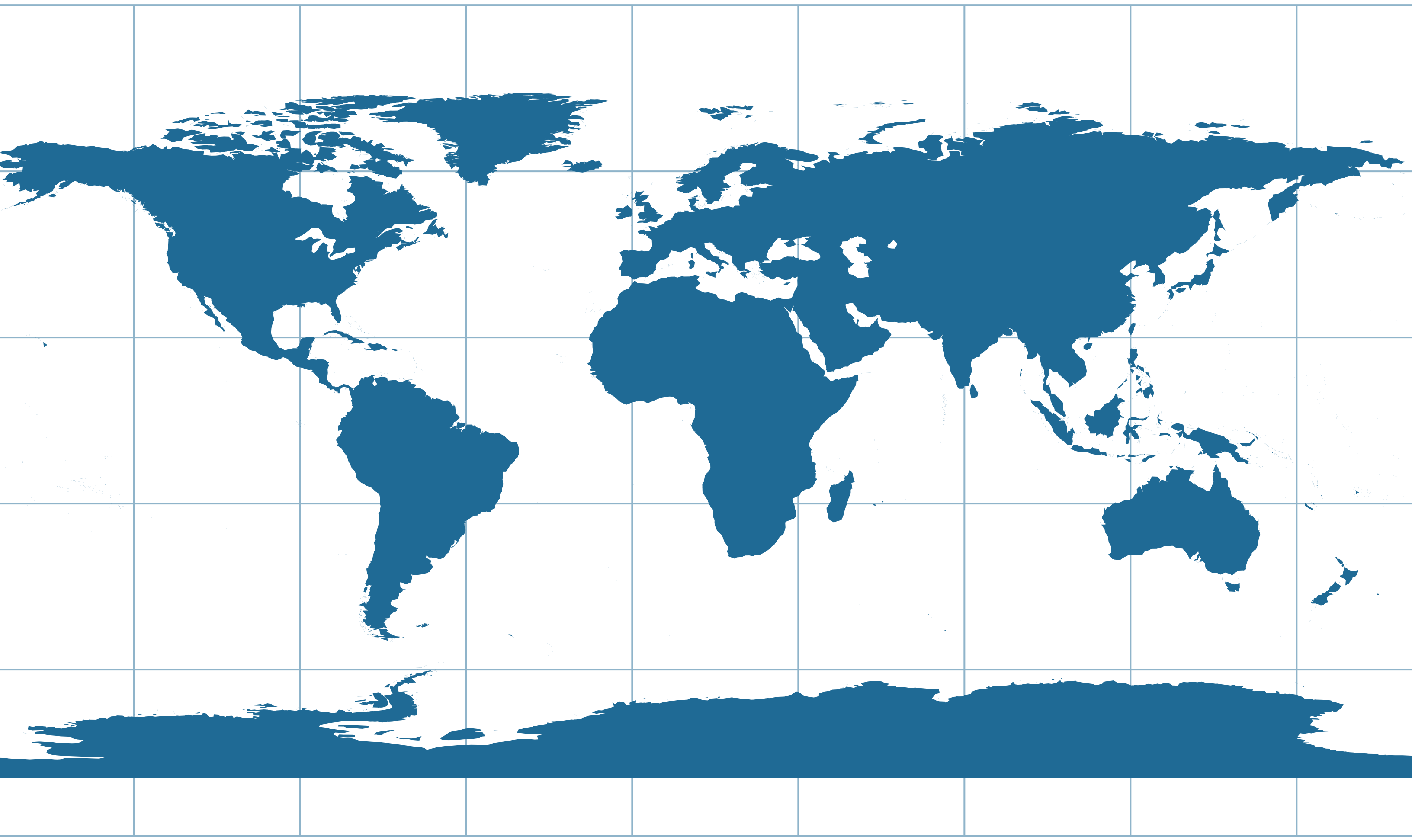
World Economic Situation and Prospects

2019

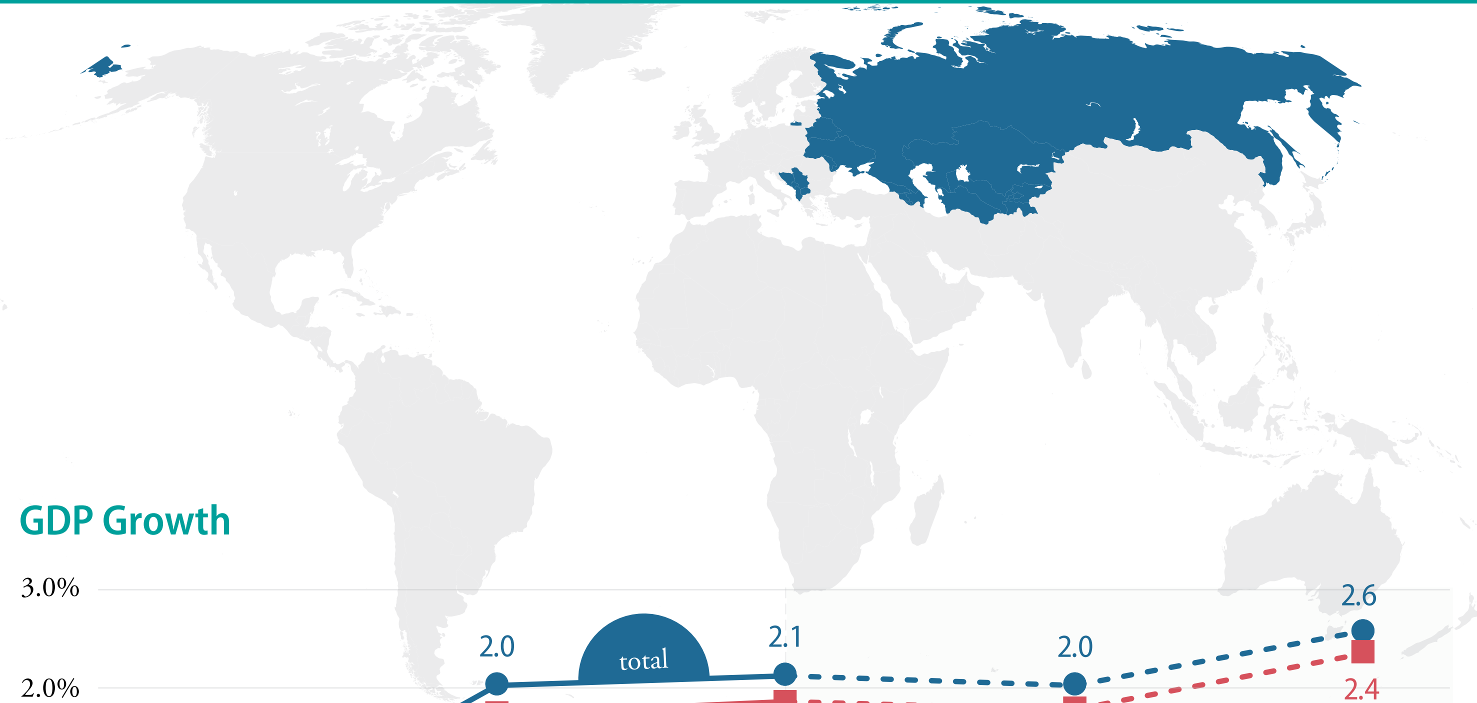
United Nations

World Economic Situation and Prospects 2019

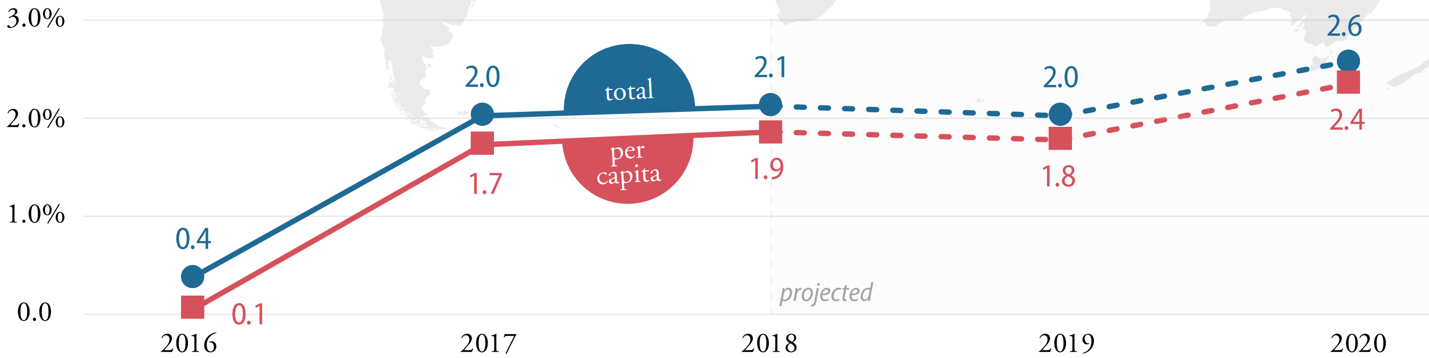


United Nations
New York, 2019

Economies in transition

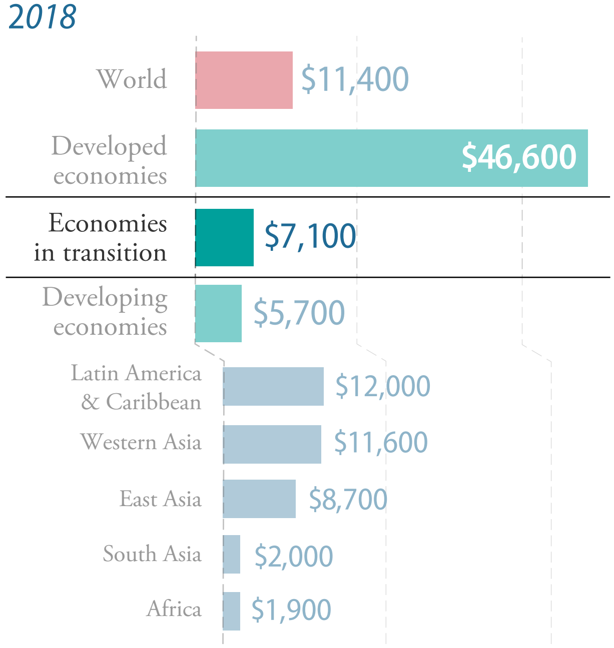


GDP Growth



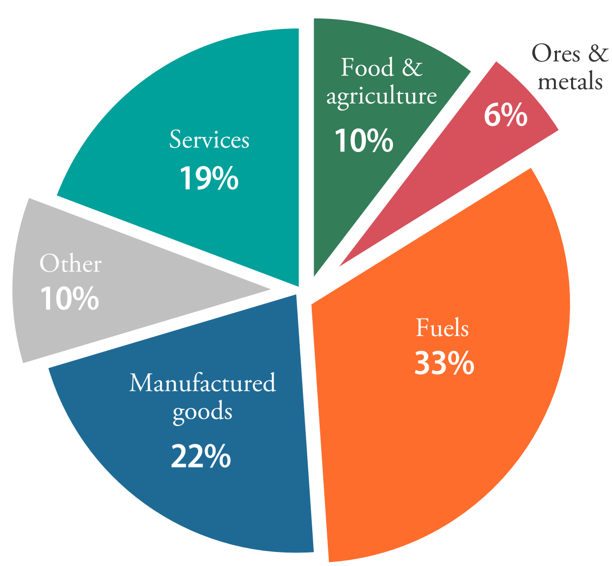
GDP per capita

2018



Exports structure

2016



Economies in transition

- Economic trends both in the CIS and South-Eastern Europe are broadly positive
- Commodity dependence and tighter access to external funding pose risks for the CIS economies
- Despite strong growth in South-Eastern Europe, many structural problems still have to be addressed

The Commonwealth of Independent States and Georgia: commodity price increases and remittances sustained growth

Most economies of the Commonwealth of Independent States (CIS) saw favourable economic outcomes in 2018, with accelerating growth and tapering inflation, as external conditions were generally supportive. Commodity prices increased, including not only oil but also other commodities such as aluminium or cotton, which are important for non-energy-exporting CIS countries. The recovery in the Russian Federation has supported activity across the region via trade and remittance channels. After two years of improvements, however, the dynamics in the terms of trade are likely to be less favourable in 2019. The aggregate CIS growth is expected to decelerate modestly in the outlook, as the strong expansion recorded by some of the smaller economies in 2018 may not be sustainable, fiscal policies are growth-neutral at best and monetary tightening is on its way in several countries.

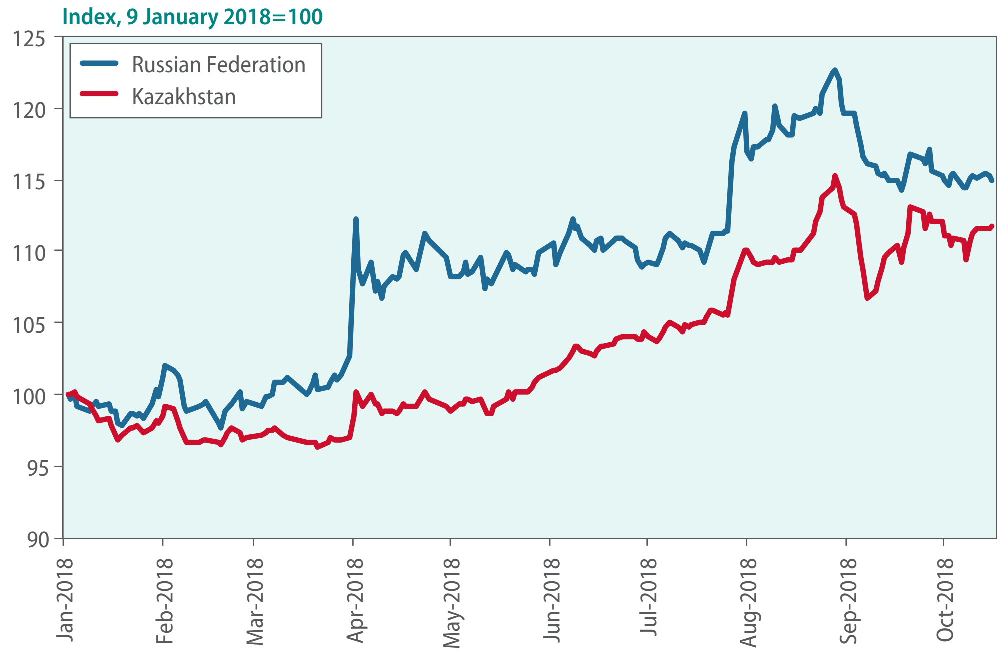
Risks to the outlook persist

Aggregate GDP of the CIS and Georgia is expected to increase by 2.0 and 2.5 per cent in 2019 and 2020, respectively. The region—the Russian Federation in particular—continues to show a lack of economic dynamism, since structural impediments to growth remain despite the improved macroeconomic frameworks. In the presence of adverse demographic trends in the European part of the CIS, increased attention is required to productivity-enhancing factors. A sudden downturn in commodity prices remains the main downside risk for the region, given the slow progress in output diversification. Other risks include banking sector weaknesses, which have not been eliminated despite numerous bailout efforts, geopolitical conflicts, and also tightening of access to external funding and debt refinancing.

Russian economy to remain on a low-growth trajectory

The Russian economy expanded by an estimated 1.5 per cent in 2018, mostly driven by private consumption, while a higher oil price has allowed rebuilding of fiscal buffers. The FIFA 2018 World Cup, whose preparations contributed to fixed investment earlier, provided a large boost to the tourism industry. Meanwhile, consumer spending gradually recovered at the beginning of the year thanks to a stabilized currency, sharp disinflation and the pick-up in household borrowing. However, geopolitical tensions have led to several rounds of additional economic sanctions in 2018, including the possibility of freezing several large Russian banks' assets abroad and restricting their dollar transactions, and targeting Russian sovereign debt. This has complicated activities of Russian companies and exerted downward pressure on the rouble. The central bank has temporarily suspended foreign-exchange purchases conducted in accordance with the budget rule and reversed monetary loosening by lifting policy interest rates in September. Meanwhile, business lending remains supressed. The depreciation of the rouble also had regional spillover effects, particularly to Kazakhstan (figure III.6).

Figure III.6
Exchange rate vs the US dollar in the Russian Federation and Kazakhstan, January–October 2018



Source: UN/DESA, based on data from the IMF Exchange Rate database.

The Russian economy is expected to remain on a low-growth trajectory, at about 1.5–2.0 per cent in 2019–2020. Constraints to growth prospects include insufficient business lending; weak investment; banking sector vulnerabilities and moderately conservative fiscal policy; and prioritizing the build-up of protective buffers. Lifting the value added tax (VAT) rate in January 2019 may add to inflationary pressures in 2019, curb consumer spending, and prevent monetary relaxation. International sanctions remain a source of uncertainty, deterring investment and raising financing costs. For example, the share of non-residents in the domestic bond market has started to decline while yields have increased. Full implementation of the proposed United States sanctions may push the Russian economy into a protracted stagnation with negative regional spillovers, as the scope for import substitution is largely exhausted. On the positive side, however, the country has a large current account surplus, low public debt and has massive foreign-exchange reserves. The implementation of the social and economic development programmes for the period until 2024 will improve infrastructure and add to GDP growth, especially beyond 2019.

Other energy-exporting economies of the CIS should maintain a positive growth trajectory in 2019–2020, thanks to relatively high oil prices and prudent macroeconomic policies. In Kazakhstan, growth reached 4 per cent in 2018, reflecting the rising oil and gas output and investment in transport infrastructure. As oil output at the giant Kashagan field is approaching full capacity, growth is expected to come from the non-energy sector in 2019–2020. Escalation of trade disputes between China and the United States may affect some of Kazakhstan's exports of intermediate goods (chemical products and metals). In Azerbaijan, the planned rise in natural gas output should accelerate growth in 2019 above the low levels seen in 2018. In Turkmenistan, efforts are on the way to diversify natural gas export markets and develop the non-energy sector.

Belarus and Ukraine face large external debt repayments

Among the CIS energy importers, the economy of Ukraine has expanded by about 3.2 per cent in 2018 and this trend is likely to continue. However, further progress is hampered by mass emigration, which is also driving up wage costs. The sharp increase in remittances has mitigated external financing needs, but tough policy choices remain, as large external debt repayments are looming in 2019. The possible downscaling, or even suspension, of the Russian natural gas transit beginning in 2019 presents a serious risk. Belarus, which is also facing external debt repayments, benefited in 2018 from the improved Russian demand and strong expansion of industrial exports to non-CIS countries. However, emerging new disputes with the Russian Federation on the terms of oil imports may seriously damage the economy in 2019, and the country remains reliant on oil subsidies and credits from the Russian Federation in the absence of alternative sources of financing.

Some smaller CIS economies expanded strongly

In 2018, remittances to the smaller CIS countries remained robust, increasing in dollar terms by over 15 per cent in the first half of the year. This bolstered private spending, although the weakening of the Russian rouble may undermine the purchasing power of those transfers. In the Caucasus, strong economic activity was recorded in Armenia, driven by construction, mining, manufacturing and services. In Central Asia, growth was robust in Tajikistan, thanks to larger aluminium and gold exports and Chinese investment in metals processing. The series of economic reforms in Uzbekistan attracted foreign investment and spurred interregional trade. Growth in these countries may slightly decelerate in 2019 if higher inflation erodes purchasing power.

Looking forward, the Central Asian region should benefit from the implementation of the Belt and Road Initiative (BRI), through upgrades of the railway, road and energy infrastructure, improved connections with China and Europe, and better market access. However, in some cases, funding of the BRI project has driven up external debt, giving rise to longer-term financial stability risks. The signing of a convention determining the legal status of the Caspian Sea in August 2018 by the littoral States may in the longer run encourage investment and exploration of new oil and gas fields in the Caspian basin. The delimitation of the seabed is still unclear and remains a limiting factor.

Additional inflationary pressures are possible in 2019

Inflation in early 2018 has been on a declining trend throughout the region. The observed deceleration was particularly large in Azerbaijan, as the impact of past exchange-rate depreciation wore off. However, some price pressures are emerging. In the Russian Federation, inflation has been accelerating, driven by the recent bout of exchange-rate weakness; the planned VAT hike in 2019 will push inflation further. In Ukraine, increases in gas prices will boost inflation in 2019.

Labour market performance has been positive. The unemployment rate continued to decline to record-low levels in the Russian Federation. By contrast, in Kazakhstan, the unemployment rate remained practically unchanged, although employment levels continued to grow. For the smaller CIS economies, seasonal migration to the Russian Federation is alleviating labour market pressures.

Amid rising inflationary expectations and increased uncertainty, earlier loosening of monetary policies has been halted or reversed. The depreciation of the rouble and increasing uncertainty put further interest rate cuts on hold in the Russian Federation early in the year and, in September 2018, led to the first hike since December 2014. The National Bank of Ukraine delivered a number of interest rate increases, prompted by concerns regarding (i) inflation expectations, (ii) the expected risks caused by a decreasing appetite for emerging assets and (iii) uncertainties around International Monetary Fund (IMF) programmes. Monetary policy was also tightened in Kazakhstan and Uzbekistan, reflecting

Box III.2

New fiscal rules in energy-exporting countries of the Commonwealth of Independent States

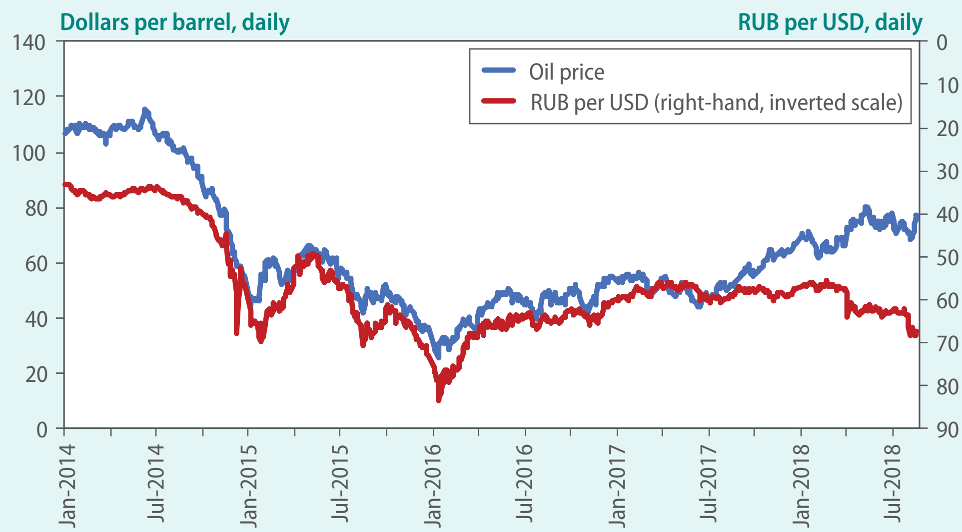
Managing the output, inflation and currency volatility created by fluctuating oil prices has been an ongoing challenge for energy-exporting economies in the Commonwealth of Independent States (CIS). The decline that began in 2014 ushered a new environment of persistently lower prices. This shock was initially partially absorbed by countercyclical spending, which, at different speeds, was replaced by fiscal consolidation. Foreign currency assets that accumulated in existing oil funds were depleted, although the depreciation of national currencies has partly offset the losses in domestic currency terms. In a context of restricted access to external finance, due to the sanctions against the Russian Federation and a worsened environment for emerging markets, the importance of rebuilding fiscal buffers to reduce vulnerability to external shocks has increased.

Fiscal rules, which impose quantitative constraints on government finances, have been used to reduce the impact of changes in commodity prices on the domestic economy. In the Russian Federation, a new fiscal rule was introduced in 2017 and slightly modified in 2018. A structural non-oil primary balance of the federal budget is calculated using a $40 per barrel oil price benchmark (in 2017 prices, with annual indexation to account for inflation). This balance should be zero or positive, although allowances are made for a transitory period; plans for 2019–2021 envisage an annual deficit of about 0.5 per cent of GDP. Revenues derived from oil prices exceeding $40 per barrel are set aside to buy foreign currency in the domestic market, fuelling the growth of international reserves under current price levels. The rule also sets limits on the use of National Welfare Fund resources, depending on the level of accumulated resources.

In Kazakhstan, according to the current fiscal rule, all hydrocarbon revenues accrue to the National Oil Fund of the Republic of Kazakhstan (NFRK), with the exception of customs duties, which are directly allocated to the budget. Annual guaranteed transfers flow from the NFRK to the budget. There are plans to reduce these transfers from 4.5 per cent of GDP in 2018 to 3.0 per cent of GDP by 2020. At the same time, the rule also targets the non-oil deficit. In Azerbaijan, a fiscal rule will be implemented as of 2019 setting limits on the use of oil revenues and overall expenditures. The impact of these fiscal rules

Figure III.2.1

Oil price and exchange rate in the Russian Federation, 2014–2018



Sources: Central Bank of Russia, US Energy Information Administration (via FRED).

(*continued*)

Box III.2 (*continued*)

is to weaken the link between oil price dynamics, on the one hand, and economic performance, budget revenues, inflation and the exchange rate on the other. The design of the new fiscal rule in the Russian Federation has indeed broken the traditional correlation between the exchange rate and the oil price (figure III.2.1). This has also increased the profitability of energy companies. In the past, higher oil prices increased revenues but also local costs, given the accompanying appreciation of the exchange rate.

The current design of fiscal rules also presents some limitations. In Kazakhstan, guaranteed transfers from the NFRK are not linked to changes in revenues due to oil prices, while discretionary transfers persist, thus undermining the credibility of the fiscal framework. In the Russian Federation, the rule does not cover off-budget expenditures and therefore does not constrain procyclical spending per se. In both countries, State-owned enterprises may be a source of contingent fiscal risks.

Oil and gas reserves horizons are relatively long in the region. As a result, macro stabilization concerns, rather than intergenerational considerations, have dominated the design of fiscal rules. Typical price-based rules, such as the one adopted in the Russian Federation, provide an anchor for fiscal policy but do not address the fact that resources are exhaustible. However, demographic trends and rising pension liabilities point to the need for a long-term savings target for the National Welfare Fund.

The recovery of oil prices since mid-2017 will allow a more rapid rebuilding of buffers. However, there is the danger that this may undermine fiscal consolidation efforts. These efforts should also pay attention to the need to preserve growth-enhancing spending in key areas such education, health or infrastructure.

Author: José Palacín (UN/ECE).

rising inflationary risks and currency pressures. By contrast, in Azerbaijan, rapid disinflation allowed for a series of rate cuts, and the policy rate was marginally reduced in Belarus, Georgia and Kyrgyzstan. Overall, policies remain relatively tight, thus limiting the growth of private credit.

Fiscal policies are expected to stay largely conservative

Continued economic recovery and higher oil prices have boosted public finances, narrowing fiscal deficits. Fiscal policy in the Russian Federation is constrained by the fiscal rule introduced in 2017 (box III.2). To boost budget revenue, particularly for programmes aimed at the social and economic targets announced in May 2018, the Russian Government has decided to lift the VAT rate in January 2019 and increase the pension age. The planned budget for 2019–2021 assumes maintaining the estimated surplus of 2018 and increasing reliance on non-hydrocarbon revenues. Building a massive net sovereign asset position remains a priority and public spending may stagnate in real terms if inflation accelerates. In Kazakhstan, significant funds were used in 2017 to bail out the banking sector; stronger economic activity in 2018 helped to consolidate the budget and a tighter fiscal rule has been introduced. Azerbaijan has also adopted a fiscal rule restricting spending growth and aiming to reduce the public debt. In Turkmenistan, numerous state subsidies were removed in 2017 and free utilities for households will be discontinued in 2019; the budget is being consolidated after earlier massive infrastructure spending. A more supportive fiscal stance is expected in Uzbekistan, utilizing the accumulated wealth fund.

Among the energy importers, conditionality of IMF programmes—requiring, in some cases, a reduction in the size of the public debt—places restrictions on fiscal policy in Ukraine and in a number of other countries. Fiscal space is also constrained by external debt repayments, particularly in Belarus. In Georgia, deficit reduction is projected to be accompanied by significant capital expenditure increases. In Tajikistan, further support to the banking sector may be needed.

South-Eastern Europe: positive economic trends set to continue

The countries of South-Eastern Europe saw accelerated economic growth in 2018, reflecting robust domestic demand, both consumption and investment, in the context of a favourable external environment. Serbia, the largest economy, bounced back strongly from the past slowdown, bolstered by agriculture and construction sectors, with a double-digit growth in investment. Solid economic performance was also recorded in Albania, as exports and domestic demand remained strong and investment was boosted by foreign interest in the energy sector. Growth in the former Yugoslav Republic of Macedonia picked up from nearly zero last year. A surge in investment boosted growth in Montenegro, but the completion of some infrastructure projects will moderate the growth in the outlook.

Labour markets improve, but structural unemployment remains a drag on the economies

Labour markets in the region continued to improve in 2018, with the unemployment rate falling to a record low in Albania, although persistently high unemployment in Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia remains a sustained drag on the outlook, with damaging implications for labour quality. Inflation has somewhat accelerated, fuelled by stronger domestic demand and higher energy and food prices. However, price increases remained moderate and inflation is largely below central banks' targets. Among the countries with flexible currencies, monetary policy was relaxed in Albania and Serbia.

Stronger growth is constrained by structural unemployment and inadequate infrastructure

The region's aggregate GDP is expected to expand by 3.7 per cent in both 2019 and 2020, supported mostly by investment and exports. Stronger growth is needed to address the region's diverse problems, including the need for reindustrialization and a low labour force participation rate. However, the longer-term capacity expansion is constrained by structural unemployment, improving but still inadequate infrastructure, dependence on foreign financing, and a still challenging business environment. High levels of outward migration and increasing dependency ratios are becoming policy challenges, in particular in Serbia. The region is attracting large foreign direct investment (FDI) inflows; a significant part of these inflows target sectors such as financial services, telecommunications, real estate and retail trade. The recent investment financed by loans from China has driven up external debt.

Joining the EU remains a policy anchor

The prospect of EU accession, confirmed by the European Commission (2018b) strategy paper, and the decision by the Council of the EU to open accession negotiations with Albania and the former Yugoslav Republic of Macedonia in 2019 (if they meet certain conditions) remain important macroeconomic policy anchors. The pre-accession assistance provided by the EU has a tangible developmental impact. However, Brexit may lead to about a 10–15 per cent decline in funding available to EU accession countries. Given the importance of trade, investment and remittance links with the EU, any deterioration in the economic performance of the EU will have negative consequences for the region. Some countries are strongly exposed to Greece and Italy and would suffer spillovers from possible deterioration in those countries.