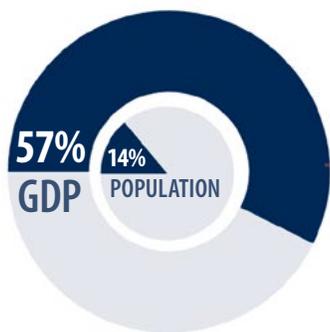




## Snapshot: Developed economies

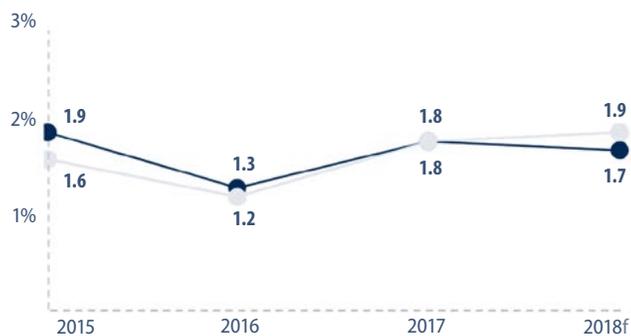


Share of the world

### GDP growth



### GDP per capita growth



### GDP per capita



DEVELOPED ECONOMIES  
WORLD

## Chapter III

# Regional developments and outlook

## Developed economies

### United States: Stronger growth supported by an improvement in business investment

Following an estimated growth of 2.2 per cent in 2017, the United States of America is forecast to expand at a steady pace of 2.1 per cent in both 2018 and 2019. This marks a significant improvement compared to the 1.5 per cent growth recorded in 2016. The acceleration largely stems from shifting dynamics in business investment and, to a lesser extent, net trade.

Steady growth in the United States is underpinned by a sustained pace of expansion in household spending, estimated at 2.6 per cent in 2017, following growth of 2.7 per cent in 2016. However, over the same period, real personal disposable income growth averaged a mere 1.1 per cent. This indicates that consumers have drawn down savings in order to sustain expenditure growth, resulting in a deterioration of the savings rate by nearly 3 percentage points since 2015. In late 2017, household savings stood at 3.4 per cent of disposable personal income, compared to an average of 5.6 per cent since 1990.

Over a longer-term perspective, since 1940, the only other time when the household savings rate dropped below 4 per cent was just prior to the global financial crisis, when household spending was buoyed by excessive optimism and overinflated asset prices. Given that consumer spending cannot be financed indefinitely by a continued drawdown in savings, sustained strength in household demand going forward will depend on firmer growth in real disposable income.

The recent deterioration in savings raises concerns over whether the growth in household spending has been fuelled by inflated asset prices. House prices in the United States are nearly as high today as they were at the peak of the housing market bubble in 2006–2007 (figure III.1), which ultimately acted as one of the triggers of the global financial crisis. Underlying fundamentals in the housing market, however, are more closely aligned with house prices than they were in 2006–2007.

The level of investment in housing remains nearly 15 per cent below pre-crisis peaks. Household indebtedness also remains below previous peaks due to a significant deleveraging process, although it has been on the rise since 2013. Mortgage delinquency rates continue to decline, and house prices, when viewed relative to income, remain well below pre-crisis levels (figure III.1). Collectively, these indicators suggest that the housing market does not pose an immediate threat to financial stability, but nonetheless merits monitoring over the forecast period. Further deterioration in household savings, combined with a rise in debt, could signal a buildup of excessive leverage in the household sector.

Despite strong job creation, growth in real personal disposable income has remained weak in the United States. This highlights the weak growth of average wages, which in part reflects stagnant wages at the lower end of the wage spectrum, resulting in a rise in the ratio of mean-to-median wages (figure III.2). The most recent data suggests that wage inequality

**Stable household spending sustained at the cost of depleting savings**

**House prices approach pre-crisis levels, but supported by stronger fundamentals**

**Wage inequality increased while unemployment rate declined**

**Labour market conditions have tightened**

may have started to improve slightly, although it is premature to identify this as a trend. Going forward, stronger wage growth among lower income earners would help to sustain solid household spending growth, as those on the lower-end of the income scale tend to consume more from current income.

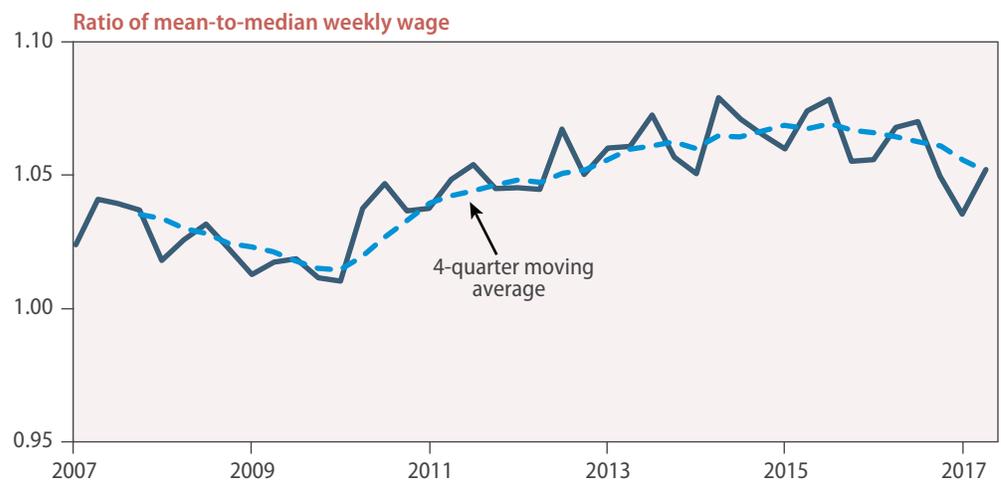
In mid-2017, the unemployment rate in the United States declined to its lowest level since 2001, and is hovering below what is considered its long-run equilibrium level. Nevertheless, pockets of higher unemployment persist in certain sectors and regions of the country. In addition, labour force participation rates of workers over the age of 55 have declined significantly since the global financial crisis. Notwithstanding these prevailing weaknesses, overall labour market conditions have clearly tightened. Given the forecast for steady GDP growth, the tighter labour market is expected to exert some upward pressure on wages in 2018, especially for lower-paid jobs. This should help redress the recent rise in wage

**Figure III.1**  
**House prices in the United States**



Source: UN/DESA, based on data from BIS Residential Property Price Database, U.S. Bureau of Economic Analysis, Table 2.1.

**Figure III.2**  
**Wage inequality in the United States**



Source: UN/DESA, based on data from U.S. Bureau of Labor Statistics, Current Population Survey and Current Employment Statistics.

inequality. Shifts in income tax brackets and standard deductions expected in the 2018 budget<sup>1</sup> may partially offset any improvement in after-tax wage inequality, as independent estimates indicate that the bulk of tax relief would be directed towards households with the highest incomes (Tax Policy Center Urban Institute and Brookings Institution, 2017).

The core inflation measure closely monitored by the Federal Open Market Committee (FOMC) of the Fed averaged about 1.6 per cent in 2017, drifting slightly downward from March. This did not deter the FOMC from forging ahead with its balance sheet normalization plan in October 2017 (see further discussion in chapter II). Inflation is expected to rise towards the Fed target of 2 per cent over the course of 2018, contingent on an acceleration in wage growth.

Non-residential investment saw a relatively broad-based revival in 2017, after contracting by 0.6 per cent in 2016. The rise in equipment investment, which accounted for 40 per cent of investment growth in the first three-quarters of the year, is particularly encouraging, as it lays the foundation for a revival in productivity growth.

While the United States' proposed infrastructure plan to support \$1 trillion in infrastructure investment has not yet gained traction, a recovery in external demand coupled with expectations for stable domestic growth will continue to support moderate investment growth into 2018. Planned cuts to corporation tax may also encourage investment. However, lingering uncertainties regarding future trade relationships and the withdrawal of monetary stimulus are likely to hold back a more robust rebound in investment activity over the forecast horizon.

### Canada: Sharp growth acceleration in 2017

GDP growth in Canada is estimated to have reached 3 per cent in 2017, placing the country among the fastest growing developed economies. The acceleration in growth was supported by fiscal stimulus measures, coupled with a sharp rise in household consumption and some revival in business investment. As in the United States, more than 40 per cent of Canada's business investment growth in the first half of 2017 was driven by investment in machinery and equipment, in particular computing equipment and transportation vehicles. (figure III.3). If sustained, the reorientation of investment towards machinery and equipment has the potential to underpin stronger productivity growth over the medium term.

The recent surge in consumer spending is partly attributable to strong gains in housing wealth. Canada's housing market was relatively unscathed by the global financial crisis, and house prices have continued to rise steadily nationwide, with particularly strong gains in cities such as Toronto and Vancouver. While mortgage arrears remain very low, the outstanding stock of residential mortgages has doubled in size since 2006. This prompted policymakers to introduce measures to moderate demand in major cities. These measures include a higher property-transfer tax on some non-resident investors, as speculative demand from foreign investors has partly driven house price growth in some large cities. By mid-2017, growth in housing starts had begun to moderate.

The Bank of Canada is expected to continue to withdraw monetary stimulus from the economy, following interest rate rises of 25 basis points in both July and September 2017, pointing to further moderation in the housing market next year. As consumer spending becomes more closely aligned with income, GDP growth in Canada is forecast to moderate to 2.2–2.3 per cent per annum in 2018 and 2019.

**Rise in inflation towards central bank target contingent on acceleration in wage growth**

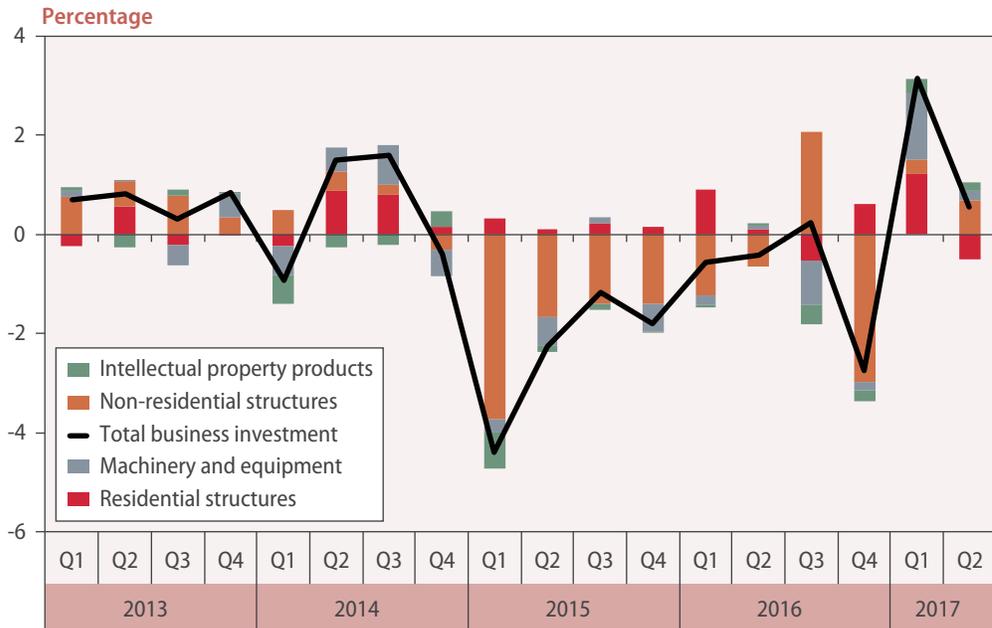
**Recovery in equipment investment lays foundation for a revival of productivity growth**

**Canada among the fastest growing large developed economies in 2017**

**Housing market expected to moderate in 2018**

<sup>1</sup> See <https://www.whitehouse.gov/the-press-office/2017/09/27/unified-framework-fixing-our-broken-tax-code>

Figure III.3  
Decomposition of investment growth in Canada



Source: Statistics Canada, Table 380-0068.

### Japan: Domestic demand growth leads the economic expansion

Economic growth in Japan accelerated to unexpectedly high levels in 2017, with GDP growth reaching an estimated 1.7 per cent. The robust economic growth is prompted by the continuously accommodative macroeconomic policy stance, and is led by a rapid expansion of domestic demand. Steady external demand growth from Asia and North America also contributed to the growth.

**Exceptional growth momentum of 2017 expected to taper off**

The present momentum is expected to taper off over 2018 and 2019, as the impact from fiscal stimulus measures ease. GDP is forecast to grow by 1.2 per cent in 2018 and 1.0 per cent in 2019. Consumer price inflation is estimated at 0.3 per cent in 2017, well below the Bank of Japan’s (BoJ) inflation target of 2 per cent. Nevertheless, consumer price inflation is projected to rise to 1.4 per cent in 2018, and 1.8 per cent in 2019, due to upward pressure on wage levels as well as the proposed sales tax hike in October 2019.

**Monetary and fiscal policy stance in Japan remains accommodative**

Despite the Government’s commitment to fiscal consolidation, particularly to lowering its debt dependency, the fiscal policy stance remained accommodative in 2017. The implementation of public investment projects introduced in the supplemental budgets in the 2016 fiscal year provided a significant stimulus to Japan’s economic expansion over the first half of 2017.

The BoJ has continued to maintain a set of unconventional monetary easing measures — Quantitative and Qualitative Monetary Easing (QQE) — and is committed to using the balance sheet to expand the monetary base at the present pace. However, compared to the speed of monetary base expansion, the growth of broad money stock remains sluggish. The year-on-year growth rate of broad money stock, M2, has only gradually accelerated and reached the 4 per cent mark in February 2017 for the first time since August

2015. Nevertheless, the recovery in broad money growth reflects an accelerated growth in bank lending, particularly for investment purposes.

Through its intervention, the central bank effectively set an upper bound on the 10-year Japanese Government Bond (JGB) yield at 0.1 per cent. The BoJ asserted controls over rising yields in the market in February 2017 and July 2017 by announcing fixed-rate purchase operations. This intervention measure, known as the Yield Curve Control component of QQE, resulted in a widened yield spread between 10-year JGB and United States Treasury bonds. Over the first nine months in 2017, the yield spread averaged 226 basis points, up by 37 basis points from the 2016 average. This intervention has helped stabilize the value of the Japanese yen against the US dollar. The yen/dollar exchange rate was around 112 for the first nine months in 2017. In 2016, the exchange rate fluctuated between 121 and 100.

Japanese industrial operating profits were strengthened by competitiveness gains related to the lower value of the Japanese yen (figure III.4). Industrial production continued to grow in 2017, albeit at a moderate pace. Estimates for inventories in the second quarter of 2017 signalled the start of an inventory buildup phase, which may last until mid-2018. Rising industrial production, inventory accumulation, and profit growth will support the growth momentum into the first quarter of 2018.

While consumer confidence improved during the first half of 2017, growth in household expenditure was held back by low growth in average real wages. Japanese labour markets have been in a paradoxical phase since 2011. The decline in the unemployment rate has coincided with a decline in the real wage rate (figure III.5). However, the real wage level bottomed out in 2016. The labour market has tightened, as the unemployment rate reached 2.8 per cent in July 2017, the lowest level since 1994. In light of the robust growth in industrial operating profits, real wages will likely come under increasing upward pressure in the coming quarters.

The main downside risk for the Japanese economy in the short run is an abrupt appreciation of the Japanese yen. Since the current exchange rate has been bolstered by the BoJ's intervention, abandoning its yield curve control measure, for either financial or political reasons, could lead to a rapid appreciation of the yen. This would reduce competitiveness, restrain industrial operating profits, and reverse progress towards defeating deflation, all of which would drive GDP growth down.

Japan also faces structural challenges that weigh on its potential growth. These include a declining population and persistently high public debt, with limited room to expand tax revenue.

## Australia and New Zealand: More expansionary fiscal stance supports outlook

Australia and New Zealand both posted solid economic growth in 2017, estimated at 2.8 per cent and 2.5 per cent, respectively. In 2018, GDP growth is expected to reach 3 per cent in Australia and 2.9 per cent in New Zealand, supported by a more expansionary fiscal stance and solid consumer spending in both countries. While investment in Australia will be driven by a booming housing market, the housing cycle in New Zealand has started to turn, after house prices increased by more than 20 per cent compared to early 2015. Residential construction activity in New Zealand has slowed, and is expected to remain soft in 2018–2019.

**Yield curve control has helped stabilize the currency**

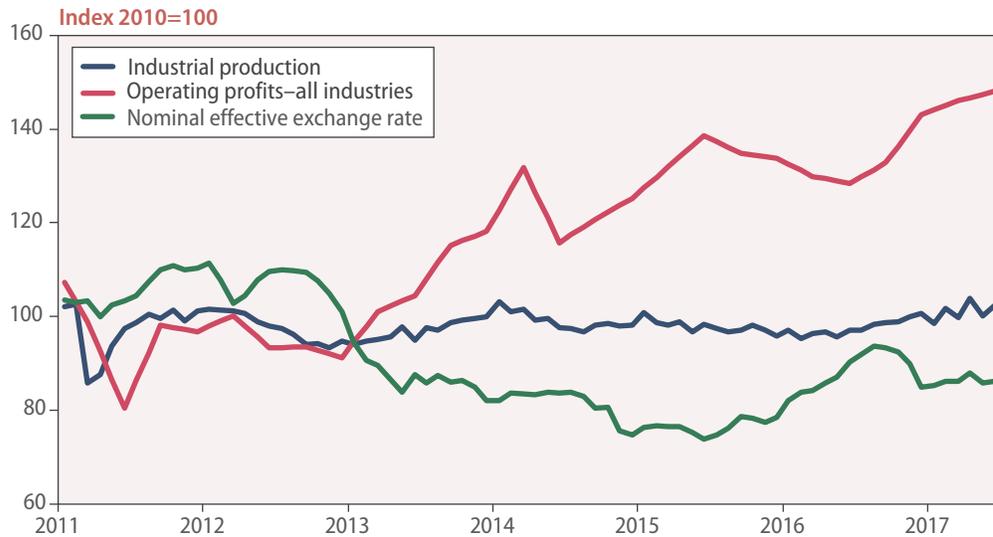
**Competitiveness gains drive stronger profit growth**

**Real wage growth remains weak, but will come under increasing upward pressure**

**Risks to the outlook include a sharp appreciation of the yen**

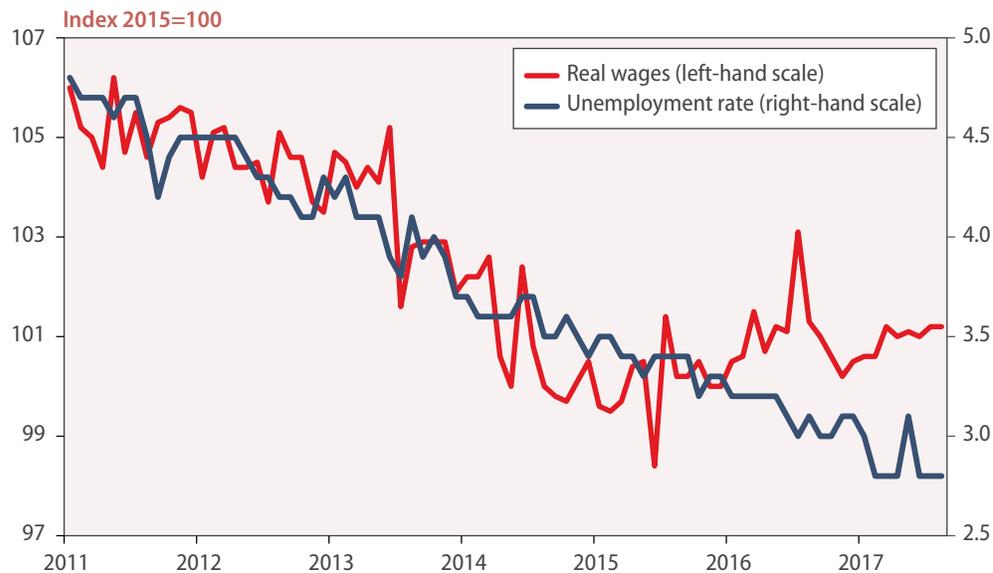
**Housing market cycle has turned in New Zealand, but risks of an abrupt adjustment in Australia remain**

**Figure III.4**  
**Industrial production and operating profits in Japan**



Sources: Japan Ministry of Economy, Trade, and Industry; Bank of Japan.

**Figure III.5**  
**Unemployment rate and real wages in Japan**



Sources: Japan Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare.

As in Canada, both Australia and New Zealand have introduced several measures to restrict the role of speculative non-resident investors in the housing market. Nevertheless, house prices in Australia have continued to rise steadily and residential investment is projected to remain strong. The Reserve Bank of Australia has warned that some borrowers, especially those with lower income, may struggle to meet mortgage payments when interest rates rise from their prevailing low rates. While adjustment in the housing market may unfold gradually, there is a risk that Australia will experience an abrupt turn in the housing cycle, driving a sharp slowdown in economic growth.

## Europe: Robust growth amid continued policy challenges

Economic activity in Europe remains robust, with real GDP growth forecast to reach 2.1 per cent in 2018. Household consumption will remain a major contributor to growth, underpinned by rising disposable incomes, falling unemployment, further upward pressure on wages and the continued low level of interest rates. The expansionary monetary policy stance will also continue to underpin business investment and construction activity. Nevertheless, the European Central Bank (ECB) decision to taper the pace of its asset purchases and eventually cease expansion of its balance sheet will have some dampening effect, contributing to a slight downtick in growth to 1.9 per cent in 2019.

This overall solid aggregate growth trajectory encompasses several economies with markedly higher growth rates. For example, Spain is forecast to see growth of 2.6 per cent in 2018 and 2.4 per cent in 2019, driven by private consumption, fixed investment — especially in construction and machinery — and solid external demand, including tourism.

A similar combination of solid domestic and external demand will drive growth in Ireland, with a growth forecast of 2.8 per cent and 3.1 per cent for 2018 and 2019, respectively. By contrast, Italy will register the lowest growth in the region, with 1.4 per cent and 1.1 per cent in 2018 and 2019, respectively. Slow employment growth and weak consumer sentiment related to political uncertainty will hinder private consumption growth, while weak public investment and limited access to bank lending will cap fixed investment.

In the United Kingdom of Great Britain and Northern Ireland, growth will decelerate to 1.4 per cent in both 2018 and 2019, as the economy will face increasing pressure from the effects of the decision to leave the EU. The weaker pound sterling has contributed to the rise in import cost pressures while taming domestic demand. At the same time, business investment is suffering from significant uncertainty regarding the future framework for the economic relations of the United Kingdom with the EU and the rest of the world. This includes, in particular, the looming loss for businesses located in the United Kingdom of the right to operate in EU member countries under the umbrella of unified EU regulations.

The outlook for Europe is subject to several downside risks. Negotiations over the exit of the United Kingdom from the EU remains a major source of uncertainty. Any negative surprises or perceived increase in the probability of a negotiation failure would further crimp business investment in the United Kingdom. In terms of euro area economic policy, the ECB has already shifted its policy stance by reducing the amount of its monthly asset purchases. Implementing the further reduction in its stimulus will be challenging in terms of both its precise design and communication to the public, creating important risks for actual or even perceived policy missteps.

In the area of fiscal policy, the euro area's lack of a stronger and more coherent institutional underpinning will remain a major weakness. The continued excessive reliance on targets for budget deficits leaves open the problem of enforceability and the risk of renewed tensions between member states, especially if there is a new economic downturn.

International trade will remain a major driver of growth for Europe. The overall positive economic trends within the region in terms of falling unemployment rates, rising incomes, stronger consumption and solid consumer and business confidence will lead to a continued strong expansion of trade between EU member states. In addition, steady expansion in other major global export markets such as the United States and China will also underpin solid external demand. Despite this positive baseline forecast, the trade trajectory for Europe will face a number of headwinds.

**Private consumption is a major driver of solid economic growth**

**Spain and Ireland will lead growth performance in the European Union, while Italy and the United Kingdom will see slower growth rates**

**Downside risks include Brexit and economic policy**

**Both intra-EU trade and global demand will support growth**

A major challenge for exporters lies in the appreciation of the euro against the US dollar, which makes European exports more expensive abroad and, thus, less competitive. However, past episodes of currency appreciation showed the capacity of many exporters to absorb the negative effects of a stronger currency by increasing their productivity or by using their pricing power based on quality and the provision of niche products. Second, negotiations over exact procedures for the exit of the United Kingdom from the EU not only create major uncertainties, but could also spark negative economic shocks if negotiations fail. Third, stronger protectionist tendencies in the global arena would kindle significant downside risks, especially for the heavily export-oriented sectors and companies in Europe, including many small and medium-sized enterprises.

**Aggregate unemployment has been declining, but remains elevated in several economies**

Against a backdrop of solid economic growth, unemployment has been on a downward trend across the EU, with the overall unemployment rate declining to 7.5 per cent in September 2017 compared to 8.5 per cent in the previous year. This solid aggregate trend masks significant dispersion among national labour markets. The Czech Republic, Germany and Malta registered the lowest unemployment rates, with 2.7 per cent, 3.6 per cent and 4.1 per cent, respectively. By contrast, unemployment was the highest in Greece, Spain and Italy, with rates of 21.0 per cent (July 2017), 16.7 per cent and 11.1 per cent, respectively, and stood at around 10 per cent in Croatia, Cyprus and France.

Youth unemployment remains a serious challenge. It reached 16.6 per cent EU-wide in 2017, and exceeded 35 per cent in Greece, Italy and Spain. Although employment should be boosted by the robust economic forecast, the spillover effects of this boost will not be fully exploited unless policymakers take action, for example, to reduce skill mismatches.

**Drastic technology shifts could fundamentally change the automotive supply chain, with significant consequences for employment in some economies**

In various European economies with significant automotive sectors such as the Czech Republic, Germany and Slovakia, drastic technology shifts in the automotive industry — tied to electric vehicles and autonomous driving — will cause significant economic and employment impacts. Notably, any meaningful adoption of electric vehicles stands to revolutionize the automotive supply sector, as entire subsystems and components needed for conventional engine technology will not be required anymore. While new technologies, including those linked to battery technology or autonomous driving, will create new opportunities in the automotive supply chain, this would still involve significant structural changes, for example regarding the skill profile of the workforce.

**The solid macroeconomic picture will lead to further increases in inflation**

Inflation in Europe has been on an upward trend and has remained solid. This is true even after the one-off effects from lower oil prices fade. The aggregate inflation rate is forecast to increase from 1.6 per cent in 2017 to 1.8 per cent in 2018, with a further acceleration in inflation to 2.1 per cent in 2019. A number of factors are driving this price trajectory.

In the United Kingdom, the still lingering effects of the depreciation of the pound sterling in 2016 has pushed up import prices, leading to inflation forecasts of 2.5 per cent and 2.9 per cent for 2018 and 2019, respectively. Unemployment has decreased in numerous economies, with some regions experiencing labour market conditions equivalent to full employment and real wages showing some solid increases, which, in turn, will underpin private consumption. On the other hand, the sharp appreciation of the euro against the dollar during 2017 will exert a moderating effect on inflation on the import side.

**Monetary policy has reached a turning point**

The ECB monetary policy stance has in large part driven financial market movements in 2017. The ECB reduced the amount of its monthly asset purchases, albeit with an extension of the purchase programme, and adjusted the language in its policy guidance by dropping the reference to possibly lower interest rates. These hints of a reduction in the

monetary policy stimulus and some expectations of more pronounced moves by the ECB in this direction helped to support the sharp increase in the value of the euro against the dollar during 2017 (figure III.6) and underpinned higher yields on euro area benchmark bonds.

Notably, the yield on the German 10-year bond reached almost 0.60 per cent in July 2017, compared to around -0.19 per cent in the previous year. In view of robust economic growth and inflation trends, the elevated levels of consumer and business confidence indices, as well as the extremely loose current monetary policy stance, the ECB is likely to initiate additional steps to remove some of its stimulus in 2018. This includes further guidance on its path for reducing asset purchases, which are expected to continue until at least September 2018. Guidance regarding interest rate normalization may also be announced, which will begin well past the end of the asset purchase programme. At the same time, the ECB is expected to continue reinvesting maturing asset holdings for an extended period of time, bolstering support for financial markets.

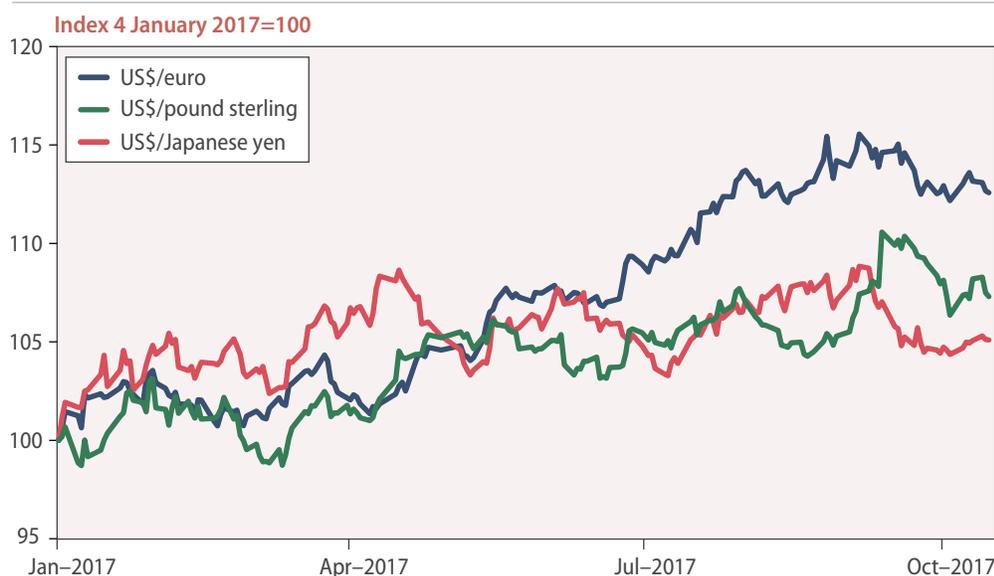
Rising inflation pressure also underpinned an increase in interest rates by the Bank of England in November 2017, with policymakers stating that further interest rate hikes may be required.

Fiscal policy will have a less negative impact on growth compared to recent years that have been marked by fiscal consolidation. The implemented fiscal adjustments have led to measurable improvements in fiscal budget positions. In 2016, only France and Spain exceeded the EU limit for budget deficits of 3.0 per cent of GDP by registering a deficit of 3.4 per cent and 4.5 per cent, respectively.

A number of countries, like Austria and Germany, will increase fiscal spending to integrate a large number of migrants. However, fiscal policy space will remain limited in the EU as a whole, with the aggregate debt-to-GDP ratio standing at 86 per cent and Belgium, Cyprus, France, Greece, Italy, Spain and Portugal featuring debt-to-GDP ratios around or in excess of 100 per cent. The current low level of interest rates reduces the costs

**Fiscal policy will have a less negative impact on growth**

Figure III.6  
Major developed market currencies' exchange rates against the US dollar



Source: IMF Exchange Rate Query Tool.

Note: A rise indicates an appreciation.

of servicing these debts, but the turn in monetary policy towards a normalization of interest rates points to higher levels of fiscal spending on servicing public debt in the future.

In the United Kingdom, the budget deficit will reach around 3.5 per cent of GDP in 2018. Fiscal policy will remain under pressure from the effects created by the decision to leave the EU. In the course of this process, the United Kingdom has to reorganize public support mechanisms and financial flows in a plethora of policy areas, and undertaking this administrative exercise alone already entails a major fiscal cost.

Economic growth in the EU members from Eastern Europe and the Baltic States continues to outpace the EU average, thanks to capital accumulation and productivity gains. The aggregate GDP of the group of EU-13 countries, which also includes Cyprus and Malta, is estimated to expand by 4.2 per cent in 2017, 3.6 per cent in 2018 and 3.5 per cent in 2019. As in 2016, Romania will remain the fastest-growing European economy over the forecast horizon, with GDP growth projected to approach 6 per cent in 2017.

The expansion in the EU-13 in 2017 has been largely driven by the robust export performance of the manufacturing sector in Eastern Europe, and also a recovery of investment following the earlier slump (in particular, in construction activity) in 2015–2016 that was related to the interval between EU funding cycles.

Private consumption has also contributed notably to growth, supported by a surge in nominal wages amid tight labour market conditions. The Czech Republic in 2017 had the lowest unemployment rate in the EU, and in a number of countries, including Hungary, Poland and Slovakia, the unemployment rate has declined to record low levels. A rapid expansion in private credit, as well as an increase in social transfers also supported growth in some countries.

There are signs that some EU-13 economies may be operating above potential, as reflected in the accelerating inflation — from negative or near zero figures in 2015–2016, inflation surged to around 2 per cent in most EU-13 countries and exceeded the target in the Czech Republic by almost 1 percentage point, prompting the central bank to become the first in the EU to start a gradual monetary tightening in 2017. In Lithuania, inflation accelerated to an alarming 4.8 per cent at the end of 2017.

Consumption-driven growth and rising private debt may hide numerous risks. The rising housing prices across Eastern Europe, and the increased exposure of the financial sector to housing loans raise concerns about the emergence of another housing bubble similar to the pre-2008 period.

Although the positive growth differential between the EU-13 countries and the rest of the EU is expected to remain, the current strong growth may not be sustainable in the medium term. In some countries, the outflow of labour to their richer EU counterparts is constraining further capacity expansion. The projected slowdown in 2018–2019 also reflects expectations of a mild fiscal tightening and weaker private consumption in response to the higher inflation.

**Economic growth in the EU members from Eastern Europe and the Baltic States continues to outpace the EU average**

**Robust exports, investment and private consumption have been major drivers of growth**

**Some economies of the EU-13 may be operating above potential**

**Labour outflow, fiscal tightening and inflation likely to constrain growth**

## Snapshot: Economies in transition



Share of  
the world

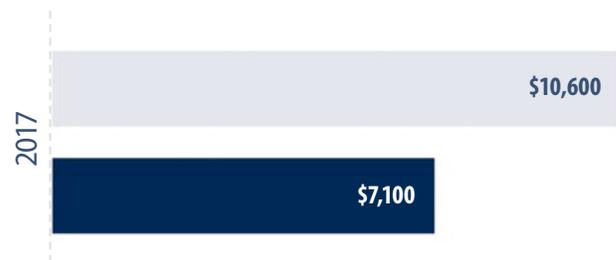
### GDP per capita growth



### GDP growth



### GDP per capita



■ ECONOMIES IN TRANSITION  
■ WORLD

## Economies in transition

### The Commonwealth of Independent States and Georgia: Cyclical recovery, but uncertain long-run prospects

The pace of economic activity in the Commonwealth of Independent States (CIS) is accelerating, marked by the return to growth in the Russian Federation after a two-year contraction. Improved terms of trade, a more supportive external environment and less volatile macroeconomic conditions, including tapering inflation and stabilized exchange rates, have created a more favourable environment for the region's economies.

Belarus is exiting recession and growth has accelerated in Kazakhstan; Armenia, Kyrgyzstan and Uzbekistan have reported vibrant economic activity indicators. Aggregate GDP of the region, which remained practically flat in 2016, is expected to increase by around 2.2 per cent in 2017; growth is projected to accelerate to around 2.3 per cent in 2018 and 2.4 per cent in 2019. The Central Asian economies are expected to expand faster than other CIS economies, benefiting from stronger remittance inflows, the implementation of the "Belt and Road" initiative, and, in some cases, fiscal spending on development. Integration

within the framework of the Eurasian Economic Union (composed of Armenia, Belarus, Kazakhstan, Kyrgyzstan and the Russian Federation) boosted trade among the members in 2017, despite the remaining trade barriers. On the other hand, association agreements concluded with the EU by Georgia, Republic of Moldova and Ukraine and containing free trade agreements have influenced the directions of trade of those countries, leading to some trade fragmentation in the CIS area.

**Long-run growth faces structural constraints**

However, for most of the CIS, projected growth is modest and will remain well below the rates seen in the pre-crisis period. Cyclical and structural factors constrain both near-term and long-run economic prospects. International sanctions against the Russian Federation, initially imposed in 2014, remain in place. They restrict access to certain technologies, including deep-water oil exploration and drilling equipment, and limit access to capital markets. New sanctions introduced by the United States in 2017 may target energy pipelines and also sovereign debt.

The unresolved conflict in the east of Ukraine weighs on the country's economy, as loss of control over the resources in the east has reduced export capacity. Room is limited for fiscal spending both in energy exporters and energy importers, while banking sectors in some countries need bailouts. Progress in economic diversification in the CIS remains slow and dependency on natural resources, albeit to varying degrees, remains a source of vulnerability in the region.

In the longer run, unfavourable demographic trends in the European part of the CIS will lead to a shrinking workforce and increased dependency ratios, putting additional burdens on pension systems. In the Russian Federation those adverse trends are to a certain extent mitigated by intra-CIS migration (box III.1). On the other hand, as younger workers leave smaller CIS economies to take up long-term residency in the Russian Federation, their departure undermines future growth prospects — even while alleviating current labour market pressures in their home countries.

**Recovery is driven by domestic demand**

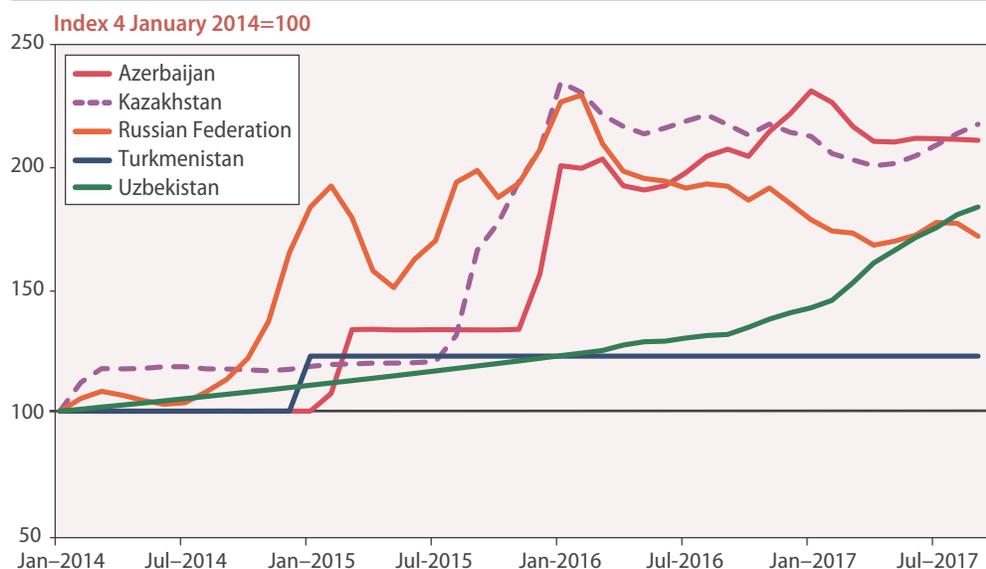
The observed recovery is largely driven by domestic demand. Although in the Russian Federation, unlike in the previous crisis in 2009, private consumption suffered the brunt of the recent adjustment, the dynamics of retail trade and mortgage lending are improving amid positive real wage growth. However, consumption is still relatively weak. Inventory accumulation is expected to have made a large contribution to growth in 2017. Investment has been boosted by the 2018 FIFA World Cup preparations. However, numerous uncertainties and the high cost of capital are holding private investment back. Counter-sanctions adopted by the Russian Federation since 2014 — banning food imports from most OECD economies — have prompted expansion of some sectors, such as agriculture and food processing. In the outlook period, the country is expected to remain on a low-growth trajectory.

Among the other energy exporters, increasing oil production at the giant Kashagan field in Kazakhstan has contributed to higher exports. Further infrastructure development may help to sustain growth at above 3 per cent in the medium term.

Azerbaijan is the only CIS country where GDP is expected to have contracted in 2017, due to a contraction of oil production and problems in the financial sector. The launch of a new gas field will support a recovery in 2018–2019. In Uzbekistan, growth is likely to remain strong, as the liberalization of currency regulation and the ongoing shift to convertibility opens new investment opportunities.

Thanks to the relatively quick exchange rate reaction of the Russian Federation to the oil price decline (figure III.7), the recent recession has been milder compared to past

Figure III.7  
Average monthly exchange rates of the CIS energy-exporters versus the US dollar



Sources: IMF International Financial Statistics and United Nations estimates.

Note: A rise indicates a depreciation.

contractions. By contrast, in other energy exporters, there was an initial reluctance to let the currency depreciate and the adjustment is still ongoing.

Among the energy-importers, in Ukraine, after the cumulative 15 per cent fall in GDP in 2014–2015, the recovery continued for a second year, despite the company seizures and trade blockade in areas in the east of the country. The minimum wage was doubled in 2017 and private consumption is gaining momentum; gross fixed capital formation shows robust dynamism after its collapse in 2014–2015.

The reorientation of trade towards the EU, however, has been accompanied by a shift in production, with an increasing weight on agricultural products. Although external financing options have improved, low growth creates challenges for external debt sustainability. Belarus in 2017 has come out of recession, with strong industrial growth and a good harvest. The settlement of the dispute with the Russian Federation on oil deliveries and gas debts has boosted exports and improved economic prospects. In the medium term, these countries are expected to remain on a low-growth trajectory. They also face large debt servicing payments.

The recovery of remittances from the Russian Federation is contributing to the acceleration of economic activity in Central Asia and the Caucasus. In Armenia, the economy has bounced back strongly, amid rapid industrial growth and higher copper prices. In Kyrgyzstan, large increases in gold production boosted output and the economy expanded by over 6 per cent in the first half of 2017.

The region is benefiting from somewhat easier access to capital. A number of countries, including Belarus, the Russian Federation, Tajikistan and Ukraine have taken advantage of the search for yield among international investors to launch eurobonds. Belarus, in addition, has refinanced its debt with the Russian Federation following the agreement on payments for gas arrears and a new deal on energy deliveries.

## Box III.1

**Migration: Labour markets and remittances in the CIS**

The Russian Federation has been a major destination for both permanent and temporary migrants from other Commonwealth of Independent States (CIS) countries. In contrast with the years following the collapse of the Soviet Union, economic considerations have driven recent population movements. Wages in the Russian Federation are much higher than in neighbouring countries, especially in Central Asia, which is the focus of this box. In these countries, temporary migration to the Russian Federation provides a major source of income.

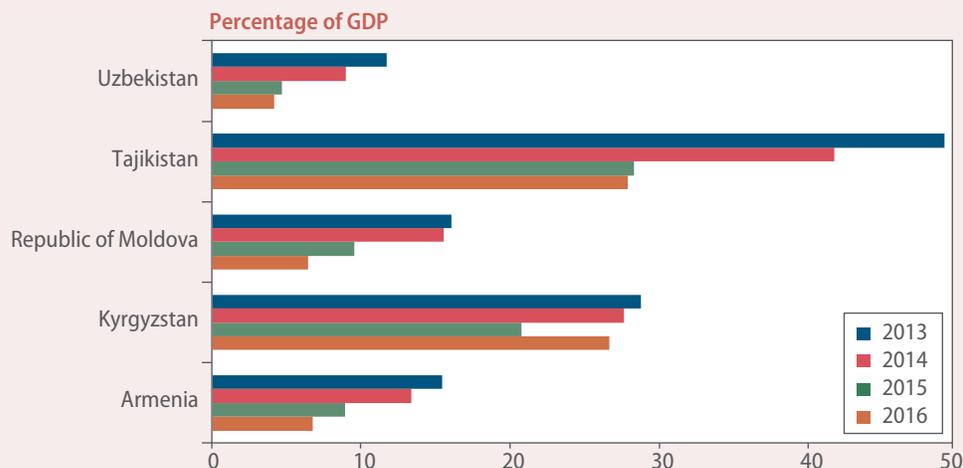
Over the last two decades negative natural growth and rapid population ageing has characterized the demographic structure of the Russian Federation. Net migratory flows from other CIS countries explains overall population increases. Official projections show that the ratio of the elderly to the working age population will increase steadily, from 45.5 per cent in 2017 to 54.1 per cent by the end of 2035. Adverse demographic trends have contributed to the slow growth of the labour force, which has increased by only 1.5 per cent between 2010 and 2016, despite rising labour participation rates. By contrast, the countries of Central Asia have exhibited more favourable demographic trends, with natural growth rates of above 2 per cent annually.

Methodological changes and the persistence of irregular flows have made it difficult to obtain an accurate picture of migration levels. However, trends in remittance flows clearly highlight the importance of these revenues for Central Asian economies (figure III.1.1). Quarterly data provided by the Central Bank of the Russian Federation on cross-border monetary transfers by physical persons closely tracks remittance figures compiled on an annual basis by the World Bank. Overall remittances expressed in dollar terms peaked in 2013, before declining sharply as the Russian economy contracted and the rouble depreciated. As the recession came to an end in late 2016, this negative trend has now reversed (figure III.1.2).

Meanwhile, changes in Russian legislation were introduced in 2014–2015 to regularize migration and curb illegal work. After the creation of the Eurasian Economic Union (EEU) in 2015, a different access regime to the labour market of the Russian Federation emerged for members and for those outside the EEU. This helps explain the resilience of remittances to Kyrgyzstan, which joined the EEU in mid-2015, relative to other recipients in Central Asia.

Remittances remain a major transmitter of external shocks, as seen during the recent downturn. The large declines observed in 2015–2016 draw into question the general belief that these flows are relatively stable, and suggests a high degree of labour market flexibility for migrant workers, who provide a

Figure III.1.1

**Remittances from the Russian Federation as a percentage of GDP**

Sources: Central Bank of the Russian Federation and IMF.

(continued)

buffer for firms when adjusting to changes in demand conditions. In fact, migrants are especially represented in low-skill jobs in sectors such as construction and retail, which contracted the most during the recent downturn. In addition, the dynamics of remittances in the Russian Federation are closely associated with the evolution of non-tradable output and display a very seasonal pattern.

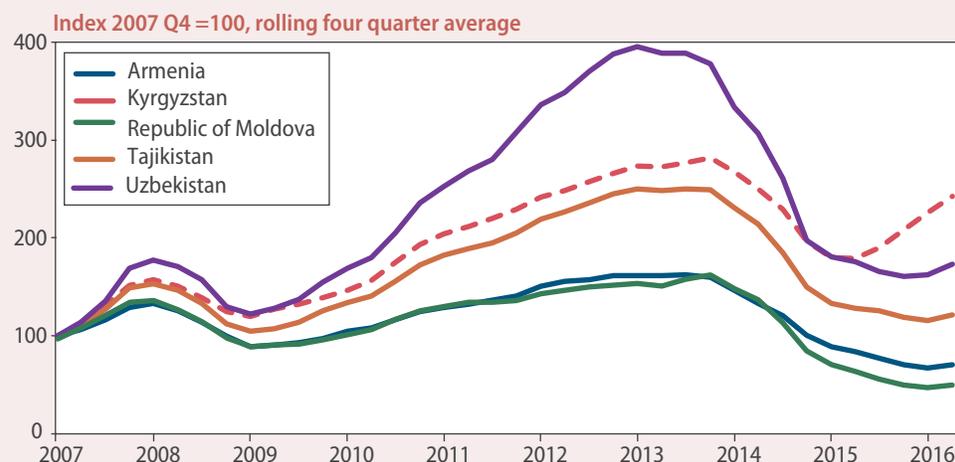
In receiving countries of the CIS, remittances are largely used to finance higher consumption. Stronger remittance flows also tend to provide an impetus to construction. Money transfers from migrants have also been a major source of liquidity for the banking sectors of the small Central Asian countries (the cost of sending remittances from the Russian Federation to other CIS countries are among the lowest in the world, which has encouraged the use of formal channels). Consequently, their decline contributed to the weakening of financial institutions, through both deteriorating asset quality and creating funding pressures. These patterns in general limit the contribution of migration to human capital accumulation and development in the region.

Given the projected demographic dynamics, large migratory flows are likely to continue, although these will not only be influenced by economic conditions but also by regulatory changes. Remittances will remain a major source of income for Central Asian countries. However, the recent large declines have exposed the underlying economic vulnerability of these economies and the continued need for economic diversification.

Box III.1 (continued)

Author: José Palacín (ECE)

Figure III.1.2  
Remittances from the Russian Federation



Source: Central Bank of the Russian Federation.

Inflation in the CIS exhibited large heterogeneity in 2017, ranging from a near-zero inflation in Armenia to double-digit price increases in Azerbaijan and Ukraine. In several countries, price pressures have eased amid the strengthening of exchange rates. By contrast, hikes to utility costs pushed inflation up in others. In the Russian Federation, lower food prices, driven by a good harvest and the resumption of imports from Turkey, have brought inflation to record low levels. Stronger domestic demand and the lifting of disinflationary pressures related to the exchange rate appreciation of 2016 may create some inflationary pressures next year. Inflation has fallen into single digits in Belarus, supported by a tight monetary policy and the reduction of directed lending, and in Kazakhstan, thanks to the stronger currency. On the other hand, inflation remains elevated in Azerbaijan and Ukraine, at 12 and 15 per cent, respectively. In late 2017, inflation subsided to a record low level in Belarus, at around 6 per cent. In Uzbekistan, the ongoing shift to currency con-

Inflation performances diverge

vertibility will push inflationary pressures. For the countries with relatively high inflation rates, further disinflation is expected in 2018–2019.

**Labour markets remained resilient during the crisis**

Employment held up well during the crisis, given wage flexibility and the use of part-time work. The recovery is resulting in growing wage gains, the reduction of involuntary adjustment mechanisms and declines in unemployment rates. In the Russian Federation, falling unemployment is being accompanied by a shrinking labour force. The economy of Kazakhstan continued to generate jobs, in part thanks to the ongoing urbanization.

**Monetary loosening continues, with some exceptions**

Declining price pressures allowed for a cautious loosening of monetary policies, although countries in the region are in different positions in this easing cycle. The National Bank of Ukraine sharply reversed its previous softening in view of accelerating inflation. In the Russian Federation, even after a series of policy rate cuts in 2017, real rates are high compared to other emerging markets. Lending, in particular to households, has picked up, but the banking sector in the region remains generally in poor shape.

State support has been substantial in recent years. However, more support will be required, despite tangible success in stabilizing the financial system. In 2017, the Central Bank of the Russian Federation intervened to rescue the largest private bank in response to a massive deposit withdrawal. The cost of restructuring the banking sector looms large for several CIS countries and will contribute to a rise in public debt. The ongoing consolidation of the sector may raise the risk of excessive concentration in some countries.

**Fiscal stances consolidating, but gradually**

Fiscal consolidation is gradual, as energy-exporting countries adapt to the reality of persistently low energy prices. New fiscal frameworks for the use of hydrocarbon resources are being deployed in Kazakhstan and the Russian Federation to reduce the economies' sensitivity to oil prices. In some energy importers, fiscal policy is constrained by the terms of IMF programmes. There is a heightened emphasis on the efficiency of public spending and its contribution to growth in the region. While fiscal consolidation is moving ahead, pension systems in some countries — where demographic conditions are adverse — post large deficits, requiring sizeable transfers.

The geopolitical situation in the CIS remains complicated and weighs on economic prospects. Once more, the recent downturn has exposed the vulnerability of the region to falling commodity prices. To take advantage of depreciated exchange rates, stronger investment and certain structural reforms will be needed.

## South-Eastern Europe: Moderate, but relatively more balanced growth

Economic activity in South-Eastern Europe is supported by improved economic prospects in the EU and stronger domestic demand. Infrastructure-related investment continues to boost growth, in particular in Montenegro. Private consumption is playing an increasing role, in particular, in Albania, where employment and wages have increased. However, in Serbia, the largest economy of the region, a harsh winter has disrupted transport links and reduced construction activity. Later in the year, a drought caused a poor agricultural harvest. These factors dampened the growth outlook.

Domestic political uncertainties in the former Yugoslav Republic of Macedonia weigh on business investment and private consumption. Growth of the aggregate GDP of the region subsided from 2.9 per cent in 2016 to an estimated 2.5 per cent in 2017, but is expected to accelerate to 3.2 per cent in 2018. The region is seeing increased investment from

China, mostly in the form of construction projects, financed by loans from China. While these loans provide a welcome upgrade to infrastructure, they also drive up public debt.

The current growth pattern in the region is more balanced than in the pre-crisis period, when rapid expansion was accompanied by massive current account deficits (figure III.8) and increasing private and public indebtedness. Still, current account deficits continue to create external financing needs, making the region vulnerable to a deterioration in financing conditions. On the positive side, foreign direct investment (FDI) remains the main source of financing in the region and increased export capacity will reduce external imbalances in the future.

To overcome the structural problems of the region, stronger growth is required. A more robust pace of job creation is needed to prevent people from leaving — especially youth. Unemployment remains high, particularly in Bosnia and Herzegovina and in the former Yugoslav Republic of Macedonia, despite the introduction of public sector programmes. Stronger regional integration within the Central European Free Trade Agreement (CEFTA) framework would also be welcome.

Despite progress in fiscal consolidation and some success in stabilizing public debt in Albania and Serbia, the two largest countries, debt burdens remain significant in the region. In the former Yugoslav Republic of Macedonia and in Montenegro, further infrastructure spending is planned, which can lead to further fiscal deficit widening.

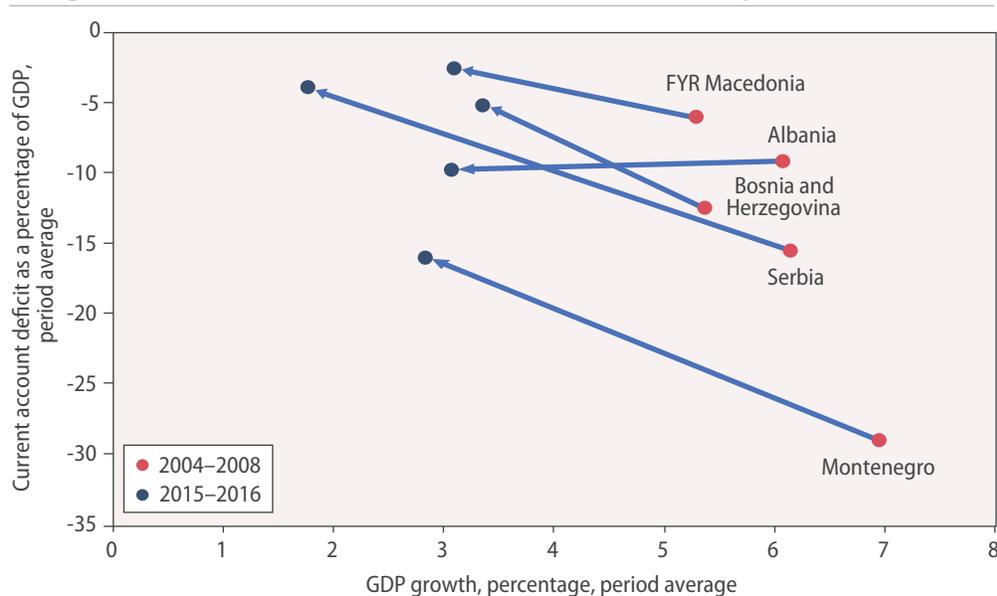
Economic prospects of South-Eastern Europe depend on growth dynamics in the European Union. Geopolitical tensions are also a downside risk. The prospect of EU accession remains the most important policy anchor for the region, and in many aspects, developments on that front will determine both the political and economic outlook.

**Current pattern of growth is more balanced, but stronger job creation is needed**

**Public debt remains a burden**

**EU accession remains the most important policy anchor**

Figure III.8  
GDP growth and current account deficits in South-Eastern Europe



Sources: IMF International Financial Statistics and UN/DESA.



Share of the world

## GDP growth



## GDP per capita growth



## GDP per capita



AFRICA  
WORLD

## Developing economies

### Africa: Gradual cyclical improvement continues

**Acceleration in growth driven mainly by cyclical improvements**

Africa's economic growth is projected to pick up to 3.5 per cent in 2018 and 3.7 per cent in 2019 (or 3.3 per cent and 3.5 per cent in 2018 and 2019, respectively, excluding Libya). The projected modest improvement in growth is underpinned by strengthening external demand and a moderate increase in commodity prices. The improvement in growth will also be supported by more favourable domestic conditions, including the restoration of oil production in Algeria, Angola and Nigeria, the increase in oil production from new fields in Ghana and the Republic of Congo, and the recovery in agricultural production and mining in South Africa. The improvement in the region's aggregate growth in 2018–2019 is largely attributable to a recovery in Egypt, Nigeria and South Africa, three of Africa's largest economies.

Compared to forecasts made a year ago, there was an overall downward revision to growth for the continent as a whole, due to a slower than anticipated recovery in many commodity-exporting economies, especially fuel and mineral exporters. Looking ahead, growth in Africa remains constrained by several domestic obstacles, including foreign

exchange controls in Angola and Nigeria, weather-related shocks especially in East Africa, and political uncertainty leading to low business confidence in countries such as the Democratic Republic of Congo, Kenya and South Africa. There are also security threats in East Africa, and in countries in the Sahel region.

Though growth appears to have firmed from very low levels in 2016, it remains barely higher than population growth, estimated at 2.5 per cent in 2018–2019. This means per capita GDP growth — projected to increase from 0.5 per cent in 2017 to 1.0 per cent in 2018 and 1.2 per cent in 2019 — will remain inadequate for Africa to make significant progress towards the Sustainable Development Goals (SDGs), in particular the eradication of poverty and hunger.

The region's aggregate GDP masks considerable variation among its subregions (figure III.9). The less resource-dependent countries in East Africa, such as Djibouti, Ethiopia and the United Republic of Tanzania, and in West Africa, including Côte d'Ivoire, Ghana and Senegal, will continue to witness above average growth, supported by vigorous infrastructure investment, strong services sectors and a recovery in agricultural production. By contrast, many oil and minerals exporters will witness weak growth, as commodity prices remain well below their 2014 levels and fiscal consolidation efforts constrain public investment.

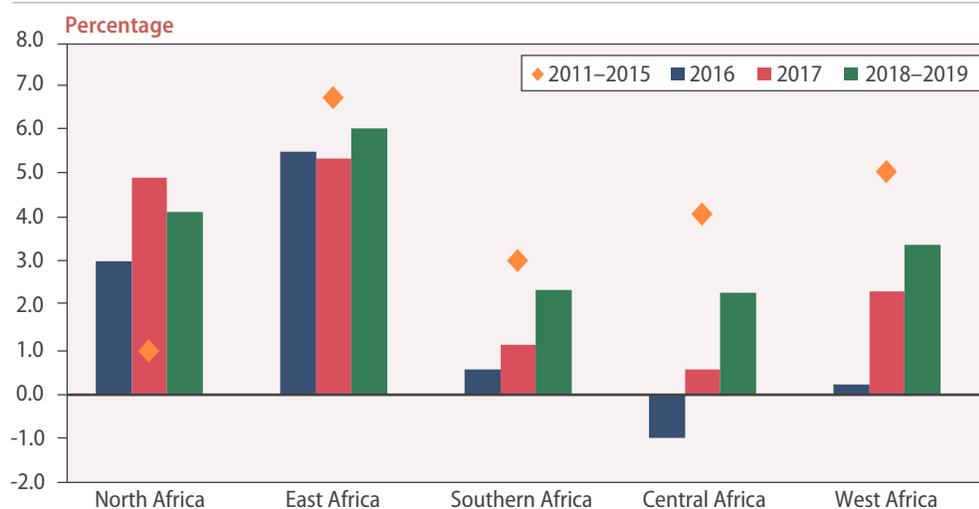
The strong headwinds that the region faced in 2016 eased in 2017. Moderately increasing commodity prices and recovering external demand have contributed to a narrowing of current account deficits, especially among the highly commodity-dependent economies. An improvement in external financing conditions has also led to a decline in borrowing costs and improved access to finance. This has enabled some countries to re-enter the eurobond market.

Internally, drought conditions have eased in countries in East and Southern Africa. The security situation has also improved, particularly with regards to militant attacks on oil pipelines. Nonetheless, tensions remain high in several areas, especially in Somalia. In some countries, recent elections have been conducted without major incidents (e.g., Angola). By contrast, elections sparked political tensions in others, such as Kenya. Risks of heightened political tensions remain in advance of several elections lying ahead in 2018–2019, and a rapidly changing situation in Zimbabwe.

**Current economic recovery is insufficient to raise living standards**

**Headwinds to growth have subsided in 2017**

Figure III.9  
Average annual GDP growth in Africa, by subregion



Source: UN/DESA.

In 2017, the African economies are estimated to have expanded in aggregate by 2.6 per cent (excluding Libya), following growth of 1.7 per cent in 2016, one of the slowest rates of expansion in the past two decades. The recovery was supported by improvement in large oil exporting economies, such as Angola and Nigeria, and by Morocco where the agricultural sector recovered from the devastating drought of 2016.

Nigeria contributed about half of the improvement in Africa's overall growth in 2017. In contrast, growth was restrained by adjustment to lower commodity revenues in countries such as Côte d'Ivoire (which saw world cocoa prices and fiscal revenues plummet in 2017). Ethiopia, Kenya and the United Republic of Tanzania, still among the fastest growing economies in Africa, also slowed compared to 2016, as did fuel exporters such as Algeria, Cameroon and Gabon. The drought in East Africa continued into early 2017 affecting agricultural production in Kenya and Uganda and worsening famine conditions in Somalia and South Sudan.

**Current account deficits narrowed**

Current account deficits have narrowed in many African countries, especially among the oil and mineral exporters, as a result of a partial recovery in some commodity prices. Mining companies throughout the continent have increased production and exports. The North African economies benefited as well from a recovery in the tourism sector and growing demand for exports from Europe. The improvement was particularly remarkable in Egypt where the current account deficit narrowed rapidly, and foreign reserves surpassed a level last seen in 2010 as a result of the decision to float the currency and lift most capital controls in November 2016.

In Nigeria, oil exports recovered as militant attacks on oil pipelines subsided and oil production slowly increased, although production has not returned to previous levels. However, the current account deficit remains high in oil-importing economies, particularly in East Africa where some countries sustain high capital imports for infrastructure projects and a higher cost of fuel imports driven by the increase in global oil prices. Also, the situation remains vulnerable in Libya, Sudan, and Tunisia where foreign reserves were in decline in the first half of 2017.

Stabilization of several currencies, after sharp depreciations in 2016, eased inflationary pressures in many countries across the continent in 2017. In addition, better weather conditions contributed to lower food price inflation, especially in areas previously damaged by drought, easing household budget constraints which have hampered domestic demand. However, the inflation rate remains high.

In the Democratic Republic of the Congo, inflation is estimated to have increased by 20 percentage points in 2017, to nearly 45 per cent. High inflation is fuelled by a steep depreciation in the domestic currency, amid low commodity prices and high government deficits. In Egypt, the average inflation rate for 2017 is estimated to be 30.5 per cent, reflecting a substantial increase in food prices due to Egypt's high import reliance on grains. Libya and Sudan are also estimated to have inflation of close to 27 per cent, mainly due to a rapid expansion of the monetary base by their respective central banks to cope with the fiscal deficit.

In Angola and Nigeria, inflation is decreasing albeit remaining high, due to foreign exchange pressures and depreciated parallel exchange rates. Nevertheless, overall, exchange rates are expected to continue to stabilize across the region.

**Disinflationary pressures created monetary policy space**

Several central banks in Africa decreased their key policy rates in 2017 amid lowering inflationary pressures. However, monetary policy is expected to remain tight in the Demo-

cratic Republic of the Congo, Egypt, Sierra Leone and Tunisia to stabilize the value of the national currency and halt accelerating inflationary pressure.

The fiscal policy stance should remain tight in the outlook period, even as rising commodity prices allow a moderate easing of fiscal pressures. Fiscal deficits remain high, particularly among oil and mineral exporters. For example, in Sudan, the fiscal deficit is expected to widen in 2017 due to a decline in oil transit fees from South Sudan and lower levels of oil production from aging oil fields. In most countries, fiscal stabilization has come at the expense of decreased expenditure as opposed to structural fiscal reforms. For example, cocoa exporters, including Côte d'Ivoire and Ghana announced cuts to government expenditure in 2017.

However, some countries have taken a notably different path. In North Africa, some fiscal authorities have started fiscal consolidation efforts in a framework of structural reforms. Examples include the new value-added tax (VAT) law in Egypt and Algeria's ambitious fiscal consolidation plan for 2017–2019, which sets out a long-term strategy to foster greater private sector activity and economic diversification. Coupled with sharp exchange rate depreciations in some countries, the elevated level of fiscal deficits has increased public debt in Africa. The deterioration in public finances forced Benin, Cameroon, Chad, Gabon, Niger, Sierra Leone and Togo to seek financial assistance from the IMF in 2017.

Capital inflows have improved from the very low levels of 2016 at the same time as borrowing costs have declined. Apart from Ghana and Mozambique, where the fiscal deficit remains considerably high, sovereign spreads have diminished. In the beginning of 2017, Nigeria and Senegal successfully returned to the eurobond market, benefiting from decreased risk aversion regarding investment in developing economies and low financial market volatility.

East Africa continues to host the fastest growing economies in Africa with an expected annual growth rate of 5.9 per cent in 2018 and 6.2 per cent in 2019. Ethiopia, Kenya, the United Republic of Tanzania and Uganda lead the growth performance of the subregion with average growth of 6 per cent per annum, supported by infrastructure investments and an improving business environment. In Ethiopia, fiscal stimulus, foreign investment in infrastructure and manufacturing, diversification of the economy towards tourism and strong internal demand will continue to support growth.

Strong fundamentals sustain the growth of the Kenyan economy with the services sector growing and infrastructure projects supporting development in the long term. The development of oil and gas sectors will be one of the main drivers for the next years in the United Republic of Tanzania, which should also benefit from oil investments in neighbouring Uganda as oil is going to be exported through a pipeline towards Tanzanian shipping port facilities. The performance of the Somalian economy will continue to depend heavily on how the security situation and drought conditions evolve. The Democratic Republic of the Congo is profiting from a higher price of cobalt, driven by policy shifts towards zero emissions vehicles in developed economies and China. However, unsolved political tensions largely offset this positive development.

Average growth in North Africa is estimated at 4.1 per cent in 2018 and 2019 (3.5 per cent in 2018 and 3.6 per cent in 2019, excluding Libya). Stable economic growth is forecast to continue in 2018 with a scenario of stable commodity prices, further improvement in the security situation, and continuing economic recovery in Europe.

Moreover, the decision by the United States to ease economic and trade sanctions against Sudan may positively impact the Sudanese economy in 2018. In 2017, the economies in North Africa began to rebound due to robust growth in tourism, owing to the

**Significant fiscal adjustments lie on the horizon for commodity exporters**

**East African economies grow at the fastest pace in the continent**

**North Africa benefits from increased tourism**

improving security situation, and to a recovery in commodity prices. In addition, the economic recovery of European economies also supported exports, as Europe remains the region's largest trading partner.

The recovery in oil and gas prices pushed real GDP growth in Algeria and Libya. The higher price of iron ore in 2017 versus 2016 sustained the economic expansion of Mauritania. Stable gold prices positively impacted Sudan. A substantial jump in crop yields in Morocco and Tunisia, after a severe drought in the previous crop year, contributed to the economic expansion in both economies along with the phosphate rock industry. Overall, the improvement in the region's business sentiment and consumer confidence in 2017 is revealed by the rising number of tourists visiting North Africa. The positive impact from recovering tourism was particularly felt in Egypt and Tunisia.

**Nigerian economy will recover oil production and output performance**

The West African economies are projected to grow by 3.3 per cent in 2018 and 3.4 per cent in 2019. Growth in Nigeria will propel the regional average forward. The country exited recession in 2017 due largely to a rebound in oil production and increase in fiscal expenditure. Looking ahead, returning business confidence is evidenced by improvement in the Purchasing Managers' Index. Improved prospects are also demonstrated by a stable foreign exchange rate for importers and exporters, convergence of the parallel and official exchange rates, improved foreign exchange reserves, decreasing inflation and improving oil prices — all paving the way for output recovery.

However, structural challenges remain, as evidenced by Moody's Investors Service cut to Nigeria's sovereign issuer rating. Challenges include a possible return of militants' attacks on oil pipelines as the country heads into its presidential campaign season, and a failure to broaden the non-oil revenue base.

Average growth in West Africa masks some of Africa's fastest growing economies, including Benin, Burkina Faso, Côte d'Ivoire and Senegal. Growth will remain supported by robust infrastructure project implementation. Côte d'Ivoire was particularly hit by the decline in cocoa prices, since 40 per cent of its export revenues originate from this commodity. However, strong private investment will compensate for shortfalls in government spending. Ghana, which also saw its export revenues drop due to lower prices for gold, cocoa and oil exports, is projected to see stronger economic growth in 2018, as new oil fields nearly double oil output. The economies of the Sahel continue to face serious threat from violent conflict, weighing on growth prospects.

**Previously delayed fiscal adjustment has started amid security concerns**

The Central African economies are projected to grow by 2.1 per cent in 2018 and 2.5 per cent in 2019, supported by the increase in oil prices. Looking ahead, the security situation in the region will continue to hamper its prospects for investment and GDP growth. In Cameroon, growth will be driven by the implementation of large infrastructure projects and a rise in gas production in 2018 which should compensate the decline in oil production since 2016, although significant political tensions and security threats pose risks to the outlook.

Despite vulnerabilities to the spread of terrorist activities from Nigeria, an easing of fiscal austerity will improve growth in Chad, along with a stronger oil sector performance. Equatorial Guinea joined the Organization of the Petroleum Exporting Countries (OPEC) in May 2017 and is taking steps to stem the decline in its oil production. Nevertheless, the economy is expected to remain in recession over the forecast period, as it adjusts to a lower oil price.

**Political uncertainty weighs on prospects in Southern Africa**

In Southern Africa, growth is expected to average 2.3 per cent in 2018 and 2.5 per cent in 2019, supported by increasing agricultural production. However, an infestation of armyworm might pose a substantial risk to crops in the region and possibly beyond. Additionally, investment is expected to remain subdued mainly due to political uncertainties, further constrained by a lack of reforms, an unfavourable institutional environment, and slowly addressed infrastructure gaps.

In South Africa, net exports will rebound but fail to compensate weak growth in private consumption and investment. Borrowing costs have risen after the country's credit rating was downgraded to sub-investment level in April 2017 due to heightened political uncertainty. In Angola, growth will rise, sustained by increased industrial activity and improving energy supplies. Developments in mineral prices and the mining sector will determine growth in Botswana and Namibia. Growth in Zambia remains dependent on the price of copper, and will be held back by deficiencies in the electricity supply, 97 per cent of which is generated by hydropower.

In Zimbabwe, high debt levels, structural and institutional constraints, lack of liquidity, and a challenging environment as the country undergoes political transition, will continue to constrain the economy. Prospects have improved in Malawi since it re-established relations with foreign donors. Investment in Mozambique is being hampered by the government's default in January 2017 and the high level of debt. Growth in Mozambique will additionally be held back by political tensions.

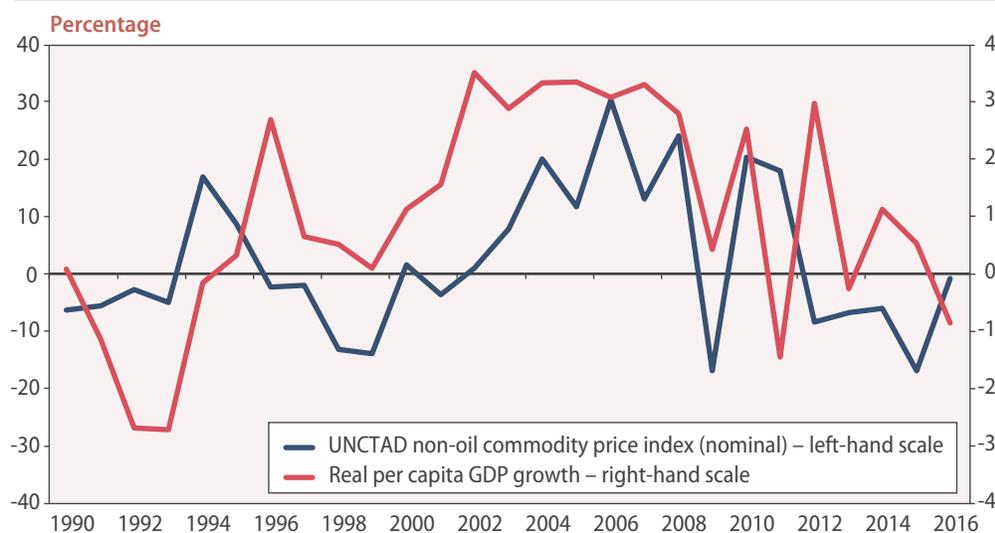
The outlook for Africa remains subject to a number of risks. Externally, a sharper than expected increase in global interest rates or an increase in the premium for sovereign bonds could decrease sovereign access to financing, which has become an increasingly important source for domestic investment in recent years, and endanger debt sustainability.

Further downgrades to sovereign ratings could hinder investment confidence. Moreover, lower export demand (for instance, from a less gradual moderation in Chinese growth) or a reversal in commodity price growth (as seen for some commodities in early 2017), could decrease FDI and remittance flows and generally threaten the recovery momentum. In certain least developed countries (LDCs), a decrease in the amount of aid received could have significant negative implications.

Internally, an absence of policies of fiscal adjustment to a lower commodity price level could jeopardize macroeconomic stability and the growth trend in many countries. Other risks are posed by potential escalation of the security threat, especially in the Sahel region and in Somalia, and political instability ahead of key elections in Egypt, Nigeria and South Africa. At the same time, economic reform measures in North Africa, including the introduction of new taxes, might destabilize the political and social situation, in a region which

**Outlook clouded by external and internal factors**

Figure III.10  
Growth of commodity prices and real GDP per capita growth in Africa



Sources: UN/DESA and UNCTADstat.

**Debt, fiscal reform,  
drought and conflict  
among the greatest  
challenges**

continues to post high unemployment rates, particularly among youth and women. Finally, several agricultural economies remain exposed to weather-related shocks.

Considerable policy challenges lie ahead for Africa. Large fiscal deficits, growing interest payments and valuation changes from exchange rate depreciation are contributing to a rapid accumulation of debt, especially in oil-exporting countries.

Fiscal adjustment plans should be developed and strictly implemented to avoid the high rate of debt accumulation of recent years. The adjustment could benefit from increased and sustained efforts in domestic resource mobilization, rather than expenditure compression. Over-reliance on commodity revenues must be curbed, through economic diversification and structural transformation, to avoid the pass-through of commodity price volatility to macroeconomic conditions (figure III.10).

In the medium-term, investments in human capital and transparent governance and institutions could help support economic diversification. Acute malnutrition must be urgently addressed in the conflict-affected areas of northeast Nigeria and South Sudan and in the dry areas of East Africa, especially in Somalia. The current growth momentum should be strengthened in sustainable and inclusive ways, so that everyone can gain, and poverty can be reduced (see Box III.2).

#### Box III.2

#### Inclusive growth in Africa

Since the turn of the century, Africa's growth performance has been unprecedentedly strong, with an average annual growth rate of 4.7 per cent between 2000 and 2015, compared to 2.4 per cent between 1980 and 2000, thus rekindling hope for more rapid development on the continent. However, between 2000 and 2014, income inequality measured by the Gini coefficient fell only slightly from 44.7 to 42.5. This has spawned concern over whether the recent growth has been inclusive.

Based on a sample of 42 countries for the period 1990–2014, Hussein, Mukungu and Awel (2017) explore the current state of inclusiveness of Africa's growth and highlight the factors that drive inclusive growth in Africa. The study relies on a unified single measure of inclusiveness that integrates growth and income distribution (GDP per capita growth, and income equity growth) following a methodology developed by Anand, Mishra and Peiris (2013). While developments clearly differ across countries, in general the modest rise in inclusiveness (estimated to have increased by 25 per cent over the sample period) has been driven by economic growth raising the level of GDP per capita, while inequality measures have remained largely stagnant.

In figure III.2.1, quadrant I shows countries where growth was inclusive through a rise in both average income per capita and equity. Notably, countries such as Burkina Faso, Ethiopia and Mali recorded greater inclusiveness due to improvements in GDP per capita growth as well as equity. However, Kenya and Uganda, for instance, registered greater inclusiveness by ensuring more equity growth and marginal growth in per capita GDP or marginal equity growth and more growth in per capita GDP, respectively.

In quadrant II, since GDP per capita has contracted, the unified measure of inclusiveness will only have improved if the observed equity growth exceeds in absolute value the percentage decline in GDP per capita. Burundi and Madagascar are in this quadrant. In both cases, the marginal growth in equity could not compensate for the contraction in GDP per capita growth, hence in both cases inclusiveness deteriorated over the sample period.

Quadrant III clearly indicates a decline in inclusiveness in two countries, Côte d'Ivoire and Guinea-Bissau, since both GDP per capita and income equity have declined.

*(continued)*

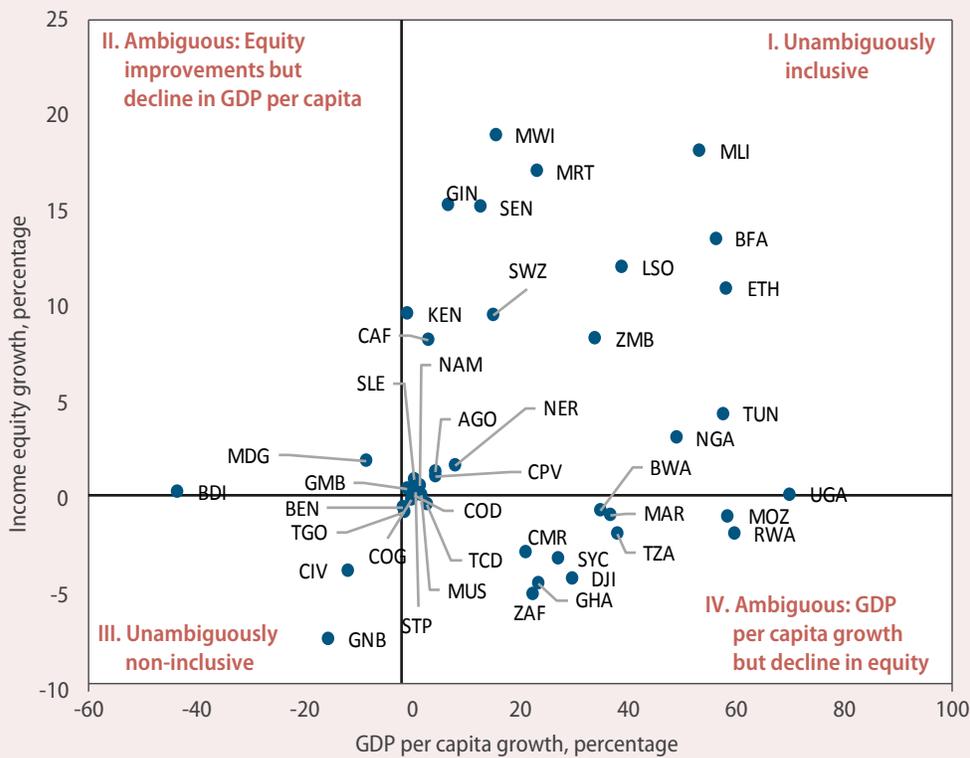
In quadrant IV, since income equity has declined, inclusiveness will only have improved if GDP per capita growth exceeds in absolute value the percentage decline in income equity. Several countries registered inclusive growth while growth was non-inclusive for some. For instance, Mozambique and Rwanda have clearly seen improvements in inclusiveness despite declines in equity, due to rising GDP per capita. In contrast, growth in Benin and Togo has been non-inclusive since the decline in income equity eclipsed the marginal GDP per capita growth in these countries.

Hussein, Mukungu and Awel (ibid.) show that investment, government spending, loose monetary policy, competitive and efficient financial institutions, better ICT infrastructure as well as better institutions help to promote more inclusive growth. Therefore, in pursuit of achieving the SDGs and Africa’s Agenda 2063, African countries must strive to implement macro policies and strategies aimed at achieving both higher economic growth and improved equity.

Box III.2 (continued)

Authors: Khaled Hussein, Allan Mukungu and Yesuf Awel (ECA)

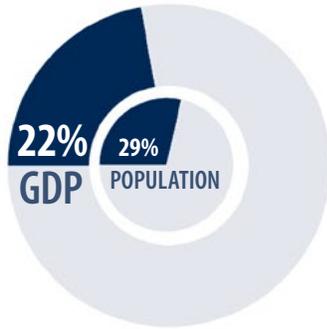
Figure III.2.1  
Inclusiveness matrix for a sample of African countries, 1990–2014



Sources: Authors’ computations based on World Development Indicators 2016.

Note: Both the horizontal and vertical axes represent cumulative percentage changes over the sample period. See Table J in the Statistical annex for definitions of country codes.

## Snapshot: East Asia



Share of  
the world

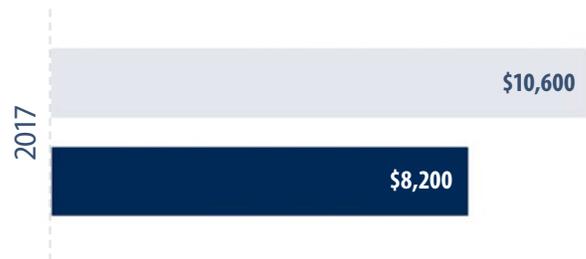
### GDP growth



### GDP per capita growth



### GDP per capita



■ EAST ASIA  
■ WORLD

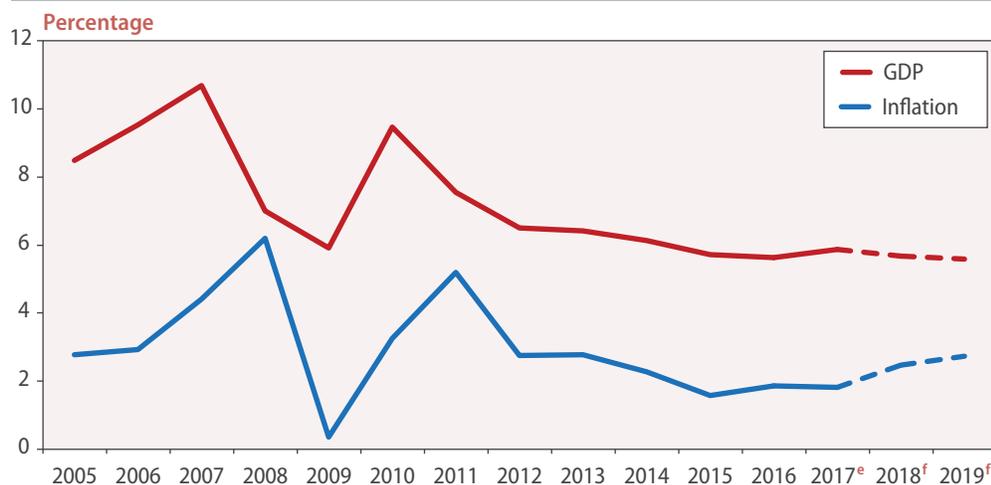
## East Asia: Steady growth supported by robust domestic demand

The short-term growth outlook for East Asia remains robust, driven by resilient domestic demand and an improvement in exports. The region's favourable outlook is also supported by accommodative monetary policy and expansionary fiscal stances across most countries. Following growth of 5.9 per cent in 2017, the East Asian region is projected to expand at a steady pace of 5.7 per cent in 2018 and 5.6 per cent in 2019 (figure III.11). Nevertheless, the region faces several downside risks, arising mainly from high uncertainty in the international policy environment and elevated debt levels.

**Private consumption remains key driver of growth for the region**

Private consumption will remain the key driver of growth in East Asia, supported by modest inflationary pressures, low interest rates and favourable labour market conditions. In addition, public investment is likely to remain strong in most countries as governments continue to embark on large infrastructure projects, aimed at alleviating structural bottlenecks. Amid rising capacity utilization rates, private investment activity is also expected to pick up, particularly in the export-oriented sectors.

Figure III.11  
GDP growth and inflation in East Asia



Source: UN/DESA.

Given the region's high trade openness, growth in East Asia is benefiting from the ongoing recovery in global trade activity. The recovery in the region's exports is being largely driven by growing intraregional demand. Improving demand from the developed countries, particularly the United States and Europe, is also providing an impetus to regional exports, amid the gradual revival in investment in these economies.

More specifically, the region is experiencing a strong rebound in exports of electrical and electronic goods (figure III.12), amid the upturn in the global electronics cycle. In Malaysia, the Republic of Korea, Taiwan Province of China and Thailand, shipments of semiconductors and consumer electronics grew at a double-digit pace in 2017, reflecting rising external demand and the strong integration of these economies into global and regional production networks in the electronics industry.

In the outlook period, export growth is expected to temper, given waning base effects. However, a continued expansion in external demand will generate positive spillovers to the domestic economy through the income and investment channels.

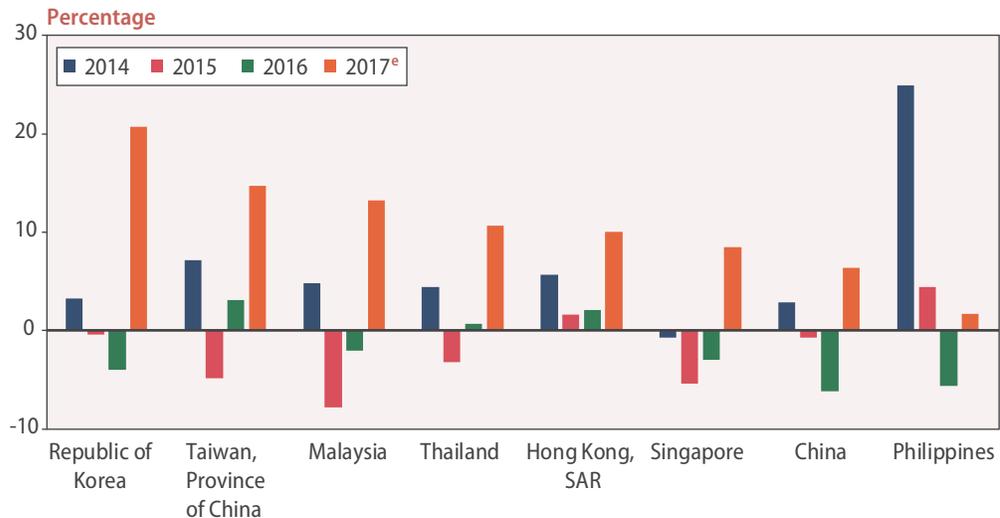
Despite robust economic activity, inflationary pressures are expected to remain subdued across most of the region, amid moderate growth in global oil prices. In 2017, higher agriculture production weighed down on food prices in countries such as China, Indonesia and Thailand. In Indonesia, Malaysia and the Philippines, adjustments to energy or transportation subsidies during the year exerted some upward pressure on overall prices. However, the effect of these one-off factors on headline inflation rates is expected to dissipate going forward. Furthermore, core inflation remains low in many economies, reflecting limited capacity pressures in the region.

Amid subdued inflation and high uncertainty in the external environment, monetary policy is likely to remain accommodative over the forecast period. In 2017, Indonesia and Viet Nam reduced their key policy rates, in efforts to stimulate bank lending and boost growth. For many countries, however, there is limited room for further rate cuts. Policy rates are at historic lows in several countries, with rates in the Republic of Korea, Taiwan Province of China and Thailand currently below 2 per cent. Furthermore, as developed economies normalize monetary policy, central banks in East Asia are faced with the poten-

**Strong global demand for electrical and electronic goods has been driving the rebound in exports**

**Inflationary pressures expected to remain subdued across the region**

Figure III.12  
Annual growth in electrical and electronic exports  
in selected East Asian economies



Source: National authorities.  
Note: Electrical & electronic (E&E) products refer to those listed under HS codes 84 and 85. 2017<sup>e</sup> refers to year-on-year growth in E&E exports from January–September 2017 for the Republic of Korea, January–July 2017 for Malaysia and the Philippines, and January–August 2017 for all other countries.

**Fiscal policy to play a more active role in supporting domestic demand**

**Growth in China to remain solid, as fiscal measures provide support to domestic demand**

tial risk of managing large capital outflows. Elevated private sector debt in several countries also poses a constraint to the effectiveness of lower interest rates.

Against this backdrop, fiscal policy in the East Asian economies is expected to play a more active role in supporting domestic demand. In 2017, several countries including China, the Philippines, the Republic of Korea, Taiwan Province of China and Thailand announced a range of fiscal and pro-growth measures, including accelerating infrastructure investment, improving access to finance for small and medium enterprises, and enhancing corporate tax incentives.

In China, growth is expected to remain solid, underpinned by favourable domestic demand and accommodative fiscal measures. Amid ongoing economic rebalancing efforts, growth will moderate at a gradual pace from 6.8 per cent in 2017 to 6.5 per cent in 2018 and 6.3 per cent in 2019. In 2017, the Chinese economy expanded at a faster pace compared to the previous year, marking the first acceleration in growth since 2010. The stronger than expected growth was in part attributed to the implementation of policy stimulus measures, including higher infrastructure spending. Private consumption remains the main driver of growth, as reflected in the continued strong increase in sales of consumer goods in 2017. Looking ahead, household spending in China is expected to remain robust, supported by healthy wage growth, rising disposable income and steady job creation.

Manufacturing activity in China also strengthened in 2017, buoyed by an improvement in both domestic and external demand, as well as rising business confidence. Coupled with a stronger rise in producer prices, these developments also contributed to double-digit growth in industrial profits during the year. On the investment front, however, overall fixed asset investment growth eased, despite continued strong infrastructure investment. This in part reflects ongoing structural reform measures to reduce excess capacity in several heavy industries, such as steel and coal.

In 2017, the Chinese authorities announced a range of monetary, macroprudential and regulatory measures aimed at mitigating rising financial sector vulnerabilities, which include elevated corporate debt, rapid credit growth and high property prices. Notably, pol-

icymakers are prioritizing the deleveraging of state-owned enterprises, including through tighter controls on debt acquisition as well as accelerating the debt-for-equity swap programme.

In addition, some measures to cool the property sector are expected to weigh on real estate investment going forward. Nevertheless, while efforts to address financial imbalances will contribute to more sustainable medium-term growth, the Chinese authorities are faced with the policy challenge of ensuring that these measures do not derail the economy's short-term growth prospects. In this environment, fiscal policy is expected to remain supportive of growth.

The Republic of Korea is projected to grow at a sustained pace of 2.8 per cent in 2018 and 2019, following an estimated growth of 3.0 per cent in 2017. Growth is expected to be broad-based across demand components, supported by policy measures and a favourable external environment. Exports grew at a double-digit pace in 2017, driven primarily by strong demand for semiconductors and petrochemical products. Amid an improvement in business sentiment and dissipating political uncertainty, private investment growth also rebounded in 2017, as capital spending in the information and technology sector picked up. Looking ahead, investment activity is projected to remain on an upward trend, buoyed by improving demand. In addition, the Government's supplementary budget, aimed at expanding welfare benefits and promoting stronger job creation, is expected to spur consumer spending. Nevertheless, geopolitical tensions in the Korean Peninsula will continue to adversely affect investor sentiments and domestic financial markets. Trade tensions with China also pose a risk to the exports outlook.

Stronger global demand for electronics has also boosted the growth outlook of the other economies in the region that are closely integrated into global and regional electronics production networks. Following subdued growth of 1.5 per cent in 2016, growth in Taiwan Province of China picked up to 2.2 per cent in 2017, and is projected to strengthen further to 2.4 per cent in 2018. In 2017, the surge in electronics and machinery exports generated positive spillovers to domestic demand, particularly in private investment. The favourable growth outlook is also reinforced by the announcement of a fiscal stimulus programme in early 2017. The plan includes the implementation of large infrastructure projects and measures to promote job creation.

Meanwhile, growth in Singapore accelerated from 2.0 per cent in 2016 to 3.0 per cent in 2017, as the strong expansion in exports boosted activity in the manufacturing and logistics sectors. Private investment however, remained sluggish, while consumer spending continued to be weighed down by weak job creation, slower wage growth and declining house prices. In 2018 and 2019, the Singaporean economy is projected to expand at a steady pace of 2.7 per cent. The projected gradual recovery in the housing market will lend support to consumption and investment activity, while improved external demand conditions are likely to spur more investment in the trade-oriented sectors.

The favourable growth outlook for the large economies in the Association of South-east Asian Nations (ASEAN)<sup>2</sup> is underpinned by robust domestic demand conditions, amid improving external demand and a modest recovery in commodity prices. In the Philippines, growth is projected to gain further traction, rising from 6.7 per cent in 2017 to 6.9 per cent in 2018 and 2019. Private consumption, which accounts for nearly 70 per cent

**The growth outlook in the Republic of Korea, Taiwan Province of China and Singapore has strengthened**

**Growth in the ASEAN economies underpinned by robust domestic demand**

<sup>2</sup> ASEAN member countries consist of Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Viet Nam.

of GDP, is expected to sustain a healthy momentum, driven by large remittance inflows and buoyant consumer confidence. Fixed investment growth is also projected to remain strong, as the authorities continue to embark on large infrastructure development projects. In addition, the planned introduction of tax reform measures is expected to support the increase in public expenditure.

Following stronger than expected growth of 5.4 per cent in 2017, growth in Malaysia is projected to remain relatively steady at 4.9 per cent in 2018 and 5.0 per cent in 2019. In tandem with the growth recovery in key trading partners, Malaysia's exports saw a broad-based rebound in 2017, driven primarily by double-digit increase in demand for electrical and electronic products and an improvement in exports of commodities, particularly crude oil, palm oil and natural gas. While this strong export momentum is likely to moderate in the outlook period, growth in the Malaysian economy will be underpinned by robust domestic demand. Private consumption will be supported by continued wage and employment growth, as well as higher welfare payments. The investment outlook in Malaysia also remains strong, amid ongoing infrastructure projects and capacity expansion in the manufacturing and services sectors. In Thailand, GDP growth picked up to 3.5 per cent in 2017, as a robust expansion in private consumption and exports more than offset the weakness in private investment. Going forward, the Thai economy is projected to register growth of 3.4 per cent in 2018, supported by a pickup in public investment that largely offsets weaker investment in the private sector. Lingered political uncertainty will continue to weigh on investor sentiments. In Indonesia, the growth outlook remains stable, against a backdrop of steady growth in private consumption and public expenditure. Growth is projected to improve slightly from an estimated 5.2 per cent in 2017 to 5.3 per cent in 2018, as additional monetary policy easing measures lend support to businesses and private investment activity. In addition, a series of policy reforms to improve the business climate, progressively introduced since late 2015, will bolster future investment prospects of the Indonesian economy. Meanwhile, the positive growth outlook for Viet Nam is underpinned by buoyant FDI inflows, particularly in the electronics sector, as well as strong tourism revenue.

**ASEAN LDCs to continue growing at a rapid pace, but structural challenges remain**

The LDCs in ASEAN, namely Cambodia, Lao People's Democratic Republic and Myanmar, are projected to continue achieving growth rates of above 7.0 per cent in 2018 and 2019, as incomes rise from relatively low bases. Alongside vigorous private consumption growth, strong infrastructure investment, particularly in the energy and transportation sectors, is also boosting growth in these economies. Growth is also benefiting from the improvement in external demand, especially from within the Asian region. Nevertheless, low levels of productivity, amid shortfalls in essential infrastructure continue to pose a challenge to medium-term growth prospects and to making significant progress towards the SDGs.

**Steady growth in the Pacific Island economies**

Meanwhile, the Pacific Island economies, including Kiribati, Papua New Guinea, the Solomon Islands and Vanuatu, are expected to grow at a steady pace in the forecast period. The positive outlook is supported by continued growth in revenues from the agriculture, mining, fisheries and tourism industries. Given high commodity dependence, however, the growth prospects of these economies remain highly susceptible to commodity price and weather-related shocks.

**East Asia faces downside risks, particularly rising trade protectionism**

Looking ahead, the region faces considerable downside risks to its growth outlook, mainly arising from high uncertainty in the external environment. In particular, a potential sharp escalation in trade protectionism measures by the United States could disrupt regional production networks, harming the region's growth prospects. In addition, faster-than-ex-

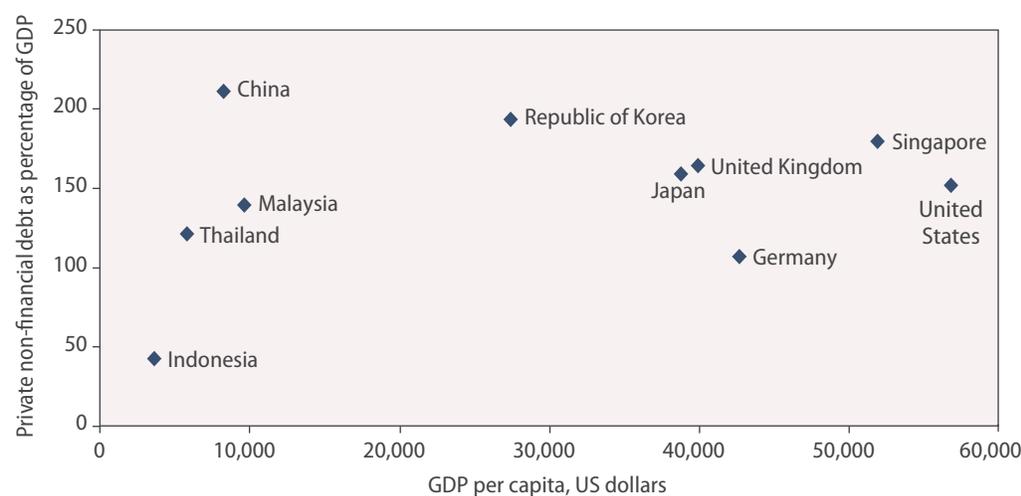
pected monetary policy normalization in developed economies may trigger sudden and large capital outflows from the region, potentially disrupting domestic financial conditions. Furthermore, rising geopolitical tensions, notably in the Korean Peninsula, continue to weigh on investor sentiments.

On the domestic front, financial sector vulnerabilities, particularly high corporate and household debt, will continue to weigh on investment prospects in several countries. In China, the country's high debt, particularly relative to the level of its GDP per capita (figure III.13), has raised concerns over financial stability risks arising from a possible sharp deleveraging process. While ongoing policy measures to contain financial vulnerabilities is expected to result in a gradual growth moderation in China, the risk of a sharper-than-expected growth slowdown remains. The materialization of such a risk would have considerable ramifications on the rest of East Asia, given the region's high trade exposure to the Chinese economy.

Given the favourable macroeconomic environment in the short term, policymakers in the region have more policy space to make progress on structural reforms aimed at enhancing economic resilience and improving the quality of growth. Policy strategies geared towards raising productivity growth are vital in boosting the region's dynamism and medium-term growth prospects. This includes placing greater focus on addressing critical infrastructure gaps, upskilling of the workforce and initiatives to foster innovation as well as research and development investment. In addition, stronger redistribution policies and social safety nets will not only invigorate domestic demand, but also contribute to more sustainable and inclusive growth.

**Measures to boost productivity growth are needed to strengthen East Asia's medium-term growth prospects**

Figure III.13  
Private non-financial debt and nominal GDP per capita of selected East Asian and developed economies, 2016



Sources: Bank for International Settlements and UN/DESA.

## Box III.3

**20 years after the Asian financial crisis**

The year 2017 marks the 20<sup>th</sup> anniversary of the Asian financial crisis (AFC). Major crisis-affected economies often cited include Indonesia, Malaysia, the Republic of Korea and Thailand, although the AFC also dampened economic growth in several other East Asian economies, such as Hong Kong SAR, the Philippines and Singapore.

This box shows that the region's macroeconomic fundamentals have improved in the past two decades, partly aided by enhanced policy management following the AFC. This has helped emerging Asian economies to benefit from a long period of financial stability, including during the global financial crisis. However, pockets of domestic financial vulnerabilities remain today, particularly rising private sector debt amid a high degree of global policy uncertainty.

Macroeconomic fundamentals and financial stability in the crisis-affected economies have strengthened amid policy adjustments and reforms. At a macro level, the AFC was primarily caused by burgeoning external imbalances, such as large current account deficits amid foreign debt-fuelled business investment. At a sectoral level, loose prudential regulation and supervision resulted in the build-up of financial and corporate vulnerabilities. Given the unprecedented scale of economic turmoil that the AFC brought, the crisis triggered policymakers in the region to spend considerable effort in addressing these issues. Some examples of policy measures include:

**Enhancing macroeconomic management.** The crisis-affected economies have adopted a more flexible exchange rate regime and inflation targeting framework, which helped reduce external account imbalances and increased the effectiveness of monetary policy in managing inflation. In 1996, the year before the AFC began, the current account deficit in the crisis-affected economies amounted to 3.4 per cent to 8 per cent of GDP, while foreign exchange reserves were equivalent to only two to five months of imports. In recent years, these economies have enjoyed sizeable current account surpluses or much smaller deficits, while reserves are currently worth at least seven months of imports.

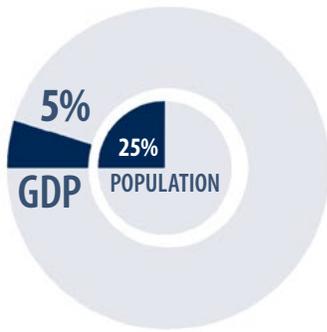
**Strengthening macroprudential regulation and supervision.** To achieve greater financial stability, the crisis-affected economies shut down and merged financial institutions, introduced new financial supervisory agencies, and promoted transparency and data disclosure. Among several other factors, such policy changes helped reduce the share of non-performing loans from its peak of 19 per cent to 49 per cent of total loans in Indonesia, Malaysia and Thailand in 1998 to below 3 per cent in recent years.

**Increasing regional financial cooperation.** In addition to correcting the macro- and sectoral-level causes of the AFC, countries in the region have worked more closely on financial cooperation to help cushion future shocks. A key example is the Chiang Mai Initiative that started in 2000 as a series of bilateral swap agreements among ASEAN+3 countries to address balance of payments and short-term liquidity issues. The initiative became a single, multilateral agreement in 2010 with the current fund size of \$240 billion.

Despite commendable progress, potential sources of financial vulnerabilities remain. Structurally, an effort to diversify sources of financing beyond traditional, dominant banks has seen mixed results. On debt instruments, while the size of the local currency corporate bond market is quite large at 45 per cent to 75 per cent of GDP in Malaysia and the Republic of Korea, the ratio is lower at 20 per cent in Thailand and only 3 per cent in Indonesia. The small size is exacerbated by low levels of market liquidity and relatively short maturity periods. On equity instruments, Indonesia's stock market capitalization remains relatively small and at close to half of GDP, is largely unchanged in the past two decades.

Another source of financial vulnerability is high private sector debt. Corporate and household debts combined ranged from 122 per cent to 195 per cent of GDP in Malaysia, the Republic of Korea and Thailand in 2016. In all three economies, private sector indebtedness was higher in 2016 than in 2007, with household debt in Malaysia and Thailand rising particularly rapidly. Available data also suggests that debt repayment ability is lower among individuals and companies with larger debt burdens.

Maintaining financial stability in Asia remains a challenging task. Rising private sector debt in the region comes at a time when global policy uncertainty is high and interest rates in major developed economies, particularly the United States, are on an upward trend. The risk of sharp reversal of portfolio capital inflows remains, especially if geopolitical tensions in the region intensify. Finally, rising intraregional trade and financial linkages call for greater vigilance and cooperation among policymakers in the region.



Share of the world

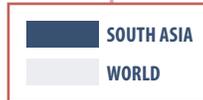
GDP growth



GDP per capita growth



GDP per capita



South Asia: A favourable short-term outlook with significant medium-term challenges

The economic outlook remains steady and largely favourable in South Asia, driven by robust private consumption and sound macroeconomic policies. Monetary policy stances are moderately accommodative, while fiscal policies in several economies maintain a strong emphasis on infrastructure investment. The recovery of external demand is also buttressing growth. Against this backdrop, regional GDP growth is expected to strengthen to 6.5 per cent in 2018 and 7.0 per cent in 2019, following an estimated expansion of 6.3 per cent in 2017.

The positive economic outlook is widespread across the region, with most economies projected to see stronger growth rates in 2018 compared to 2017. In addition, regional inflation is expected to remain stable and at relatively low levels. The favourable prospects for inflation, coupled with mostly sustainable current account deficits, will facilitate macroeconomic policy management across the region in the near term. Overall, this positive outlook is a continuation of the improvement in economic conditions in South Asia over the past several years (figure III.14), and will contribute to gradual progress in labour market indicators and a reduction in poverty rates.

South Asia remains the fastest-growing developing region...

Figure III.14  
South Asia: GDP growth and consumer-price inflation



Source: UN/DESA.

Note: Figures for 2017 are partly estimated; figures for 2018 and 2019 are forecasts.

...but there are several downside risks that can affect the short-term outlook

Notwithstanding this short-term outlook, South Asian economies face several downside risks and uncertainties, which could significantly alter the projected growth trajectory. On the domestic front, the reform agenda, a crucial element of higher productivity growth, could experience setbacks in some countries, while heightened regional geopolitical tensions may restrain investment projects.

On the external front, the monetary normalization process in the United States poses risks to financial stability across the region. Tighter global liquidity conditions could significantly affect capital flows into the region, leading to a spike in financing costs, depreciation in exchange rates and a decline in equity prices. This could adversely impact banking and corporate sector balance sheets as well as the capacity to roll over debt, especially in countries with relatively low financial buffers and high dollar denominated debt.

Despite the growth slowdown in 2017, the outlook for India remains positive

Despite the slowdown observed in early 2017 and the lingering effects from the demonetization policy, the outlook for India remains largely positive, underpinned by robust private consumption and public investment as well as ongoing structural reforms. Hence, GDP growth is projected to accelerate from 6.7 per cent in 2017 to 7.2 per cent in 2018 and 7.4 per cent in 2019.

Nevertheless, the anaemic performance of private investment remains a key macroeconomic concern. Gross fixed capital formation as a share of GDP has declined from about 40 per cent in 2010 to less than 30 per cent in 2017, amid subdued credit growth, low capacity utilization in some industrial sectors and balance sheet problems in the banking and corporate sectors. In this environment, vigorous public investment in infrastructure has been critical in propping up overall investment growth.

Meanwhile, the economic situation in the Islamic Republic of Iran has improved visibly in recent years. In 2017, GDP growth remained relatively robust at 5.3 per cent, after surging by an estimated 12.5 per cent in 2016 due to a strong expansion of oil production and exports. GDP growth is expected to remain above 5.0 per cent in 2018 and 2019, supported by easing monetary conditions and an improving external sector. However, the moderately favourable outlook is contingent on the capacity to attract foreign investments and is subject to significant geopolitical risks and uncertainties.

Among the smaller economies in the region, economic activity in Pakistan is expected to remain vigorous, with GDP growth projected to reach 5.5 per cent and 5.2 per cent in 2018 and 2019, respectively. Economic activity will be supported by a pickup in exports and rising investment demand, which is expected to benefit from an improving business sentiment, the China-Pakistan Economic Corridor (CPEC) and other infrastructure initiatives. However, a rising current account deficit coupled with a recent deterioration of fiscal accounts, pose risks to the baseline projection.

Meanwhile, the Bangladesh economy is set to continue expanding at a rapid pace, underpinned by strong domestic demand, especially large infrastructure projects and new initiatives in the energy sector. GDP growth is expected to remain above 7.0 per cent in 2018 and 2019. Following several years of subdued economic activity and balance of payment problems, growth in Sri Lanka is gradually gaining momentum. The recovery has been supported by stronger external demand and moderate investment growth. In Nepal, economic growth is projected to slow from the peak of 7.5 per cent observed in 2017, but to remain above 4.5 per cent, closer to its medium-term potential (figure III.15).

Inflation prospects remain benign across the region. Consumer price inflation reached a multi-year record low of 4.9 per cent in 2017, due to relatively low commodity prices, waning depreciation pressures and good harvest seasons in most countries that have supported lower food prices, notably in India. In 2017, inflation declined to record lows in India and Nepal, while it remained relatively muted in comparison to historical figures in Pakistan, Bangladesh and the Islamic Republic of Iran.

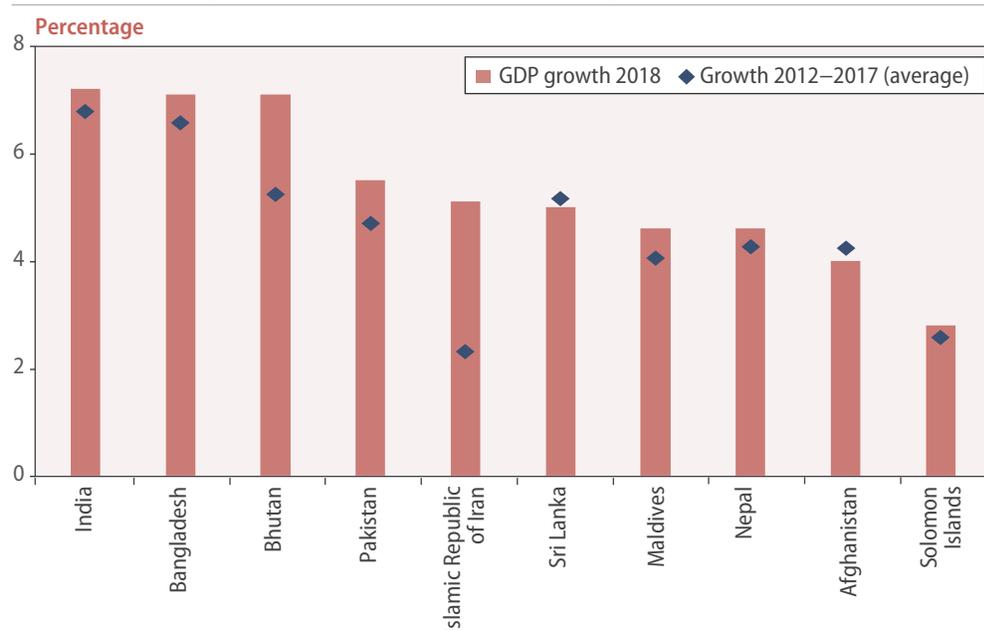
By contrast, inflation in Sri Lanka tended to increase throughout 2017, pushed by depreciation pressures, relatively high credit expansion and the drought's impact on food prices. In the outlook, consumer price inflation in South Asia is expected to rise moderately to 5.8 per cent in 2018 and 5.9 per cent in 2019, still well-below historical levels in the region.

Against this backdrop, monetary policy stances are mostly accommodative in the region, following an easing cycle initiated in previous years. In 2017, monetary conditions

**GDP growth in Bangladesh remains robust, while economic activity in Sri Lanka is slowly picking up**

**Monetary policy stance remains mostly accommodative...**

Figure III.15  
South Asia: GDP growth, 2018 and 2012–2017 (average)



Source: UN/DESA.

Note: Figures for 2018 are forecasts.

were eased further in countries such as India, the Islamic Republic of Iran and Nepal. In India, the key policy rate was cut by an additional 25 basis points in August, while monetary authorities in the Islamic Republic of Iran reduced reserve requirements from 13 per cent to 10 per cent to encourage lending to small and medium-size enterprises.

Yet, credit growth remains moderately subdued across the region, particularly so in industrial sectors in India. In response, the Indian Government has implemented a range of policy measures to address the relatively elevated levels of non-performing loans, for instance through a large recapitalization plan for State-owned banks and by implementing new insolvency proceedings.

Looking ahead, there exists some degree of uncertainty over the monetary policy stance in India. Subdued inflation, coupled with a good monsoon season, offers scope for additional monetary easing. However, if inflation accelerates faster than anticipated, the loosening cycle could end abruptly. Meanwhile, the Central Bank of Sri Lanka is modifying its monetary policy and exchange rate framework, moving towards an inflation-targeted policy approach.

Amid relatively high levels of public debt, fiscal policies are officially in a moderately tight stance in most economies. Ongoing fiscal consolidation efforts, however, have yielded different levels of progress, as public budgets have been in reality more expansionary. In India, the fiscal deficit has declined visibly, and it is expected to narrow further to 3.2 per cent of GDP in 2018. In Sri Lanka, the fiscal deficit has also narrowed, amid strong consolidation pressures under the Extended Fund Facility arrangement with the IMF. By contrast, the fiscal deficit has recently expanded in Pakistan, and it continues to be moderately high in Bangladesh, at about 5 per cent of GDP. Given the large development needs across the region, budget deficits are expected to remain relatively high but manageable in the outlook period. Several economies have introduced new initiatives to strengthen the tax base, including comprehensive tax reforms in India and Sri Lanka.

Beyond the favourable economic situation and its short-term risks and uncertainties, there are crucial areas that South Asia needs to address to unleash its growth potential and to promote a more sustained and inclusive development path in the medium term. First, strengthening the fiscal accounts constitutes a key challenge for most economies. The low level of tax revenues and largely rigid public expenditure throughout the cycle contribute to persistent structural deficits across the region. Moreover, efforts to widen the tax base have so far exerted only partial success.

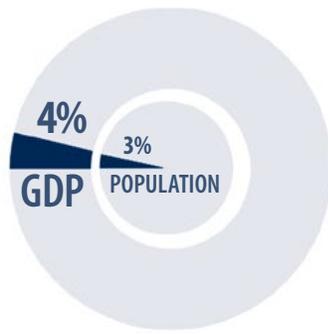
Improved tax revenues are critical to build fiscal buffers and strengthen the capacity to implement countercyclical policies. Proactive fiscal policies play a crucial role in stabilizing economic activity and supporting development priorities, for example in social protection, poverty and inequality dimensions. Second, the region needs to tackle large infrastructure gaps, particularly in the areas of energy, telecommunications, sanitation and water access, as well as transport and connectivity. The enduring infrastructure deficits in some of these areas pose a threat not only to productivity gains and economic growth, but also to alleviating poverty.

Thus, promoting private investments in infrastructure projects should be a key policy priority through a wide range of measures, including public investments that crowd-in private investments and public-private partnerships — as well as better implementation capacities in the public sector, regulatory changes and structural reforms.

**...while fiscal policies are moderately tight but with significant degrees of freedom**

**Tackling structural issues should be a key priority to promote stronger productivity gains, more inclusive growth and greater poverty reduction**

## Snapshot: Western Asia



Share of  
the world

### GDP growth



### GDP per capita

### GDP per capita growth



■ WESTERN ASIA  
■ WORLD

## Western Asia: Outlook mixed, overshadowed by oil market and geopolitical factors

The economic outlook for Western Asia remains mixed, overshadowed by oil market developments and geopolitical factors. GDP growth for Western Asia slowed to an estimated 1.9 per cent in 2017. A slow recovery is projected, with GDP growth forecast to be 2.3 per cent for 2018, and 2.7 per cent for 2019.

Oil market developments remained the most influencing factor to the region's economies in 2017, particularly in the major oil exporting economies of Bahrain, Iraq, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. As oil prices are forecast to recover gradually (see discussion in Chapter I), the GDP growth of the member states of the Cooperation Council for the Arab States of the Gulf (GCC), namely Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates, is forecast to bottom out in 2018, followed by a gradual acceleration. Despite a significant negative contribution of the oil sector to real GDP growth in 2017, a resilient domestic demand expansion prevented the GCC economies from a severe contraction. Domestic demand in GCC economies has been

supported by the stabilizing value of financial and real estate assets as well as strong foreign investors interest — mainly from South and East Asia.

**Intraregional resource flows decline as a regional repercussion of the slowdown in GCC economies**

Weaker growth in GCC economies had regional repercussions, causing a dip in intraregional resource flows from GCC economies to the region's oil importing economies. Stagnation in intraregional trade, workers' remittances, portfolio investments and FDI posed less favourable external conditions for growth, particularly in Jordan and Lebanon.

The geopolitical situation continues to influence the economies in Western Asia. The Iraqi economy regained a degree of stability as the security situation improved. The dire economic situation in the Syrian Arab Republic and Yemen continues as both countries face humanitarian crises due to ongoing armed violence. While geopolitical tensions continued to impact negatively on neighbouring economies, particularly Jordan, Lebanon and Turkey, several signs of resilience were observed in those economies.

After exhibiting a resilient growth in 2016 despite political turbulences, the expansion of the Turkish economy accelerated in 2017. The real GDP growth for 2017 is estimated at 3.3 per cent, supported by strong domestic and external demand. The present momentum is expected to taper off as GDP growth is forecast to slow to 2.1 per cent in 2018.

A robust economic expansion continued in Israel despite a deceleration in the rate of GDP growth in 2017 from the previous year. The real GDP growth of Israel for 2017 is estimated at 2.9 per cent. Growth in both domestic and external demand led the present strong expansion, supported by accommodative fiscal and monetary policies. The present momentum is expected to continue, as GDP growth is forecast to be 3.1 per cent in 2018.

**Inflation trends vary for country-specific factors**

The average annual consumer price inflation of Western Asia is estimated to be 4.8 percent in 2017. However, inflation trends varied among Western Asian economies depending on country-specific factors. Average consumer price inflation is forecast to drop to a moderate pace of 4.5 per cent in 2018 and 3.9 per cent in 2019. Inflationary pressures have remained weak in GCC economies, particularly on food prices. By contrast, inflation rates in Jordan and Lebanon picked up in 2017 after deflation in 2016. Conflict-related inflationary pressures were well contained in Iraq.

Hyperinflation continued in the Syrian Arab Republic and Yemen, but the inflation rate is expected to drop significantly in Syria with the stabilizing value of the Syrian pound. In 2018, the economic recovery in GCC countries is expected to produce mild inflationary pressure, which could be reinforced by the expected introduction of a unified VAT in 2018.

The consumer price inflation rate in Turkey is estimated to be 10.8 per cent in 2017, in part reflecting a rise in import prices due to the depreciation of the Turkish lira. The rapid growth of the broad money stock continued well into 2017. The inflation rate is forecast to be 8.3 per cent in 2018 as the pass-through impact of the Turkish lira's steep devaluation in 2016 dissipates.

Consumer price inflation in Israel is estimated to be 0.2 per cent in 2017. The appreciation of the shekel put the economy into deflationary territory. However, overheating domestic demand and upward pressure on wage rates are expected to create inflationary pressures in Israel — with inflation forecast to rise to 2.3 per cent for 2018.

**Policy interest rate in GCC economies and Jordan rise in line with the Fed**

Financing costs in GCC economies and in Jordan and Lebanon have been rising, which suppressed the growth of the broad money stock. As the majority of economies in the region peg their national currencies to the US dollar, central banks in Bahrain, Jordan, Kuwait, Qatar, Saudi Arabia and the United Arab Emirates increased their respective policy interest rates in line with the federal funds rate hikes in the United States.

Despite the ongoing armed conflict, central banks in Iraq, the Syrian Arab Republic and Yemen remained functioning, and have endeavoured to exert some economic order by stabilizing the foreign exchange rates and maintaining money circulation.

The Central Bank of the Republic of Turkey tightened its policy stance by raising its policy rate, aiming to stabilize the Turkish lira. Its late liquidity window rate had reached 12.25 per cent in April 2017 and stood at the same rate as in November 2017. The Central Bank of Israel maintained a record low level of its policy rate at 0.1 per cent.

Due to a moderate increase in fiscal revenues in GCC economies, and in Jordan and Lebanon, deficits are expected to edge down in those economies over 2017 and 2018. However, fiscal authorities remained cautious against loosening the policy stance, instead proposing tax reforms to strengthen the revenue base and to reduce public debt. The introduction of the VAT has been legislated in Saudi Arabia and the United Arab Emirates and will become effective on 1 January 2018. Other GCC economies are expected to follow. If implemented, a 5 per cent VAT will be imposed on a wide variety of goods and services (see Box III.4).

The Turkish Government is expected to maintain fiscal prudence by taking a tighter stance after having increased expenditure as part of stimulus measures introduced in 2017. This will keep both deficits and debts at a manageable level.

The fiscal policy stance remained accommodative in Israel due to its strong fiscal position. Fiscal expenditures are expected to grow, despite the planned introduction of tax cutting measures over 2017 and 2018.

External balances improved in some Western Asian economies, particularly in major oil exporting economies as oil export revenues recovered from the lows of 2016. A moderate recovery in tourism also supported the improvement. For 2017 and 2018, Kuwait, Qatar, Saudi Arabia and the United Arab Emirates are projected to record current account surpluses. Bahrain and Oman will continue to see current account deficits in 2017 before reaching surpluses in 2018. Growth in non-oil trade is expected in Bahrain and the United Arab Emirates, but the trade structure of the GCC economies remains highly oil-dependent.

Current account deficits are expected to edge down in Jordan and Lebanon over 2017 and 2018. Stagnating resource inflows, such as FDI and workers' remittances, constrain the range of trade deficits that can be financed by financial account surpluses. The Syrian Arab Republic appears to have regained a stable external balance, as the value of the Syrian pound stabilized since August 2016. The Syrian pound even edged up against the US dollar, and stood at SYP 498/\$ in November 2017.

The depreciation of the Turkish lira continued in 2017 albeit at a slower pace than in the previous year. Due to an improving trade balance, the central bank's foreign reserves rebounded in the second quarter of 2017. Despite active interventions by the central bank, the Israeli shekel continued to appreciate in 2017, impacting the price competitiveness of exports to Europe. However, strong growth in service trade kept the current account in surplus, accelerating foreign reserves accumulation.

The employment situation remain mixed in the region. A large share of the population is out of work due to armed conflicts in the region, and the chronically high unemployment situation in Jordan and Lebanon has not improved. However, national employment conditions have moderately improved in GCC economies along with the labour force nationalization policies. More GCC nationals took up private sector jobs that had been traditionally tasked to foreign workers.

A gradually rising female labour participation rate in GCC economies also supported labour force nationalization. Nevertheless, due to a large number of new entrants to labour markets, unemployment rates remained high as indicated by available national data. The

**Fiscal authorities remain cautious against loosening fiscal stance**

**External balances improve in major oil exporting economies**

**The unemployment rate, particularly for women, remains high in some Western Asian economies**

## Box III.4

## A preliminary assessment of the economic implications of GCC-wide VAT

In an effort to reduce their fiscal dependency on oil revenue, the Cooperation Council for the Arab States of the Gulf (GCC) countries have attempted to implement various tax reforms over the last decades. The income and corporate taxes mostly targeting foreigners have been introduced during times of low oil prices, and have been occasionally abandoned by a recovery in oil prices. In particular, the introduction of value-added tax (VAT) has been discussed extensively but not implemented yet as many GCC countries would want to remain a tax-free area to attract foreign investment and maintain the status of an international service hub.<sup>a</sup>

Meanwhile, the recent drop in oil prices and its implications in terms of fiscal deficit and indebtedness and dwindled foreign reserves reinforce a further robust basis for the VAT introduction in GCC countries. Recently, a decision has finally been made to implement a GCC-wide VAT at 5 per cent starting January 2018 in Saudi Arabia and the United Arab Emirates, and by the end of 2018 for the rest of the GCC States. In effect, a newly introduced VAT could have substantial socioeconomic implications for household consumption paths by raising consumer prices. Its effect on growth, trade and sectoral production could depend significantly on how governments utilize the generated revenues.

A preliminary assessment using the MIRAGE global computable general equilibrium (CGE) model<sup>b</sup> shows that the net impact of a GCC-wide VAT at 5 per cent could generate a considerable fiscal revenue (countries varying between 0.9 per cent and 3.1 per cent of GDP). If these revenues are only used to improve the fiscal balance, this could generate a slowdown in growth, an increase in unemployment, a rise in inflation and a reduction of household consumption. This further implies a reduction in imports under an assumption that public spending remains unchanged, which in a modelling-context of fixed balance of payments can be associated with a real depreciation of exchange rates and an increase of total exports.

In contrast, the results could completely change if these revenues were utilized for public expenditure while leaving the public deficit unchanged.<sup>c</sup> Model estimates suggest that the net impact of the VAT shock on growth will be positive, as government expenditure could bring about cycles of spending that would positively affect employment creation and domestic demand (known as the Keynesian multiplier). The estimated job creation would increase household revenue and consumption and pull in additional imports from the rest of the world. The rise in economic activity and domestic demand would raise fiscal revenue over and above the direct impact of the VAT rise.

While successful implementation of VAT is important as a revenue generator, its socioeconomic effects depend on the use of these revenues, which is even more critical, as demonstrated by the preliminary assessment. If the revenue generated by VAT is used only to improve fiscal balances, the implementation could hinder sustainable growth and employment. Meanwhile, both growth and job creation could be positive if the revenue is allocated to public spending. Not only should policymakers effectively implement the new taxation, they should also consider its broad implications and distributive effects.

<sup>a</sup> Abed and Davoodi (2003).

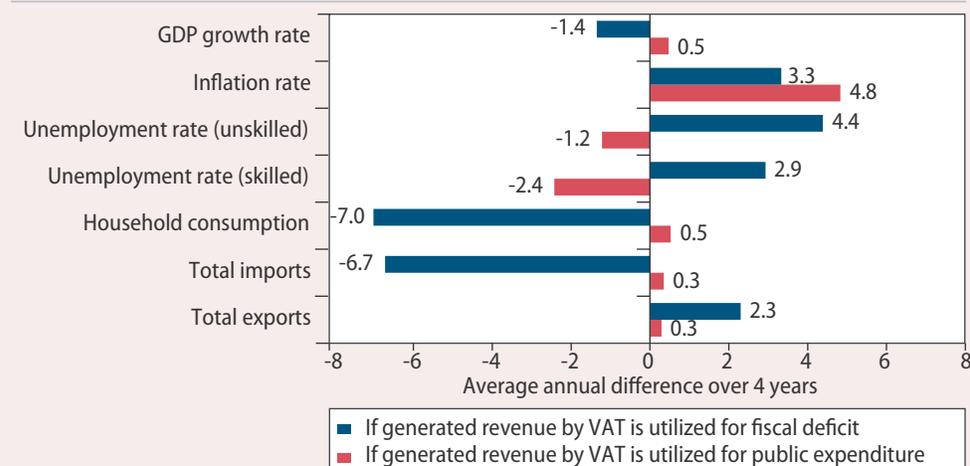
<sup>b</sup> The GCC-wide VAT at 5 per cent rate is modelled for four years (2018–2021) to estimate its distributive effects of two broad policy options—the generated revenue by VAT is simulated to utilize to either reduce fiscal deficit or increase government expenditure. The impacts are averaged across six countries.

<sup>c</sup> Based on IMF country reports and Article IV missions, reports and consultations.

Author: Seung-Jin Baek (ESCWA)

Figure III.4.1

## Macroeconomic implications from introducing VAT in GCC countries



Source: Author's own elaboration on the basis of ESCWA (2017).

Note: The figure shows percentage point differences for GDP growth rate, inflation rate and unemployment rates between the business-as-usual scenario and the two policy scenarios, and percentage differences in the volume of household consumption, imports and exports.

unemployment rate in Jordan stood at 18.2 per cent (13.9 per cent for male and 33.0 per cent for female) in the first quarter of 2017. The unemployment rate among Saudi nationals stood at 12.8 per cent (7.4 per cent for male and 33.1 per cent for female) in the second quarter of 2017. After registering a seven-year high in January with 13 per cent, the unemployment rate in Turkey came down to 10.2 per cent in June 2017. Male unemployment has quickly come down to 8.6 per cent, whereas the female unemployment rate rose moderately to 13.5 per cent. Employment dynamics in Israel bucked the regional trend as the unemployment rate continued to drop to 4.1 per cent (4.1 per cent for male and 4.2 per cent for female) in August 2017.

Geopolitical tensions, political instability and oil market developments persist as the main downside risks for Western Asian economies. Oil prices are expected to stay between \$50 per barrel and \$60 per barrel over 2017 and 2019. However, energy-saving measures as well as the expanded use of renewables may slow the growth in crude oil demand earlier than projected. Major oil exporting economies may need to expedite reform measures in order to diversify their economies before oil prices level off in response to the structural shift in energy markets.

**Geopolitical tensions and oil market developments continue to dominate economic prospects**

## Snapshot: Latin America and the Caribbean



Share of  
the world

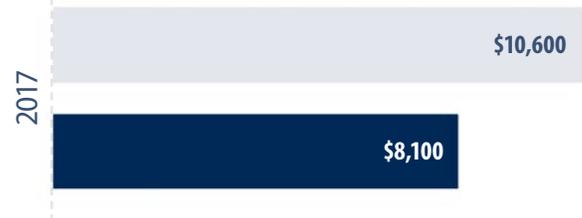
### GDP growth



### GDP per capita growth



### GDP per capita



■ LATIN AMERICA AND THE CARIBBEAN  
■ WORLD

## Latin America and the Caribbean: The recovery is projected to strengthen

Against a backdrop of favourable global conditions, the economic recovery in Latin America and the Caribbean<sup>3</sup> is set to gain further traction during the forecast period. After growing by an estimated 1.0 per cent in 2017, the region's economy is projected to expand by 2.0 per cent in 2018 and 2.5 per cent in 2019. These growth rates would be the strongest that the region has seen since 2013. The recovery will be largely driven by a broad-based improvement in economic activity in South America, including in the two largest economies Argentina and Brazil. While average growth in the region is projected to strengthen gradually, it will remain well below rates observed during the commodity boom of the 2000s. A prolonged period of subpar growth would hamper the region's progress towards achieving the SDGs.

<sup>3</sup> The country classification is based on United Nations Economic Commission for Latin America and the Caribbean (ECLAC). The region of Latin America and the Caribbean comprises three subregions: South America; Mexico and Central America (which includes Caribbean countries that are considered part of Latin America, namely, Cuba, the Dominican Republic and Haiti); as well as the Caribbean.

The economies of South America, many of which are specialized in the production of primary goods (particularly oil, minerals and food), were heavily affected by the negative terms of trade shock in 2015–2016. In 2017, these economies benefited from a combination of stronger global growth — and thus stronger external demand — and a modest recovery in commodity prices. This not only helped the terms of trade and export earnings, but also fiscal revenues.

At the same time, domestic demand started to recover in 2017. Total investment has expanded for the first time since 2013 and private consumption has picked up, supported by lower inflation and looser monetary policy. Despite solid growth in exports, the external sector constituted a drag to growth in 2017 as the rise in domestic demand drove imports up. On average, South America's economy has grown by an estimated 0.4 per cent in 2017, after two consecutive years of economic contraction. Notably, Argentina, Brazil and Ecuador, which all saw contractions in economic activity in 2016, have returned to growth in 2017.

In 2018, South American economies are forecast to see a further pickup in growth to 1.8 per cent. The economic recoveries in Argentina and Brazil are expected to strengthen as investment accelerates and labour markets improve; Paraguay and the Plurinational State of Bolivia are projected to post robust growth rates well above the subregional average; Chile and Peru will likely see notable improvements in their economic performance as some of the factors that dragged growth down in 2017 ease (including a copper mine strike and forest fires in Chile and floods in Peru). Meanwhile, Colombia's economic slowdown appears to have bottomed out and a mild recovery is expected in 2018. The Bolivarian Republic of Venezuela will likely see a further contraction in economic activity in 2018 amid continuing disruptions to the productive base.

The subregion of Mexico and Central America is expected to grow by 2.5 per cent in 2017 and 2.6 per cent in 2018. The countries in this subregion continue to benefit from higher remittances and stronger global growth, including that of its main trading partner, the United States. Private consumption continues to be the main driver of growth, supported by low inflation rates and strong remittance inflows.

The Dominican Republic, Nicaragua and Panama will remain among the region's fastest-growing economies, benefiting from buoyant private consumption, robust public investment and a strong tourism sector. Growth in Mexico is projected to pick up slightly in 2018 to 2.4 per cent. Assuming NAFTA renegotiations are concluded in the first quarter of 2018 as scheduled, this will ease uncertainty regarding future trade relations, and support a slight recovery in private investment. A positive growth impulse is also likely to come from reconstruction spending following the two devastating earthquakes that hit Mexico in September 2017.

In English-speaking Caribbean economies, GDP growth averaged only 0.2 per cent in 2017. This weak performance reflects several factors: ongoing contractions in some of the subregion's commodity exporters, in particular Suriname and Trinidad and Tobago; the damage caused by Hurricanes Irma and Maria in several countries in September 2017, including losses in tourism; and persistent structural barriers, such as elevated unemployment, high debt burdens, insufficient access to finance and weak infrastructure. In 2018, economic growth is projected to accelerate to 1.8 per cent, supported by increased reconstruction spending and stronger private investment.

Amid abundant global liquidity and reduced risk aversion, portfolio capital flows to Latin America continued to rise in 2017 and this positive trend is expected to continue in 2018. While financial volatility remains very low, indicators of global policy uncertainty

**The economic recoveries in Argentina and Brazil are projected to gain momentum**

**The forecasts for 2018 and 2019 are contingent on a continued benign international environment**

are still elevated as risks related to protectionism, monetary tightening and geopolitical issues prevail. A marked growth slowdown in China presents an additional risk, especially for South America's commodity-exporting countries.

**Average urban unemployment increased further in 2017, but a mild decline is expected for 2018**

Slow growth in parts of Latin America and the Caribbean continues to weigh on labour markets, affecting both the quantity and quality of employment. The region's average urban unemployment is estimated to have increased for a third consecutive year, rising from 8.9 per cent in 2016 to 9.4 per cent in 2017. This reflects both a decline in the urban occupation rate and an increase in the labour force participation rate. Job creation has mainly occurred in the self-employment category, which is often associated with lower quality jobs. Total wage employment, by contrast, has seen only a modest increase.

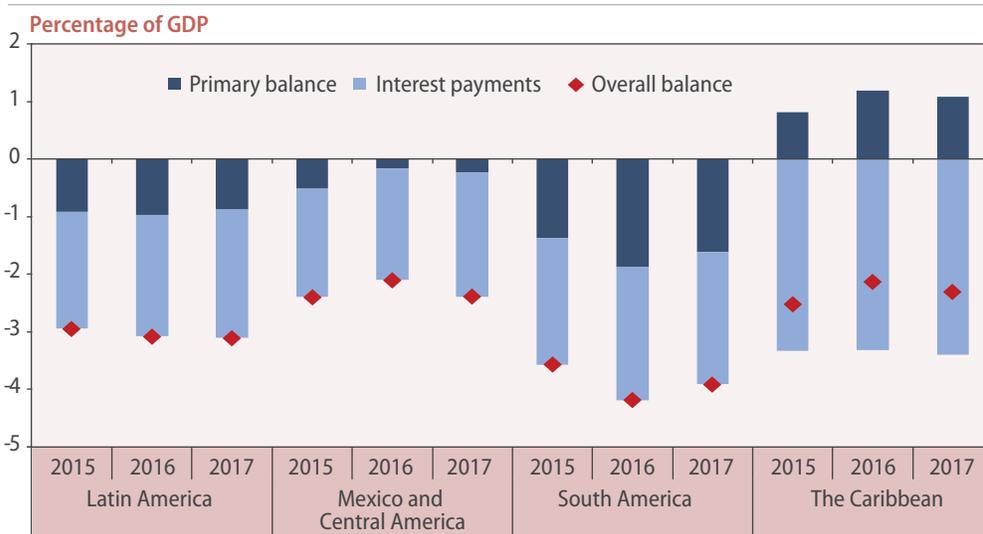
Trends in the crisis-hit countries of South America and the rest of the region differ significantly. In fact, much of the year-on-year increase in regional unemployment can be attributed to Brazil, where unemployment surged in 2016. After peaking at a record level of 13.7 per cent in March 2017, the country's unemployment rate has started to decline — a trend that is expected to continue in 2018 and 2019. The labour market performance in Mexico and Central America has generally been more favourable. In Mexico, the unemployment rate has remained near a decade-low of 3.2 per cent amid robust job creation in the private sector. Looking ahead, average urban unemployment in the region is projected to decline slightly in 2018 and 2019 as the recovery in Brazil and other South American economies gains momentum.

**Recovery of fiscal space in Latin America and the Caribbean remains slow...**

The average fiscal deficit in Latin America remained steady at an estimated 3.1 per cent of GDP in 2017, albeit with significant differences across subregions (figure III.16). Following three consecutive years of improvement, the unweighted average fiscal deficit in Mexico and Central America is expected to have widened to 2.4 per cent of GDP, owing mainly to a deceleration in public revenue growth.

Similarly, in the Caribbean, where countries on average are running primary surpluses, the average fiscal deficit is estimated to have risen from 2.1 per cent of GDP in 2016 to 2.3 per cent of GDP in 2017. By contrast, in South American countries, the average deficit

Figure III.16  
Latin America and the Caribbean: Central government balances, 2015–2017



Source: ECLAC, based on official figures.

Note: Figures reflect simple (unweighted) averages of country data; Latin America and South America exclude the Plurinational State of Bolivia and the Bolivarian Republic of Venezuela; the Caribbean includes: Antigua and Barbuda, Bahamas, Barbados, Belize, Granada, Guyana, Jamaica, Saint Kitts and Nevis, Saint Vincent and the Grenadines, Santa Lucia, Suriname and Trinidad and Tobago.

is expected to have narrowed slightly, from 4.2 per cent of GDP in 2016 to 3.9 per cent of GDP in 2017, as fiscal consolidation efforts, including public spending cuts, continued.

The persistence of fiscal deficits in the post-crisis period has put upward pressure on public debt levels. The average public debt level of central governments in Latin America reached a simple average of 37.3 per cent of GDP by the end of 2016, up from 30.7 per cent in 2009. The consolidation efforts seen in South America over the past few years have helped to stabilize public debt. The regional average, however, masks significant differences between countries, with central government debt ranging from about 20 per cent of GDP in Peru to more than 70 per cent of GDP in Brazil. In the Bolivarian Republic of Venezuela (excluded in the regional average), the Government announced plans in November 2017 to refinance and restructure its external debt. However, there is immense uncertainty about what this process would entail and how it could eventually play out. In the Caribbean, high levels of public debt that entail an average annual interest burden in excess of 3 per cent of GDP remain a key fiscal constraint and a significant development barrier, although some progress has been made in recent years.

Public revenue growth has remained relatively weak in Latin America in 2017, in contrast with an upturn in the Caribbean. In Latin America, total revenues as share of GDP have decreased slightly, reflecting lower tax revenues. The unexpected increase in tax revenues in 2016 was partly the result of exceptional factors. These include the implementation of new tax administration measures in some countries, particularly in Mexico and Central America, and extraordinary income from tax amnesty programmes in South America, which mitigated the fall in public revenue. Total public revenue in the Caribbean is estimated to have risen slightly in 2017, but with large variation between countries.

Due to fiscal consolidation efforts in several countries, public spending is expected to have declined marginally in South America. The spending cuts have disproportionately affected capital expenditures. In Mexico and Central America, public spending is expected to remain stable relative to output, at close to 19 per cent of GDP. Public spending is estimated to have risen slightly in the Caribbean to about 30 per cent of GDP in 2017, with a certain shift towards higher capital expenditure, in part related to reconstruction efforts in the aftermath of natural disasters.

While consolidation measures are likely to continue during the outlook period, gains in fiscal space will take longer to materialize. Modest economic growth and moderate commodity prices will continue to weigh on fiscal revenue growth. Efforts to cut or to constrain growth in public expenditure threaten to worsen the already large structural deficits in the provision of public services, particularly in the areas of education, health and social security, possibly lowering potential growth in the future.

Against the backdrop of declining inflation, weak economic activity and improved financial stability, several South American central banks, including those in Brazil, Chile, Colombia and Peru, have eased monetary policy during 2017. The Central Bank of Brazil cut its main policy rate aggressively from 14.25 per cent in October 2016 to a current level of 8.25 per cent, the lowest level since 2013. In Argentina, by contrast, the central bank raised its reference rates in 2017 as inflation has remained above target. As South America's recovery gains momentum and economic slack diminishes, the monetary easing cycle is expected to come to an end. In the absence of negative shocks, policy rates are projected to remain largely unchanged over the next year. A moderate tightening of monetary policy is possible in the later part of the forecast period.

**...despite continuing fiscal consolidation efforts, especially in South America**

**Monetary authorities in South America have utilized available policy space to stimulate domestic demand**

In Mexico and Central America, monetary authorities generally had less scope to stimulate economic activity, partly due to elevated inflation pressures and exchange-rate volatility. Policy rates were raised in Costa Rica, the Dominican Republic and Mexico. In Mexico, the protracted tightening cycle, which started in late 2015 and saw the main policy rate rise from 3 per cent to 7 per cent, has likely come to an end. In 2018, the central bank is expected to pursue a broadly neutral stance as inflation will start to come down, albeit remaining above the 3 per cent target rate.

In countries that are dollarized (Ecuador, El Salvador and Panama) or have a pegged exchange rate against the dollar (e.g., Bahamas, Barbados and Belize), monetary policy is essentially imported from the United States. As such, local interest rates are projected to rise in line with those of the Fed.

#### Box III.5

#### The rise of the international bond market and corporate debt in Latin America

Since the start of the global financial crisis (2007–2009), the international bond market has become a major source of funding for emerging market economies including those of Latin America. The decomposition of the stock of debt issued by sector shows the rapid rise in importance of the debt of the financial and, more prominently, of the non-financial corporate sector. The increased debt of the non-financial corporate sector has been accompanied by a decline in firms' profitability, amid lower commodity prices and slower growth. This has had a negative effect on investment, and may continue to restrain investment in 2018–2019. Following the global financial crisis, the deleveraging process witnessed by global banks and other large financial institutions was accompanied by a significant decline in their profitability levels. On average, between the pre- and post-global financial crisis period, profitability measured by the rate of return on equity (ROE), which measures the amount of net income returned as a percentage of shareholders' equity, declined by 50 per cent (from 15.5 per cent to 7.7 per cent on average) in the United States.

Meanwhile, for Europe, ROE declined from 14.4 per cent to 4.9 per cent. Moreover, in the case of both Europe and the United States, the largest decline in profitability occurred in banks with the largest asset levels. Deleveraging by global banks contributed to the decline in cross-border bank lending throughout the world. Between the periods 2001 and 2008 and 2010 and 2015, the rate of growth of cross-border bank lending declined from an average of 14.6 per cent to 7.5 per cent for the United States, 16.0 per cent to 4.8 per cent for Japan, and 16.7 per cent to -1.0 per cent for the euro area.

Part of the slack in lending was filled by the bond market, which became a major source of funding for emerging market economies including those of Latin America. In the case of Latin America, the total stock of outstanding international debt securities issued, which averaged \$332 billion between 2000 and 2007, increased to \$881 billion in 2017. The stock of debt is concentrated in Mexico and the larger countries of South America (Argentina, Brazil, Chile, Colombia, Peru and the Bolivarian Republic of Venezuela), which account for 89 per cent of the total international debt stock in Latin America and the Caribbean.

The decomposition of the stock of debt issued by sector (including the government, the central bank, financial corporations and commercial banks) for the period 2000–2017 shows several stylized facts. First, although the government is the most important issuer of international debt, its importance has declined over time.

A second stylized fact is the rapid rise in importance of the debt of the financial and, more prominently, of the non-financial corporate sector. The stock of international debt securities of the financial sector rose, on average, from \$47 billion to \$241 billion between 2000–2007 and 2017. The decomposition between the private and public sector components also shows that the former explains the bulk of the rise in debt. For its part, at the regional level, the stock of the non-financial corporate sector expand-

*(continued)*

Box III.5 (continued)

Table III.5.1  
Stock of international debt securities

	In US\$ billions						As percentage of the total						As percentage of GDP			
	2000-2007	2009	2012	2015	2016	2017	2000-2007	2009	2012	2015	2016	2017	2000-2007	2009	2012	2015
Latin America and the Caribbean																
Government	235	228	255	287	334	351	70.8	58.8	40.2	36.3	38.8	39.8	9.7	5.7	4.4	6.1
Central banks	0	0	0	0	0	0	0.1	0.0	0.0	0.0	0.0	0.0	1.5	0.0	0.0	0.0
Financial corporations	24	43	106	126	121	120	7.3	11.0	16.7	15.9	14.1	13.7	1.1	1.1	1.8	2.7
Commercial banks	10	21	61	61	57	56	3.0	5.5	9.6	7.7	6.6	6.3	0.9	0.6	1.2	1.4
Other financial corporations (private)	7	18	33	39	40	40	2.2	4.5	5.1	5.0	4.6	4.5	0.3	0.4	0.6	0.8
Public banks	5	3	11	19	18	18	1.6	0.8	1.7	2.4	2.1	2.1	0.3	0.2	0.4	0.9
Non financial corporations	49	74	167	254	284	289	14.8	19.1	26.3	32.0	33.0	32.9	2.4	1.9	3.0	5.5
Other financial corporations (public)	1	1	2	6	6	6	0.3	0.2	0.4	0.8	0.7	0.7	0.7	0.2	0.2	0.3
TOTAL	332	387	634	792	860	881	100.0	100.0	100.0	100.0	100.0	100.0	17.0	10.1	11.5	17.7

Source: BIS (2017c).

ed from \$49 billion to \$289 billion for the same period. The data also shows that the stock of corporate debt is more important for South America than Central America.

The countries that are most exposed to corporate debt in the international bond market include Mexico and, within South America, Brazil, Chile, Colombia and Peru. Available data between 2000 and 2015 shows that for Mexico, the stock of debt of the non-financial corporate sector increased visibly from 3.1 per cent to 11.9 per cent of GDP. During the same period, the stock of debt of the non-financial corporate sector in Brazil expanded from 2.2 per cent to 8.5 per cent, from 3.3 per cent to 16.1 per cent in Chile, from 1.0 per cent to 6.3 per cent in Colombia and from 0 per cent to 4.9 per cent in Peru. Other countries in South America such as Argentina and Paraguay have, in comparative terms, smaller corporate debt ratios.

Companies that have issued debt in the international bond market have registered, on average, high levels of indebtedness and declining levels of profitability. The available evidence for Argentina, Brazil, Chile, Colombia, Mexico and Peru shows that the leverage (measured by the debt-to-equity ratio) of the companies that have issued debt in the international bond market increased from 116 per cent to 141 per cent between 2009 and 2015. At the same time, profitability measured by the ROE fell from 11.5 per cent to 1.4 per cent

Against a backdrop of higher corporate borrowing, a drop in returns implies rising financing costs and a weaker capacity to meet obligations. This may lead to a decline in production levels and capital spending, with macroeconomic repercussions as these firms represent a large percentage of total assets for the economy as a whole, whether considered at the country level, or by sector of economic activity. The firms that have issued debt in the international bond market are also among those that have the highest capitalization ratios. While only 3.7 per cent of large listed companies have issued debt in the international bond market, their share of total assets, and of fixed-asset spending and long-term investment, is quite high (figure III.5.1).

Author: Esteban Pérez Caldentey, ECLAC

(continued)

Box III.5 (continued)

Figure III.5.1

**Latin America (selected countries): Non-financial firms that issued debt in international bond markets, 2015**