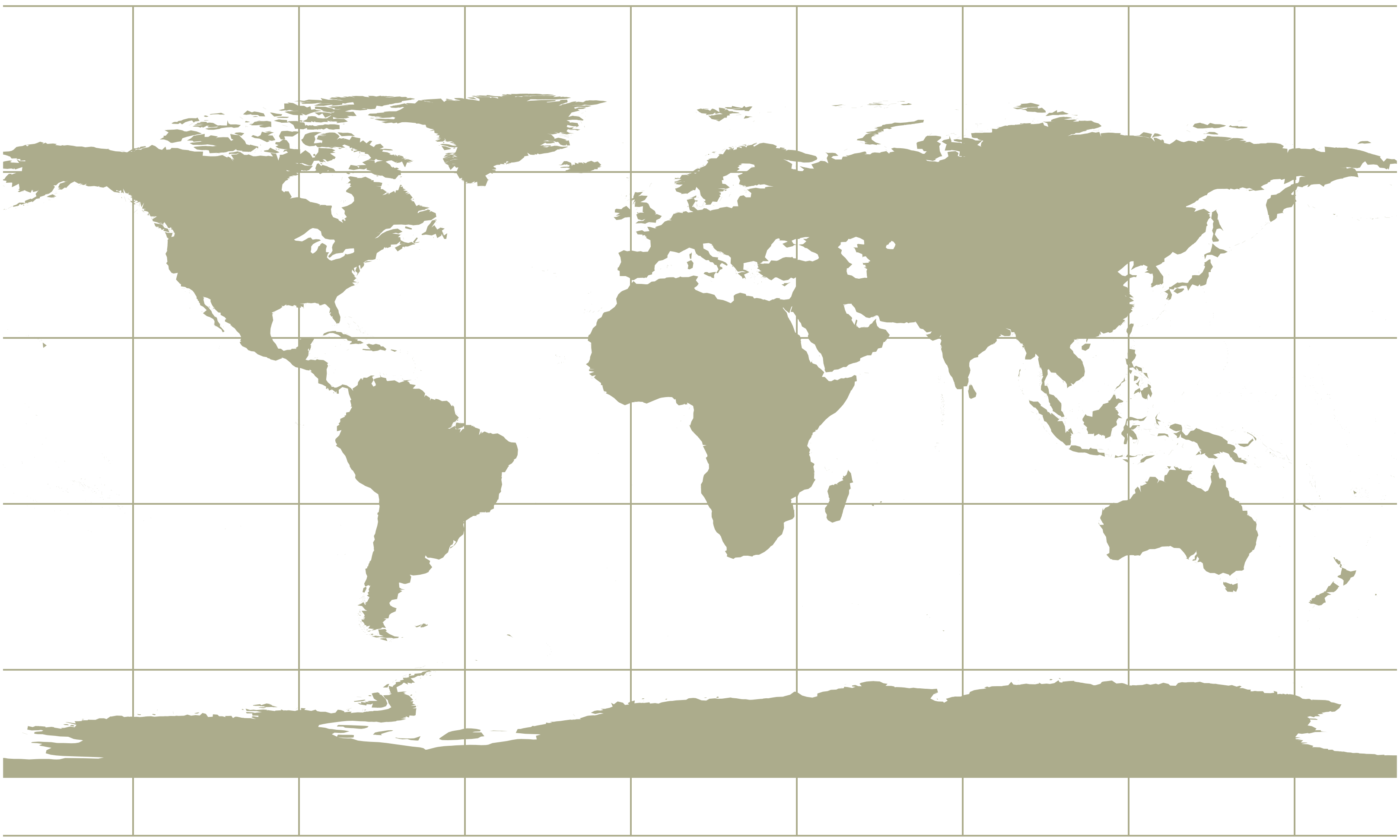
World Economic Situation and Prospects 2015



United Nations
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Chapter IV
Regional developments and outlook

Developed market economies

The developed market economies are expected to gradually strengthen over the forecast period, with growth of gross domestic product (GDP) projected to be 2.1 and 2.3 per cent in 2015 and 2016, respectively, up from the estimated 1.6 per cent in 2014 (see annex table A.1). There is an increasing divergence of performance within the group. The United States of America, Canada and the United Kingdom of Great Britain and Northern Ireland are experiencing a period of relatively strong growth, while growth is much weaker and more at risk in the economies of the euro area and Japan. Inflation rates reflect this varying performance: Japan continues to struggle to end its deflationary past and push inflation towards its 2 per cent target while the euro area increasingly flirts with entering deflation. Policy stances also reflect this divergence. The euro area and Japan continue to strengthen highly accommodative monetary policies, while the United States and the United Kingdom contemplate the beginning of policy normalization, bringing policy to a more neutral stance. This policy divergence was reflected in strong currency movements in the latter half of 2014, which are expected to continue in the forecast period.

North America

The United States: growth prospects continue to improve

The economy of the United States is expected to expand in 2015 and 2016 at the pace of 2.8 and 3.1 per cent, respectively. While robust growth in business investment will be the major driver, household consumption is also expected to strengthen, along with a continued improvement in employment. The fiscal drag on GDP growth from cuts in government spending will remain, but the pace of the spending reductions will be much milder than in the previous few years. The United States Federal Reserve (Fed) is expected to start raising interest rates from mid-2015 on, but the monetary policy stance will continue to be accommodative until the end of 2016. Inflation is expected to stay benign. The contribution from the external sector to GDP growth will be limited, as export growth is expected to be curbed by the strong appreciation of the dollar. The downside risks for the economy are mainly associated with the possible increase in financial volatility in response to the normalization of monetary policy. Sizeable corrections in equity prices and bond yields could produce significant adverse effects on the growth and stability of the real economy.

Investment strengthens as firms are in solid financial positions

Business investment, particularly investment in equipment, has been strengthening and is expected to expand at a pace of about 6 per cent in 2015–2016, with investment in industrial equipment leading at a pace of 8–9 per cent. Most firms in the United States are in solid financial positions. For instance, companies in the Standard & Poor's 500 index have the lowest ratio of net debt to earnings in two decades, more than $3 trillion in cash and record earnings per share. With long-term interest rates at record lows, companies have the potential to boost investment more than projected if the prospects for aggregate demand strengthen further and uncertainties about economic policy diminish. Meanwhile, housing investment, which continued to recover in 2014, although at a subdued pace compared with 2013, is expected to improve further in 2015–2016.

Growth in consumer spending has been moderate, at an estimated pace of 2.2 per cent in real household consumption for 2014, lower than the previous year. Real household consumption is projected to grow by 2.7 and 3.0 per cent in 2015 and 2016. While personal income increased by about 4.0 per cent in 2014, the household saving rate also increased slightly, to 5.1 per cent from 4.9 per cent in 2013, reflecting a certain degree of precaution taken by middle-income households with regard to their spending.

The labour market holds the key to household consumption

Five years after the Great Recession, payroll employment in the United States has finally exceeded the pre-crisis peak registered in January 2008. Increases in payroll employment in 2014 have averaged 230,000 per month, up from the monthly pace of 190,000 during 2012–2013. The unemployment rate has declined more than 4 percentage points from its peak in 2009, to below 6 per cent in late 2014, although the rate of underemployment remains above 11 per cent. The proportion of long-term unemployment (27 weeks or longer) has also been declining from the peak of 46 per cent in 2009 to 31 per cent in 2014, but is still notably higher than the pre-crisis level.

The decline in the unemployment rate has also been accompanied by a steady drop in the rate of labour force participation, although this stabilized during 2014. Labour force participation had actually begun to decline in early 2000, well before the Great Recession, partly reflecting the ageing of the baby boom generation; however, the pace of decline accelerated with the recession of 2008–2009. The drop in the participation rate since 2008 can be attributed to increases in four factors: retirement, disability, school enrollment and worker discouragement. These changes are a combination of both structural and cyclical movements, the latter due to the recession and slow recovery. The stabilization of the labour force participation rate since 2013 could partly reflect the return of discouraged workers to the labour force in response to the improvements in the labour market. Employment is expected to continue increasing at an average monthly rate of more than 200,000, with the unemployment rate dropping to 5.5 per cent by 2016 (see annex table A.7).

The current-account deficit has declined but is expected to stabilize going forward

Growth in both exports and imports has been sluggish in the past two years, at an annual pace of 2–3 per cent. Some moderate improvement is expected, increasing to a rate of about 5–6 per cent in 2015–2016. Growth in the exports of the United States will continue to be driven by increasing foreign demand for capital goods and industrial supplies, while imports of the United States will continue to undergo a structural change, with the trend of declining petroleum imports continuing as domestic energy production rises. The United States dollar has appreciated significantly in 2014, but a continued appreciation of the dollar may curb export growth of the United States in the future. The current-account deficit of the United States has been narrowing to $420 billion in 2014, or less than 2.5 per cent of GDP. The deficit is expected to stabilize around this level in 2015–2016, as the effects of a strong dollar on the deficit are offset by the continued decline in imports of petroleum.

Fiscal policy has been tightening in the United States since 2011, with government spending in real terms declining by about 13 percentage points cumulatively in the past four years. In the outlook for 2015–2016, fiscal policy is expected to remain restrictive, but less severe than in 2014. Real federal government spending is expected to decline by less than 1 per cent in 2015–2016. The debt ceiling is expected to be increased in the forecast period.

The Fed ends quantitative easing and prepares to withdraw accommodation

The Fed is expected to gradually normalize its monetary stance during 2015–2016, from the extremely accommodative "anti-recession" mode to a more neutral position, but the stance will remain supportive of growth. The Fed stopped its programme of purchasing long-term government bonds and mortgage-backed securities in late 2014, but will maintain the size of its balance sheet. The Fed will keep the federal funds interest rate within the range of 0.0 to 0.25 per cent until mid-2015 and is expected to start raising its policy interest rate gradually thereafter.

Certain risks in the next two years are associated with the uncertainties in monetary policy. The Fed has a dual mandate to promote both maximum employment and price stability, but because inflation has remained tame for the past several years, employment has been the dominant policy concern. The extremely accommodative monetary policy in the past five years has mainly been enacted to confront the challenges in the labour market, but as the economy approaches full employment, the Fed is preparing to normalize its monetary stance. There are two types of risk. First, if the signs of inflation come later than usual in the recovery, maintaining zero interest rates until inflation emerges could be too late, and would be followed by an abrupt and potentially disruptive tightening of policy later on. On the other hand, tightening monetary policy immediately when inflation approaches 2 per cent may prevent labour markets from recovering fully. Another risk is the possibility that the United States will be entrapped in secular stagnation (box IV.1).

Canada: growth depends on exports

Driven by strong growth in exports, together with robust household consumption and some recovery in investment from the contraction in late 2013 and early 2014, Canada's GDP is estimated to have grown by 2.3 per cent in 2014. In the outlook for 2015–2016, exports are expected to continue expanding at a robust pace of about 6 per cent, providing an important support to GDP growth. However, improvement in the labour market has been slow, with employment rising only marginally and mainly in terms of increases in part-time workers. Meanwhile, household indebtedness remains a concern. As a result, consumption spending is expected to be curbed in 2015–2016. Business investment is expected to recover, but only at a slow pace, as surveys show that firms are largely focusing on the replacement of existing equipment rather than new expansion. GDP is projected to grow by 2.6 and 2.8 per cent in 2015 and 2016, respectively.

With consumer price index (CPI) inflation close to 2 per cent—the midpoint of the inflation-targeting range of the central bank—and the output gap continuing to be negative, the Bank of Canada is expected to maintain its policy interest rate at the current level of 1 per cent until the end of 2015, to be followed by a gradual tightening. On the fiscal front, Canada is in one of the better positions among developed countries, with the government deficit currently standing at 1.8 per cent of GDP. In the outlook period, fiscal policy is expected to be in a neutral stance, and the deficit will narrow slightly, to below 1.5 per cent of GDP by 2016.

Box IV.1

Secular stagnation

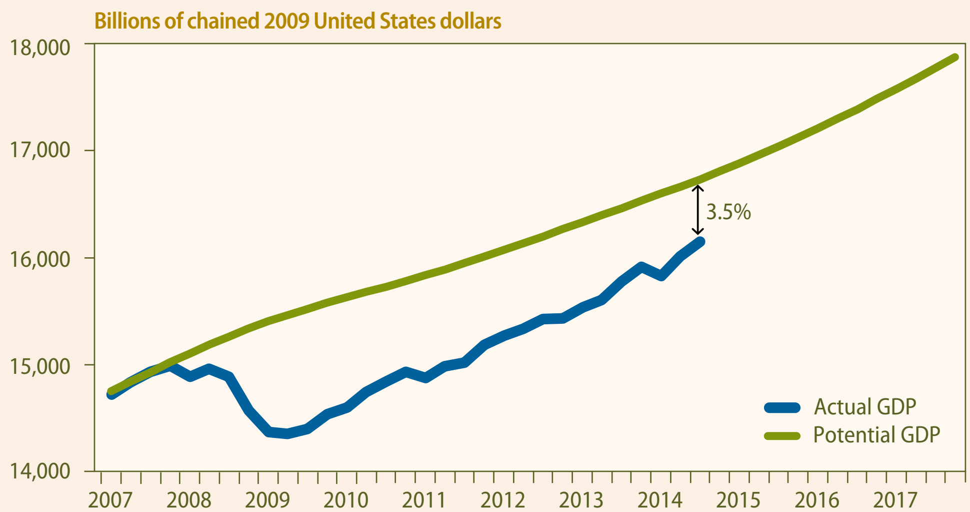
By historical standards, a full six years after the eruption of the global financial crisis, growth remains subdued in the world economy, particularly in the United States of America and the euro area. This observation has prompted some economists to postulate the hypothesis of "secular stagnation", suggesting the anaemic growth may continue for a considerably long period.

Weak investment demand

Some analysts emphasize weak aggregate demand, as evinced in the conspicuously large output gaps in major developed economies (figure IV.1.1).[a] By this view, in the aftermath of the financial crisis, because central banks cannot lower nominal interest rates below the zero lower bound, real interest rates remain too high to boost sufficient investment demand relative to savings, thus leading to both inadequate employment and aggregate demand. Main policy proposals from these analysts include: (a) the central banks of major developed economies should raise their inflation targets to 4 per cent from the current target of 2 per cent, so as to push down real interest rates; (b) governments should increase public investment in infrastructure.

Figure IV.1.1

Actual and potential GDP in the United States, 2007–2017



Source: UN/DESA, based on data from the United States Bureau of Economic Analysis and Congressional Budget Office.

Note: Last data point for the actual GDP is 2014 Q3.

a For example, Lawrence H. Summers, "Reflections on the 'new secular stagnation hypothesis'", in *Secular Stagnation: Facts, Causes and Cures*, Coen Teulings and Richard Baldwin, eds. London: CEPR Press, 2014.

b See Robert J. Gordon, "The demise of U.S. economic growth: restatement, rebuttal, and reflections", NBER Working Paper, No. 19895, Cambridge, Massachusetts: National Bureau of Economic Research.

Supply bottlenecks

Another group of economists focuses on supply constraints as the main factor behind growth stagnation. For instance, Robert Gordon[b] has identified four indicators that may curb the growth of the United States in the next few decades: demography, namely, ageing and stagnant population growth; education, i.e., no further increase in average education levels; widening inequality; and high public debt that makes public services unsustainable. These four bottlenecks may reduce the per capita gross domestic product (GDP) growth rate in the United States from the average of 2.0 per cent in the past century to 0.8 per cent in the next few decades. The policies proposed by this group of economists include reforms of the education system, labour market and social welfare system.

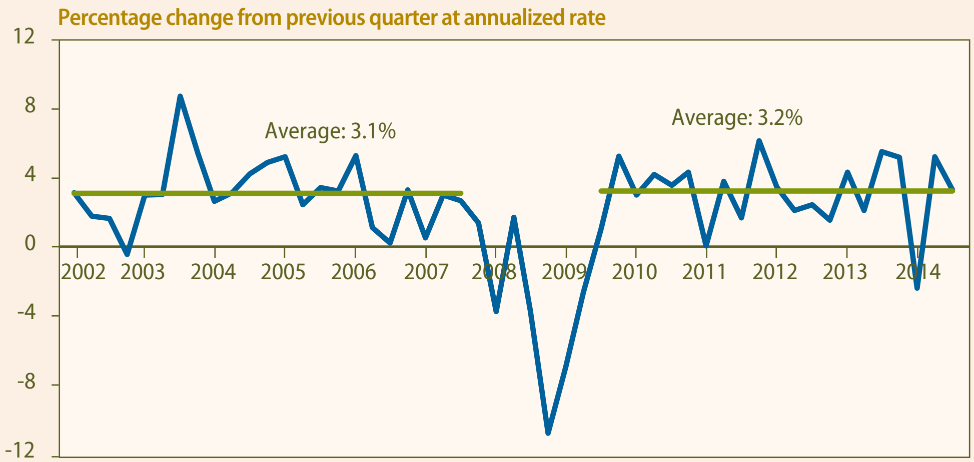
Debate on secular stagnation

The term "secular stagnation" was first coined by the Harvard economist Alvin Hansen in 1938, to describe the gloomy outlook during the Great Depression, but his pessimistic outlook proved to be wrong as growth in the United States accelerated forcefully in the 1940s. Nevertheless, some economists still

(*continued*)

Box IV.1 (*continued*)

Figure IV.1.2
Private sector GDP growth rate in the United States, 2001–2014



Source: UN/DESA, based on data from Bureau of Economic Analysis, United States Department of Commerce.
Note: Last data point is 2014 Q3.

believe that the growth acceleration in the 1940s was stimulated by the surge in government spending during WWII, but currently no such scale of fiscal stimulus is available.

Some critics pointed out that secular stagnation in the United States was not validated, as the growth rates for GDP minus government expenditure in the United States in the aftermath of the financial crisis are actually higher than that in the period prior to the crisis (figure IV.1.2).

Source: UN/DESA.

Developed Asia

Japan: policy actions drive the short-term dynamics

The consumption tax hike created turbulence

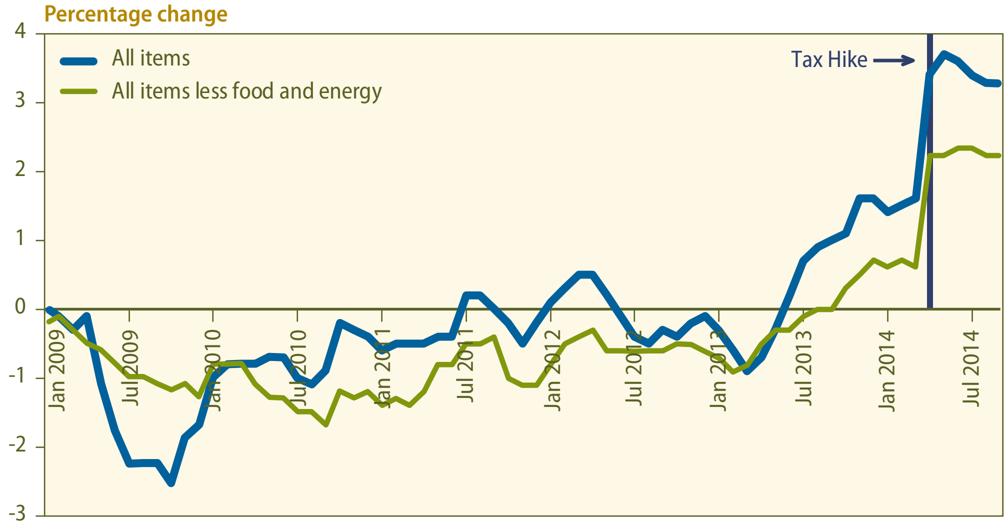
In Japan, GDP has been strongly affected by the Government's fiscal consolidation programme. In April 2014, the consumption tax rate was raised by 3 percentage points. In anticipation of this, households brought forward their purchases of durable goods; private consumption therefore expanded significantly in the first quarter at an annual rate of 9.1 per cent, but this reversed in the second quarter with consumption dropping by 18.6 per cent. As a result, GDP fluctuated egregiously, and the economy fell into a technical recession in the second and third quarter. For the year as a whole, GDP is estimated to grow by only 0.4 per cent in 2014 and is projected to expand by 1.2 per cent in 2015 and 1.1 per cent in 2016 (see annex table A.1).

The fiscal stimulus package introduced in 2013 raised public consumption and investment by about 2 per cent in 2013. After the end of the package, the Government introduced a new supplementary budget in early 2014, but the magnitude has not been sufficient to fully offset the negative impact of the higher taxes.

Monetary easing was expanded

The unconventional monetary policy measures implemented in April 2013 drove down the yields on securities and also guided inflation expectations upward, as the year-on-year change in the CPI climbed from -0.9 per cent in March 2013 to 1.6 per cent at the end of 2013 (figure IV.1). After the sales tax hike, inflation increased further to 3.7 per cent within two months, but then started to decelerate. The Bank of Japan estimated that core inflation, net of the tax effect, was only 1.25 per cent for the third quarter, and, consequently, it expanded monetary easing substantially in October 2014. The annual headline inflation rate for 2014 is estimated to reach 2.7 per cent and is projected to be 1.3 per cent in 2015 and 1.5 per cent in 2016 (see annex table A.4).

Figure IV.1
CPI inflation in Japan, January 2009–September 2014



Source: UN/DESA, based on data from the Bureau of Statistics, Government of Japan.

Yen depreciation has a limited impact on exports

Monetary easing has led to a strong depreciation of the Japanese yen vis-à-vis all major currencies. In early November 2014, the yen's value against the dollar was about 23 per cent lower than in late 2012. This depreciation has helped to increase inflation through the higher price of imported goods.

The deprecation of the yen starting in late 2012 was expected to provide a boost to exports, but the recovery in exports has been slower than expected. In 2013, total export volumes increased by only 1.6 per cent. With a rebound of more than 7.0 per cent in the first quarter, exports are estimated to grow by 4.4 per cent in 2014, and are forecast to grow by 2.4 per cent in 2015. In the first half of 2014, import volumes increased by more than 10 per cent, owing to the front-loading of consumption. Import growth is expected to mirror that of exports in 2015. Although the trade balance is predicted to remain in deficit, the current-account balance is expected to remain in slight surplus, with the help of a continuous surplus in investment income.

Wages remain tepid

The labour force had been declining since 2000 due to the ageing of the population, but in late 2013, it started to increase as the participation rate rose. After five years of continuous decline, employment has increased since 2013 and is expected to continue to pick up in 2015. The unemployment rate is estimated to have decreased from a level of 4.0 per cent in 2013 to 3.5 per cent in 2014, with a further decline to 3.3 per cent projected for 2015 (see annex table A.7). But the improvement in the labour market has so far led to only tepid increases in the nominal wage rate. For 2014 as a whole, it is estimated that real wages will decline, underpinning weaker private consumption growth.

Australia and New Zealand: growth driven by investment

The Australian economy is estimated to have grown by 3.0 per cent in 2014 and is forecast to grow by about 2.4 per cent in both 2015 and 2016. Export volumes will grow by about 5 per cent per year on average during the outlook period, as new mining facilities enter the production stage. Investment in large mining resources projects is expected to continue expanding until 2015 and sustain the growth in overall fixed investment. Both private and government consumption are predicted to grow by 2.0 to 2.5 per cent in 2015–2016. The consumer inflation rate will remain within the target zone of the central bank over the outlook period.

New Zealand's economy is estimated to have grown by 3.0 in 2014, and will grow by 3.3 per cent in 2015, mainly driven by the solid expansion of capital investment. Private consumption will maintain relatively stable growth in the coming years. Government consumption is expected to be curbed by concerns regarding fiscal deficits. Export growth is expected to increase at about 2.5 to 3.0 per cent in 2015–2016. Import growth will remain high, partly as a consequence of strong investment growth. The Reserve Bank of New Zealand raised its policy rate in 2014 and is expected to tighten further in 2015–2016.

Europe

Western Europe: moderate improvement in the outlook period

Western Europe continues to be held back by the travails of the euro area, where the level of GDP has yet to regain its pre-recession peak, unemployment remains extremely high in many countries, and inflation is at alarmingly low levels. The emergence from recession in the second quarter of 2013 and subsequent strengthening of activity into the beginning of 2014 raised hopes that the euro area had finally entered a period of sustained growth; but activity decelerated sharply in the second quarter and, despite a slight up-tick in the third quarter, the outlook has deteriorated. Some of the initial decline can be attributed to seasonal effects, but the impact of the geopolitical tensions in Ukraine has played a clear role, affecting trade and confidence. This highlights the weakness of the recovery and the ease with which it can be disturbed. In the EU-15,[1] GDP is estimated to have grown by only 1.2 per cent in 2014 and is expected to strengthen only modestly to 1.5 and 1.9 per cent in 2015 and 2016, respectively.

Systemic risks in the euro area have subsided, but activity remains weak and fragile

The stresses surrounding the euro area sovereign debt crisis have by now almost completely dissipated, owing in large part to the European Central Bank (ECB) announcement of the Outright Monetary Transactions facility in September 2012, which signalled that the ECB would do whatever it takes to end the crisis. But many legacies of the Great Recession and the subsequent sovereign debt crisis continue to depress activity: Fiscal austerity programmes, while lessened in intensity, remain in place against a backdrop of extremely high debt levels in many countries. Private sector balance-sheet repair, also lessened in intensity, continues to be a drag on activity. The banking system remains under stress and lending conditions remain fragmented, with bank credit in periphery countries, particularly for small to medium-sized enterprises (SMEs), extremely challenging to obtain. Labour markets in many countries are characterized by very high rates of unemployment, which is increasingly becoming long term.

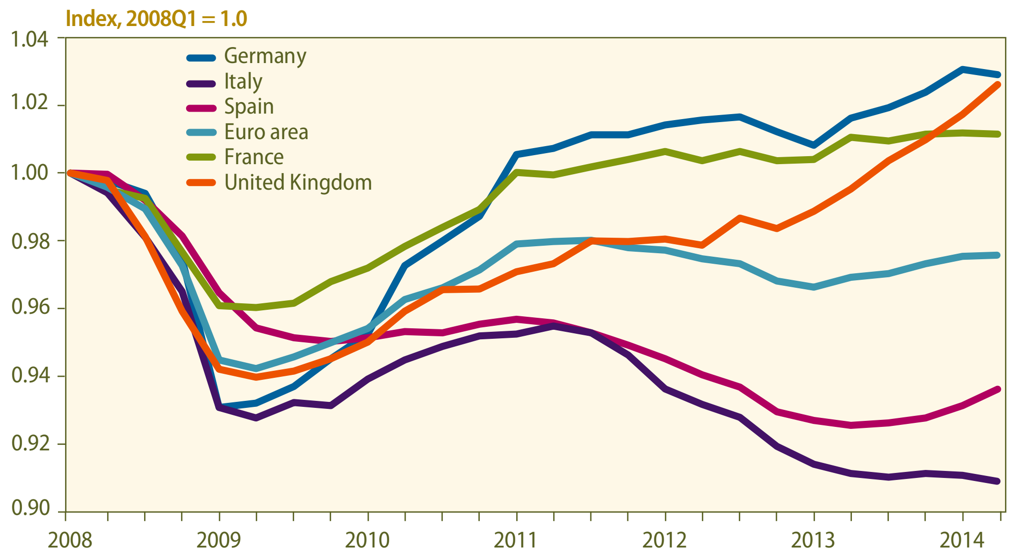
Country prospects are diverse

A reflection of these legacies and structural characteristics—which vary in degree and type across countries in the region—is that in the large economies, the evolution of the level of GDP has been quite diverse in the six years since the onset of the Great Recession: Italy

1 The EU-15 refers to the 15 countries that were members of the European Union (EU) prior to its enlargement on 1 May 2004. The countries are: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom of Great Britain and Northern Ireland.

and Spain remain well below pre-recession levels, while France, Germany and the United Kingdom have all regained their previous levels (figure IV.2).

Figure IV.2
Western Europe GDP indices, 2008–2014 Q2



Source: OECD, *Main Economic Indicators*.

Going forward, economic prospects still differ. Italy is estimated to contract by 0.4 per cent in 2014, the third consecutive year of decline, and is projected to recover by only 0.5 and 1.1 per cent in 2015 and 2016, respectively. France is nearly stagnant, estimated to have grown by only 0.3 per cent in 2014, after growing 0.2 per cent in 2013 and before some acceleration to 0.8 and 1.3 per cent in 2015 and 2016, respectively. Germany started the year strongly but slowed as the geopolitical tensions around Ukraine mounted, with GDP growth estimated to be 1.4 per cent in 2014. Given the poor momentum, growth is expected to be only 1.4 and 1.7 per cent in 2015 and 2016, respectively. A ray of hope exists, however, in that some of the crisis countries have resumed growth. Spain resumed positive growth in mid-2013 and has been strengthening since, growing by 1.2 per cent in 2014 and expected to grow by 2.1 and 2.5 per cent in 2015 and 2016, respectively. In Ireland and Portugal, two of the smaller countries swept into the euro area debt crisis, positive growth has also resumed. In all three cases, recoveries remain extremely fragile and they have yet to recover their pre-recession GDP levels. The only example of more robust growth is outside the euro area, in the United Kingdom, where GDP is estimated to have grown by 3.1 per cent in 2014 and is projected to grow by 2.6 per cent in 2015 and 2.5 per cent in 2016.

Consumption provides some support

Private consumption expenditure is expected to be of modest support to growth in the forecast period, stemming from a number of factors: consumer confidence, despite falling back somewhat in the last few months, has increased significantly since its low point in the final quarter of 2012; energy prices have come down; government austerity programmes have diminished in intensity; and labour markets have finally stabilized with rates of unemployment, albeit extremely high in many countries, coming down somewhat and wages picking up gradually.

Investment remains a weak spot

Investment expenditure continues to be a major weak spot in the euro area. It is expected to stabilize and gradually pick up, but not to provide much support to growth. Following the easing of euro area problems, industrial confidence had improved significantly, but has seen a reversal since the tensions around Ukraine emerged, particularly in those countries with a strong manufacturing orientation. Capacity utilization has increased significantly since the end of the Great Recession, but remains low by historical standards. Funding conditions vary tremendously across the region; interest rates on loans, particularly to SMEs, are much higher in the periphery countries than elsewhere in the region. Housing investment has started to turn around, but remains a drag on activity in some countries.

Exports improved in 2014 and are expected to gradually pick up in 2015 and 2016. The appreciation of the euro during 2013 accentuated the poor performance of exports, but its subsequent reversal in the second half of 2014—and assumed further depreciation in 2015 and 2016—provide a boost. However, the geopolitical tensions around Ukraine will provide another negative impulse to trade. Import volumes continued to rebound from their collapse in 2012, in line with the evolution of income, as the region recovered from the negative headwinds of the sovereign debt crisis; they are expected to gradually strengthen in 2015 and 2016, but will be held back by the depreciation of the euro.

High rates of unemployment will persist for many countries

Unemployment remains at high levels in many countries in the region, particularly in the euro area where, after peaking at 12.0 per cent in mid-2013, the rate of unemployment has come down by only 0.5 percentage points as of late 2014. Going forward, a weak growth profile, the continuing need for structural adjustments, and the re-entry of discouraged workers into the labour market as conditions improve, is causing a glacially slow improvement in rates of unemployment. In the EU-15, the rate of unemployment is estimated to have averaged 10.5 per cent in 2014 and is projected to improve to 10.2 in 2015 and 9.9 in 2016. Again, there is tremendous diversity in unemployment in the region, standing at 5.1 per cent in Germany and 6.4 per cent in the United Kingdom, but reaching 10.2 per cent in France, 12.6 per cent in Italy and 24.6 per cent in Spain in 2014.

These figures also mask the much harsher conditions faced by youth in the region, with unemployment above 23 per cent in the euro area as a whole but above 53 per cent in Spain, 44 per cent in Italy and 35 per cent in Portugal in late 2014. Another major concern is that the persistence of high rates of unemployment in some countries will lead to more workers transitioning to the ranks of the long-term unemployed (defined as being unemployed 12 months or more) or dropping out of the labour force. Long-term unemployment has increased significantly in the aftermath of the Great Recession, up from 3.0 per cent of the labour force in the euro area in 2008 to 6.0 per cent in 2013.

Inflation continues to decelerate, raising deflation fears

Headline inflation decelerated almost continuously in the euro area during 2014, registering 0.4 per cent year over year in October and raising fears that the region would fall into deflation. To some extent, this results from temporary effects such as the decline in energy and food prices and the earlier appreciation of the euro; however, weak economic activity is the major cause, as core inflation has also drifted down, remaining below 1 per cent since May 2014. This low rate of inflation for the euro area as a whole meant that individual countries that were adjusting their competitive positions, such as Greece, Italy, Portugal and Spain, were already in deflation.

Inflation is expected to gradually pick up but remain low. Output gaps are still substantial and expected to close only slowly in the outlook period. Wages are expected to increase modestly, but not much in excess of productivity gains. Oil prices are expected to remain low in 2015 and 2016. Some upward pressure on inflation will come from the depreciation of the euro. The harmonized index of consumer prices for the euro area is estimated to have reached 0.7 per cent in 2014 and is expected to rise modestly to 1.2 and 1.7 per cent in 2015 and 2016, respectively.

The ECB adds new stimulus measures

Over the past year, the ECB made a number of policy adjustments, both conventional and unconventional. It cut its policy interest rates twice, bringing its main refinancing rate to 0.05 per cent, its marginal lending rate to 0.30 per cent, and introducing a negative interest rate of -0.20 per cent on its Deposit Facility Rate. The ECB also announced four new or enhanced unconventional policies: i) an extension of the existing unlimited short-term liquidity provided by main refinancing operations until at least 2016; ii) a new policy of targeted longer-term refinancing operations, where banks will be able to borrow money at highly favourable terms, but on condition that they meet lending benchmarks; iii) another new policy of purchasing asset-backed securities; and iv) a revival of the covered bond purchase programme. The aim is to bring the ECB balance sheet back to the levels prevailing at the beginning of 2012, about 3 trillion euro, which means a total increase of about 1 trillion euro.

In the outlook period, it is assumed that the ECB will keep policy interest rates at their current levels through mid-2016, followed by a gradual increase. Unconventional policies will be carried out as announced and the central bank balance sheet will return to 2012 levels through the end of 2016. There will be no new programme of sovereign bond buying. The Bank of England, facing a very different economic environment, is expected to embark on a path of policy normalization beginning in early 2015.

Fiscal policy maintains its emphasis on deficit reduction

Fiscal policy in the region is still heavily biased towards deficit reduction. In the euro area, the Stability and Growth Pact (SGP) requires most countries to consolidate their budgets, but the pressure has eased considerably, with a number of countries granted additional time to reach their budget targets. At the aggregate level, progress has been made: the deficit-to-GDP ratio for the euro area as a whole has gone from 4.2 per cent in 2011 to 2.5 per cent in the second quarter of 2014.

But 8 out of the 20 regional economies remain under the Excessive Deficit Procedure, so the pressure continues. In addition, the Fiscal Compact, which entered into force in 2013, adds additional budgetary requirements to those in the SGP. Structural government budget deficits should be less than 0.5 per cent of GDP (or less than 1 per cent of GDP if their debt-to-GDP ratio is below 60 per cent) and debt ratios above 60 per cent will require remedial action. The conclusion is that government budgets will remain under pressure for an extended period.

In the outlook period, it is assumed that, for a majority of regional economies, fiscal policy will continue to be focused on reducing fiscal imbalances. The degree of consolidation will be less onerous than in the past few years. The debt crisis countries will continue their adjustment programmes, and any shortfalls due to growth underruns will not be made up; rather, the timetable for achieving targets will be extended. Finally, it is assumed that no countries will ask for formal assistance under the European Stability Mechanism.

The euro depreciates as policy divergence among the major economies widens

During the first half of 2014, the dollar/euro exchange rate ranged from 1.35 to 1.40, but has since depreciated significantly to near 1.25. The major cause is the recent announcements of additional stimulus by the ECB, together with evidence that the euro area recovery is faltering and the anticipation of the beginning of policy normalization by the Fed due to a strong recovery in the United States. The euro is expected to continue to depreciate against the dollar from an average of 1.34 in 2014 to 1.25 in 2015 and 1.21 in 2016.

Risks are once again tilted to the downside

The underlying growth momentum in the region has decelerated to the point where an exogenous event could lead to a return to recession. The current tensions around Ukraine have already had a serious negative impact on activity and confidence. The weak state of the recovery is characterized by extremely high unemployment in many countries, which becomes more entrenched as the number of long-term unemployed increase, and by dangerously low inflation that could turn into Japan-style deflation. Aside from being exceptionally difficult to exit, deflation would also increase real government debt burdens and perhaps reignite the debt crisis as fiscal targets become increasingly difficult to achieve.

The new EU members:[2] slow but stable recovery amid geopolitical tensions

The new EU member States continue to recover from the long-lasting consequences of the global economic and financial crisis and a sharp slowdown of growth in 2012. This recovery solidified in 2014, thanks to emboldened domestic demand, easing of fiscal austerity, a turnaround in the inventory cycle, and, in the first quarter, rising economic dynamism in the EU-15. This moderate but stable growth path is expected to continue despite downgraded prospects for the EU-15, as domestic demand becomes an increasingly important driver of growth. Although households' foreign-currency-denominated debt still remains a major macroeconomic problem in some of those countries, record-low inflation and increasing real wages, along with improving labour markets, have boosted households' confidence. Investment is benefiting from the expansion in public sector projects, in particular utilizing EU funds, and declining financing costs. Nevertheless, the region still remains heavily dependent on the external environment: the upcoming policy normalization of the Fed may lead to more volatile capital flows; deleveraging by foreign banks is not completely over yet; and the geopolitical tensions in the region create additional risks.

All countries are estimated to register positive growth rates in 2014, with the exception of Croatia, where a confluence of factors—including tight fiscal policy to meet the requirements of the SGP and the loss of duty-free access to the Central European Free Trade Agreement (CEFTA) markets of the neighbouring countries—led to a contraction in output. The aggregate GDP of the new EU member States is estimated to have grown by 2.6 per cent in 2014, and projected to grow by 2.9 per cent in 2015 and 3.3 per cent in 2016.

Geopolitical tensions present risk but did not have a large impact

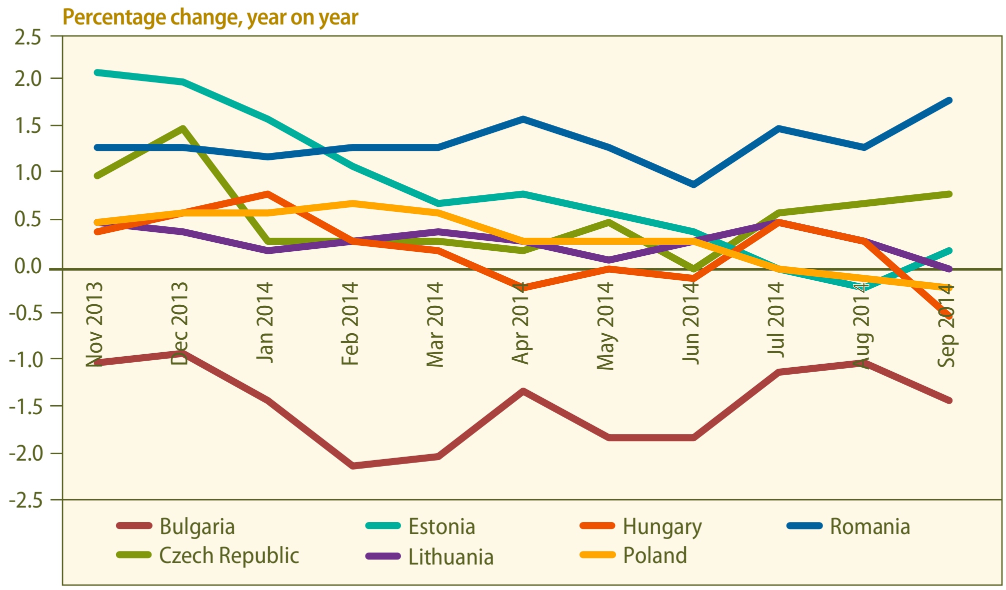
The unfolding geopolitical conflict around Ukraine and the sanctions imposed between the Russian Federation and many leading Organization for Economic Cooperation and Development (OECD) economies have certain repercussions for the region, apart from weak growth in the EU-15. The restriction on supplying deep-water drilling equipment to the sanctioned Russian oil companies will impact some of the countries in Central Europe, which are integrated into the production chain of the embargoed products. The Russian ban on food imports, imposed initially for one year, will affect the Baltic States and, to a smaller extent, Poland, through direct losses by the agricultural sector, effects on the logistics system, state budgets, and banks exposed to agricultural borrowers. However, at the macroeconomic level, those effects are not expected to be very large in 2015, unless the geopolitical tensions escalate further.

Inflation reaches record lows

The lower energy and food prices and cuts in administered utility prices drove inflation in the new EU members to record-low levels in 2014, with repeated incidents of defla-

2 This subsection mainly refers to the new EU member States in Central and Eastern Europe.

Figure IV.3
Inflation dynamics in selected new EU member States, November 2013–September 2014



Source: Eurostat.

tion in a number of countries (figure IV.3). Annual inflation in the region is expected to be well below the respective targets set by the central banks and negative in some cases. A moderate strengthening in domestic demand is likely to add a percentage point to annual inflation in 2015. This outlook is subject to the potential risks of higher energy prices in case of disruptions in natural gas supply through Ukraine.

Labour markets strengthened

Positive trends in the region's labour markets continued in 2014, although the progress was uneven across countries. In the Czech Republic, Hungary (where the public works programme had an impact), Poland and Slovakia, unemployment rates dropped by a percentage point or more over the course of the year. In the Baltic States, both net outward migration and the increased employment figures contributed to the improvement in labour markets. In Croatia, however, there was little tangible progress, as fiscal policy is contractionary, output is contracting, and some companies, losing duty-free access to the CEFTA markets, have outsourced production to countries with a cheaper labour force. Positive trends are expected to continue in 2015. For example, the entitlement of the citizens of Bulgaria and Romania to employment in any EU country since 2014 should somewhat mitigate pressure in the labour markets of those countries. There are, however, risks that employment gains in the sectors exposed to trade with the Russian Federation (such as agriculture or food processing) may be reversed. Given the largely structural nature of unemployment in the region, achieving any tangible progress will require committed policy actions.

Fiscal austerity is gradually abandoned

Fiscal austerity in the new EU members is being gradually phased out, as most of those countries have succeeded in rebuilding their public finances. The impact of fiscal policy on growth in 2014 may be expansionary in some cases. However, certain countries, including Poland, still have budget deficits exceeding 3 per cent of GDP and are subject to the excessive deficit procedure of the EU. The recapitalization of several domestic banks in Slovenia in 2014 imposed heavy costs on public finances. As a consequence, the high-deficit countries will have to remain on the track of fiscal consolidation in the near term. In addition, the Governments in the region, often facing pressure from the EU, are aiming at long-term fiscal sustainability and have serious public finance reforms on their agenda for 2015 and beyond. Nevertheless, most of the region will face less fiscal drag in 2015. A modest pickup in growth will favourably affect public revenues, and in certain areas, public spending will support growth.

Interest rates are at record lows

Monetary policy remains the main instrument for macroeconomic stimulus in the new EU members. In the countries with flexible currencies (the Czech Republic, Hungary, Poland and Romania), policy interest rates are at record-low levels after a series of reductions in 2013 and 2014. The much-improved current-account positions mitigate the vulnerability of those countries to external shocks. Apart from maintaining the record-low policy rates, a number of central banks in the region use additional measures. These include direct interventions in the currency market (in case of the Czech National Bank) and channelling funds to SMEs through commercial banks (in the case of the Hungarian National Bank). Those countries which are members of the euro area (Estonia, Latvia, Slovakia and Slovenia) maintain the low policy rate of the ECB. Lithuania is set to join the euro area in 2015. Loose monetary policy is likely to continue in 2015, as a spike in inflation is unlikely, although the weaker currencies adversely affect the holders of foreign-currency-denominated loans. However, if the Fed raises interest rates in the second half of 2015, the region's central banks may be forced to adjust their policies.

The region's credit markets, however, are still stagnating, with minor exceptions, as the asset quality of domestic banks remains low and credit demand is recovering slowly. The attempts to resolve household indebtedness in Hungary and some proposed banking regulations may affect profitability of the banking sector, restricting its lending ability.

Current accounts are in healthy positions

The current-account positions of the new EU members are much healthier than in the pre-crisis period, thanks to trade surpluses run by several economies in the region and increasing transfers from the EU. Even if deficits slightly increase in 2015—in particular because of a deficit in investment income—they should not endanger macroeconomic stability in the near term.

A renewed protracted slowdown in the EU-15 remains the major macroeconomic risk for the region. A potential disruption in the flow of Russian natural gas through Ukraine would also have detrimental consequences for the industries of the new EU members. Strengthening of the balance sheets of EU-15 banks as a result of the recent stress tests, or losses incurred in the Russian Federation or Ukraine, may prompt them to limit their exposure to the region.

Economies in transition

Amid a challenging external environment, aggregate GDP growth in the Commonwealth of Independent States (CIS) and South-Eastern Europe further decelerated to a mere 0.8 per cent in 2014, down from 2.0 per cent in 2013 (see annex table A.2). This slowdown reflects weakness in both regions. In the outlook period, aggregate growth is forecast to recover to 1.1 per cent in 2015 and 2.1 per cent in 2016.

South-Eastern Europe: slow recovery derailed by natural disasters

After returning to growth in 2013, overall economic activity in South-Eastern Europe slowed down in 2014. Floods in May had a severe impact in Bosnia and Herzegovina and

Serbia, causing significant damage to housing and infrastructure (including bridges, roads, and energy and telecommunications grids) and hampering economic activity; as a result, the Serbian economy contracted in 2014. In the rest of the region, economic performance improved, helped by a mild strengthening of activity in the EU. Growth is expected to pick up in 2015, boosted by reconstruction work in flood-affected areas, planned infrastructure projects and continued recovery in the EU. The aggregate GDP of South-Eastern Europe increased by only 0.7 per cent in 2014 and growth rates of 2.7 per cent and 3.0 per cent are expected for 2015 and 2016, respectively.

After contracting for two years, a modest recovery of domestic demand also took place, with the notable exception of Serbia. Infrastructure, tourism and energy projects have supported economic expansion in the region. However, high unemployment, ongoing fiscal adjustments and elevated indebtedness constrain growth.

Unemployment declines, but remains high in most countries

Labour markets in South-Eastern Europe are characterized by very high unemployment and low employment rates, especially in Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia. Despite some decline, unemployment still remained close to 20 per cent in Serbia. In the former Yugoslav Republic of Macedonia, some growth in employment led to a marginal improvement in the unemployment rate amid growing economic activity. In Albania, the gap between male and female participation rates, which runs at about 20 percentage points, increased further.

Low inflation persists, owing to weak demand

Inflation remained low in the region, owing to weak domestic demand. In Serbia, lower food prices and the stability of the exchange rate contributed to the deceleration of inflation in 2014. In Bosnia and Herzegovina, prices declined for a second consecutive year. Deflationary pressures were also strong in Montenegro, despite increases in electricity prices. Low inflation prompted monetary easing in Albania and a series of interest rate cuts were undertaken in Serbia.

Substantial fiscal problems linger

Large fiscal gaps persist throughout the region, resulting from slow growth and large spending commitments. In Albania, progress in clearing government arrears has improved the business climate and boosted demand. In Bosnia and Herzegovina, fiscal consolidation continued under an International Monetary Fund (IMF) programme, but the floods and the electoral calendar have complicated adjustment plans. There was no progress in reducing the large public deficit in Serbia, despite some wage and pension cuts that were accompanied by the elimination of the solidarity tax. In the outlook period, the countries are likely to face fiscal drag, as they implement cuts in public sector wages and subsidies to state-owned enterprises in a bid to reduce fiscal deficits.

Large external imbalances continue

Export growth slowed in 2014 in Serbia, where the floods in May destroyed industrial capacity. By contrast, sluggish wage increases and a weak currency raised competitiveness and boosted exports in Albania. Export growth also accelerated significantly in the former Yugoslav Republic of Macedonia. The current-account deficits widened in most countries in the region. In Albania, the double-digit current-account deficit as a percentage of GDP increased further, driven by faster import growth. In Montenegro, the current-account deficit—the largest in the region—also widened further, reflecting the impact of the bankruptcy of the KAP aluminium smelting factory on export capacity. In the former Yugoslav Republic of Macedonia, the external gap rose sharply, but remained the lowest in the region.

Significant structural fragilities remain

The region's future economic performance will largely depend on the outlook for the European economy and the possibilities for higher exports and remittances in a context where significant structural fragilities exist. The uncertain situation in the euro area thus presents the main downside risk for the region. High unemployment rates will continue to put a brake on domestic demand. Policy space is restricted by the presence of large public debts and fiscal deficits. The banking sector remains in poor shape, in particular in Bosnia and Herzegovina and Serbia. Poor infrastructure and a still challenging business environment limit the ability to attract investment to boost growth and raise productive capacity.

The Commonwealth of Independent States:[3] uncertainty damages economic prospects

A sharp slowdown pervades CIS economic activity

Economic growth in the CIS slowed down sharply in 2014. Despite some improvement in global activity, geopolitical tensions resulted in a difficult external environment with high levels of uncertainty. Economic activity in the Russian Federation, the largest economy in the CIS, came to a standstill, thus reducing growth prospects in the region. In Ukraine, a severe output contraction followed years of sluggish expansion. A mild recovery in aggregate output growth is expected in 2015, provided that geopolitical tensions ease and output stabilizes in Ukraine. The aggregate GDP growth of the CIS and Georgia decelerated from 2.0 per cent in 2013 to 0.8 per cent in 2014, and is projected to strengthen modestly to 1.1 per cent in 2015 and 2.1 per cent in 2016.

Uncertainty weighs on investment

Sluggish domestic demand drove the slowdown in the region in 2014. In the Russian Federation, investment plummeted as a result of higher financing costs and uncertainty linked to the sanctions imposed by, among others, the United States and the EU. The pace of expansion of household consumption decelerated markedly, reflecting declining wage and retail lending growth. Net external demand, boosted by the devaluation of the rouble, prevented the economy from falling into a recession; near-zero growth is expected in 2015 with serious downside risks and a persisting problem of capital outflows (box IV.2) In Ukraine, GDP contracted sharply, as the conflict in the south-east affected economic activity in the industrial regions of Donetsk and Luhansk and weighed negatively on investment. Despite the recovery of potash exports and a good harvest, growth was sluggish in Belarus. In Kazakhstan, spillovers from the Ukrainian crisis depressed economic activity, as the Russian Federation and Ukraine are major export destinations for the country. A decline in oil extraction contributed to the slowdown in Azerbaijan. By contrast, rapid growth followed the development of the Galkynysh gas field in Turkmenistan. Lower remittances from the Russian Federation have constrained consumption in the region's lower-income countries.

Unemployment in the Russian Federation continues to decline

Despite the slowdown in economic activity, the labour market in the Russian Federation remained tight, with the unemployment rate continuing to edge downwards and reaching historical lows during the year as the employment level increased. In Kazakhstan, the unemployment rate remained unchanged, as job creation absorbed the increase in the active population. By contrast, unemployment rose rapidly in Ukraine, amid a severe contraction of economic activity. Unemployment also increased sharply in some Central Asian countries, which had seen lower remittances.

Inflation accelerates in many countries

Currency depreciations (figure IV.4) created upward price pressures in many countries, including the Russian Federation, where food import bans also contributed to inflation. In Belarus, the weakening of the exchange rate boosted the already high inflation. In Ukraine, inflation surged as the national currency plummeted, bringing the rate of annual change to double digits, in sharp contrast with the mild deflation observed in 2013. In

3 Georgia is not a member of CIS, but its performance is discussed in the context of this group of countries for reasons of geographic proximity and similarities in economic structure.

Box IV.2

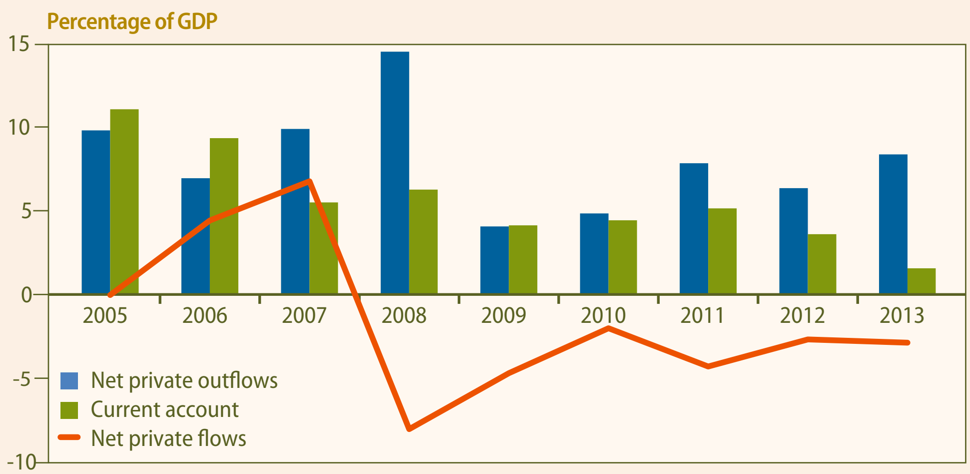
The Russian Federation: a net external creditor in need of financing

The Russian Federation has posted persistent, albeit declining, current-account surpluses over the last decade, averaging almost 6 per cent of gross domestic product (GDP) per year in 2005–2013. Mirroring the current-account surpluses, the country has seen net accumulation of foreign assets by the private and public sectors and increases in reserves. Substantial resources have been channelled into the existing sovereign wealth funds (accounting for 9.6 per cent of GDP by the end of September 2014) and invested in liquid foreign assets, which are part of international reserves.

In most years, private capital outflows have been much higher than current-account surpluses (figure IV.2.1). The difference between the net purchase of foreign assets by the private sector and the current-account surplus was equivalent to an annual average of 3.6 per cent of GDP in 2007–2013. This creates a financing gap that needs to be covered by drawing down reserves, raising foreign financing (i.e., ensuring private capital inflows) or a combination of both mechanisms.

Figure IV.2.1

Current-account balance and private capital flows in the Russian Federation



Source: Central Bank of the Russian Federation.
Note: A positive sign for net private outflows implies an exit of capital. Net private flows (line) are the difference between net private inflows and net private outflows. A positive sign indicates an entry of capital and a net acquisition of foreign liabilities.

Private capital outflows partly reflect a desire for portfolio diversification. The internationalization of Russian corporations has led to the acquisition of foreign companies. Some outflows are associated with "round-tripping"—that is, Russian capital that returns to the country under the cover of a different nationality. Offshore financing structures have been used to provide protection against a still challenging business environment and obtain other advantages. The authorities are now promoting "de-offshorization" initiatives to limit capital outflows, while seeking to apply Russian taxation to structures that use offshore companies administered from the Russian Federation. Outflows are also the result of the negative assessment of investment opportunities in the country.

In addition to legitimate, registered outflows, there are a number of unrecorded capital outflows, which would correspond to a narrow definition of capital flight. The Central Bank of the Russian Federation includes an estimate of fictitious transactions in the balance of payments, which were equivalent to 45.0 per cent of the current-account surplus and 2.2 per cent of GDP on average during the period 2005–2013. As these flows are considered unlikely to return to the country, they are excluded from the statistics on the international investment position.

Given this continued leakage, access to foreign financing remains important. There were sizeable private capital inflows in 2005–2008, averaging 11 per cent of GDP annually. However, the global financial crisis of 2008–2009 marked a significant retrenchment, alerting Russian banks and corporations about the risks of rising foreign financing and reduced investor appetite for Russian assets. In 2010–2013, average annual private capital inflows were only 3.9 per cent of GDP, well below outflows of 6.8 per cent of

(*continued*)

Box IV.2 (*continued*)

GDP. Russian banks have now moved into a positive net foreign asset position, as the growth of assets, mainly in the form of deposits abroad and loans, has outstripped the increase in liabilities.

Credits from foreign banks represented 2.3 per cent of fixed capital investment in 2010, but this ratio fell to 1.2 per cent by 2012. In addition, foreign banks' claims on the Russian Federation's non-bank private sector fell by $12.2 billion in 2009–2012, in sharp contrast with the $87.5 billion increase observed in 2004–2007. While funding has declined, corporations' access to external financing remains important in overcoming the limitations of the domestic financial system regarding the availability and cost of long-term financing. The current geopolitical tensions have created a more adverse external environment for raising capital. The conflict in Ukraine has had a negative impact on investor sentiment and led to the introduction of sanctions by a number of countries, thus restricting the ability of Russian companies and banks to access international capital markets and increasing the cost of financing. About one quarter of bank and corporate external debt (a total of $650 billion) needed to be repaid or refinanced in the next twelve months, according to data from the end of the first quarter of 2014. As was the case during 2008–2009, the authorities have deployed substantial foreign reserves to alleviate the situation. In addition, they are also seeking financing from other non-Western sovereigns.

The capital of state-owned banks targeted by the sanctions is being boosted by public equity injections, including $5.4 billion for the major bank, VTB, in order to shore up banks' positions in a worsened economic climate which is accompanied by loss of access to capital markets. Funding from the repayment of state subordinated loans granted to shore up the banking sector during the 2008–2009 financial crisis is being used to finance those equity purchases. The authorities also plan to use the National Wealth Fund ($83 billion by the end of September 2014) to provide long-term support to corporations affected by the sanctions. In addition, the Central Bank of the Russian Federation is providing foreign-exchange liquidity to the sector. Overall, the direct implication of the sanctions has been an increase of the influence of the state on financial intermediation in the Russian Federation.

These initiatives provide a temporary cushion against ongoing turbulence. Addressing structural problems, including the persistent leakage of the financial account, would require more sustained reforms that promote financial development, including local currency financing, and boost confidence in investment opportunities in the country. Increased monetary credibility, leading to lower inflation, would facilitate the emergence of long-term financing sources. The consolidation of a larger domestic institutional investor base would increase domestic financing options, adding to the possibilities offered in a financial system that is primarily bank-based.

Source: United Nations Economic Commission for Europe.

Kazakhstan, despite the devaluation of the currency, inflation remained within the target range, supported by a good harvest.

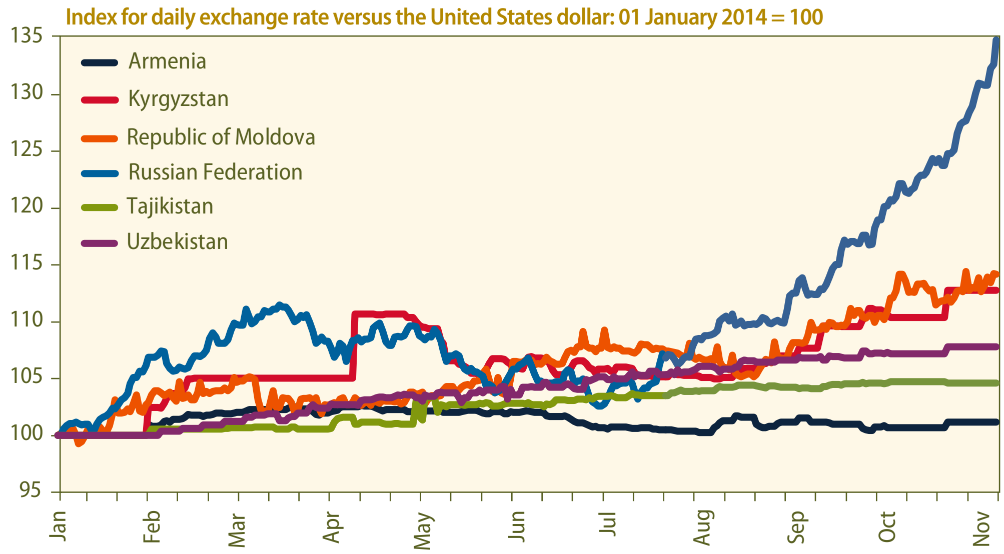
Currency turbulence prompts tightening

Depreciation pressures have constrained monetary policy in many countries in the region. In the Russian Federation, the central bank raised policy rates several times and maintained its commitment to greater exchange-rate flexibility, despite earlier interventions to offset the impact of geopolitical tensions. The National Bank of Ukraine was forced to hike policy rates sharply and introduced restrictions on foreign-currency transactions in order to stem capital outflows and currency depreciation. By contrast, the authorities of Kazakhstan prompted the devaluation of the tengue, despite growing foreign-exchange reserves, to preserve competitiveness. Despite slowing economic activity, Tajikistan raised rates in response to mounting inflation. By contrast, rates were lowered repeatedly to stimulate the economy in Belarus, contributing to the weakening of the currency. Armenia also cut rates, as the inflationary pressures linked to gas price increases in 2013 abated.

Fiscal expenditures increase

Energy-producing countries had some policy space to address the economic slowdown. In the Russian Federation, fiscal revenues were boosted by the depreciation of the rouble, thus offsetting the impact of a lacklustre economic performance. Real public expenditure increased, after declining in 2013, which provided some lift to economic activity. There are plans to introduce a wage freeze in the 2015 federal budget, which will negatively affect growth. Despite conservative fiscal plans, sharply lower prices would force the authorities to

Figure IV.4
Depreciation of currencies in the CIS, 2014



Source: UN/DESA, based on data from relevant central banks.
Note: An upward movement represents a depreciation of the national currency against the United States dollar.

tap into the reserve fund to finance planned expenditures. Kazakhstan deployed resources from its sovereign wealth fund to finance a stimulus programme. In Ukraine, economic contraction and conflict-related costs resulted in a larger deficit, including a sizeable gap at the state oil and gas company Naftogaz, which accounts for about one fourth of the total deficit.

The current-account surplus widens

External balances have improved, as a result of the contraction of imports, which has been accompanied by a deceleration in the growth of exports. In the Russian Federation, the devaluation of the rouble, import restrictions and continuing energy export revenues led to a widening of the current-account surplus, thus reducing pressures on reserves from growing capital outflows. In Ukraine, falling domestic demand and the depreciation of the national currency led to a large reduction of the current-account deficit, despite the worsening in the terms of trade. The large devaluation of the Belarusian rouble helped to keep the trade deficit down. Past gains in closing the external gap in Georgia were reversed, amid strengthening domestic demand. In the Kyrgyz Republic, the poor performance of exports to non-CIS countries and lower remittances widened the current-account deficit. The establishment of the Eurasian Economic Union, on the basis of the existing Customs Union of the Russian Federation, Belarus and Kazakhstan, will require further harmonization of economic regulations in the CIS area and should bolster intraregional economic ties in the forecast period.

Downside risks dominate

Economic prospects depend largely on the evolution of the geopolitical situation. Easing of tensions would facilitate access to finance, reduce risk premia and improve investment sentiment. By contrast, further escalation would have detrimental consequences for the region, through trade, investment and remittances channels. The Russian Federation has substantial foreign-exchange reserves to withstand current turbulence, but continued instability would affect investment for an extended period of time. This would make it more difficult to address emerging supply constraints and raise potential growth. Fragilities in the banking sector persist in some countries (with the share of non-performing loans exceeding 30 per cent) and may get worse in the current environment, as many loans are denominated in foreign currencies. The region also remains vulnerable to declines in commodity prices, which would compound the effect of other negative influences on growth and reduce policy choices.

Developing economies

Developing economies experienced a slowdown in GDP growth in 2014 as the protracted weakness in external demand was accompanied by increasing challenges on the domestic front. These factors were further exacerbated by global crises, such as the Ebola outbreak and geopolitical conflicts. Average GDP growth in developing economies decelerated from 4.8 per cent in 2013 to 4.3 per cent in 2014 (see annex table A.3). This was the slowest pace since the global financial crisis and the second-slowest since 2003. Among the different regions, only South Asia saw a marked strengthening of economic activity, led by a recovery in India. By contrast, growth weakened notably in Latin America and the Caribbean, where lower international commodity prices, structural constraints and, in some cases, macroeconomic imbalances resulted in a downturn in investment. Economic growth also decelerated in East Asia, where China continued to move towards lower, but more balanced and sustainable growth, and in Western Asia, where activity was held back by lower oil prices, the intensification of conflicts and external imbalances. In Africa, growth was stable, but well below potential and with large differences among the various subregions. In the outlook period, developing economies are forecast to see a gradual strengthening of growth, with aggregate GDP projected to increase by 4.8 per cent in 2015 and 5.1 per cent in 2016. Growth in all developing regions, except East Asia, is projected to improve in 2015–2016. However, the outlook is subject to significant uncertainties and downside risks, including a further escalation of geopolitical crises, a sharper-than-expected slowdown in China and a severe tightening of global liquidity conditions in the face of a normalization of United States monetary policy.

Africa: solid aggregate growth accompanied by significant downside risks

Africa continues to see robust growth, driven by private consumption and investment

Africa's overall growth momentum is set to continue, with GDP growth expected to accelerate from 3.5 per cent in 2014 to 4.6 per cent in 2015 and 4.9 per cent in 2016.[4] Growth in private consumption and investment are expected to remain the key drivers of GDP growth across all the five subregions and all economic groupings, underpinned by increasing consumer confidence, the expanding middle class, improvement in the business environment and the reduction in the cost of doing business. Government consumption will remain high, due mainly to increased spending on infrastructure. However, its contribution to growth will decrease because of fiscal consolidation measures, mostly in Central, Southern and West Africa. Net exports will continue to have a negative contribution to growth across all the subregions as significant investments in infrastructure, commodity exploration and increasing domestic demand drive rising imports. Oil-exporting countries are expected to see a rebound from low growth of 3.2 per cent in 2014 to 4.8 per cent in 2015. Underpinning the slowdown in 2014 were moderating oil prices coupled with disruptions in oil production and political unrest in parts of North (Libya) and West Africa (Central African Repub-

4 These growth rates exclude Libya, owing to unreliable data amid the unstable situation in the country.

lic and Mali). Oil-importing countries' growth will improve from 3.7 per cent in 2014 to 4.4 per cent in 2015. Mineral-rich countries are expected to build on their growth momentum and accelerate from 3.4 per cent in 2014 to 4.1 per cent in 2015. This is mainly owing to increased investment and new mineral discoveries in countries such as Sierra Leone (in iron ore and diamond production), Zambia (in copper mining), Botswana (in copper, coal and diamonds), Namibia (in uranium and diamonds), Angola (in coal mining) and Ghana and Liberia (in gold mining). Africa's non-oil and non-mineral-rich economies, the fastest-growing countries on the continent, will see their growth momentum strengthen further. Growth will increase from 3.9 per cent in 2014 to 4.8 per cent in 2015, driven by a strong expansion in services, agriculture and spending on infrastructure in countries such as Ethiopia.

North and Southern Africa will see a marked increase in growth

Growth is expected to vary significantly across subregions. North[5] and Southern Africa are expected to experience some acceleration in growth, from 2.7 per cent and 2.9 per cent in 2014 to 3.6 per cent and 3.6 per cent in 2015, respectively. The enhanced growth prospects for North Africa are underpinned by improving political stability in Egypt and Tunisia. In the Southern African subregion, although Angola, Mozambique and Zambia will continue to be the fastest-growing economies, the 2015 growth acceleration is expected to be mainly driven by more investment in the non-diamond sector in Botswana, a recovery in private consumption in South Africa and increased investment in mining and natural gas exploration in Mozambique.

Central and West Africa are expected to experience a more moderate increase in growth, from 4.3 per cent and 5.9 per cent in 2014 to 4.7 per cent and 6.2 per cent in 2015, respectively, with increased political instability and terrorism in some of the countries in this region (e.g., Central African Republic, Mali, Nigeria) preventing an even stronger expansion. The Ebola outbreak in West Africa (box IV.3) and possible increased political instability in the run-up to elections in Nigeria constitute major downside risks for the outlook in the subregion.

East Africa will be the fastest-growing subregion

Regional integration in the East African Community is expected to continue to boost GDP growth of this subregion, from 6.5 per cent in 2014 to 6.8 per cent in 2015, making it the fastest-growing African subregion. Kenya and Uganda will be the key drivers of growth between 2014 and 2015. Kenya's growth will benefit from the rapid expansion in banking and telecommunications services, the rise of the middle class, urbanization and investment in infrastructure, particularly railways, while Uganda's growth will be supported by increasing activity in sectors such as construction, financial services, transport and telecommunications.

Inflation will moderately decelerate

Inflation in the African region is expected to remain constant at an average of 6.9 per cent in 2015 and moderate slightly to 6.8 per cent in 2016 (figure IV.5). Inflation has come down since its peak in 2012, thanks to the moderating global prices in commodities, food, oil and industrial imports. Increasingly prudent monetary policies across the region are also credited for the subdued inflation. Oil-importing countries are expected to be the major beneficiary of falling prices of oil and other commodities. Inflation is estimated to fall slightly from 5.6 per cent in 2014 to 5.4 per cent in 2015 in these countries (see annex table A.6). Oil-exporting countries continued to see high inflation in 2014 at 8.1 per cent and will likely see a slight increase to 8.2 per cent in 2015. Mineral-rich countries are expected to experience a slight decrease in inflation. The risk remains that declining commodity and oil prices and tighter monetary policies in the United States could negatively weigh on the currencies of both oil- and commodity-exporting countries, leading to imported inflation.

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5 These growth rates also exclude Libya.

Box IV.3

The economic and social impacts of the Ebola virus disease outbreak

West Africa is currently experiencing the largest and most complex outbreak of the Ebola virus disease (EVD), with the number of deaths—4,950 as of 4 November 2014—exceeding the fatalities of all previous outbreaks combined. The EVD first appeared in 1976 in Nzara, Sudan, and Yambuku, Democratic Republic of the Congo. Since then, more than 20 outbreaks have been registered, mainly in rural areas of East and Central Africa. The first episode in West Africa was recorded in March 2014 in Gueckedou, Guinea. The disease then spread to the capital city Conakry and to the neighbouring countries of Liberia and Sierra Leone, which today form the epicentre of the disease. As of 4 November, a total of 13,241 cases have been recorded in the three countries, with Liberia accounting for almost 50 per cent of the cases and Sierra Leone for almost 40 per cent. The spread of the EVD to major urban centres together with the weak capacity of public health systems are important factors in explaining the severity of the outbreak. A limited number of cases have also spread to Mali, Nigeria, Senegal, Spain and the United States of America, but have been contained. While the immediate concern is to save lives and contain the spread of the disease, a comprehensive response to the epidemic must take into account that the epidemic causes impacts which go beyond public health concerns.

Economic impacts

Since the beginning of the outbreak, the dramatic worsening of the economic prospects for Guinea, Liberia and Sierra Leone have led to a spiral of downward revisions in gross domestic product (GDP) growth. The estimated GDP growth for Guinea in 2014 is 2.3 per cent, Liberia 5.1 per cent and Sierra Leone 8.5 per cent, with the latter two both having registered double-digit growth in the previous year. While it is too early to come to a final assessment of the impact of the EVD outbreak on economic growth, the observed trends and disruptions of economic activity are worrisome. The outbreak has resulted in increased labour absenteeism and unemployment, changes in consumption patterns and reduced investments. Opportunities to do business have shrunk with the closure of markets for weeks and cross-border trade is heavily reduced by the restraints on people's movements. The economic performance at the sectoral level has been affected as well, as economic activity in the key sectors of agriculture, mining and services has been seriously hit. In particular, farmers have abandoned their farms and most international expatriates have left the affected countries. Meanwhile, disruptions in international and national transport constrain the service sector and some businesses and banks have reduced their hours of operation. Stocks are declining, prices are rising and government revenues have been reduced, generating important shortfalls in public budgets at the very time when the fight against Ebola actually requires increases in public expenditures.

Despite the severe consequences for the directly affected countries, the economic impact on the West African subregion and Africa as a whole is expected to be limited in view of the small size of the affected economies, as long as a further spread of the disease across borders can be prevented. In 2013, the combined GDP of Guinea, Liberia and Sierra Leone accounted for only 2.42 per cent of West Africa's GDP and 0.68 per cent of Africa's GDP. In recent years, average growth in West Africa has been leaping ahead of Africa as a whole, with growth rates of 6.7 per cent for 2012 and 5.8 per cent for 2013, compared with 4.0 per cent and 3.7 per cent for Africa.[a] Notwithstanding the consequences of the EVD outbreak, the economic prospects for West Africa as a subregion remain positive, with a moderate increase in growth to 6.2 per cent expected in 2015.

Social impacts

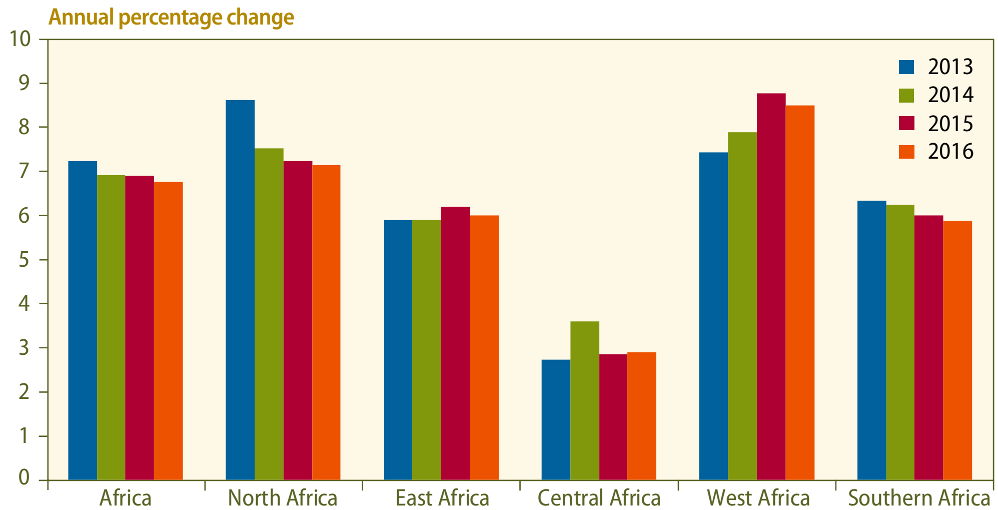
Beyond the suffering of the EVD patients and their families, the affected countries also risk a rise in morbidity and mortality from diseases other than Ebola. The containment of Ebola patients requires a refocusing of funds and medical personnel. Before the EVD crisis, there was one physician in Guinea, to cover the health concerns of 10,000 persons. In Liberia and Sierra Leone, there were only 0.1 and 0.2 physicians per 10,000 persons, respectively. The loss of medical personnel and the diversion of funds due to EVD have further reduced the capacity of these already weak public health systems. In addition, those in need of medical attention may avoid health centres, fearing quarantine, stigma and the possibility of contracting the disease.

The provision of other social and educational services has also been restricted. Schools have been closed in the three heavily affected countries, with no clear timeline for the resumption of normal activity. This and other disruptions in the provision of public services may have consequences that reach far beyond the immediate impacts. In particular, progress towards the Millennium Development Goals in the domains of education and health is at risk of being undone owing to the crisis.

a Growth numbers for Africa exclude Libya.

Source: United Nations Economic Commission for Africa/Sub-Regional Office for West Africa.

Figure IV.5
Consumer price inflation in Africa by region, 2013–2016



Source: UN/DESA.
Note: Data for 2014 are estimates, data for 2015–2016 are forecast.

Central Africa will register the lowest inflation rates in the region

At the subregional level, Central Africa is set to continue seeing the lowest inflation rates in the region as well as the biggest decline between 2014 and 2015, mainly because most countries in this region pursue a similar monetary policy, which is based on pegging their common currency, the Communauté Financière Africaine (CFA) franc, to the euro. In Southern Africa, inflation is expected to decrease from 6.2 per cent in 2014 to 6.0 per cent in 2015, owing to lower oil and global food prices. Other factors that will contribute to inflation reduction include the improvement in domestic food supply in Malawi and Zambia, tight monetary policy in Lesotho and South Africa, and appreciation of the currency in Botswana and Zambia.

In East Africa, inflation is expected to rise slightly, from 5.9 per cent in 2014 to 6.2 per cent in 2015. In Kenya, inflation will be lower, but will continue to be driven by the outcome of the rainy season. In the United Republic of Tanzania, inflation will come down slightly, but will continue to remain at about 6 per cent, driven by a weakening shilling and rising electricity tariffs. In West Africa, inflation is expected to increase from 7.9 per cent in 2014 to 8.8 per cent in 2015. Nigeria is likely to be the key driver of West Africa's inflation, due to fiscal expansion in the run-up to the 2015 elections and the growing consumer demand. In Ghana, increases in water and power tariffs, which caused inflation to peak at 17.5 per cent in 2014, will continue to be a source of inflationary pressures even into the first quarter of 2015. Nevertheless, given public backlashes, additional tariff increases may be postponed until after the 2016 elections, resulting in lower although still relatively high inflation in 2015.

North Africa will see a fall in inflation

North Africa is expected to register a further fall in inflation from 7.5 per cent in 2014 to 7.2 per cent in 2015, while West Africa overtakes it as the subregion with the highest inflation in Africa. Falling global food prices will particularly benefit Algeria and Mauritania, where food and commodity prices constitute a large proportion of the inflation basket. Morocco is likely to continue to have low inflation, due to moderating domestic demand, falling international food prices and mild currency appreciation against the United States dollar. In Egypt and Libya, disruptions in supply chains caused by political instability are expected to continue being a major challenge for monetary authorities. Cuts in food and energy subsidies and high minimum wages for government employees will also drive inflation in Egypt.

The aggregate fiscal balance will remain in deficit

Fiscal balances for African countries are set to remain negative as countries maintain their investment in infrastructure, expenditure on public sector wage bills, transfers and subsidies, and other social sector projects. However, the region's fiscal deficit is expected to slightly decline in 2015. This decline is expected to be driven by decreases in East, North and Southern Africa. In South Africa, the fiscal deficit is estimated to decrease from 4.4 per cent of GDP in 2014 to 3.7 per cent of GDP in 2015, as fiscal authorities have undertaken measures to reduce the fiscal deficit by minimizing corruption and inefficiencies and by cutting allocations to non-essential expenditures. In Botswana, the buoyant revenue from mineral taxes, income and value-added taxes, and the Southern African Customs Union revenue-sharing scheme will improve the fiscal surplus from 1.2 per cent of GDP in 2014 to 1.5 per cent in 2015. Nigeria's fiscal deficit is expected to increase by 0.1 percentage points to 2.1 per cent of GDP, owing to increased expenditure in the lead-up to elections. Egypt, Ghana and the United Republic of Tanzania face fiscal sustainability issues, with their fiscal deficits expected to average about 11 per cent, 8 per cent and 6 per cent of GDP, respectively, between 2014 and 2016.

All the economic groupings in Africa are expected to experience an improvement in fiscal balances in 2015. However, oil-importing and mineral-rich countries are expected to register the largest improvement of 1.2 and 1.3 percentage points, respectively, because of lower oil prices. Other factors that will contribute to these improvements in fiscal balances include fiscal consolidation, the emergence of new sources of revenue and innovative resource mobilization in some economies such as Botswana, Cameroon, the Republic of the Congo and South Africa. However, at the individual country level, fiscal balances may deteriorate in Nigeria, Sudan and the United Republic of Tanzania because of increased spending in the lead-up to national elections scheduled for 2015.

The moderating oil price will affect current-account balances

Oil-exporting countries will continue to have current-account surpluses, although moderating oil prices will trim these surpluses in 2015. On the other hand, current-account deficits of oil-importing countries will decrease as a result of this moderation. Mineral-rich countries will continue to have the largest current-account deficits because of deficits on services and other intangible trade, due to the reliance on imported services. Moreover, as the mining sectors are dominated by multinational companies, mineral-rich countries face structural deficits on the income account when these companies pay external debt and repatriate profits.

Current-account balances of open economies such as Botswana, Kenya, Nigeria and South Africa could benefit from increasing net exports as their currencies weaken owing to tighter monetary policy in the United States. However, this will depend on whether the weakened currencies will not affect competitiveness through their effect on imported inflation. South Africa is expected to reduce its current-account deficit from 5.4 per cent of GDP in 2014 to 4.7 per cent of GDP in 2015. Despite falling oil prices, Nigeria's current-account balance is expected to remain positive, benefiting partly from higher remittances from its large diaspora population. A major impact on the trade patterns of Africa could emanate from the Economic Partnership Agreements that are being negotiated with the EU (box IV.4).

Downside risks include weakening trade and tighter financial conditions

Despite the continuation of relatively robust growth across the region, a number of internal and external risks may derail Africa's medium-term economic performance. First, a more drastic fall in oil and commodity prices, a renewed weakening in the developed

Box IV.4

Economic Partnership Agreements and their implications for structural transformation in Africa

Africa's exports and imports have expanded more than fourfold over the last twelve years. However, this expansion has mostly stemmed from an increase in prices rather than volumes, while the growth of exports in volume terms was increasingly outpaced by that of imports. Even more importantly, over the last 10–15 years, the composition of Africa's exports has become increasingly skewed towards primary commodities. Even in sectors where the continent displays revealed comparative advantages, African producers are often relegated to low-value-added products.[a]

Against this background, it is clear that the impact of the Economic Partnership Agreements (EPAs) between the European Union (EU) and African, Caribbean and Pacific (ACP) countries needs to be considered in the context of the latter's structural transformation and industrialization agenda.[b] In this context, the long-term economic impact of EPAs will be determined especially by the pronounced and multifaceted asymmetries between the two parties. These refer not only to the economic size and level of development of the two regions, but also to two key facets of their bilateral trade relations:

1. Although it has been declining, the weight of the EU as an export market for Africa continues to significantly exceed the corresponding importance of Africa as an export market for Europe.
2. Africa's exports to the EU continue to be concentrated in a narrow range of mostly primary commodities, whereas EU exports to the region are significantly more diversified.

This lopsided pattern of bilateral trade relations has persisted for several decades, despite the preferential market access granted by the EU to exports from ACP countries.

The negotiations on the EPAs were launched in 2002 as part of the Cotonou Agreement, with the aim of making the trade relations between the two parties compatible with World Trade Organization principles.[c] The focus has been on a reciprocal but asymmetric free trade agreement, whereby the EU would immediately grant 100 per cent duty-free access to ACP-originated exports, whereas ACP countries would progressively liberalize "substantially all trade" with the EU.[d] ACP countries have approached negotiations grouping themselves into seven blocks, five of which are in Africa, namely West Africa, Central Africa, Eastern and Southern Africa, the East African Community (EAC) and the Southern African Development Community (SADC). In parallel, it is noteworthy that the least developed countries (LDCs), which include as many as 34 African economies, have in any case duty-free and quota-free access to the EU market under the Everything but Arms (EBAs) initiative, a unilateral preferential scheme of the EU for LDCs.

Leaving aside the limited differences in the negotiating text of the various African blocks, EPAs have traditionally raised a number of concerns. First, they have created tension between LDCs and non-LDCs, in so far as LDCs would ultimately have to open up their economies to EU products without any significant gain, whereas only non-LDCs would actually have improved access to the EU market. This situation, coupled with the structural asymmetries in trade relations, suggests that export gains for Africa are likely to be confined to a relatively narrow range of countries and products, while the EU could expand its exports to a wide range of countries and for a broader array of products. Second, EPAs could derail Africa's progress towards regional trade integration for two main reasons:

a. Africa's negotiating configuration of country groupings in the EPAs is not consistent with the existing Regional Economic Communities (REC), thereby hampering the establishment of REC-level Custom Unions, especially in presence of overlapping memberships;

b. The EPAs could adversely affect intra-African trade, since in some African countries, EU-originated products may ultimately face lower tariffs than similar African products originated outside a country's REC.[e]

(*continued*)

a United Nations Economic Commission for Africa, "Building trade capacities for Africa's transformation: A critical review of Aid for Trade", Addis Ababa, 2013.

b Northern African economies are not included in the ACP group, and their trade relations with the EU are regulated under the Euro-Mediterranean Partnership Agreement, rather than under the EPAs.

c Unilateral preferences previously accorded by the EU to ACP-originating goods represented a breech to the general WTO principle of most favoured nation and, hence, needed a specific waiver to be granted by other WTO members.

d Although there is no precise definition of "substantially all trade", the expression has commonly been interpreted as meaning approximately 80 per cent of trade.

e Precisely for this reason, it is imperative that African countries accelerate their progress towards the reduction of trade barriers not only within each REC, but also across RECs, working towards the establishment of the Continental Free Trade Area.

Third, even though the EU has pledged to support African countries in facing the adjustment costs of EPAs, these costs are likely to entail revenue losses from lower import duties and export taxes, sources of public revenues which play a significant role for a number of African countries. Fourth, some controversial provisions in the text of the EPAs may curtail African countries' policy space, in particular with regard to export taxes and the pursuit of trade liberalization agreements with other significant trade partners.

Against this background, progress in the EPA negotiations has been mixed across African regions and countries. While negotiations have already been concluded in West Africa and the SADC, a few outstanding issues remain in the case of the EAC. Progress has been slower in Central Africa and Eastern and Southern Africa, although most non-LDC countries in these regions have already concluded an interim EPA with the EU and, therefore, are not at risk of losing trade preferences.[f]

Box IV.4 (*continued*)

f Interim EPAs have been signed by Cameroon, Madagascar, Mauritius, Seychelles and Zimbabwe. All information concerning the status of Economic Partnership Agreement negotiations is taken from official EU documents, updated as of October 2014.

Source: United Nations Economic Commission for Africa.

economies, or a further slowdown in demand for commodities in China would negatively weigh on Africa's trade earnings. Second, tighter global financial conditions in developed economies (such as the United States) might result in the outflow of private capital and increase the volatility of currencies. Third, the Ebola outbreak is a major risk for West Africa's medium-term growth prospects. In addition to the severe human toll, the outbreak has already had a significant negative impact on trade in both goods and services (particularly travel and tourism) in the West African subregion. Fourth, political instability and terrorism in a number of African countries and civil and labour unrest in other countries will continue to be a source of pessimism, disruption and damage, and negatively weigh on investment, trade and tourism on the continent. However, the aggregate number of armed conflicts in Africa has decreased since 2000, and more initiatives are being undertaken at the continental level to address issues of peace and security.[6] Finally, weather-related shocks will continue to be a source of downside risks, given that most African economies are still dependent on agricultural production.

East Asia: growth projected to remain robust

East Asia remains the world's fastest growing region, even as GDP growth slowed from 6.4 per cent in 2013 to 6.1 per cent in 2014. The outlook for the region as a whole is robust, with growth projected at 6.1 per cent in 2015 and 6.0 per cent in 2016. China's transition to more moderate growth is expected to be offset by higher growth in other economies, such as Indonesia, Singapore, Thailand and Viet Nam. In many economies, investment and exports are projected to pick up in the forecast period, supported by government programmes and a gradual recovery in developed countries. Household consumption is expected to remain strong on the back of subdued inflation, robust labour markets and generally low real interest rates. Fiscal policy remains moderately supportive of growth and most countries have sufficient space to provide additional stimulus, if necessary. The key downside risks for East Asia are related to the upcoming tightening of global liquidity conditions—which could result in weaker growth of domestic consumption and investment—and to a sharper-than-expected slowdown in China.

6 United Nations Economic Commission for Africa, "Frontier markets in Africa: misperceptions in a sea of opportunities", Addis Ababa, 18 July 2014.

China's growth is projected to further moderate in 2015–2016 as authorities focus on the quality of development

China's economy, which accounts for two-thirds of East Asia's total output, is transitioning to a more consumption- and service-oriented and more environmentally sustainable system, which has resulted in lower headline GDP growth. In 2014, the economy expanded by an estimated 7.3 per cent, down from 7.7 per cent in 2013, as growth in exports and investment slowed. A further gradual deceleration to 7.0 per cent in 2015 and 6.8 per cent in 2016 is forecast. This lower growth trajectory is in line with the Government's focus on raising the quality of development and partly reflects policy measures aimed at curbing financial risks. The slowdown in China has negatively impacted growth in other East Asian economies, especially Hong Kong Special Administrative Region of China, where business investment weakened and tourist spending dropped over the past year. Indonesia and Thailand also saw growth decelerate in 2014 owing to country-specific factors. In Indonesia, domestic demand weakened, following policy measures to curb inflation and reduce the current-account deficit, and net exports contributed less than in 2013 (figure IV.6). Market sentiment improved, however, following presidential elections in July, and the economy is likely to gain some strength in 2015 and 2016. Thailand's economy contracted in the first quarter of 2014 and was flat in the first half of the year as political instability weighed heavily on domestic demand, in particular investment (figure IV.6). Full-year growth in 2014 remained subdued at an estimated 1.1 per cent; further strengthening of activity depends critically on the implementation of public investment projects. In the baseline outlook, a moderate improvement to 3.9 per cent growth is forecast for 2015. In the Republic of Korea, growth picked up to 3.4 per cent in 2014, although high household debt, a stagnant property market, subdued consumer sentiment and sluggish exports weighed on activity. Easier monetary policy and a gradual improvement in external demand are expected to support activity in 2015–2016, with growth forecast to strengthen slightly. Malaysia and the Philippines were among the best-performing countries in East Asia in 2014, following strong consumption and investment demand. While overall conditions in both countries are expected to remain benign, a moderation in growth is projected for 2015. Viet Nam is expected to see a gradual strengthening of growth in the forecast period, mainly owing to stronger investment, whereas Papua New Guinea is set to record a jump in GDP growth in 2015 as it starts to export liquefied natural gas.

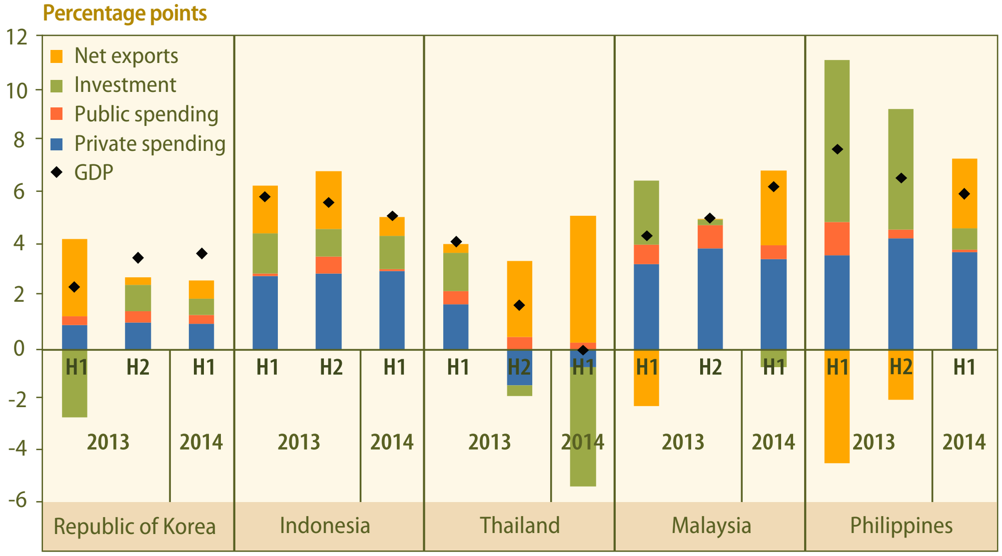
Labour markets are expected to remain robust amid stable growth

Given the region's solid growth outlook, the labour market situation is likely to remain robust. With few exceptions, official unemployment rates in the region are low. In the region's higher-income economies, average unemployment rates in 2014 ranged from 2.0 per cent in Singapore to 4.0 per cent in Taiwan Province of China. In the Republic of Korea, unemployment edged up in 2014, partly as a result of an increase in the labour force participation rate (see annex table A.8). In China, despite slower economic growth, the unemployment rate in 31 large and mid-size cities remained at about 5 per cent in 2014 as employment growth, particularly in the service sector, has been faster than expected. The unemployment rate rose marginally in Thailand in 2014, while declining slightly in Indonesia and the Philippines. In most countries, the jobless rate for those aged 25 to 29 continued to be two to three times higher than for the other age groups. Widespread vulnerable employment remains a particular concern in the region's lower-income economies, notably in Indonesia, the Philippines and Viet Nam.

Falling commodity prices keep consumer price inflation low

Average consumer price inflation in East Asia fell to 2.4 per cent in 2014, down from 2.8 per cent in 2013 owing to further declines in international commodity prices and limited demand pressures (see annex table A.6). In most countries, inflation is within or below the target ranges set by the central banks. Recent trends in inflation varied across the region, largely corresponding to the strength of domestic demand. In China, average inflation declined from 2.7 per cent in 2013 to 2.1 per cent in 2014, in line with slower eco-

Figure IV.6
East Asia: contributions of expenditure components to real GDP growth, January 2013–June 2014



Source: UN/ESCAP, based on data from CEIC database (accessed 23 September. 2014).
Note: Investment refers to gross capital formation, i.e., outlays on additions to the fixed assets of the economy plus net changes in the level of inventories. Differences between GDP growth and the sum of components are due to statistical discrepancies.

nomic growth and stable food prices. Inflation also slowed in Hong Kong Special Administrative Region of China, Indonesia, Singapore and Viet Nam, but accelerated in Malaysia and the Philippines, consistent with above-trend economic growth. Inflation is expected to temporarily rise in Malaysia as a result of the introduction of a new consumption tax and in Indonesia, where a further reduction of fuel price subsidies is planned. For the region as a whole, consumer price inflation is expected to accelerate gradually in the outlook period, rising to 2.7 per cent in 2015 and 2.9 per cent in 2016.

Monetary policies move in different directions as macroeconomic trends diverge

Monetary policy remained generally accommodative across East Asia. The moves by central banks in the past year reflect the different macroeconomic trends in the region. For much of 2014, China's central bank opted for only targeted measures to support the economy, rather than generalized policy easing. However, in late November, the authorities cut interest rates for the first time in more than two years in a bid to boost growth. The Republic of Korea, Thailand and Viet Nam also cut their main policy rates during the year in an attempt to revive domestic demand. In contrast, the central banks of Malaysia and the Philippines raised interest rates amid strong growth and rising inflationary pressures. At the same time, monetary and financial authorities in a number of countries used macroprudential measures to address financial sector risks, such as curbs on real estate lending. An increasing number of East Asian central banks are expected to gradually tighten monetary policy in the latter part of the forecast period in the face of improving global conditions, higher interest rates in the United States, and a pickup in domestic inflation.

Several Governments provide additional fiscal stimulus to support growth

Fiscal policy was generally supportive of growth across East Asia. In several countries, the Governments tried to further stimulate economic activity. In China, the authorities implemented measures to support domestic demand, including tax relief for small firms and accelerated fiscal and infrastructure spending. In July, the Government of the Republic of Korea announced a stimulus package of $11.7 billion, targeting low-income households, small firms and the property market, and introduced for 2015 the most expansionary budget since 2009. In Thailand, the military Government unveiled plans to spend $75 bil-

Box IV.5

Reprioritizing public expenditure for sustainable development in East Asia[a]

Many East Asian countries are in the process of making existing public expenditure more efficient and of reprioritizing public expenditure towards inclusive growth and sustainable development. These policy measures are aimed at freeing significant amounts of financial resources by improving expenditure management of their budgets. Critically, the huge savings from curbing non-developmental expenditures and removing, or reducing, subsidies should allow policymakers to be more ambitious in their inclusive growth programmes.

A significant amount of non-developmental expenditure is devoted to military spending, which totalled over $258 billion in 12 countries of the East Asia region in 2013. Military expenses often exceed those on health and education combined.[b] Significant resources are also spent on subsidies, especially for energy. In East Asia alone, fossil fuel consumption subsidies totalled about $76 billion in 2012. Fuel subsidies amounted to 3.0 per cent of GDP in Brunei Darussalam and Indonesia, 2.6 per cent in Thailand, 2.5 per cent in Viet Nam and 2.4 per cent in Malaysia.[c] In most cases, these subsidies present a drain on government financial resources and impede the Government's capacity in other fields.

Moreover, energy subsidies tend to mostly benefit the wealthier groups in society; they inherently encourage wastage, and result in fuel-intensive production. Importantly, poorly targeted energy subsidies have had little impact on either enhancing inclusive growth or reducing extreme poverty. However, curbing increasing levels of non-development expenditure and removing or reducing harmful subsidies is politically challenging. In several countries, the removal of subsidies has sparked protests, especially from influential interest groups.

Rationalizing subsidies is a key reform that would raise public financial resources for productive investment and sustainable development in the region. According to the United Nations Economic and Social Commission for Asia and the Pacific, estimates for savings of individual countries—including Indonesia, Malaysia, the Philippines and Thailand—from these subsidies would be sufficient to finance, for instance, a comprehensive policy package comprising income security for older persons and all those with disabilities, as well as providing universal access to health and education.

At the national level, several countries have started to introduce policy measures and multifaceted reform agendas, which include a reduction in energy subsidies and an expansion of public expenditure on education, health and social protection. These policy measures will provide further support for fiscal consolidation, while also releasing financial resources for inclusive growth policies.

For example, Indonesia and Malaysia rationalized energy price subsidies and/or raised electricity tariffs to restore medium-term fiscal sustainability. Indonesia decided in mid-2013 to cut fuel subsidies to curb its fiscal deficit, while Malaysia reduced fuel subsidies in September 2013 and again in October 2014. Indonesia faced steep price increases as subsidy rationalization pushed up prices of gasoline and diesel by 44 per cent and 22 per cent, respectively. In the case of Malaysia, the initial impact on inflation has been more moderate as the price increase in 2013 took effect when overall inflationary pressure was low. In both countries, the Government limited the direct negative impact of the subsidy reduction on low-income households by providing assistance through compensatory cash transfers and increased welfare payments. In Indonesia, the fiscal savings from the initial subsidy cuts have been lower than expected (partly due to a weaker currency). However, further subsidy rationalization should boost fiscal resources for social spending on items such as the country's universal health-care plan, which was launched in 2014 and aims at complete coverage by 2019.

One important caveat is that policymakers must avoid one-size-fits-all approaches in the case of removal or reduction in subsidies. Rather, policy reforms need to take into account the net welfare effects, especially on poor and vulnerable households. The removal of energy subsidies—which are often regressive and tend to hinder public spending on education, health, social protection and physical infrastructure—should be complemented by policy reforms that include targeted cash transfers to ensure that poor and vulnerable households are not put in even worse positions. In contrast, policymakers may need to approach food subsidies differently as these generally benefit low-income groups.

a This box is based on analyses in United Nations Economic and Social Commission for Asia and the Pacific, *Economic and Social Survey of Asia and the Pacific 2013: Forward-Looking Macroeconomic Policies for Inclusive and Sustainable Development* (United Nations publication, Sales No. E.13.II.F2) and in "Sustainable development financing: perspectives from Asia and the Pacific", background paper prepared for the Asia-Pacific Outreach Meeting on Sustainable Development Financing, held in Jakarta on 10-11 June 2014, available from http://www.unescap.org/sites/default/files/UNESCAP-SDF-Paper-1July2014-share.pdf.

b Stockholm International Peace Research Institute (SIPRI) Military expenditure database, available from http://www.sipri.org/research/armaments/milex/milex_database, accessed 5 November 2014.

c International Energy Agency data, available from http://www.iea.org/subsidy/index.html

Source: United Nations Economic and Social Commission for Asia and the Pacific.

lion over eight years to improve transport infrastructure. Most East Asian economies have the fiscal space to further boost investments in human and physical capital. Public debt as a share of GDP ranges from less than 40 per cent in Indonesia and the Philippines—which have reduced debt over the past decade—to 45 to 60 per cent in Malaysia and Thailand. Moreover, countries are reprioritizing expenditures and pursuing tax policy and administration improvements. In particular, several countries, such as Indonesia and Malaysia, are in the process of reforming their energy subsidy systems (see box IV.5).

Exports present a mixed picture

East Asia's trade and current-account surpluses have narrowed since the global financial crisis. In 2013, the region's combined current-account surplus stood at about 3.0 per cent of GDP, compared with a high of 8.3 per cent in 2007. The trend towards lower surpluses marginally reversed in 2014 as import growth slowed more rapidly than export growth. Several countries, such as Malaysia, the Philippines and Viet Nam saw dynamic export growth in 2014, led by strong international demand for electrical and electronic products. Export growth was less buoyant, but still solid, in other parts of the region, including China, the Republic of Korea, Singapore and Taiwan Province of China. These economies saw export revenues (in dollar values) grow by an estimated 3–5 per cent in 2014. By contrast, export revenues contracted slightly in Indonesia and Thailand during this period. The decline in Indonesia can be attributed to weak international commodity prices and new regulations banning the export of unprocessed minerals. The decline in Thailand mainly reflects the impact of the political turmoil and a shift in global demand for some electronic products. Imports generally grew at a slower pace than exports in 2014, largely owing to a weakening of investment activity in the region and lower international commodity prices. China saw import spending rise only marginally in 2014, while Indonesia and Thailand experienced marked declines. Net capital inflows to the region were slightly higher than in 2013, despite considerable outflows at the beginning of 2014. Most currencies registered gains against the euro and the yen, but significant losses against the dollar, which began appreciating sharply in mid-2014.

Tightening of global liquidity conditions and slowdown in China pose downside risks

The key downside risks for East Asia are related to the upcoming tightening of global liquidity conditions and to the slowdown of China's economy. The Fed's upcoming increase in interest rates could lead to a marked adjustment in credit conditions for East Asia's emerging economies, resulting in weaker investment and consumption growth than currently anticipated. This risk factor is particularly relevant for countries with high household or corporate debt, such as the Republic of Korea, Malaysia and Thailand, and for economies with potential housing-market bubbles, including Hong Kong Special Administrative Region of China, Singapore and Thailand. A sharper-than-expected slowdown in China would have a severe impact through trade and finance channels on other economies in the region, in particular commodity exporters such as Cambodia and Indonesia.

South Asia: growth set to strengthen, led by gradual recovery in India

South Asia's economic growth is set to reach a four-year high of 5.4 per cent in 2015, up from an estimated 4.9 per cent in 2014 and well above the 4.1 per cent recorded in 2013. For 2016, a further acceleration to 5.7 per cent is forecast. The recovery is expected to be led by a pickup in growth in India, which accounts for about 70 per cent of regional output. Other economies, such as Bangladesh and the Islamic Republic of Iran, are also projected to see stronger growth in the forecast period. Along with robust external demand, growth is expected to be underpinned by a moderate strengthening of domestic consumption and investment as several countries benefit from improved macroeconomic conditions. Governments have started to make some progress in implementing economic policy reforms, thus providing support to business and consumer confidence. The growth projections for 2015 and 2016 rest on several key assumptions, including normal monsoon conditions, stable or slightly moderating global food and energy prices, a limited impact of higher international interest rates on regional credit conditions and continued policy reforms.

Growth in India picks up as government reforms encourage investment

India's economy expanded by an estimated 5.4 per cent in 2014, an improvement from growth of 5.0 per cent recorded in 2013, but still significantly below the 8.0 per cent pace of the pre-crisis period. The recovery is partly the result of improved market sentiment after the new Administration took office in the second quarter of 2014 and announced plans to reform the bureaucracy, labour laws and public subsidies. The authorities implemented reforms to ease restrictions on foreign direct investment (FDI), speed up investment in large-scale projects and lift state control on diesel prices. After years of sluggishness, fixed investment has started to gain strength. This has also been reflected in a mild recovery in the manufacturing and construction sectors. A subpar monsoon, along with fiscal constraints, has, however, weighed on economic activity. Going forward, India is projected to see a gradual acceleration in growth, with GDP forecast to expand by 5.9 per cent in 2015 and 6.3 per cent in 2016. Meanwhile, Bangladesh and Sri Lanka maintained strong growth of 6.2 per cent and 7.8 per cent, respectively, in 2014, amid buoyant household consumption and investment. Both economies are expected to expand at a strong pace in 2015 and 2016 as favourable conditions remain largely intact. Although Pakistan's GDP growth rebounded to an estimated 4.2 per cent in 2014 after robust private and public consumption, macroeconomic fundamentals remain fragile in the face of ongoing security concerns and low fixed investment that is constrained by the shortage of domestic savings. Growth is forecast to decline slightly in 2015, before picking up again in 2016. The Islamic Republic of Iran is estimated to have seen a return to mildly positive growth in 2014 as macroeconomic conditions stabilized and the partial lifting of sanctions helped non-oil exports. A more robust recovery depends, however, on a comprehensive nuclear agreement and further sanctions relief, especially for oil exports and the financial sector.

Cross-country differences in unemployment rates are large

India's manufacturing sector registered employment gains through June 2014. A weak start in 2014 was more than offset by a strong second quarter, when several sectors, such as textiles, metals and information technology, saw marked increases in employment levels. In general, the job market situation in South Asian countries appeared to be relatively stable in 2014, although data are limited and do not fully reflect the reality of the employment situation. The differences in official unemployment rates between countries have remained large as growth trends continued to diverge. In the Islamic Republic of Iran, the unemployment rate was estimated at 10.7 per cent in the second quarter of 2014 as economic activity remained weak. Unemployment in Sri Lanka, by contrast, declined further to 4.1 per cent in the first quarter of 2014 amid robust domestic demand. In countries with available data (including India, the Islamic Republic of Iran, Pakistan and Sri Lanka), unemployment rates remained significantly higher for women than for men. In the Islamic Republic of Iran, the female unemployment rate was estimated at 19.4 per cent in the second quarter of 2014, compared to 9.0 per cent for men. This is particularly alarming since the labour force participation rate is much lower among women than men. The share of vulnerable employment, defined as unpaid family workers and own-account workers, is as high as 60 per cent in Pakistan and 80 per cent in India. This illustrates the magnitude of the employment challenges the region is facing and highlights the importance of generating quality employment.

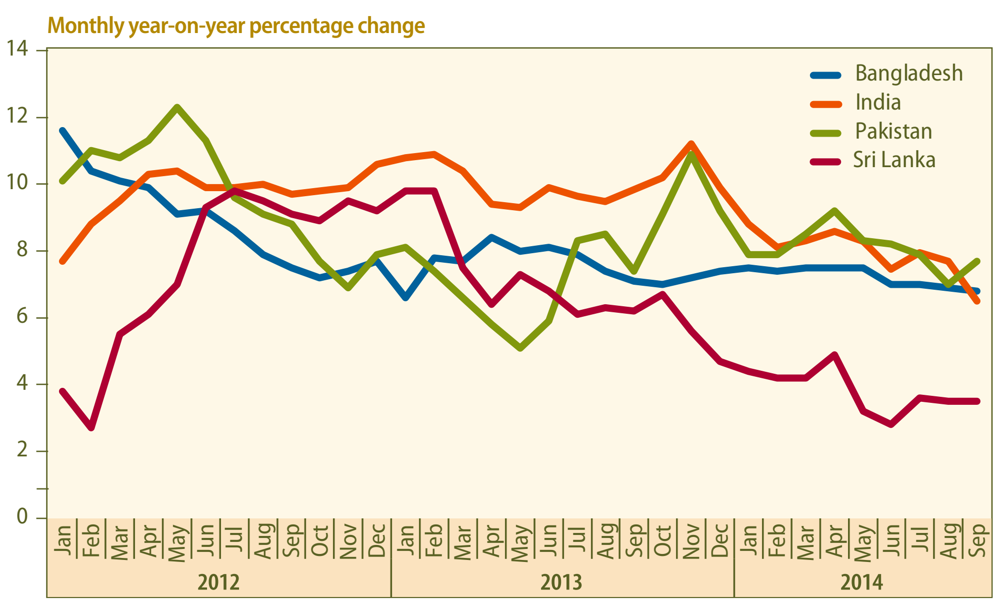
Inflation is trending down amid lower oil prices and limited demand pressures

Average consumer price inflation in South Asia (figure IV.7) declined considerably from 14.7 per cent in 2013 to 9.2 per cent in 2014. Falling international prices of oil and other commodities, vigilant monetary policies and limited demand pressures contributed to lower inflation, offsetting the impacts of a late monsoon arrival and floods in certain parts of the region. India's consumer price inflation rate fell below 7.0 per cent year on year in the third quarter, compared to 10.4 per cent in the final quarter of 2013. This also helped bring down price pressures in Nepal, which is closely tied to India through the exchange-rate peg and strong trade flows. In Sri Lanka, inflation declined to a multi-year low of 3.5 per cent in the third quarter of 2014. In the Islamic Republic of Iran, consumer prices were up by an estimated 17.8 per cent in 2014, after a 40 per cent surge in 2013, when the international sanctions had led to significant supply shortages and a sharp devaluation of the rial. In most countries of the region, food inflation remained slightly higher than overall inflation. Going forward, average inflation in the region is expected to moderate further to 7.8 per cent in 2015 and 7.2 per cent in 2016, as commodity prices will likely remain subdued and domestic demand picks up only gradually. There are, however, notable upside risks to the baseline inflation forecast. Given the dominance of traditional agriculture and the reliance on imported commodities, South Asia is very vulnerable to weather conditions and global price developments. Further reductions of subsidies, (in Pakistan, for example) and a new round of currency weakness could also push inflation rates above current projections.

India's central bank maintains a firm anti-inflationary stance

Amid slowing inflation and a slight recovery in growth, monetary policy in South Asia remained fairly stable in 2014. The Reserve Bank of India (RBI) has kept its key policy interest rate at 8 per cent, following upward adjustments in response to inflation pressures and capital outflows between mid-2013 and early 2014. India's monetary authorities emphasized that while inflation has slowed, the balance of risks was still to the upside. The RBI is expected to maintain its firm anti-inflationary stance, but could start easing mone-

Figure IV.7
Consumer price inflation in South Asia, January 2012–September 2014



Source: UN/DESA, based on national data.

tary policy in the course of 2015. As in India, policy rates were also left unchanged in Bangladesh, Pakistan and Sri Lanka in 2014 and no significant changes to the monetary policy stance are expected for 2015–2016. Bangladesh's central bank raised the cash reserve ratio by 50 basis points to 6.5 per cent in June to curb excess liquidity in the banking system, and Sri Lanka's central bank increased the pressure on commercial banks to cut lending rates.

Fiscal deficits trend down, but remain large as Governments struggle to meet targets

Mildly expansionary fiscal policy has supported economic growth over the past year, but persistently large fiscal deficits add risk to medium-term debt sustainability. Fiscal deficits generally trended down in 2014, but remained high at about 4 per cent of GDP in India, 5 per cent in Bangladesh and Sri Lanka, and 7 per cent in Pakistan. Military spending and heavy price-subsidy bills accounted for a significant portion of total government expenditures in these countries. In the outlook period, most countries are expected to see a further slight improvement in their fiscal balances (relative to GDP), as efforts to rationalize subsidy bills and to expand the tax base yield some results and economic growth picks up (box IV.6). Deficit reduction, however, will likely be slow and most Governments will struggle to meet their announced targets.

Current-account positions improve as exports gain strength

Most South Asian economies, including Bangladesh, India, the Islamic Republic of Iran and Sri Lanka, recorded solid export growth in 2014. India's exports benefited from the marked depreciation of the rupee in 2013, and Bangladesh and Sri Lanka registered expansions of garment exports amid robust demand in developed economies. As some of the sanctions against the Islamic Republic of Iran were suspended, exports started to recover in 2014, albeit at only a moderate pace. Pakistan's exports, by contrast, remained weak in 2014, held back by persistent power shortages and poor infrastructure. On the import side, South Asia's economies generally benefited from the decline in fuel prices in 2014. Moreover, some country-specific measures, such as an import duty on gold and silver in India, helped curb total import spending. Current-account positions thus improved in 2014 in most economies. Bangladesh, Nepal, Pakistan and Sri Lanka recorded a further increase in workers' remittances, which account for more than 5 per cent of GDP in these economies. Similarly, tourist arrivals continued to rise, although tourism revenues remain small relative to merchandise exports, except in Nepal. India's current-account deficit moderated from a peak of 6.1 per cent in the last quarter of 2012 to 0.2 per cent in the first quarter of 2014. International reserves increased in most of the region's economies and currently range from close to four months of imports in Pakistan to nine months in Nepal. Except in Sri Lanka, the share of external debt in total debt is also relatively low.

Fragility of the global economy and country-specific weaknesses pose downside risks for growth

There are significant downside risks to the baseline outlook for South Asia, related to the continuing fragility of the global economy and country-specific weaknesses, such as volatile security conditions, agricultural dependency on the monsoon and difficulties in implementing structural reforms. A decline in global liquidity, along with a re-emergence of domestic inflationary pressures, could lead to a tightening of domestic credit, particularly in India and Pakistan, which would likely weaken consumption and investment activity.

Western Asia: weak economic recovery is projected, but significant downside risks remain

In Western Asia, GDP growth is projected to pick up in many countries, albeit to relatively modest levels compared with previous years (figure IV.8). After slowing from 4.0 per cent

Box IV.6

Mobilizing domestic tax revenues for development in South Asian countries[a]

Governments have a range of options for augmenting fiscal space for productive and countercyclical spending to support sustainable development. Among these options, strengthening tax revenues is critical, particularly in South Asia, where average tax revenues of the central Government reached only 10.7 per cent of gross domestic product (GDP) in 2011/12. Such low levels of tax revenue limit the ability of Governments to address the region's large development needs. In Afghanistan, Bangladesh, Bhutan, the Islamic Republic of Iran and Pakistan, tax-to-GDP ratios were close to, or at, single-digit levels, much lower than in other developing countries in Asia and the Pacific (figure IV.6.1).

Figure IV.6.1

Central government tax revenue in selected East and South Asian economies

Source: World Bank and IMF Government Finance Statistics.

Note: Data refer to the most recent available year (2012 or 2011). For Bhutan and the Islamic Republic of Iran, data refer to 2009.

One reason for the low levels of tax revenue is that many people are exempt from taxes due to low incomes; also, a high proportion of people work informally or in agriculture—activities on which it is more difficult to collect taxes, especially income tax. But even wealthier individuals pay little income tax, owing to high tax avoidance and non-compliance, as well as inadequate institutional mechanisms to ensure payment of taxes. The tax gap between the de jure tax objective and the actual revenue is caused by underreporting of taxable income, voluntary taxpayer registration and various individualized tax exemptions, all combined with poor tax administration, namely insufficient inspection and auditing. In Bangladesh and Pakistan, for example, only about 1 per cent of the population pays income tax; in India that proportion is only 3 per cent.

Many countries therefore collect more tax from corporations than from individuals, as is the case in Bhutan, the Islamic Republic of Iran, Maldives and Sri Lanka, where corporate income tax accounts for more than three quarters of direct tax revenues. Yet, corporate tax bases are often eroded by numerous tax exemptions and allowances that are granted to attract foreign direct investment (FDI) and private inflows. For instance, preferential tax treatment is offered in Sri Lanka to the tourism and construction sectors, in India to insurance service providers, and in Pakistan to power-generating companies.

a This box is based on analysis in United Nations Economic and Social Commission for Asia and the Pacific, *Economic and Social Survey of Asia and the Pacific 2014: Regional Connectivity for Shared Prosperity* (United Nations publication, Sales No. E.14.II.F.4).

(*continued*)

Box IV.6 (*continued*)

Tax revenues have also been negatively affected by government measures that liberalize trade and reduce trade-related taxes and/or duties in order to encourage trade and investment flows. In the Maldives and Pakistan, for instance, tax revenues from international trade declined by over 5 per cent of GDP between 1990 and 2011. Most countries have increased consumption taxes, such as on goods and services through a value added tax (VAT) or a general sales tax, to offset declines in taxes and/or duties on trade flows. Yet, the collection efficiency of VAT is quite low, particularly in Bangladesh, India and Pakistan, indicating tax exemptions and difficulties in implementing the complex tax system. In Afghanistan, Pakistan and Sri Lanka, the revenue from consumption taxes has been unable to offset declines in revenues generated from trade.

A number of countries are resorting to innovative tax measures to raise additional revenue. For instance, in India a "super tax" is levied on individuals whose annual income exceeds about $170,000. India has also introduced a 3 per cent education levy (or "cess") on income tax, corporate tax, excise and customs duties and service tax to finance universal access to basic education. It has also introduced a securities transaction tax to stop avoidance of the capital gains tax. In Sri Lanka, a deemed dividend tax is designed to encourage boards of companies to increase dividends, while in Bangladesh, VAT has been extended to private education and health providers.

The good news is that the tax potential is sizeable in South Asia, reaching several percentage points of GDP. Using an econometric analysis that captures structural and developmental factors (such as the value added in the agricultural sector, GDP per capita and the degree of trade openness in a country) and that allows for differences between developing regions, the United Nations Economic and Social Comission for Asia and the Pacific (ESCAP) estimated that current tax revenues were significantly lower than their potential (table IV.6.1).[b] Fully utilizing the tax potential would thus boost tax revenues in most South Asian economies, making valuable resources available for development.

To strengthen tax revenues, countries clearly need to broaden tax bases and rationalize rates. They also need to tackle tax evasion and tax fraud more forcefully and improve tax administrations.

Greater regional cooperation is also of critical importance as it would enable countries to harmonize taxes and combat competition for FDI, which is creating a "race to the bottom" in terms of taxation of profits. Such cooperation would help avoid double taxation and also tackle the problem of transfer pricing, used by multinational corporations to divert profits to low-tax countries through subsidiaries. Regional cooperation could also be a useful tool to deal with tax havens. ESCAP has proposed creating an Asia-Pacific tax forum to share best practices in tax policies, tax administration and tax reforms.

b The tax-to-GDP ratios in table IV.7.1 are taken from the Economic and Social Survey of Asia and the Pacific 2014, ibid., and differ slightly from those provided in figure IV.6.1. For more details on the computation of the tax potential, see chap. 3 of the ESCAP report.

Table IV.6.1
Estimated tax potential in selected South Asian economies

	Year	Tax-to-GDP ratio (percentage) Actual	Tax-to-GDP ratio (percentage) Potential	Tax gap (percentage points)	Tax gap as a proportion of current revenue (percentage)
Afghanistan	2011	8.8	15.0	6.2	70.5
Bangladesh	2013	10.5	18.0	7.5	72.1
Bhutan	2009	9.2	16.0	6.7	72.9
Iran (Islamic Republic of)	2013	5.8	13.1	7.2	124.5
Pakistan	2012	10.3	12.1	1.8	17.3

Source: UN/ESCAP.

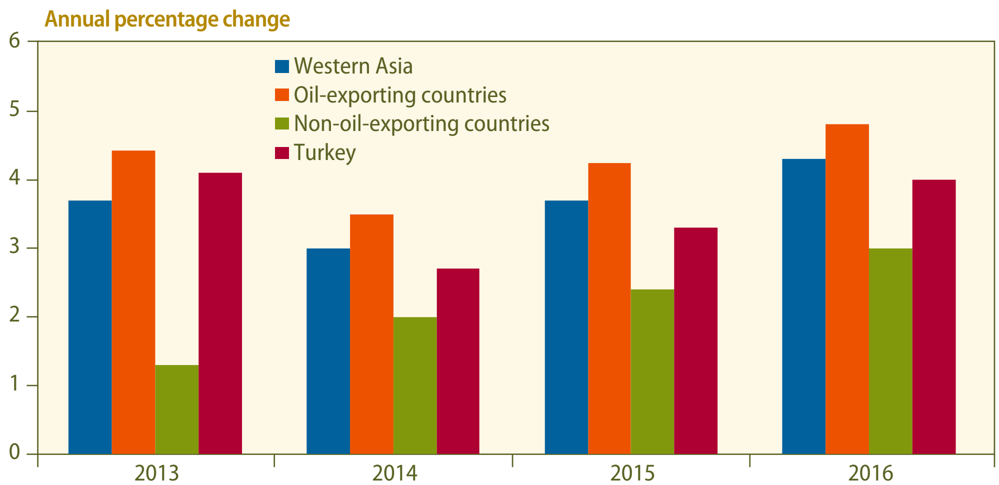
Source: Economic and Social Survey of Asia and the Pacific 2014: Regional Connectivity for Shared Prosperity, ESCAP.

in 2013 to 2.9 per cent in 2014, GDP growth is expected to reach 3.7 per cent in 2015 and 4.3 per cent in 2016. Nevertheless, there are important downside risks to this forecast, in particular if oil prices decline further and if armed conflicts in Iraq and the Syrian Arab Republic escalate.

The Turkish economy is expected to improve moderately in 2015, driven by government spending and exports

In Turkey, the biggest economy in the region, real GDP growth decelerated from 4.1 per cent in 2013 to 2.7 per cent per cent in 2014. The slowdown is mainly due to deceleration of private consumption and investment. Private consumption increased only by 0.4 per cent in the second quarter of 2014, after a 3.2 per cent increase in the previous quarter, compared with 5.1 per cent in 2013. This overall slowdown in private demand largely reflects tighter monetary policy, which started in January 2014 to fight currency depreciation and inflation. In the outlook period, a moderate economic recovery is expected, with GDP growth averaging 3.7 per cent a year in 2015–2016, supported by government spending and stronger external demand, provided that the depreciation of the national currency will continue to help the export sector.

Figure IV.8
GDP growth in Western Asia, 2013–2016



Source: UN/DESA.
Note: Data for 2014 are estimates, data for 2015–2016 are forecast.

Oil-exporting countries will continue to grow faster than non-oil-exporting countries, supported by expansionary fiscal policies

Oil-exporting countries, in particular, member countries of the Cooperation Council for the Arab States of the Gulf (GCC), namely Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates, are expected to continue growing faster than non-oil exporters. Despite lower oil prices, demand from East and South Asia strengthened through increased interregional trade linkages. At the same time, several economies in the region were able to limit the negative impact of the subdued oil sector by increasing fiscal spending and stimulating domestic demand. For instance, Saudi Arabia is expected to register the same GDP growth in 2014 as in 2013. The forecast for this subgroup remains fairly positive, despite expected lower oil prices in 2015. Domestic demand will remain strong, stimulated by ongoing public investment in infrastructure, as many of the countries enjoy sizeable financial reserves to cope comfortably with lower oil prices. Qatar and Saudi Arabia are both expected to register slightly faster GDP growth in 2015, at 6.7 per cent and 4.2 per cent, respectively.

For Iraq, another oil-exporting country, limited data prevent confident assessment of the current economic situation. Despite stable crude oil exports, the collapse of non-oil-sec-

Box IV.7

The impact of the Iraqi crisis on neighbouring countries' current accounts

On 10 June 2014, a powerfully armed militant group, the "Islamic State" in Iraq and the Levant—or ISIL—seized control of Mosul, the main city of Northern Iraq. This incursion marked a major escalation of the armed violence and the beginning of a crisis situation in Iraq, in addition to the conflict in the neighbouring Syrian Arab Republic. By mid-September, 1.8 million Iraqis in need of assistance were internally displaced,[a] amplifying the humanitarian crisis in the region. The Iraqi economy was seriously impacted, particularly in the region of the Kurdish Regional Government, which had been on a stable economic development path—more than any other provincial regions within Iraq. Despite international intervention, the situation has yet to see any concrete political stabilization.

The economic impact of the present crisis has been mostly felt through the disruption of intraregional trade, even though concerns over Iraq's oil-exporting capacity received broader attention. Major transport routes from Turkey and Jordan to Iraq were forced to close for formal commercial activities with few exceptions. For instance, the Syrian Arab Republic and Iraq host truck routes which link the member countries of the Cooperation Council for the Arab States of the Gulf and the rest of Western Asia. As transport routes through the Syrian Arab Republic had already been severed, the closure of Iraqi routes seriously hampered the intraregional trade networks on the ground.

This situation more severely affected neighbouring countries, for which Iraq is one of the most important export markets. While Iraq's exports consist mostly of crude oil[b], the country imports a variety of goods, such as electronic machinery, vehicles, raw materials, and food products, from its neighbouring countries, and has become a growing destination market for exporters in the region. In 2013, Iraq was the largest export destination for Jordan, the second largest for Turkey and the fourth for Lebanon.

Those neighbouring countries have registered sizeable bilateral trade surpluses with Iraq in recent years. Considering the chronic overall current-account deficits in these countries (figure IV.7.1-A), their trade surplus with Iraq has been crucial. In a hypothetical scenario where there had been no bilateral trade with Iraq, the current-account deficit would have widened by 28.9 per cent in Jordan, 18.1 per cent in Turkey and 4.7 per cent in Lebanon in 2013 (figure IV.7.1-B).[c] This shows the extent to which bilateral trade with Iraq is important for the countries' current accounts and balance of payments.

The loss of export earnings from the Iraqi market in 2014 is estimated to reach $360 million for Jordan, $110 million for Lebanon, and $4.5 billion for Turkey. As a result, current-account deficits are estimated to widen by 8.4 per cent in Jordan, 1.7 per cent in Lebanon, and 8.0 per cent in Turkey, compared to the initial forecast values. Although Jordan, Lebanon and Turkey hold sufficient levels of foreign reserves that can be used in case of severe foreign-exchange constraints, weaker external positions make these countries more vulnerable to the increasingly uncertain international financing conditions due to the anticipated normalization of the monetary policy in the United States of America.

a United Nations High Commissioner for Refugees (UNHCR) Iraq, "Operational update: internally displaced persons", 1-15 September 2014, available from http://reliefweb.int/sites/reliefweb.int/files/resources/UNHCR_Iraq-IDP_Update_1-15_Sept_14%5B1%5D.pdf

b The share of oil exports stood at 99.6 per cent in 2013. (Data from ITC Trade Map, based on the UNCTAD COMTRADE database).

c The indicator was calculated with the following formula: (Increase of the current-account deficit in year *i*) = (Current-account deficit in year *i*) - (Net exports to Iraq in year *i*)) / (Current-account deficit in year *i*) x 100. It measures the difference between a counterfactual current-account deficit without trade with Iraq and the actual current-account deficit. Thus, it indicates, ceteris paribus, how much the current-account deficit would deteriorate if there was no bilateral trade with Iraq.

Figure IV.7.1-A

Western Asia: current-account balances in selected countries

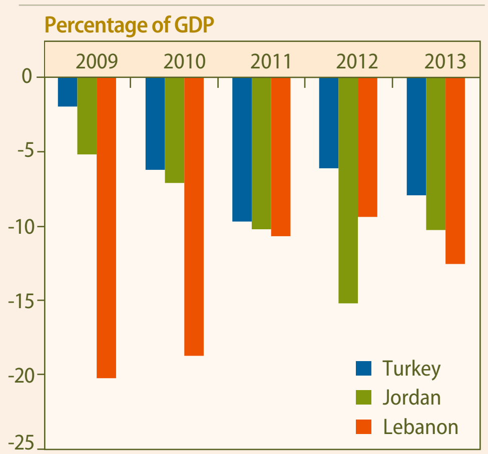
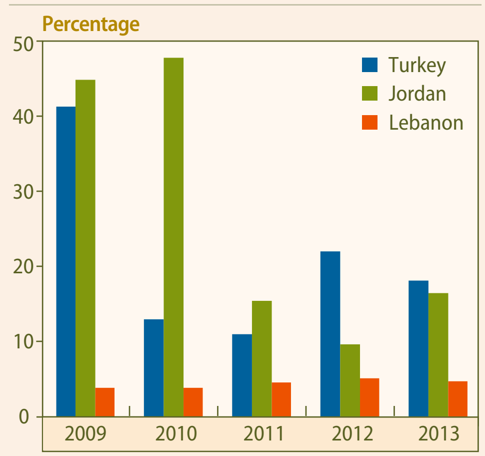


Figure IV.7.1-B

Western Asia: increase of the current-account deficit in selected countries with no bilateral trade with Iraq



Source 7.I-A: UN/ESCWA, based on national official data.
Source 7.I-B: UN/ESCWA.

Source: United Nations Economic Commission for Western Asia.

tor activities due to the expanding conflict areas in the country significantly worsened the economic situation and the standard of living. As a result, the economy is estimated to have contracted by 2.6 per cent in 2014. The ongoing armed conflict will continue to hamper the economy, although GDP growth is projected to be positive in 2015, before picking up more firmly in 2016.

The Iraqi and Syrian conflicts have significant spillover effects, encumbering economic growth in non-oil-exporting countries

Among non-oil-exporting countries, Jordan and Lebanon are experiencing a pace of economic expansion insufficient to accommodate the large influx of refugees from conflict countries in the region. GDP growth is estimated to have accelerated in these two economies in 2014, to 3.5 per cent in Jordan and to 1.8 per cent in Lebanon, driven mainly by strong growth in construction and government spending. In Israel, by contrast, GDP growth decelerated in 2014, partly owing to the conflict in Gaza, but also to lower private consumption and investment. All three countries are expected to see their economies expand at a faster pace during the forecast period.

The intensifying armed violence in the Syrian Arab Republic caused substantial losses of capital stock, hampered private investment activities and depressed growth prospects. Besides the heavy human toll, GDP has been contracting for the past three years, by 3 per cent in 2011, by 30.8 per cent in 2012 and by 37.7 per cent in 2013. As a result, the GDP level in the Syrian Arab Republic at the end of 2013 was about 41 per cent of the level in 2010. A further factor in this context has been economic sanctions. In addition, the continuing influx of Syrian refugees overburdened the economic infrastructures of Jordan, Lebanon and Turkey.

Although labour demand increased in GCC countries, unemployment figures remain high for youth

The stable domestic demand expansion in GCC countries contributed to the increase in labour demand in those countries. In spite of labour nationalization measures taken by some GCC countries, demand for additional labour in the private sector, both in skilled and unskilled categories, resulted in a growing number of immigrants. Despite job growth in the private sector throughout 2014, unemployment figures will remain high for nationals (i.e., the unemployment rates excluding foreign workers), particularly for youth, whose qualifications do not always match with current job opportunities. Moreover, the intensifying armed conflicts in Iraq, Palestine, the Syrian Arab Republic and Yemen forced workers to be either unemployed or economically inactive. The presence of a larger number of refugees is expected to continue during the forecast period, fuelling high unemployment. In addition, labour nationalization in GCC countries is expected to continue at various levels, which may have negative effects for job seekers from Jordan and Lebanon.

Inflationary pressures are well contained in the region, with the exception of a few countries

Reflecting the declining trend in international commodity prices, inflationary pressures were well contained in the region in 2014, with the exception of the Syrian Arab Republic, Turkey and Yemen. In Turkey, despite tighter monetary policy, inflation has trended up, with an anticipated annual increase of 8.9 per cent in 2014, compared with 7.5 per cent in 2013. Yemen's inflation remains in double digits, mainly as a result of fuel and electricity shortages. The average inflation rate for Western Asia increased to 4.7 per cent in 2014 from 4.4 per cent in 2013. During the forecast period, inflation is expected to remain relatively benign as oil and other commodity prices will continue to trend down, and GDP growth will remain modest.

Many countries will continue with loose monetary policies

Turkey introduced a tighter monetary policy stance in January 2014, in order to prevent further currency depreciation and high inflation. Assuming that inflation is going to remain high, the central bank will keep interest rates relatively close to current levels during the forecast period. In GCC countries, growth-supporting monetary policy regimes with historically low policy interest rates continued throughout 2014, mirroring the monetary policy stance of the United States. In non-oil-exporting countries, monetary policy will remain loose, given the anticipated low inflation and modest economic growth. The central banks in Iraq, the Syrian Arab Republic and Yemen placed their policy priority on economic stabilization, aiming to smoothly provide foreign-exchange supplies. Monetary policies in the region will be revised in line with the anticipated interest-rate hike in the United States in 2015, especially in countries where the national currency is pegged to the dollar.

Fiscal balances are expected to weaken in GCC countries

More expansionary fiscal policy is expected in Turkey in 2015–2016. In oil-exporting countries, the fiscal stance is expected to remain expansionary, although less than in previous years, given the sharp decline in oil prices. The forecast oil price of $92 per barrel in 2015 already represents a fiscal breakeven price for several oil exporters in the region. Nevertheless, growth in public expenditure in real terms is expected to continue to be the basis of support for domestic demand expansion in GCC countries. A prudent fiscal policy environment will continue in Jordan, Lebanon and Yemen, where rising government debt is pressuring fiscal balances due to higher interest payments. These countries rely more on foreign aid to carry out public investments.

The current-account deficit in Turkey is expected to improve, whereas in GCC countries surpluses will narrow

The current-account deficit of Turkey is estimated to have narrowed in 2014. This trend is likely to continue during the forecast period, but financing the deficit may become more challenging than in previous years. The trade balance has improved, as exports increased in the first half of 2014 by 8.1 per cent, while imports contracted by 2.1 per cent in the same period. Despite declining oil export revenues, GCC countries, as well as Iraq, are expected to register current-account surpluses in 2014, although narrower than in previous years. The current-account deficits are estimated to edge up in Jordan, Lebanon and Yemen in 2014, mainly owing to a deterioration of exports. In part, the external accounts of Jordan and Lebanon, as well as Turkey, have been affected by the conflict in Iraq (box IV.7). Current transfers, including remittances and foreign aid, partly offset trade balance deficits in non-oil-exporting countries. Despite lower energy and food prices during the forecast period, current-account balances will remain large.

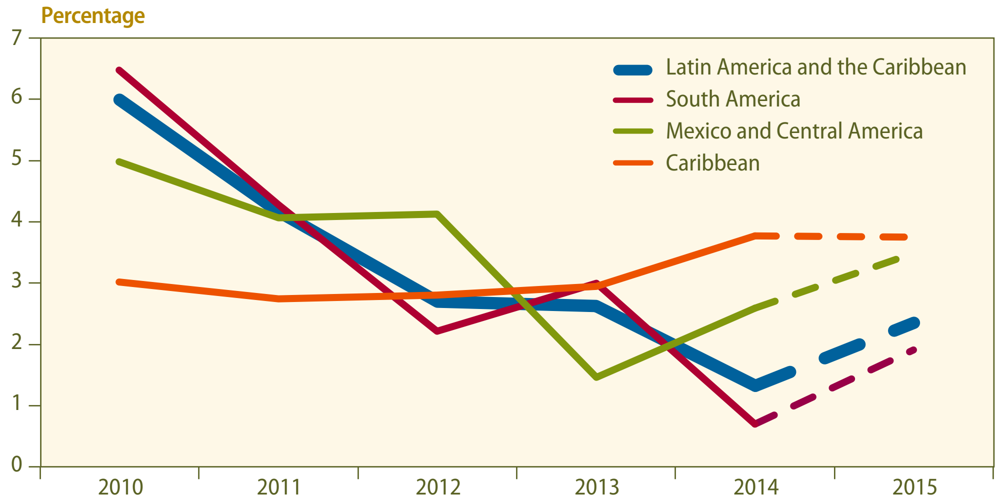
Important downside risks include the expansion of conflict areas and oil prices dropping below an average of $70 per barrel

The outlook is subject to four major downside risk factors. The first factor is the possible expansion of conflict areas in the Syrian Arab Republic and Iraq to other countries in the region. Second, should crude oil prices fall below an average of $70 per barrel in Brent, business confidence in GCC countries would be significantly affected. Third, unanticipated repercussions from monetary tightening in the United States would increase the region's funding costs. Last, any worsening in the growth prospects of Asian economies, such as China, India and the Republic of Korea, will have substantial impact on the region's exports.

Latin America and the Caribbean: moderate recovery expected for 2015, but substantial downside risks remain

Latin America and the Caribbean continues to face challenging economic conditions, amid domestic weaknesses and a less supportive external context, particularly lower commodity prices. After meagre economic growth of 1.3 per cent in 2014, the region is expected to improve moderately to an average growth of 2.4 per cent in 2015 (figure IV.9), although with considerable cross-country differences and significant downside risks. Among the subregions, the economies of Mexico and Central America are forecast to expand by 3.5 per cent in 2015, up from 2.6 per cent in 2014. By contrast, South America is expected to grow by only 1.9 per cent, compared to 0.7 per cent in 2014. The Caribbean economies are expected to expand by 3.8 per cent, similar to 2014.

Figure IV.9
GDP growth in Latin America and the Caribbean, 2010–2015



Source: UN/DESA.
Note: Data for 2014 are partially estimated. Data for 2015 are forecast.

Despite considerable heterogeneity among countries, investment demand in the region is estimated to gradually pick up after a continuing slowdown in recent years (box IV.8), led by the implementation of large public investment projects in countries such as Brazil, Chile and Mexico. Accommodative monetary conditions and supportive fiscal stances are also expected to buttress economic activity in some countries. On the external front, a sustained recovery of the United States is projected to further benefit Mexico and Central America through trade, tourism and remittance channels. The depreciation of national currencies may also contribute to increasing the competitiveness of exports.

Large South American economies continue to face major domestic vulnerabilities

Among the largest countries, GDP growth in Mexico is expected to accelerate from 2.4 per cent in 2014 to 3.4 per cent in 2015, owing to monetary and fiscal stimulus, previous structural reforms and the strengthening of the United States. After barely expanding by 0.3 per cent in 2014, the Brazilian economy is expected to grow modestly by 1.5 per cent in 2015, still affected by major supply bottlenecks. The Bolivarian Republic of Venezuela is expected to remain in recession, amid political turbulence and enduring economic imbalances, including extremely high inflation. Argentina slowed markedly last year and is expected to grow by a lacklustre 0.8 per cent in 2015, while facing a challenging path to contain inflation. After a noticeable slowdown, with GDP expanding by only 1.9 per cent in 2014, Chile's economy is expected to grow by 3.0 per cent in 2015, following a significant stimulus from monetary and fiscal policies. Other economies such as Colombia, Panama, Paraguay and the Plurinational State of Bolivia are projected to continue registering relatively strong economic growth rates in 2015, above 4.5 per cent. In addition, Peru's economy is expected to resume relatively strong growth of 4.9 per cent in 2015, up from 3.2 per cent in 2014, driven by a recovery in investment demand and resilient private consumption.

Despite lower job creation, regional unemployment remains close to record lows

The deteriorating economic conditions significantly reduced job creation, particularly in South American economies. However, unemployment remained relatively low in most countries. Furthermore, regional urban unemployment is estimated to slightly decrease in 2014 compared to the previous year. This trend is driven by a lower participation rate, especially in Argentina, Brazil, Ecuador and Mexico. Meanwhile, progress on improving the quality of employment, as measured by the number of workers covered by contributory social security systems, also decelerated in 2014. Importantly, increases in formal employment have played a significant role in reducing income inequality in the region in recent years. In addition, real wages still increased at a moderate pace in several countries, which, combined with still positive credit growth, sustained a modest rise in household consumption in the region.

Inflation has increased, but unevenly across the region

In 2014, regional inflation moderately increased to an estimated rate of 10.2 per cent, continuing a slow but permanent upward trend that began in mid-2012. However, this trend is highly heterogeneous across subregions and countries. In Mexico and some Central American countries, inflation decreased somewhat and remains relatively stable and low, at about 4 per cent. By contrast, inflation in South American economies accelerated notably, driven by Argentina and Venezuela (Bolivarian Republic of), where inflation in 2014 was about 25 per cent and 68 per cent, respectively, fuelled by the devaluation of their currencies in early 2014. Other countries, such as Brazil and Chile, have also experienced moderate rises in inflation, although at much lower levels. The regional inflation rate is projected to decline slowly, to 8.8 per cent in 2015 and 7.0 per cent in 2016.

Several countries have loosened monetary policy in order to promote economic activity

Across the region, monetary policy is facing the dual challenge of reinvigorating growth while containing inflation pressures, amid the normalization of monetary policy in the United States. Some countries have opted to ease their monetary conditions, such as Chile, Mexico and Peru. By contrast, Brazil has significantly increased interest rates to tackle persistent inflation pressures, further affecting subdued economic activity. Colombia also tightened its monetary stance in the second half of 2014, while some Central American economies tended to reduce the expansion of their monetary base. Given that inflation rates remain above official targets and that real interest rates are already low—or even negative—in some economies, the monetary policy space will be relatively restricted in the case of worsening economic conditions. Meanwhile, domestic lending in the region continued to grow, albeit at lower rates than in recent years. In particular, domestic lending to the private sector slowed in economies that are more integrated in international financial markets, as well as in some Central American economies. However, public bank lending expanded markedly in countries such as Brazil, Ecuador, Mexico, Panama and Peru as authorities sought to stimulate domestic demand.

Fiscal policies are moving to a more supportive stance, but policy space is narrowing

Given the economic slowdown, several countries, such as Chile, Mexico and Peru, are implementing more proactive fiscal policies and have announced sizeable infrastructure programmes and public-private partnership initiatives. Overall, the region's fiscal balance in 2014 is estimated to have reached a deficit of 2.5 per cent of GDP. Thus, regional fiscal balances have noticeably deteriorated, by about 3 percentage points, compared to the situation before the financial crisis, narrowing the policy space for countercyclical policies. Moreover, the general trend towards stable fiscal revenues and increasing expenditures poses a challenge for the fiscal accounts over the medium term, increasing pressures for fiscal discipline in some cases.

Access to external financial markets remains positive

Overall, financial conditions remain positive in the region, including favourable access to external financial markets and relatively strong though volatile capital flows, particularly portfolio bond inflows. Meanwhile, international reserves grew slightly in 2014, with considerable heterogeneity between countries. The economies of the Dominican Republic and El Salvador posted significant increases in reserves, while in Brazil, Mexico, Paraguay and Uruguay, international reserves augmented, although at lower rates. The slower build-up of international reserves at the regional level also reflected their use as a tool to reduce exchange-rate volatility. By early 2014, the central banks of Costa Rica, the Dominican Republic, Peru and Trinidad and Tobago had actively intervened in foreign-exchange

Box IV.8

The recent investment slowdown in Latin America

During the boom years of 2004 to 2008, investment in Latin American countries witnessed a strong recovery, after relatively low growth rates from 1999 to 2003. In the later period, regional investment grew steadily at two-digit levels, with an annual average growth rate of 10.7 per cent. This brought the regional investment rate to almost 22 per cent of gross domestic product (GDP) in 2008. The sharp increase in investment during this period mainly reflected the rise in investment in machinery and equipment. This rise was prompted by strong demand for commodities, robust domestic economic activity and decreasing prices for capital goods in terms of national currency, given the exchange-rate appreciations that prevailed during these years. Real investment in construction increased at an annual average rate of 7.4 per cent over the same period. This can be traced, in part, to rising investment in the retail sector, due to the sustained increase in household consumption. Investment in the residential sector also increased, owing to enhanced access to housing credit and higher incomes resulting from improved labour market indicators. In addition, strongly improved terms of trade contributed to increased national savings in many countries, which translated into higher availability of domestic resources to finance investment and to lower dependency on external financing. Add to this the enhanced access of most Latin American countries to external financing, at lower costs and longer maturities.

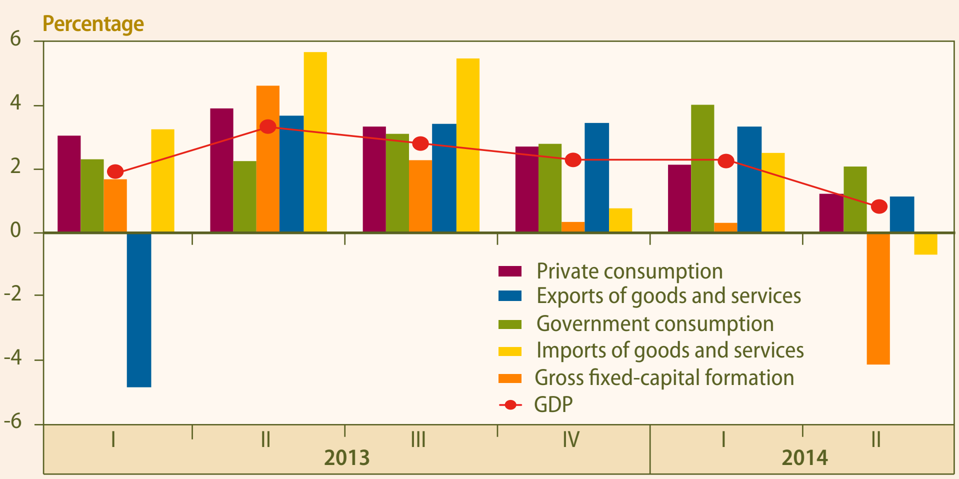
However, after the sharp post-crisis decrease in investment rates in 2009 and the subsequent rebound in 2010, investment growth in the region has slowed. While in 2011 regional gross fixed-capital formation increased by 8.9 per cent, average regional investment growth declined significantly to 2.6 per cent during 2012–2013. Despite this aggregate trend, the performance of investment at the country level has been heterogeneous. As of 2013, in South American countries, such as Argentina, Brazil and Venezuela (Bolivarian Republic of), investment rates (relative to GDP) were still lower than in 2008, while in the Plurinational State of Bolivia, Colombia, Ecuador and Peru, they were 3 to 4 percentage points higher. This heterogeneity can also be found in Mexico and Central American countries. After the sharp decrease in investment rates in 2009, investment has been growing at a slow pace; with the exception of Costa Rica and Panama, investment rates in 2013 were still below pre-crisis levels.

The downward trend in investment growth spread throughout the region during 2014, but the heterogeneity across countries remains present. In 2014, Argentina, Brazil, Chile, Mexico and Venezuela (Bolivarian Republic of) registered very low or negative growth rates; in the Plurinational State of Bolivia, Colombia and Panama, investment kept growing at relatively high rates, albeit lower than in 2013. Therefore, the regional investment rate is expected to decrease further in 2014 compared to 2013 (figure IV.8.1).

Figure IV.8.1

Growth of GDP and aggregate demand components in Latin America, 2013 Q1–2014 Q2

Year-on-year-growth rate, constant 2005 dollars



Source: UN/ECLAC, based on official data.

(*continued*)

Box IV.8 (*continued*)

Investment in machinery and equipment is the main contributor to this decline throughout the region, as imports of capital goods have noticeably contracted. The dynamism of the construction sector has also declined at a fast pace in many economies.

The recent investment slowdown is the result of various factors. For instance, expected lower external demand for commodities coupled with higher operating costs has impacted investment in big mining projects, particularly affecting countries that are specialized in the production and exports of minerals and metals, such as Chile and Peru. The culmination of big investment projects in the mining sector in Peru and in infrastructure in Panama adds to this slowdown. In addition, expectations of weak economic activity and, in some cases, financial constraints have been relevant in countries such as Argentina, Brazil, Ecuador and Venezuela (Bolivarian Republic of). The external context has had an unequal impact on Latin American countries, depending on their exposure to commodity prices, financing needs and policy space to implement countercyclical measures. In some cases, uncertainty about economic policies has further dampened investment.

Investment is expected to pick up for 2015 in several countries, but will grow below the pace seen during 2004–2008. In Mexico, the approved reforms should have a positive impact on investment in the oil and energy sector, while in Chile, local authorities have announced a large infrastructure investment programme. In Brazil, oil and infrastructure concessions and the preparation for the Olympic Games in 2016 are expected to contribute to an investment recovery. In Peru, sustained growth of domestic consumption should support investment in the retail and services sectors.

Source: United Nations Economic Commission for Latin America and the Caribbean.

markets while the Central Bank of Brazil extended the daily currency swap programme introduced in mid-2013. A number of economies have also implemented macroprudential measures to improve regulation and oversight of the financial sector and adjust their management of reserves and capital flows, such as Argentina, Brazil, Colombia, Peru and Trinidad and Tobago.

The pattern of stagnating and gradually falling prices for a number of the region's export commodities continued in 2014. As a result, the terms of trade deteriorated, albeit to varying degrees depending on a country's export structure. Overall, the current-account deficit in 2014 remained at about 2.7 per cent of GDP. Among the subregions, exports and imports increased more strongly in Mexico and Central America. By contrast, exports and imports in South America remained subdued owing to lower external demand, the fall in investment and the slowdown in household consumption. As in previous years, relatively robust FDI inflows, and to some extent bond inflows, continued to play a key role in financing current-account deficits.

A further slowdown in China remains a major risk for the region

There are several downside risks to the regional outlook. On the external front, the major risks are related to a larger-than-expected growth decline in China and thus further reductions in commodity prices, and the potential financial spillovers from the normalization of the monetary stance in the United States, which might reduce even further the policy space to reinvigorate investment and growth. A continuous decline in China's growth would be particularly adverse for commodity exporters in South America, affecting not only external demand and investment prospects but also fiscal positions in several economies.

On the domestic front, large South American countries are facing the challenge to restore economic momentum through coordinated fiscal, monetary, exchange rate, macroprudential and structural policies. For instance, recent structural reforms and infrastructure concession programmes in several countries are expected to generate benefits in the medium term. However, implementation problems or lack of coherence with other policies might derail the investment recovery. Overall, the prevailing internal and external conditions highlight the relevance of additional efforts on the reform agenda to tackle structural constraints and of proactive policies to boost productivity growth and promote the diversification of the productive structure.