impact on the growth of consumption-oriented exports, structural reforms targeted at boosting productivity and competitiveness of consumption-oriented industries could help raise the regions' market shares in China over time. Greater exchange rate flexibility could also help improve competitiveness in some cases. In addition to raising economic diversification, the regions' commodity exporters that export directly to China could seek out new export markets.
- Tourism is another potential growth area. Kazakhstan, Morocco, and Tunisia, are already starting to target Chinese tourists by increasing marketing efforts and facilitating transportation. Other countries may follow suit.
- As China's exports move up the value chains, MENAP and CCA countries could seek to pick up the slack. Success will hinge not only on improving the business environment but also increasing labor market efficiency and boosting worker talent across the region.
- Increased transit across the OBOR corridor provides an opportunity for countries to increase sales of transit-related services (for instance, restaurants, fuel stations, and hotels). To this end, structural reforms—including infrastructure and access to financing — should aim to facilitate the growth of these businesses.

OBOR offers a unique opportunity to improve infrastructure and raise potential growth in CCA and other countries in the region, and macroeconomic policies need to mitigate against OBOR's risks to debt sustainability and inflation. In the initial years of its implementation, some fiscal tightening (through taxes or cuts in noninvestment spending) and monetary tightening may be needed to avoid overheating. Capacity building will be important to ensure that the countries involved with OBOR can implement the planned increase in investment. Careful debt management is needed to minimize risks to debt sustainability.[4]

[4] Djibouti's recent experience offers a cautionary example in this context. This country's debt increased by 50 percent over the past three years, owing to Chinese debt-financed public infrastructure projects.

Box 4.1. The One Belt One Road Initiative

To raise connectivity and cooperation across Eurasia, China is spearheading the One Belt One Road (OBOR) initiative. The aim is to create the Silk Road Economic Belt connecting the Caucasus and Central Asia (CCA), South Asia, Southeast Asia, the Middle East, and Europe in a transport-linked corridor via land roads, in tandem with the 21st Century Maritime Silk Route, which will connect China to Europe via sea routes through Asia (Figure 4.1.1). These initiatives are supported by the $40 billion Silk Road Development Fund and the $100 billion Asian Infrastructure Investment Bank. China's involvement is expected to expand the economic prospects of the Middle East, North Africa, Afghanistan, and Pakistan and CCA regions by enhancing the scope for addressing infrastructure gaps and economic diversification.

Figure 4.1.1. One Belt One Road Map

Sources: *The Economist* (2016); national authorities of Pakistan.

Prepared by Pritha Mitra.

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