Chapter IV

Regional developments and outlook

Developed market economies

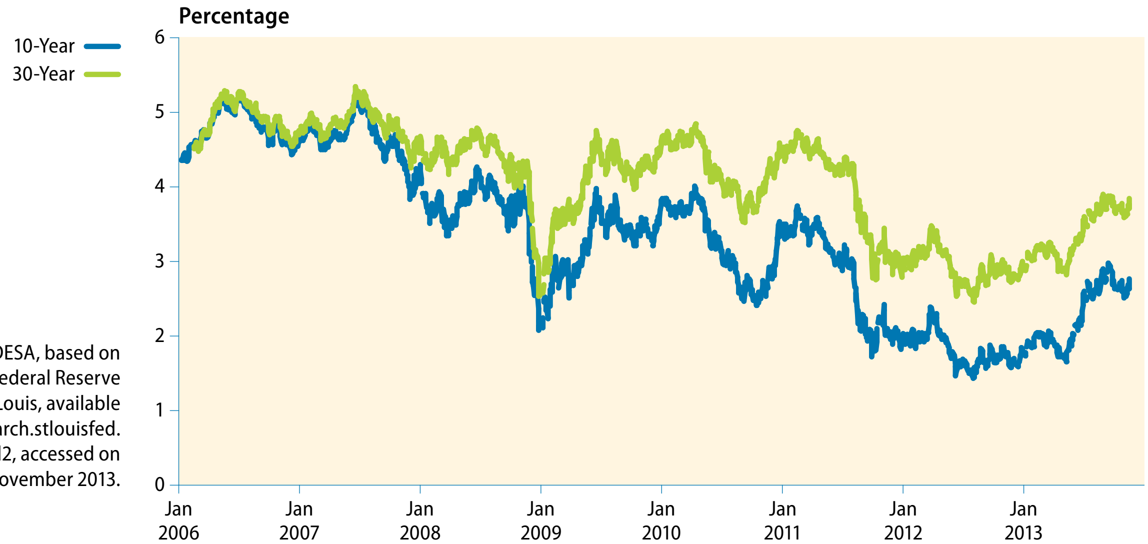
A majority of the developed market economies have finally entered a period of growth, more than five years into the aftermath of the global financial crisis. Gross domestic product (GDP) for developed countries as a whole is estimated to have grown by a subdued rate of 1.0 per cent in 2013, but is expected to strengthen to 1.9 and 2.4 per cent in 2014 and 2015, respectively. A variety of policies have effectively promoted growth and stability in these economies. The United States of America weathered the fiscal headwinds generated by the sequester, helped to some extent by the continued large-scale purchasing of long-term assets by the United States Federal Reserve (Fed). Japan's new, bold stimulus policies have so far worked to boost growth and end deflation. The euro area, as well as the rest of Western Europe, finally exited recession, buttressed by the European Central Bank's (ECB) policies for stabilizing confidence in the region. But economic activity remains weak in most developed countries, as high unemployment persists. These economies are also facing a number of different uncertainties and risks in the prospects: for the United States, a continued political wrangling on budget issues and a possible uneven process of tapering the quantitative easing; for the euro area, continued fiscal tightening and a fragmented banking system, with many banks remaining fragile; and for Japan, an anxiously awaited package of structural reforms.

North America

The United States: improved growth prospects, but downside risks remain

The economy of the United States is estimated to grow at a meagre pace of 1.6 per cent in 2013, significantly lower than the 2.8 per cent of 2012. Fiscal tightening and a series of political gridlocks over budget issues have weighed on growth. As this report is being written, uncertainties over the debt ceiling and the budget are still looming. Although monetary policy has been extremely accommodative, long-term interest rates started to increase in the second half of 2013 owing to concerns about the tapering of the quantitative easing (QE) programme (figure IV.1). Looking ahead, GDP is expected to grow by 2.5 and 3.2 per cent in 2014 and 2015, respectively, based on the assumption that the debt ceiling will be raised and the future unwinding of the monetary easing will be smooth (see annex table A.1). However, risks remain on the downside, particularly because the political wrangling over the budget may continue to linger in the coming years if public finance is not placed on a path that is sustainable.

Figure IV.1
Daily yields of United States Treasury Bonds, 3 January 2006-8 November 2013



Source: UN/DESA, based on data from the Federal Reserve Bank of St. Louis, available from http://research.stlouisfed.org/fred2, accessed on 13 November 2013.

Consumer spending is expected to strengthen moderately

Private consumption is expected to expand by 1.9 per cent in 2013, slightly lower than the previous two years. Supportive factors include wealth effects from recovering housing prices and rising equity prices. In addition, the modest increase in disposable income generated by the continued, albeit slow, growth in employment has contributed positively. On the negative side, consumer confidence has frequently been disturbed by uncertainties associated with the political fights over fiscal issues. Fiscal tightening, including higher income taxes, the expiration of the relief on payroll taxes and the sequestration on government spending, have adversely curbed consumption spending. Moreover, many households are still undertaking financial deleveraging by reducing mortgage loans relative to income. During the forecast period, some of these adverse effects are expected to lessen, with consumer spending expanding by about 2.5 and 2.7 per cent in 2014 and 2015, respectively.

Business investment has experienced a marked deceleration in 2013, growing only 2.4 per cent, less than half of the 7.3 per cent growth in 2012. Uncertainties associated with fiscal policy have delayed business decisions on capital spending and project planning, but the pace of fixed investment is expected to pick up slightly in 2014-2015.

The housing recovery has slowed

The recovery in the housing sector was hampered in mid-2013, as mortgage interest rates increased by about 100 basis points, triggered by the expectation of QE tapering. The Standard and Poor's Case-Shiller National Home Price Index has recovered about 12.0 per cent since 2011, but it is still about 20.0 per cent below the pre-crisis peak registered in 2006. The housing sector is expected to continue its recovery, supported by low inventories and the easing of lending standards for construction and land development loans.

The unemployment rate is projected to decline slowly

The labour market in the United States is still on a path of slow recovery. Payroll employment has increased at an average monthly rate of 184,000 jobs in the past year. The unemployment rate declined to 7.3 per cent in late 2013, from a peak of 10.0 per cent in 2010 (see annex table A.7). Part of the decline, however, is due to a continuous drop in the labour participation rate, resulting from several factors, including an aging population, higher school enrolment, and the number of discouraged unemployed workers no longer seeking work. The unemployment rate is projected to decline slowly, reaching 6.5 per cent by mid-2015.

Inflation has been benign, with the consumer price index (CPI) increasing at an average rate of 1.5 per cent in 2013, and expected to stay below 2.0 per cent in the 2014-2015 period (see annex table A.4).

Real exports of goods decelerated notably during 2013, growing at about 2.0 per cent, down from 3.8 per cent of 2012. Exports of food and computer equipment declined, but exports of aircraft and consumer goods increased solidly. Real imports of goods also moderated, from 2.2 per cent in 2012 to 1.7 per cent in 2013. Imports of petroleum products and computers decreased while consumer goods grew at a reasonable pace. Real exports and imports are expected to grow at a similar pace, about 5-6 per cent in 2014-2015. The trade deficit is estimated to be about $420 billion in 2013. Both the trade deficit and the current-account deficit are expected to stay at their current ratios relative to GDP in 2014-2015.

A gradual tapering of QE is expected

The Fed has maintained an extremely accommodative monetary policy stance in 2013 through two instruments: keeping the federal funds interest rate at zero and increasing the purchases of long-term government bonds and mortgage-backed securities. The target range for the federal funds rate will be kept at exceptionally low levels, as long as the unemployment rate remains above 6.5 per cent, or inflation between one and two years ahead is projected at no more than half a percentage point above the 2.0 per cent longer-run target. Therefore, it is expected that the federal funds interest rate will remain within the range of 0.0 per cent to 0.25 per cent until mid-2015. The Fed is expected to gradually reduce the amount of its purchases during 2014.

Fiscal policy in the United States has been tightened during 2013, through two channels: the expiration of the two-percentage-point reduction in payroll taxes and an increase in income taxes for the top one per cent of high-income households; and the activation of across-the-board automatic spending cuts (sequestration), worth $85 billion in 2013. As a result, government spending in real terms is estimated to decline by about 5 per cent in 2013. During the forecast period 2014-2015, fiscal policy is expected to remain restrictive, but less severe than in 2013. Government spending in real terms will be flat in 2014-2015.

Risks for the United States are associated with monetary and fiscal policies

Major risks for the economy of the United States are associated with both monetary policy and fiscal policy. The Fed is facing a dilemma: purchasing long-term assets for too long could cause asset bubbles, but tapering off too soon might choke the economic recovery and destabilize financial markets. The risks related to fiscal policy may be even more acute, as the political divide continues on the debt ceiling and budget issues.

Canada: in tandem with the United States

The Canadian economy is estimated to grow at 1.6 per cent during 2013, slightly lower than in 2012. In 2014 and 2015, GDP is expected to grow by 2.4 per cent and 2.8 per cent, respectively.

Households are becoming more anxious about their levels of debt

Residential construction has been a positive contributor to GDP growth in 2003, but the pace of construction is near a maximum. Excess inventory accumulations have been worked off, but the contributions of inventory growth to GDP are not expected until the second half of 2014. Recent increases in the personal savings rate, although related to the revisions to the national accounts, may indicate that households are becoming more anxious about their debt levels and are increasing their savings in response, curbing consumption in the near term.

The unemployment rate has improved marginally, dropping to an average of 7.1 per cent in 2013, from 7.3 per cent in 2012, and is expected to improve further to 7.0 and 6.8

in the next two years. Inflation has been running at about 1.0 per cent during 2013 and is expected to remain well below 2.0 per cent in 2014-2015.

Net exports were a negative contribution to growth in early 2013 and are not projected to add significantly to GDP growth for several quarters to come. Real exports are estimated to grow by 1.0 per cent in 2013, before increasing gradually by 2.5 per cent to 3.0 per cent in 2014-2015. Real imports are expected to follow a similar pattern.

Monetary policy in Canada is largely influenced by United States monetary policy

Real government spending has been growing more slowly than real GDP growth for the past three years. All levels of government are trying to cut deficits, inevitably affecting GDP growth. Expenditure restraint and low interest rates on government debt will permit the federal budget deficit to decline and possibly turn the fiscal balance to surplus by 2016. Monetary policy in Canada is largely influenced by United States monetary policy. Interest rates in Canada will therefore rise with those of the United States, but not before; Canadian interest rates are already higher by 100 basis points.

Developed Asia and the Pacific

Japan: out of deflation, but high public debt remains

Policy packages accelerated the recovery

A new set of bold stimulus policies adopted since late 2012 has boosted economic growth in Japan and ended the decade-long deflation. GDP is estimated to grow by 1.9 per cent in 2013 and the annual change in the CPI has turned from negative to slightly positive. However, the government budget deficit remains significant and the public debt, which is the highest among all developed countries in terms of GDP, continues to rise. The Government is expected to introduce another set of policies targeting structural reforms, along with implementing the planned increase in the consumption tax rates over the next two years. While the effects of the anticipated structural reforms remain uncertain, higher consumption tax rates can curb demand. GDP growth is projected to moderate to 1.5 per cent and 1.2 per cent in 2014 and 2015, respectively.

Fiscal policy is not yet emphasising austerity

The fiscal stimulus included a 10.3 trillion yen supplemental budget for the fiscal year ending in March 2013. The consumption tax rate will increase from the current level of 5 per cent to 8 per cent in April 2014 and further to 10 per cent in October 2015. Later this year, the Government will introduce another budget act of about 5 trillion yen to compensate for the negative impacts of the higher tax. The deficit for 2014 will not change much from the level of 10 per cent of GDP for 2013.

Monetary policy has altered the price dynamics

The Bank of Japan (BoJ) announced the new Quantitative and Qualitative Monetary Easing policy (QQME) on 4 April 2013. It targeted a doubling of the monetary base in two years through the purchase of Japanese government bonds (JGB) and other financial securities at the rate of 60-70 trillion yen per year. The scope of bond purchases was also expanded to include longer-maturity JGB. The BoJ expects to bring down the yields of longer-term securities and to boost the inflation expectations of consumers, firms, and investors. The ultimate goal is to increase the annual CPI inflation rate to 2 per cent within two years. The early impact of QQME on JGB yields has been noticeable and seems to be sustainable. QQME has also had a significant impact on the Japanese yen, which depreciated vis-à-vis the United States dollar by 21 per cent in one year as of October 2013 (see figure I.5 in chapter I).

Japan had experienced deflation for 15 consecutive years since 1998. QQME has changed the inflation expectations of economic agents, as revealed by the surveys conducted about mid-2013. The sharp depreciation of the Japanese yen has also put upward pressure on the prices for imported goods. Headline inflation rates for the first three quarters of 2013 are consistent with an annual increase in the CPI by 0.3 per cent. The annual inflation rate is forecast to increase further to 2.0 per cent for both 2014 and 2015, partly as a result of the higher consumption tax rate. However, core inflation is expected to remain lower.

The external surplus is shrinking

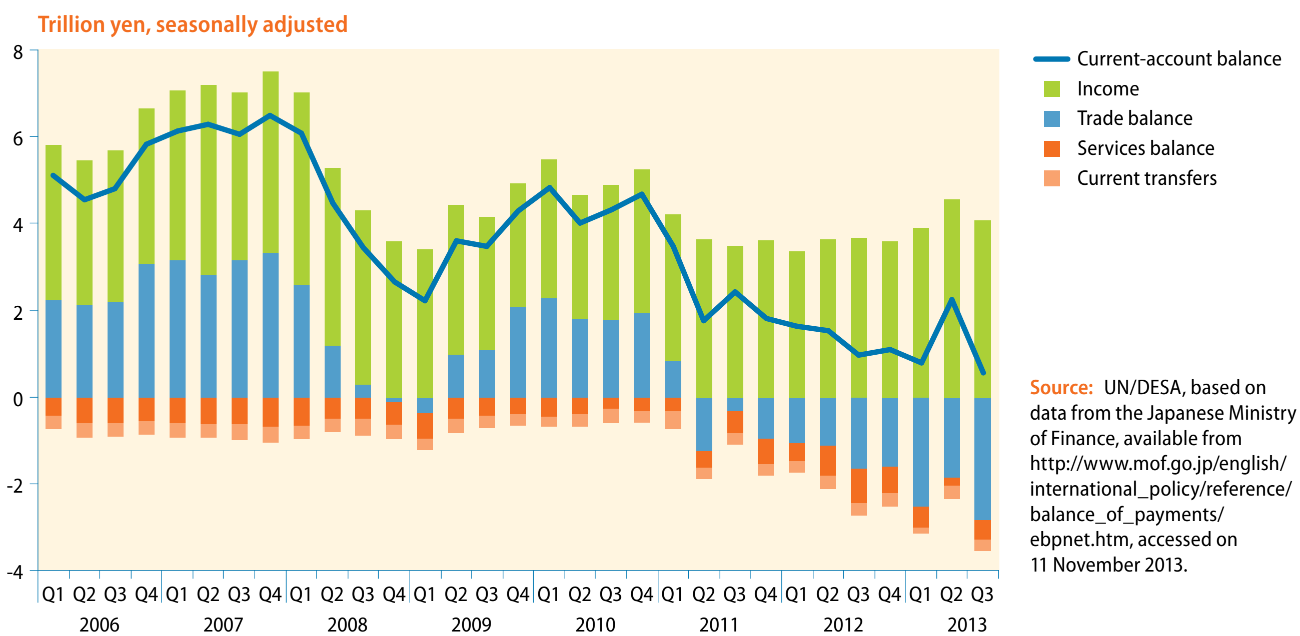
Export volumes have not returned to their pre-crisis levels. Weakened external demand and the appreciation of the Japanese yen have both hampered export growth. After the recent depreciation of the yen, it is projected that real exports will grow by 2.2 and 3.6 per cent in 2013 and 2014, respectively. Import volumes will also be growing, but at a much slower pace. The balance of merchandise trade will remain in deficit but will stop being a drag on growth in 2014. The current-account balance is projected to remain positive, although at a much lower level than the pre-crisis period (figure IV.2).

Policy choices are shifting the dynamics of consumption and investment

In 2013, private consumption is expected to grow by 1.8 per cent, supported by strengthened consumer confidence and also in part by the bringing forward of durable goods purchases to avoid the higher consumption tax. Correspondingly, private consumption growth will slow down to about one per cent in later years. In 2013, fixed investment was given a boost by the continued growth of public construction projects financed by the supplemental budget, as well as the residential investment brought forward in response to the higher consumption tax. It is predicted that investment will grow by 2.0 per cent and 1.3 per cent in 2013 and 2014, respectively.

Given the mild growth prospects, employment is expected to grow very slowly in the outlook. The labour force is likely to continue declining, owing to the drop in the working-age population. Assuming no major changes in the structure of the labour market, the average unemployment rate is predicted to fall from 4.0 per cent in 2013 to 3.7 per cent in 2014 before returning to 4.0 per cent in 2015.

Figure IV.2
Japan: Quarterly current-account balance and major components



Source: UN/DESA, based on data from the Japanese Ministry of Finance, available from http://www.mof.go.jp/english/international_policy/reference/balance_of_payments/ebpnet.htm, accessed on 11 November 2013.

Australia and New Zealand: solid growth driven by exports and investment

In Australia, after strong growth in 2012 driven by exports and intensive investment in the mining sector, export growth remains solid. Investment in the mining sector, however, is expected to peak, partly owing to weakened international prices for Australia's major mining products. The GDP growth rate is estimated to be 2.6 per cent in 2013 and projected to be 2.8 per cent in 2014. CPI inflation has been low and will likely remain so. Against this backdrop, on 6 August 2013, the Reserve Bank of Australia decided to cut its policy rate further by 25 basis points to 2.50 per cent, the eighth cut since November 2011.

In New Zealand, the initiation of delayed reconstruction to repair damage caused by the earthquakes in 2010 and 2011 boosted GDP growth to 2.7 per cent in 2012—the best performance since 2007. Fixed investment is expected to remain solid and export growth is predicted to remain stable. GDP growth is estimated to be 2.6 per cent in 2013 and is expected to be 2.8 per cent in both 2014 and 2015. The Reserve Bank of New Zealand has kept its policy rate at a historically low level; it has also decided to impose a restriction on the mortgage loan-to-value ratio starting in October 2013, based on macroprudential concerns.

Europe

Western Europe: recession ends, but growth remains weak

Western Europe emerged from recession in the second quarter of 2013, after six consecutive quarters of declining GDP. Economic activity is expected to continue to expand in the second half of the year, but at a weak pace. Annual growth rates will be negatively affected by the very strong downturn at the end of 2012 and beginning of 2013. GDP in the EU-15 is therefore expected to decline by 0.1 per cent in 2013, but projected to strengthen to 1.4 and 1.8 per cent in 2014 and 2015, respectively (see annex table A.1). The continuous weak recovery from the Great Recession has caused the output level of the European Union (EU) to be 2.8 per cent below the potential.[1] There are, however, considerable differences across countries. Among the large countries, the United Kingdom of Great Britain and Northern Ireland is expected to grow by 1.4 per cent in 2013 and strengthen to 2.2 per cent in 2014, while France and Germany are expected to grow by 0.1 per cent and 0.4 per cent, respectively, in 2013, but pick up to 0.8 per cent and 1.9 per cent in 2014. The crisis countries are showing signs of turning the corner, but they remain in delicate positions. Italy is expected to contract by 1.8 per cent in 2013 before finally exiting recession and growing by 0.8 per cent in 2014; similarly, Spain is expected to contract by 1.2 per cent in 2013, before returning to positive growth of 0.9 per cent in 2014. Among the smaller crisis countries, Cyprus and Greece are expected to continue to contract in 2014.

Tensions in the region have subsided dramatically since the ECB announced its Outright Monetary Transactions (OMT) facility. Despite the fact that the policy has yet to be activated, sovereign bond spreads have narrowed significantly since its announcement, and several crises that occurred earlier in the year saw almost no reaction in the bond markets. Nonetheless, the region faces significant headwinds going forward: fiscal austerity programmes, while less intense, remain in force; intraregional demand is still

1 European Commission, "European Economic Forecast Autumn 2013", p. 138.

exceptionally low, while extraregional demand has slowed; balance sheet repair is still an ongoing process for banks, non-financial corporations and households, placing a significant drag on consumption and investment spending; and lending conditions are heterogeneous, with bank credit amply available in some countries, while conditions in others remain extremely tight. The sharp deceleration of inflation at the end of 2013 points to some risks of deflation.

Consumption is picking up but still faces headwinds

Consumption expenditure remains weak and is estimated to have declined marginally in the euro area in 2013, as it did in 2012. It has been held back by a number of factors: deleveraging by households, which is a continuing legacy of the Great Recession; the generally poor state of labour markets; low consumer confidence, which has been badly impacted following each episode of the euro area crisis; fiscal austerity programmes; and high energy prices, which have depressed real, disposable income. Going forward, consumption spending is expected to pick up moderately, as many of these factors diminish in their intensity or, in some cases, turn around. In particular, consumer confidence has stabilized and climbed steadily since the easing of tensions in the region; household deleveraging is expected to diminish; and oil prices have stabilized and are expected to retreat slightly in the outlook. The intensity of government austerity programmes and the state of labour markets have varied tremendously across the region, explaining to some extent the more robust consumption expenditure in Austria, France and Germany, as well as in those countries that are not members of the Economic and Monetary Union. But labour markets are stabilizing in general and austerity programmes in many cases are lessening in intensity. More countries in the region will therefore see some improvement.

Investment remains a weak spot

Investment expenditure has been a major weak spot, dropping sharply in most countries in both 2012 and 2013, and is expected to make only a weak rebound going forward. Weak demand, continuing uncertainty, deleveraging, and funding difficulties in the crisis countries have been key constraints, and commercial loans to non-financial corporations continue to contract. Investment is expected to increase in 2014 and 2015 as demand picks up gradually, deleveraging eventually runs its course, and funding conditions begin to turn more favourable. But the rebound will be weak. Capacity utilization has increased since the beginning of the year, but remains low by historical standards. Industrial confidence has also improved significantly, but is now only at its long-term average. Funding conditions vary tremendously across the region; interest rates on loans, particularly to small- and medium-sized enterprises (SMEs), are much higher in the crisis countries, than elsewhere in the region. This situation will take a long time to normalize. Housing investment has started to turn around, but remains a drag on activity in some countries.

Export volume growth remains exceedingly low. In the euro area, export volumes are expected to grow by only 1.2 per cent in 2013 as a consequence of extremely weak intraregional demand, coupled with the slowing of extraregional demand, particularly from East Asia. The appreciation of the euro during the year further dampened exports. As regional and global demand pick up, exports are expected to follow suit, supported by the assumed depreciation of the euro for the rest of the forecast period. Import volumes were even weaker in 2013, estimated to have declined for the second consecutive year. Some rebound is seen for 2014 and 2015, as regional growth improves. Although the depreciation of the euro could negatively affect imports, the evolution of demand will be the dominant factor.

High rates of unemployment will persist for many countries

The relentless increase in unemployment—experienced by most countries in the region following the Great Recession—tapered off during 2013 with the rate of unemployment in the euro area increasing 0.2 percentage points during the year, to reach a new historical high of 12.2 percent. There is tremendous diversity across the region, however. In Germany the rate of unemployment is at an historical low of about 5 per cent, while Greece and Spain are facing extraordinarily high unemployment rates of nearly 27 per cent, with youth unemployment rates more than double that amount.

Going forward, the unemployment situation is expected to improve, but at a glacial pace. The growth outlook for the region is simply not strong enough to impart much dynamism to labour markets. In addition, as discouraged workers dropped out of the labour force during the recession, they will re-enter as conditions improve, delaying the improvement of the headline unemployment rate. Some discouraged workers will transition to the long-term unemployed as their skills deteriorate, or will be subject to skills mismatch due to the sectoral reallocation of resources, making their re-integration into the labour force even more challenging. In the euro area, the rate of unemployment is estimated to average 12.0 per cent in 2013 and expected to stabilize during 2014 with an average rate of 12.1 per cent before finally starting to decline to 11.8 per cent in 2015 (see annex table A.7).

Inflation decelerates but raises new fears

Headline inflation in the euro area decelerated from 2.5 per cent in 2012 to 1.5 per cent in 2013 as oil prices eased, the euro appreciated, and base effects from the previous year's high oil prices exerted negative pressure—all against a backdrop of very weak economic activity. The impact of the weak activity was evident in the movement of core inflation (abstracting from energy, food, alcohol and tobacco), which ran close to 1.5 per cent throughout 2012, but has subsequently drifted down to below 1.0 per cent during 2013.

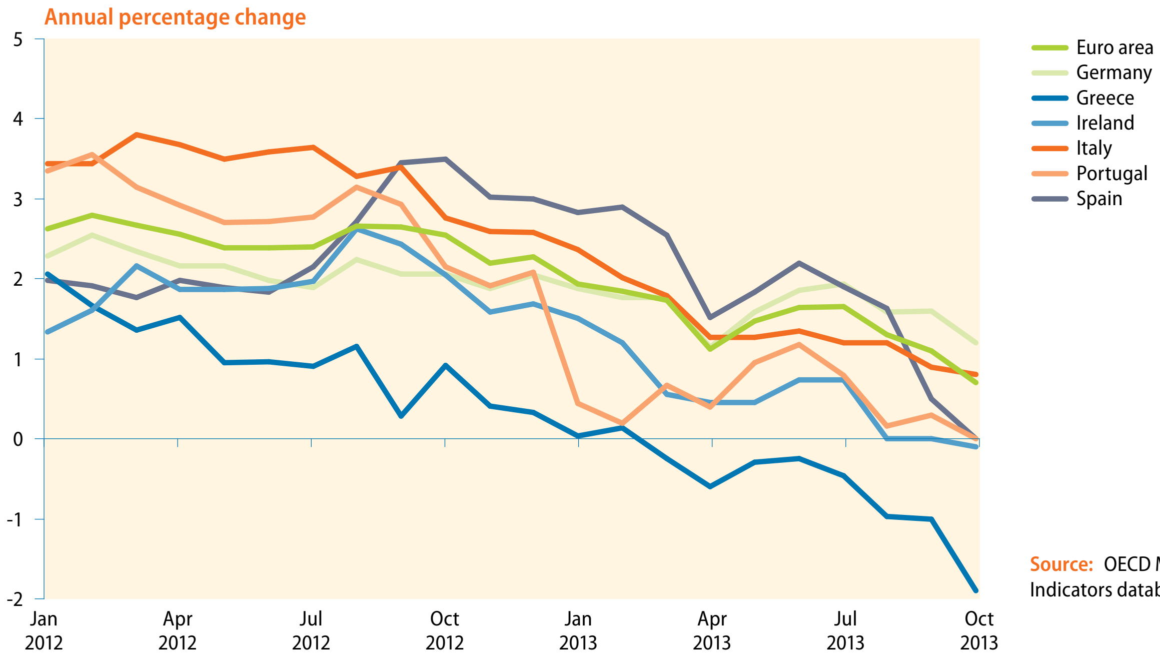
In the outlook, growth is expected to pick up only slightly, causing the output gap to remain significant. Wages will be held back by weak labour markets. Oil prices as well as other commodity prices are assumed to remain contained, but some upward pressure will come from the depreciation of the euro. Headline inflation is expected to tick up marginally to 1.6 per cent in 2014, after an estimated 1.5 per cent in 2013 and again in 2015 to 1.7 per cent (see annex table A.4). The very low rate of inflation envisaged means that the region will be close to deflation—particularly those countries that are in the process of improving competitiveness, which requires them to experience lower-than-average rates of inflation (figure IV.3).

Fiscal austerity eases somewhat, but policy remains committed to deficit reduction

Fiscal policy remains dominated by the need to reduce deficits, despite progress made since the end of the Great Recession—the euro area deficit-to-GDP ratio came down from 4.2 per cent in 2011 to 3.7 per cent in 2012, and is expected to come close to 3 per cent in 2013. However, the majority of the euro area countries remain under the Excess Deficit Procedure of the Stability and Growth Pact. Under these circumstances, fiscal consolidations of at least 0.5 per cent per annum and a two-year timetable for completion are required. Thus, the pressure remains for further austerity, although there is some recognition that its terms will need to ease in the short run. In June 2013, the Economic and Financial Affairs Council granted some countries extensions of their deadlines (to 2014 for the Netherlands and Poland, 2015 for France, Portugal and Slovenia, and 2016 for Spain). At a longer horizon, however, pressure for austerity will remain. The euro area's "fiscal compact" entered into force in 2013. This adds additional fiscal targets: the structural deficit should now be less than 0.5 per cent of GDP (with some caveats) and remedial action will now be required for countries with debt-to-GDP ratios above 60 per cent.

In the forecast period, it is assumed that fiscal policy will still be focused on reducing fiscal imbalances and that the debt crisis countries will continue with their adjustment programmes. The timetable for achieving targets will, however, be extended in some cases. In addition, it is assumed that no countries will ask for formal assistance under the European Stability Mechanism and the OMT will not be activated.

Figure IV.3
Inflation in the euro area: January 2012-October 2013



Source: OECD Main Economic Indicators database.

Monetary policy maintains an accommodative bias

Monetary policy has been dominated by various types of unconventional policies since the Great Recession, but the ECB returned to conventional measures in May and November 2013 when it cut both its main refinancing rate and marginal lending rate by a cumulative 50 basis points, bringing them to 0.25 and 0.75, respectively. In each case, the Deposit Facility Rate was left at zero, avoiding the adoption of a negative interest rate and narrowing the corridor bounded by the Deposit and Marginal Lending Rates.

Unconventional policies continue to be the policies used most effectively and most often to combat the sovereign debt crisis and the slow growth across the region. The ECB has pursued QE via a number of different long-term refinancing operations (LTROs). The ECB balance sheet expanded by more than 1 trillion euro to reach more than 3 trillion euro, particularly through the two three-year refinancing operations in December 2011 and February 2012. However, in contrast to the QE programmes of the Fed, the Bank of England (BoE) or the BoJ, the QE programme of the ECB is endogenous (passive rather than active), with liquidity being provided to banks on demand. Since January 2013, banks have been allowed to repay these loans and the ECB balance sheet has shrunk to close to 2 trillion euro.

The other major unconventional policy, introduced in September 2012, was the OMT facility. Under this policy, the ECB can potentially make unlimited purchases of selected country bonds to reduce their yields, but only if a country formally requests assistance and accepts conditionality. These purchases would not be QE, as they would be fully sterilized and have no impact on the ECB balance sheet. So far the policy has not actually been deployed, but it has acted as a powerful circuit breaker, keeping bond yields contained after a number of crises at the beginning of 2013.

In July 2013, the "forward guidance" policy was unveiled, under which the ECB committed itself to maintain policy interest rates at a low level for an extended period of time, following a similar path as that of the Fed and the BoE. However, the ECB did not link this policy to the achievement of explicit targets—unlike the BoE, which stated that it would not consider raising interest rates until the jobless rate falls to 7% or below, a similar target to that of the Fed.

During the forecast period, it is assumed that the ECB will not cut its policy interest rates further. Given the outlook for low inflation and weak growth, it is assumed that interest rates will remain at current levels through the end of 2015. It is also assumed that the existence of the OMT will keep government bond yields within appropriate bounds. In addition, it is expected that further LTROs will be introduced to smooth the winding down of the existing three-year LTROs. However, the ECB balance sheet will gradually unwind as the banking sector's needs diminish.

Risks remain to the downside

Risks to the outlook are more evenly balanced than in the past few years, but remain to the downside. There are ample possibilities for a flare-up of the sovereign debt crisis in the affected countries. This would depress consumer and business confidence across the region, or more seriously, lead to renewed turmoil in the sovereign debt markets and test the ECB OMT policy. Vulnerable banks could become insolvent, forcing more government bailouts. The Asset Quality Review being undertaken by the ECB in anticipation of assuming its new role as chief regulator in the region will likely reveal a number of banks in need of re-capitalization. On the positive side, external demand may pick up with more vigour than anticipated, giving a boost to exports and investment. In addition, some of the structural policies may begin to bear fruit sooner than anticipated.

The new EU members: tentative green shoots of recovery

In many of the new EU member States from Eastern Europe, the negative economic trends continued in the first half of 2013, with output shrinking year on year and consumer and business confidence depressed. These economies continued to feel the impact of the protracted weakness in the EU-15 trading partners, with whom their business cycles are largely synchronized, and the ongoing deleveraging by foreign banks present in the region (although deleveraging is occurring at a more modest scale). The outlook for the new EU members, however, has improved with the return of the euro area economy to positive growth in the second quarter of 2013, as reflected by more optimistic forward-looking indicators in the second half of 2013.

In 2013, the aggregate GDP growth for the region is estimated at 0.5 per cent, marginally lower than 0.6 per cent registered in 2012. The speed of economic expansion should strengthen in 2014 and 2015, in line with the improving external environment and a gradual recovery in domestic demand, to 2.1 per cent and 2.7 per cent, respectively (see annex table A.1). A more robust growth is needed, however, to return these countries to the path of sustainable convergence with the income levels of their EU-15 peers.

Croatia, the Czech Republic and Slovenia have registered a contraction in GDP in 2013. Croatia joined the EU in July 2013 and will therefore face tougher fiscal spending requirements. Its exports will become subject to tariffs in some of the important trading partners, as the result of leaving the Central European Free Trade Agreement. On the other hand, the country will receive more aid from the EU.

Prospects for the new EU members improve and growth should accelerate in 2014

For most of the region, with the exception of the Baltic States and Hungary, growth in 2013 was driven predominantly by net exports. Domestic demand in most of the countries in the first half of the year remained suppressed by high unemployment and stagnant real wages, as well as by the ongoing fiscal consolidation. Investment was held back by low foreign direct investment (FDI) inflows and stagnation in the construction sector. By contrast, the export-oriented manufacturing sector was able to benefit from the slightly improved economic situation in the EU-15, and, in the case of the Czech Republic, Hungary, Poland and Romania, also by the modest depreciation of the respective currencies versus the euro in 2013. The automotive industry—the backbone of manufacturing in Central Europe—showed signs of an upturn, and the increasing exports should have a multiplier effect, although with some lag. During the summer, both business sentiment and household economic confidence visibly strengthened. The prospects for 2014-2015 can therefore be considered with cautious optimism.

However, while private consumption may pick up in the near-term, investment is likely to remain subdued, except in the Baltic States. Most of those economies still operate below full capacity, which deters businesses from undertaking risks and investing; for many new EU members, the annual figure for investment growth in 2013 is expected to be negative. The recovery in investment will depend, among other factors, on the resumption of FDI inflows; however, capital flows to the region remain volatile (box IV.1).

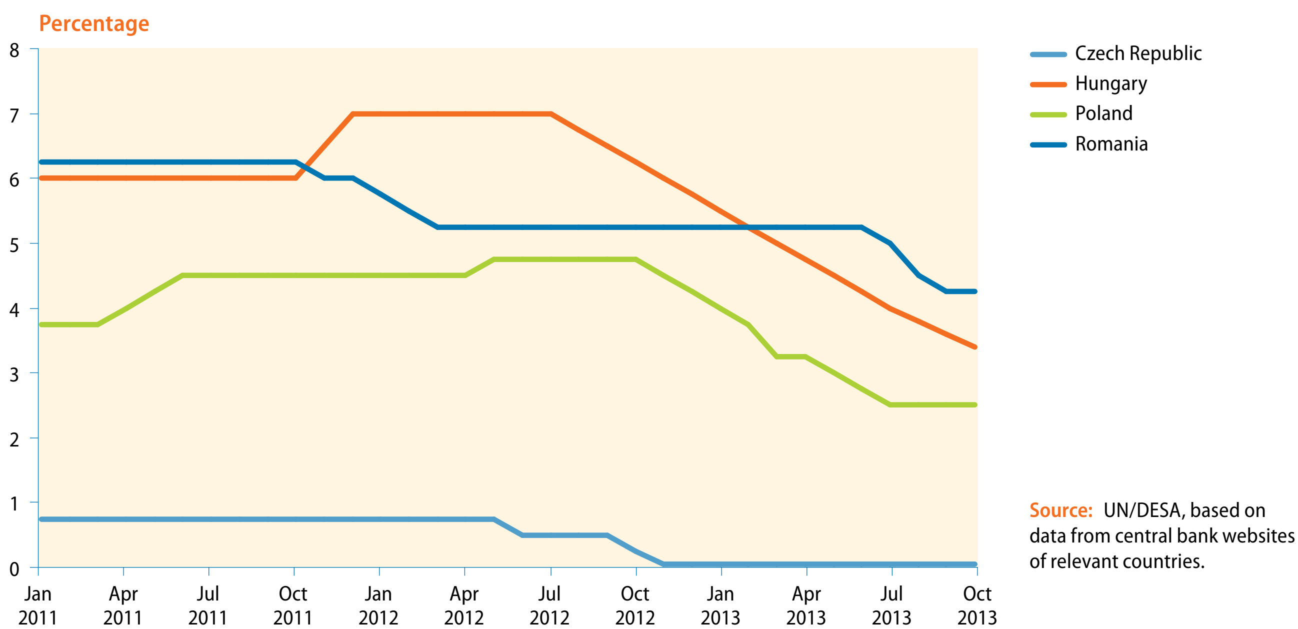
Inflation subsided to record-low levels in parts of the region

Inflationary pressures in the new EU member States have continuously weakened over the course of 2013, held back by fragile domestic demand and lower prices for food and energy, as well as administrative price reductions, such as the utility price cuts in Hungary. Annual inflation reached record-low levels in Croatia, the Czech Republic, Poland and Hungary, with core inflation estimated to be virtually zero. In 2014 and 2015, a modest acceleration of inflation is possible, in line with the pickup in economic activity and changes in indirect taxes, but inflation is expected to remain in the low single digits in most of those countries

Interest rates are cut to record-low levels…

For the new EU member States, countercyclical fiscal policy actions remain limited. In 2013 conventional and unconventional monetary policy measures were the main macroeconomic tool used to bolster economic activity in the countries with flexible exchange

Figure IV.4
Policy rates for the Eastern European countries with flexible currencies, January 2011-October 2013



Source: UN/DESA, based on data from central bank websites of relevant countries.

rates.[2] Policy interest rates were kept near zero in the Czech Republic and cut, within the course of the year, to record-low levels in Hungary, Poland and Romania (figure IV.4). In addition, the Hungarian National Bank announced the "Funding for Growth Scheme", offering funds at zero interest rates for commercial lenders, in order to help SMEs to obtain low-cost credits and to convert their foreign currency loans into the domestic currency. The Czech National Bank announced direct interventions into the currency market, in order to weaken the exchange rate and to support exports, and to prevent deflation. The scope for further interest-rate cuts in those countries will depend on the timing of tapering of the Fed bond-buying programme. The large share of foreign currency loans in some of those countries is another hurdle on further monetary easing,[3] but the low-interest-rate environment is likely to continue in 2014.

…credit growth, however, stagnates

Despite accommodative monetary policy, credit growth in the region remains either anaemic or negative. Cross-border deleveraging by the parent EU-15 banks continues, as those banks face tighter capital requirements in line with new EU banking regulations and Basel III regulatory requirements, but the magnitude of deleveraging is smaller than in the previous years. However, as banks increasingly rely on a domestic deposit base, credit supply constraints are becoming less prevalent. Low demand for loans is a larger obstacle to recovery in private credit, as households and businesses still continue to rebuild their balance sheets. Credit standards remain tight, as the share of non-performing loans remains high, exceeding 15 per cent in Hungary and Slovenia.

Fiscal policies remain conservative, but are becoming less austere

On the fiscal policy side, most Governments continued their efforts at reducing budget deficits in 2013 in order to rebuild their public finances and, for a number of countries, to exit the excessive deficit procedure of the EU. While this trend is set to continue in 2014-2015, Governments are nevertheless gradually moving away from the tight austerity path of the past few years. Provided the revenue intake improves along with economic strengthening, a slightly more expansionary fiscal policy may be expected in the region in 2014 and in 2015, especially in those countries that already have or will achieve fiscal deficits below 3 per cent of GDP.

Marginal improvement exists in the labour markets

The labour markets in the Baltic States, where the post-crisis reduction in the unemployment rate was the most noticeable, continued to improve steadily in 2013. In Latvia, the registered unemployment rate stood at 9.3 per cent in mid-2013, down from 11.6 per cent a year earlier. However, this reduction in the unemployment rate may be attributed not only to increased employment figures, but also a labour force that is shrinking as a result of the large outward migration from all three Baltic countries.

In Central Europe, the labour market situation deteriorated in late 2012, but has improved somewhat since the second quarter of 2013. In the third quarter, however, the rate of registered unemployment in the Czech Republic, Poland and Slovakia was still about a percentage point higher than a year ago. Public employment projects contributed to a reduction in the unemployment rate in Hungary, although creating jobs that require low skill and offer low pay. Unemployment may slightly decline in 2014 and in 2015, but its structural nature in the region and the continuing skill mismatch will impede serious employment gains. Some countries, such as Slovenia, still have to undertake cuts in public sector employment to meet their fiscal deficit targets, adding to unemployment in the near term.

2 Estonia, Slovakia and Slovenia are members of the euro area; Latvia will join the euro area in January 2014; Bulgaria and Lithuania have currency board regimes, with their currency pegged to the euro.

3 In Hungary, about 57 per cent of all retail loans (valued at over $15 billion) were denominated in foreign currencies in 2013.

Both external and internal risks remain

The near-term outlook is still subject to risks from a renewed slowdown in the EU-15, but also to certain domestic risks in several countries. In particular, the Slovenian banking system and the country's large current-account deficit remain a serious risk for macroeconomic stability. Although countercyclical policy measures are limited, the countries should adopt pro-growth policies and aim to improve the labour market situation, including improving participation rates. In addition, absorption of the available EU funding, especially for infrastructure, should improve significantly.

Economies in transition

Growth of the Commonwealth of Independent States (CIS) and South-Eastern Europe noticeably slowed in 2013, largely reflecting a sharp deterioration of growth in the Russian Federation. In other energy-exporting countries of the CIS, robust growth continued or resumed, while some small economies of the area also experienced moderation. South-Eastern Europe returned to positive growth in 2013, although insufficient to address the region's long-standing structural problems and reindustrialization needs. In line with the improved global economic outlook, growth in aggregate GDP of the transition economies is expected to gain momentum, accelerating to 3.3 per cent in 2014 and 4.0 per cent in 2015. Both country groups continue to face serious economic risks, owing to the composition of their exports or concentration of their export markets, and have to overcome structural challenges, such as diversification of output in the CIS economies away from the energy and primary commodities sectors. In addition, the volatility of FDI and portfolio capital flows constitute a risk factor for those economies (box IV.1).

Box IV.1

Capital flow volatility in the transition economies and new EU member States

Private capital flows into the economies in transition and the new EU member States have fluctuated considerably over the last decade and have been a significant factor behind the overall volatility that these regions have experienced (table IV.1.1). Prior to the global crisis in 2008-2009, capital inflows into these economies were among the highest of any region of the world. During the financial crisis, capital flows declined more for this region than any other and, largely as a result of this, this region's gross domestic product (GDP) decline was the largest in the world. Although global capital inflows have largely rebounded during the recovery of the last several years and even become excessive for some economies, they have remained depressed in this region during 2010-2012 at levels of less than one third of those prior to the global crisis (2005-2007).

There are numerous factors responsible for the recent depressed levels of capital inflows into these economies; these include a reduction in the availability of funds from both the traditional external sources of supply and from a reduced domestic demand for borrowing, due to slower growth and stricter lending standards. Historically, a significant proportion of inflows to the region have been channelled through Western European banks directly or through their local branches and subsidiaries. However, the parents of these banks suffered large losses during the financial crisis, the subsequent euro area sovereign debt crisis, and through the recent stricter regulatory capital requirements. As a result, these multinational banks have been attempting to deleverage by reducing loans to this region. In addition, the supply of funds available for lending by Western European banks also declined during this period when solvency concerns about these banks led to withdrawals by U.S. money market funds. For these reasons, western banks have reduced their loans in the transition economies and new EU member States. Thus, while foreign direct investment (FDI) inflows to these economies were down (as a percentage of GDP) by 51 per cent in 2010-2012 compared with 2005-2007, the category of "other capital flows", largely composed of bank loans, was down by 88 per cent. In the earlier period, bank loans were slightly greater than FDI, but in the more recent period they equal less than one third of FDI.

Box IV.1

Capital flow volatility in the transition economies and new EU member States (*continued*)

Prior to the crisis, the very large capital inflows (14.3 per cent of GDP, annually) were largely matched by outflows (8.1 per cent of GDP) and reserve accumulation (6.1 per cent of GDP). In the period after the crisis, the foreign exchange provided by much smaller inflows (4.7 per cent of GDP) was consumed primarily by capital outflows (4.4 per cent of GDP); reserve accumulation declined to only 1.3 per cent of GDP in the recent period and was financed by current account surplus (1.0 per cent of GDP) (table IV.1.1). In addition, instead of purchasing reserves from domestic savings, several of the non-energy exporters have resorted to borrowing additional international reserves through an increased use of official financing. For example, Belarus received $440 million from the Eurasian Economic Community in mid-2012, and $1.3 billion in 2013.

Aggregate figures for the region hide important country differences. Nevertheless, these basic trends of much smaller capital inflows matched by smaller capital outflows and less reserve accumulation have been observed in most of the economies in the region. For example, 22 economies experienced a decline in capital inflows, only 4 showed an increase, and 2 saw no change; 24 had a decline in capital outflows and 4 an increase; and 25 experienced a decline in the rate of reserve accumulation or an actual loss while only 3 had an increase. Despite a similarity in trends, the levels of these flows do vary. Historically and presently, the nature of capital flows varies significantly between those economies with extensive energy exports—such as Azerbaijan, Kazakhstan and the Russian Federation, which have been net capital exporters—and the rest of the economies in transition and the new EU member States, which have been net importers. Another notable difference is that the current-account balances of Azerbaijan, Kazakhstan, the Russian Federation and the economies in transition have deteriorated in the recent period, while those in the new EU member States have improved significantly. Given these differences, data for each of these three groups are provided in table IV.I.I below. (Energy-rich Turkmenistan and Uzbekistan are not considered because of the lack of appropriate data.) Although the levels and net signs on some of the balance-of-payments categories differ between the three groups, each group has observed the basic trend changes discussed above—that is significant declines in inflows, outflows and reserve accumulation.

An important concern about this decline in capital inflows is that it would lead to a decline in domestic investment and thereby reduce the prospects for long-term growth. However, since the decline in inflows was largely neutralized by the decline in outflows and reserve accumulation, the resources available for domestic absorption (consumption plus investment) did not change appreciably for the region overall. Nevertheless, there is a significant distinction between the three groups: the decline in current-account positions of the economies in transition has provided more resources for domestic use and, as a result, the investment share of national income in most of these economies was similar or even larger during 2010-2013 than during the 2005-2007 period. In contrast, the improvement in the current accounts of the new EU member States has meant that fewer resources have been available for domestic use. The investment share of GDP has therefore declined in all of these economies—by over 5 per cent of GDP in 8 of 11 cases, which will have very significant implications for their longer-term growth.

The implications of the decreased rate of reserve accumulation are more difficult to assess. There are now less reserves available (than if previous trends had been maintained) to cover imports and/or current-account deficits, which is troublesome. However, since there were less capital inflows, the amount needed to protect against capital-account reversals is less, which is favourable. This latter consideration is proving to be important; the expectation that advanced economies will scale back their quantitative easing programmes has already led to large capital outflows from many emerging markets (see chapter 1), and more are expected. Given the region's smaller inflows in 2010-2012, the current outflows and those expected in 2014-2015 are also likely to be somewhat smaller. The region may thus largely avoid the financial disturbances associated with higher global interest rates that may affect other emerging economies recently impacted by larger capital inflows. However, there are several countries where these outflows have nevertheless been quite large and the reserve losses have become problematic. For example, from May through July of 2013, Ukraine used almost 10 per cent of its international reserve assets in an attempt to stabilize the currency. Table IV.I.I also reveals that despite the large decline in inflows, declining outflows remain quite significant in Azerbaijan, Kazakhstan and the Russian Federation, showing their continued susceptibility to capital flight.

Table IV.1.1
Capital flows to new EU member States and economies in transition, 2005-2012

Region	Period	Percentage of GDP Inflows	Outflows	Change in reserves[a]	Current-account balance
Azerbaijan, Kazakhstan and Russian Federation	2010-2012	4.3	7.1	1.5	5.0
	2005-2007	11.8	9.0	9.6	8.1
	Change	-7.5	-1.9	-8.1	-3.2
Other economies in transition	2010-2012	10.6	4.1	-0.1	-8.0
	2005-2007	15.8	7.5	4.8	-4.0
	Change	-5.2	-3.4	-4.9	-4.0
New EU member States	2010-2012	3.8	0.4	1.4	-2.7
	2005-2007	16.7	7.4	2.5	-6.6
	Change	-12.9	-7.0	-1.1	3.9
Economies in transition and new EU member States	2010-2012	4.7	4.4	1.3	1.0
	2005-2007	14.3	8.1	6.1	0.6
	Change	-9.6	-3.7	-4.8	0.4

Source: UNECE, based on IMF Balance of Payments Statistics and International Financial Statistics database.
a Positive number indicates cumulation of reserves.

South-Eastern Europe: moderate growth, but high unemployment and possible financial vulnerabilities

Real economic activity in South-Eastern Europe turned positive in 2013 after experiencing a decline in GDP of almost 1 per cent in 2012. All economies in the region registered positive GDP growth in 2013. Growth should pick up slightly in 2014, thanks largely to the improving growth prospects in the EU with which it is highly integrated both in terms of trade and financial flows. The aggregate GDP of South-Eastern Europe increased by 1.8 per cent in 2013, after contracting by 0.9 per cent in 2012. Growth is projected to accelerate to 2.6 per cent in 2014 to 3.1 per cent in 2015, along with a gradual recovery in FDI flows and in domestic demand (see annex table A.2).

Projected growth is still too low to address problems in the region

However, growth at these subdued rates will not be sufficient to address the region's long-standing needs of reindustrialization, to significantly lower the exceedingly high rates of unemployment that have plagued the region since the 1990s, or to increase the labour force participation ratio. Growth at these rates is also not sufficient to warrant the large current-account deficits in these economies.

Most economies in the region grew about 2 per cent in 2013

There has been fairly limited variation in the economic performance of the South-Eastern European economies, as all of them grew in the 1.5 to 2.0 per cent range in 2013 except for Bosnia and Herzegovina, whose GDP has yet to return to its pre-crisis level. In Serbia, growth was driven by export-led manufacturing and improved agricultural output, but domestic demand remains lack-lustre and the economy is likely to remain heavily dependent on exports in the near term. In Albania, by contrast, where recession was avoided altogether in 2009, modest growth was driven both by exports and by a recovery in construction output. In the former Yugoslav Republic of Macedonia, activity was supported by large-scale public investment projects. In the outlook period, the external environment for those countries is expected to improve, including the terms of access to external finance.

As credit conditions ease, investment is set to recover gradually in 2014-2015, along with strengthening private consumption.

Labour markets in the region remain weak and require serious policy efforts

Currently, unemployment is well above ten per cent in the entire region and, given the anticipated growth rates, is likely to stay elevated for many years (see annex table A.8). In Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia and Serbia, labour force surveys estimate unemployment at over 25 per cent.[4] Unemployment in South-Eastern Europe is mostly structural and predates the financial crisis. The capital stock in much of the region was destroyed by the conflicts in the 1990s and insufficient investment in new facilities and education has resulted in a situation where the region lacks necessary production facilities and skilled labour. The situation in the region's labour markets was further aggravated by the cyclical economic downturn. Some positive trends have emerged in the former Yugoslav Republic of Macedonia, where the registered unemployment rate dropped to 28.8 per cent in the second quarter of 2013, from 31.2 per cent a year earlier, and the activity rate also increased, thanks in part to publicly financed large-scale construction projects. However, this is still a marginal improvement, and in the outlook, the unemployment rates in the region are expected to remain high. Serious efforts are needed to address them, including reductions in unit labour costs, reforms in labour market policy, improved education and training facilities, better public infrastructure, and more incentives for private sector investment.

Inflation remains moderate

Inflation has been quite moderate in South-Eastern Europe, with rates in the 2-4 per cent range (with the exception of Serbia) and should stay in the same range in 2014-2015 (see annex table A.5). Many of these economies have fixed exchange rates with the euro so that monetary policy is quite constrained. Although inflation rates in most cases are slightly higher than in the euro area, this differential appears generally consistent with productivity and price convergence trends. Albania and Serbia have more flexible exchange rates and thus slightly more monetary flexibility. Inflation in Serbia has been in double-digits in early 2013, in particular, because of higher food prices, but has gradually subsided over the course of the year. Still it is likely to be 8.4 per cent in 2013, but is expected to decline in 2014.

Fiscal policies remain tight

Fiscal policies in South-Eastern Europe remain tight, as the countries struggle to reduce their budget deficits or to comply with loan requirements by the IMF—as in the case of Bosnia and Herzegovina. In Serbia, the budget deficit is likely to approach 6 per cent of GDP in 2013. Since the Government aims to achieve a balanced budget by 2016, fiscal policy will remain tight in the medium-term. In the former Yugoslav Republic of Macedonia, however, fiscal policy will not be tightened significantly in the near-term, as large-scale public investment projects need to be completed. Formal or informal currency pegs in turn constrain the conduct of monetary policy in the region. Among the countries with flexible currencies, the National Bank of Serbia repeatedly increased its key policy rate until April 2013 in response to accelerating inflation, before cutting it several times as inflationary pressures tapered. Facing increasing risk aversion among investors, the monetary authorities are likely to put further interest-rate cuts on hold in the near-term. By contrast, the Bank of Albania brought its policy rate to a record-low level in July 2013 amid rapidly falling inflation.

Current-account deficits may become a source of vulnerability

Some countries in the region run high current-account deficits. Those deficits are likely to reach 6 per cent of GDP in Serbia, 9 per cent of GDP in Albania, and 15 per cent

4 In some countries, there are substantial differences between monthly registered unemployment rates and labour force surveys, which are only conducted on a yearly basis.

of GDP in Montenegro in 2013. Given the relatively slow rates of economic growth, deficits of this size pose vulnerability, as they are only covered in part by FDI inflows and the remainder is often financed by short-term capital flows. Pegged exchange rates or high levels of debt denominated in foreign currency limit the ability of using depreciation to address these deficits. The level of public debt in South-Eastern Europe is moderate, with four economies having public (gross) debt-to-GDP ratios of over 50 per cent, and only Albania's and Serbia's being over 60 per cent. The debt of the former Yugoslav Republic of Macedonia is relatively low at about 35 per cent of GDP.

Risks are on the downside

The major risks to the forecast are to the downside. The region has strong financial, trade and remittances linkages with the euro area (especially Greece and Italy), making it vulnerable should growth not materialize there. The region could also be negatively impacted if there are large capital reversals related to any pressure on the EU parent banks or the unwinding of the unconventional monetary policies in the advanced economies.

The Commonwealth of Independent States: slowdown follows tepid recovery

Growth slows down

The post-crisis economic expansion began to moderate in 2012 and further slowed down in 2013 throughout the region.[5] The global economy continues to provide a challenging environment for these economies, characterized by weak external demand and difficulties in accessing external finance. Sluggish growth in the Russian Federation, the largest economy in the CIS, has had a dampening effect on economic activity throughout the CIS through trade, investment and remittance channels. Nevertheless, all of the CIS, especially the other energy-exporting countries, have sustained growth—except for Ukraine which flatlined in 2013. The aggregate GDP of CIS and Georgia expanded at about 2.0 per cent in 2013, a slowdown compared with the 3.4 per cent growth achieved in 2012. Economic activity is expected to strengthen modestly in 2014 with aggregate output expanding by 3.4 per cent, and to recover more solidly in 2015 with a growth rate of 4.1 per cent.

Investment drives down domestic demand in several countries

In the Russian Federation, where GDP growth has already slowed to 3.4 per cent in 2012, the slowdown has been driven by weak investment growth, despite public support for infrastructure development. By contrast, consumption remained resilient as a result of a strong labour market, rapid nominal wage growth and fairly moderate inflation. In the outlook, structural problems—such as sluggish energy sector expansion, capacity constraints and weak investment—will prevent an acceleration of growth to the pre-crisis levels. Net private capital outflows persisted in 2013. In 2014, a partial freeze on tariffs of the natural monopolies may lead to a squeeze in their investment plans. While strong real wage growth supported consumption in Ukraine, the lack-lustre performance of investment resulted in stagnating domestic demand. Moreover, the country is facing a large external financing gap and may need to sign a loan agreement with the IMF in order to avert a possible balance-of-payments crisis. (In 2013, the country suffered several credit-rating downgrades). Ukraine faces high costs of external borrowing and in September the country's foreign-exchange reserves dropped to a level covering just 2.5 months of imports. The slowdown in China and the Russian Federation has led to weaker demand for steel, one of the main Ukrainian exports, and low growth rates are expected for the forecast period. In Belarus, economic growth markedly slowed, dragged down by plummeting exports as prices of

5 Georgia's performance is discussed in the context of this group of countries for reasons of geographic proximity and similarities in economic structure.

potash, one of the main exports of Belarus, fell on international markets. In the Caucasus, robust expansion in Azerbaijan was driven by the non-oil economy, which received a boost from continued public investment and pre-electoral fiscal stimulus. Growth slowed in Armenia and Georgia, however.

Among the countries of Central Asia, rapid growth in the oil sector boosted economic expansion in Kazakhstan despite the unresolved problems of the banking sector (non-performing loans constitute about 30 per cent of total loans and the banks are deleveraging). The Kyrgyz economy bounced back strongly from the decline driven by problems in gold production in 2012, thanks to a recovery in gold production and a strong expansion in the other sectors of the economy. Infrastructure development and rising hydrocarbons output supported growth in Turkmenistan. Despite the economic slowdown in the Russian Federation, employment dynamics have prompted large remittances benefiting the poorest countries in the region.

Unemployment falls

Despite the deceleration in growth, unemployment in most of the economies remained relatively stable or declined slightly, with the notable exception of Ukraine. In the Russian Federation in particular, the unemployment rate reached historical lows amid strong wage growth and labour shortages in some areas. By contrast, unemployment remains elevated in the low-income countries particularly in the Caucasus. Kazakhstan continued to generate new jobs for a growing, economically active population and has a relatively stable unemployment rate. Migration, predominantly to the Russian Federation, remains an important mechanism to alleviate labour market tensions in the low-income countries of the CIS.

Inflation trends diverge

Similar to 2012, inflationary trends in the CIS area diverged in 2013, with inflation rates recorded at close to double-digit figures in Central Asia and a near-zero inflation rate registered in Georgia and Ukraine. Belarus registered the highest annual inflation rate in the CIS at over 20 per cent. This followed the Government's marked increase in public sector wages and its attempt to stimulate private credit growth as the currency further depreciated. In the Russian Federation, World Trade Organization tariff reductions and increased agricultural production helped to stabilize inflation; however, it remained above the central bank's target range, thus constraining the use of monetary policy in addressing the slowing economy. A proposed freezing of prices for natural monopolies and wages for certain public sector workers could restrain inflation in 2014. In Ukraine, the possibility of a sharp exchange-rate adjustment threatens renewed inflationary pressures, but a good harvest and a sluggish economy have kept inflation down. In Kazakhstan, higher utility prices have offset the disinflationary gains resulting from declining food prices. Currency depreciation contributed to inflationary pressures in Uzbekistan. Sharp price increases in electricity and imported gas prompted the acceleration of inflation in Armenia. Lower food and oil prices and improved competitive practices have fuelled deflationary pressures in Georgia. Diverging inflation trends are expected for 2014-2015, with inflation in the Central Asian countries remaining above the CIS average.

Monetary loosening remains on hold

In the Russian Federation, inflation that is slightly over the target has prevented the central bank from loosening policy, despite the slowing economy. Amid accelerating household consumption and continued economic expansion, interest rates remained unchanged in Kazakhstan. Ukraine cut interest rates in an attempt to revive the economy, but the desire to support the exchange rate has prevented a more aggressive pace of loosening. A more flexible exchange rate would allow more room for monetary easing. However, the large share of foreign-currency denominated debt in the economy requires caution regarding possible balance sheet effects. Fears over stagnant economic growth prompted further monetary loosening in Belarus, despite fast wage increases and a depreciating currency. In

Armenia, where inflation accelerated beyond the central bank's target range, the policy rate was increased to keep rising prices in check.

Fiscal prudence prevails

In the Russian Federation, slower than anticipated growth impacted revenues and resulted in tighter spending control as the country continued to adhere to a path of fiscal prudence, despite low sovereign debt. This fiscal tightening, with a declining non-oil deficit, has been a drag on economic expansion; further budget cuts and a freeze on public sector wages is proposed for 2014. On the other hand, the Government also announced plans to spend part of the National Wealth Fund on three major transport projects in a bid to provide a stimulus to the economy. By contrast, other energy-producing countries, such as Azerbaijan and Turkmenistan, have provided a fiscal stimulus that has added to inflationary pressures. The fiscal deficit in Ukraine remained high, being compounded by the large financial gap at Naftogaz, the state oil and gas company. In Kazakhstan, continued economic expansion improved fiscal balances. In Armenia and Georgia, lower-than-planned spending has contributed to the observed deceleration of economic growth.

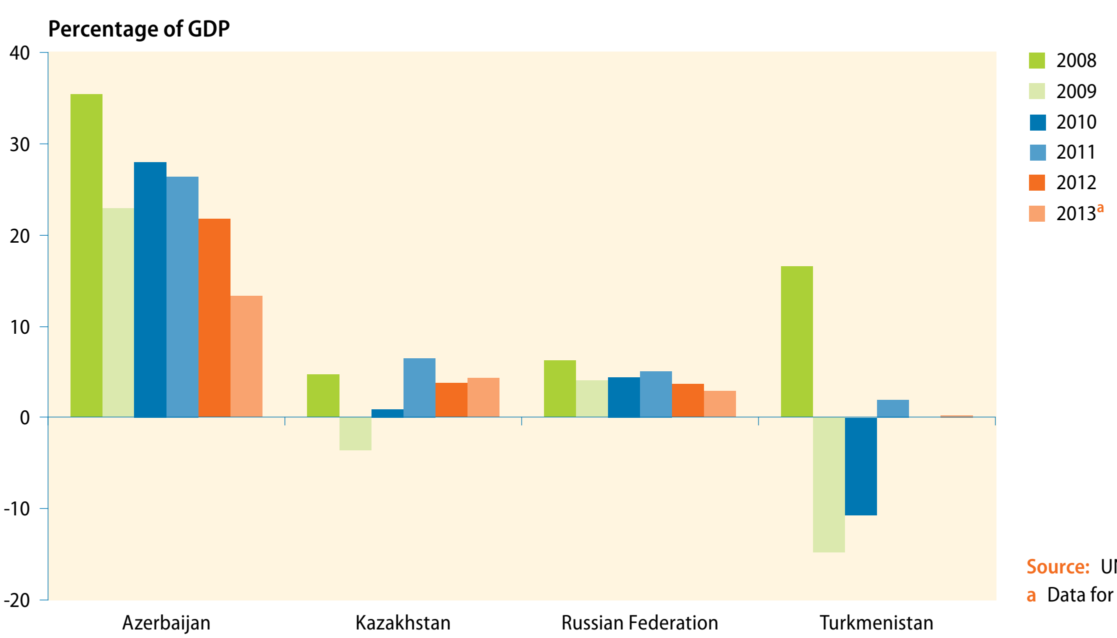
Current-account surplus in the Russian Federation shrinks further

The energy-exporting countries of the CIS continued to register current-account surpluses. However, those surpluses continued to shrink in the Russian Federation and in Azerbaijan (figure IV.5). By contrast, there was little adjustment in the large deficits observed in the low-income energy-importing economies, which remain vulnerable to any shortfalls in raising finance. In Ukraine, falling gas imports from the Russian Federation contributed to a limited correction in the elevated current-account deficit; however, the external liquidity situation remained fragile, amid large external and fiscal deficits and very precarious access to financing, with the high cost of external debt. Current reserve levels are low relative to short-term foreign debt. In Kazakhstan, the impact of rapid oil growth on external balances has been partly offset by large dividend payments to international oil companies.

Vulnerabilities remain

Some improvement in the external environment will support a better economic performance in the region in 2014, but lagging reforms aimed to increase productivity and

Figure IV.5
Current-account balances of the energy-exporting CIS countries



Source: UN/DESA.
a Data for 2013 are forecast.

competitiveness, and weak investment will constrain the pickup in growth in the CIS European countries. By contrast, a more solid performance is likely in energy-producing countries, with the exception of the Russian Federation, due to a sustained investment effort. With linkages to a still fragile global economy, the region would suffer if external conditions were to deteriorate. While weak linkages shelter the low-income countries in the region from global financial turbulences, the large deficits in Belarus and Ukraine make them vulnerable to any deterioration in capital market access. Lack of economic diversification exposes the region to reductions in commodity prices that result from a worsening global economy. While the Russian Federation and other energy-producing countries have some policy space to offset these negative trends, other economies have fewer resources with which to face these challenges.

Developing economies

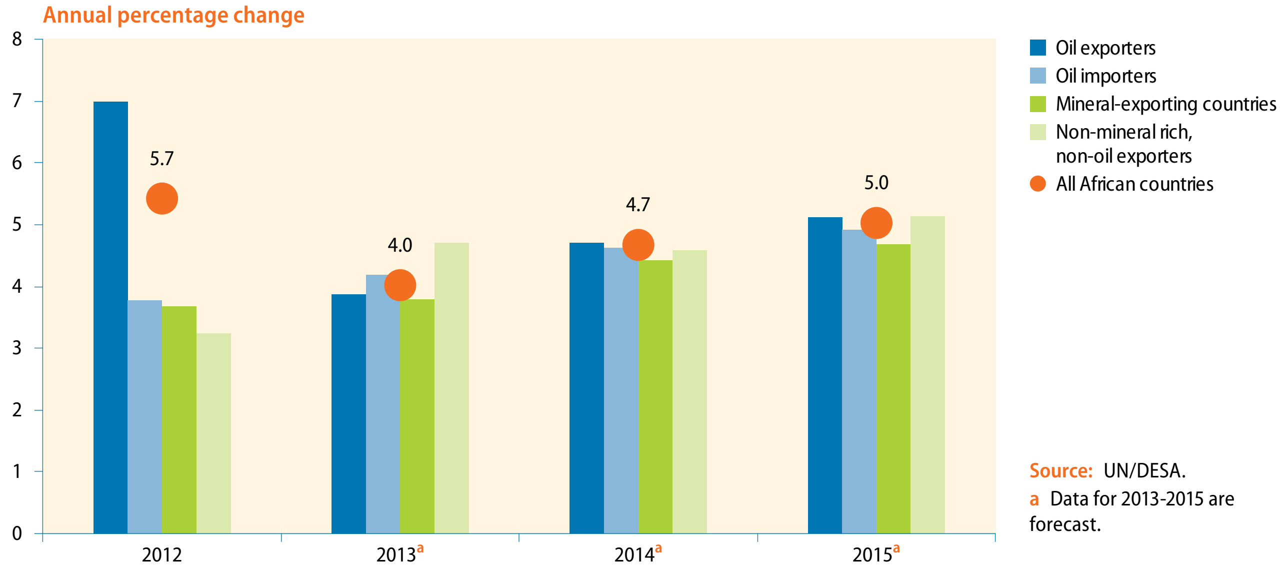
Developing economies registered a growth of 4.6 per cent in 2013, only slightly less than 4.7 percent achieved in 2012. Among the subregions, East and South Asia and Southern Africa as well as South America showed moderate increases in their growth rates. By contrast, the most pronounced decrease in growth occurred in North Africa, due to political unrest and disruptions to oil production, as well as Mexico and the Caribbean, due to structural constraints. In the outlook, developing economies will see a steady acceleration in growth to 5.1 per cent in 2014 and 5.3 per cent in 2015. However, despite these positive headline numbers, numerous developing economies continue to face significant challenges—including high unemployment, a lack of diversification into higher-value-added production and a lack of infrastructure, especially in the energy sector. At the same time, the forecast is subject to a number of risks and uncertainties. For example, the rebound in North Africa is based on the assumption of a return to a more stable political environment. In the area of monetary policy, the looming reduction in QE by the Fed holds the potential to have major effects on capital flows and exchange rates. For many developing countries with a dominant role in the agricultural sector, adverse weather conditions pose a major risk, with potentially severe impacts in the form of higher food prices or outright food shortages.

Africa: strengthening overall growth with diverse performance across subregions

Growth will accelerate, owing to improving infrastructure, still solid commodity prices and stronger domestic demand

Africa's growth prospects remain relatively strong, with the GDP growth rate projected to accelerate from 4.0 per cent in 2013 to 4.7 per cent in 2014, slightly lower than the developing countries' average of 5.1 per cent (see annex table A.3). Medium-term growth prospects are expected to be supported by improvements in the global economic and regional business environment, relatively high commodity prices, easing infrastructural constraints, and increasing trade and investment ties with emerging economies. Other important factors for Africa's medium-term growth prospects include increasing domestic demand, especially from a growing class of new consumers associated with urbanization and rising incomes, and improvements in economic governance and management. A moderate global growth recovery in 2014, underpinned by growth in industrial production in emerging and developing countries, led by China, and projected faster growth in developed countries should also stimulate growth in Africa through increased trade, investment and capital flows.

Figure IV.6
Africa: GDP growth performance by trade structures



Source: UN/DESA.
a Data for 2013-2015 are forecast.

Disruptions in oil production and political unrest in parts of North and West Africa (Central African Republic, Libya and Mali) slowed growth in Africa's oil-exporting economies[6] to 3.9 per cent in 2013 (figure IV.6). Growth is expected to rise to 4.7 per cent in 2014 as some stability returns. Growth in mineral-rich economies[7] is also expected to accelerate from 3.8 per cent in 2013 to 4.4 per cent in 2014, thanks mainly to increased investments and new mineral discoveries in countries such as Sierra Leone (in iron ore and diamond production), Zambia (in copper mining), Botswana (in copper, coal and diamonds), Namibia (in uranium and diamonds), Angola (in coal mining) and Ghana and Liberia (in gold mining). Growth in Africa's non-oil and non-mineral-rich economies[8] is forecast to moderate slightly from 4.7 per cent in 2013 to 4.6 per cent in 2014, mostly driven by strong expansion in services and agriculture in countries such as Ethiopia.

At the subregional level, growth in West and East Africa is expected to increase from 6.7 per cent and 6.0 per cent in 2013 to 6.9 per cent and 6.4 per cent in 2014, respectively. Growth is also projected to increase from 2.3 per cent and 3.6 per cent in 2013 to 3.3 per cent and 4.2 per cent in 2014 in North and Southern Africa, respectively. Central Africa's growth is expected to recover moderately in 2014 to 4.7 per cent from a slight decrease to 4.2 per cent in 2013, mainly due to political instability and violence in the Central African Republic, deceleration in oil production in the Congo (Brazzaville) and Equatorial Guinea, and reduction in oil exports from Gabon.

6 This includes Algeria, Angola, Cameroon, Chad, the Congo, Cote d'Ivoire, Equatorial Guinea, Egypt, Gabon, Libya, Nigeria, South Sudan and Tunisia.

7 This includes Botswana, Central African Republic, Democratic Republic of the Congo, Ghana, Guinea, Mali, Mauritania, Mauritius, Mozambique, Niger, Rwanda, Sierra Leone, South Africa, United Republic of Tanzania, Zambia and Zimbabwe.

8 This includes Benin, Burundi, Burkina Faso, Cabo Verde, Comoros, Djibouti, Gambia, Guinea-Bissau, Lesotho, Liberia, Madagascar, Morocco, Senegal, Sao Tome and Principe, Somalia, Swaziland, Togo and Uganda.

West Africa will continue to attract investments in the oil and minerals sector, a key source of growth in the subregion, especially in countries such as Burkina Faso, Ghana, Guinea, Liberia, Niger, Nigeria and Sierra Leone. Real GDP growth in East Africa will benefit from several positive factors including, for example, increased consumer spending in Kenya, increased consumption and investment in the natural gas sector in Tanzania, increased activity in construction, transport, telecommunications, financial services, exploration and construction in the burgeoning oil industry in Uganda, and improved agricultural and service sector growth spearheaded by the wholesale and retail trade sector performance in Ethiopia. Growth in Kenya will also benefit from an expected rebound in 2014, after a cut in growth in 2013 in key sectors (such as tourism) due to after-effects of the Westgate Mall attacks.

Growth in the Central African subregion is expected to remain strong despite decelerating as a result of political instability and violence and an expected fall in oil production in the absence of new discoveries in the Central African Republic, where growth is projected to decline to 0.8 per cent in 2014. Gabon's growth is also expected to decelerate from 5.7 per cent in 2013 to 5.4 per cent in 2014, as the country's oil fields are maturing, leading to a decline in output.

Political instability and disruptions in oil output continue to weaken growth prospects in North Africa, especially in Egypt, Libya and Tunisia. Growth in the subregion is expected to improve from 2.3 per cent in 2013 to 3.3 per cent in 2014, contingent on the assumption that some stability returns to the affected economies. Growth prospects in Southern Africa are improving, largely because of projected increases in South Africa's growth rate from 2.7 per cent in 2013 to 3.3 per cent in 2014, declining labour market unrest, increased investments, and rising mineral output. The subregion is likely to attract increased foreign investment thanks to huge coal deposits and offshore gas discoveries in Mozambique, increased oil output in Angola, and the increased investment in the copper sector in Zambia and uranium mining in Namibia.

Africa's recent relatively robust growth is heavily driven by commodity production and exports; it remains far below the continent's potential, however. Growth is still failing to translate into meaningful job creation and the broad-based economic and social development needed to reduce the high poverty and rising inequality rates seen in many countries. It is therefore essential that African countries embark on strategies to transform their economies through increased value addition in the primary commodity sector and diversification into higher productivity sectors, especially manufacturing and modern services (box IV.2).

Inflationary pressure will decrease in the light of moderating changes in food and fuel prices

Inflation across Africa is expected to decelerate slightly from an average of 8.0 per cent in 2013 to 7.8 per cent in 2014. A variety of factors will contribute, including subdued global demand, moderating international food and fuel prices, and tighter monetary policy in most African countries, despite the increased investment in infrastructure (see annex table A.6). For example, in Central Africa, inflation is expected to remain low and decelerate from 3.9 per cent in 2013 to 3.3 per cent in 2014. Monetary policy in most of the countries in the region is managed by the regional central bank, Banque des Etats de l'Afrique Centrale, and will remain focused on controlling inflation and maintaining the CFA franc's peg to the euro. South Africa is expected to tighten its monetary policy in 2014 in order to control inflation and to ensure that real interest rates return to positive territory. Exchange-rate depreciation and falling foreign reserves will be major concerns for monetary policy in a number of countries—Burundi, Egypt, Kenya, Malawi, Sudan, Uganda and the United Republic of Tanzania—although the gravity of the situation varies from country

Box IV.2

Fostering the interface between mining and manufacturing in Africa to accelerate and sustain growth

Increasing the role of mining in Africa's economic performance

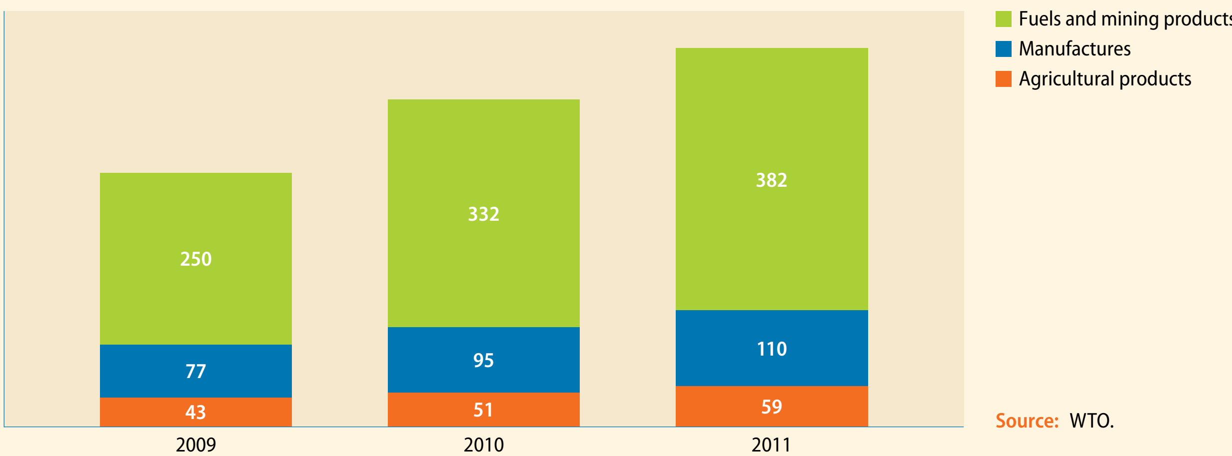
The recent strong performance of Africa's mineral sector demonstrates both the importance of mining to the continent's economic growth, and the potential for greater linkages between mining and the economy as a whole. Africa's recent commodity- and minerals-based growth has not translated into sufficient or quality job creation. With a rapidly growing working-age population, a challenge to African policymakers and mining stakeholders is to ensure that mineral endowments play a role in accelerating inclusive growth and sustainable development for the continent, particularly through the interface with manufacturing.

Estimates show that activities related to resources (excluding agriculture) accounted for 24 per cent of Africa's gross domestic product (GDP) growth over 2002-2007.[a] The importance of mineral and fuel resources is most evident in the external sector, with mining and fuel exports to the rest of the world increasing from $250 billion in 2009 to $382 billion in 2011 (figure IV.2.1), an increase from 17 per cent to 20 per cent of GDP. Hydrocarbon and metals exports account for more than half of exports in 14 African countries, which together make up 39 per cent of the continent's population.[b] In 2011, mining exports represented a significant proportion of GDP in a variety of selected mineral-rich African countries (table IV.2.1).

Figure IV.2.1

African exports by commodity, 2009-2011

Billions of United States dollars



Source: WTO.

Table IV.2.1

Share of mining sector in GDP for selected African countries, 2011

Percentage		Percentage	
Country	Share	Country	Share
Botswana	2.8	Niger	11.1
Gabon	1.3	South Africa	7.4
Guinea	17.6	United Republic of Tanzania	4.5
Mauritania	43.6	Zambia	36.5
Morocco	2.8	Zimbabwe	13.1
Mozambique	14.3		

Box IV.2

Fostering the interface between mining and manufacturing in Africa to accelerate and sustain growth (*continued*)

Africa's mining outlook is strong despite falling metals prices, which are expected to pick up modestly over the outlook period, owing to continued demand from developing countries. There is significant untapped potential as well, adding to the positive outlook. Africa is home to 40 per cent of global gold reserves and 80-90 per cent of chromium and platinum group metal reserves.[c] Gold production is robust, due to South Africa's dominant role in global gold output; also, output in West Africa, which accounted for 8 per cent of global gold output as of 2011, is increasing, with Ghana the strongest performer.[d] Recent discoveries of titanium and rare earths in Kenya, lead, copper and zinc in Ghana, and upgraded mining in Mozambique, Niger, Sierra Leone and Zambia[e] are among the developments that underpin the positive outlook of mining and overall growth in Africa. While in 2010 only one third of countries had mineral rents accounting for more than 5 per cent of GDP, increasing mineral discoveries such as these have raised expectations that by 2020 nearly all African countries will be involved in mineral extraction.[f]

The need for an enhanced interface between mining and manufacturing

As demonstrated in South Africa in 2012, policies that support a conducive business environment for mineral-based value addition can lead to large income and employment multipliers in both mining and manufacturing. For example, mining's direct impact of 267 billion rand and 524,000 jobs turned into an overall economy-wide impact of 536.1 billion rand and 1.35 million jobs.[g] In the case of Botswana, an economic diversification strategy and local content policies that focus on diamond beneficiation provided the framework for the country to create jobs and reach upper-middle-income status; diamond cutting and polishing employ more than 3,000 workers directly.[h]

Despite this potential, most African countries have been unable to link mining to manufacturing, and the mining sector continues to underperform in terms of value addition and job creation. For example, Zambia is a significant global copper producer. Yet, this industry, characterized by non-value-added exports, only accounted for 10 per cent of formal employment and 9.9 per cent of GDP in 2010.[i] Despite South Africa holding most of the world's manganese, it only controls one fifth of the global market. The development of a healthy manufacturing base is vital for an economy to achieve sustained growth and job creation, and there is evidence for strong multiplier effects from manufacturing. However, the contribution of manufacturing to GDP in Africa as a whole fell to 10.5 per cent in 2008, from a peak of 15.3 per cent in 1990.[j] Africa's share of global manufacturing exports has remained negligible at below two per cent.

The need for a stronger interface between mining and manufacturing is further underpinned by the outlook for global commodity demand. Although commodity prices are anticipated to remain near historical highs, the flat growth outlook will adversely affect those economies that depend on ever-increasing revenues from primary commodity extraction. If Africa does not capitalize on its opportunities to diversify and add value to these presently lucrative activities, it may miss the opportunity presented by the commodities boom.

In order to enhance the interface between mining and manufacturing, transformative policies for creating development linkages must be institutionalized in national development visions and continental plans in order to ensure a broad-based approach. Upstream and downstream activities should be geared towards both domestic production (for job and income creation and economy-wide knock-on effects) and to exports (to garner foreign-exchange earnings). Knowledge networks, innovation and entrepreneurship are vital for development of linkages and must be promoted, particularly since value-addition requires more complex processes to transform raw materials. As envisaged by the African Union and Economic Commission for Africa's African Mining Vision, now is the time to transform Africa's economies by capitalizing on high demand and investment, and enhancing linkages between mining and manufacturing.

a Charles Roxburgh and others, "Lions on the move: The progress and potential of African economies", McKinsey Global Institute Report, June 2010.
b Emerging Markets Forum, "Africa 2050: Realizing the Continent's Full Potential".
c *Economic Report on Africa 2013: Making the Most of Africa's Commodities: Industrializing for Growth, Jobs and Economic Transformation* (United Nations publication, Sales No. E.13.II.K.1).
d Ibid.
e See "Africa continues to grow strongly despite global slowdown, although significantly less poverty remains elusive", World Bank press release, 15 April 2013.
f See *Africa's Pulse*, vol. 6 (October 2012).
g See presentation by Jorge Maia on "The interface between mining and manufacturing in South Africa: the context" held at the Industrial Development Corporation in South Africa on 22 August 2013, available from http://www.idc.co.za/interface.
h OECD, "Export restrictions on raw materials: experience with alternative policies in Botswana", Working Paper TAD/TC/WP(2013)17, September 2013.
i *Economic Report on Africa 2013*, op. cit.
j See, *Economic Development in Africa Report 2011: Fostering Industrial Development in Africa in the New Global Environment* (United Nations publication, Sales No. E.11.II.D.14).
Source: UNECA.

to country. Loose monetary policy, high fiscal deficits, domestic currency depreciation and relatively high energy costs are among the factors that are expected to strengthen inflationary pressure in 2014 in some of the countries in East and Southern Africa. Efforts to rein in rising costs for subsidies, particularly fuel subsidies, in North Africa will put some upward pressure on inflation.

Budget balances will deteriorate in oil-importing countries

Africa's average fiscal deficit increased from 1.35 per cent in 2012 to 1.80 per cent of GDP in 2013. This is caused in part by there being a number of Governments across the continent under continuous pressure to increase spending on public services like education, health and infrastructure, and to increase wages in the public sector and provide subsidies on food and fuel. However, this deterioration was largely due to lagging revenues in oil-importing countries. Oil-exporting and mineral-rich countries recorded fiscal surpluses of 4.72 per cent and 4.97 per cent, respectively, in 2013. The fiscal outlook is brighter for the region's large economies of Equatorial Guinea, Ghana, Kenya, Morocco, Nigeria and South Africa, as considerable improvements are expected in their respective fiscal balances in 2014. Among these countries, Angola, Equatorial Guinea and Gabon continue experiencing relatively large fiscal surpluses, thanks to sustained increases in oil production and exports. Other countries, such as Egypt and Morocco, have taken steps this year to address significantly rising deficits created by the rising costs of subsidies.

The overall current-account deficit will decline slightly

Africa's overall current-account deficit is expected to slightly decline from 1.8 per cent of GDP in 2013 to 1.7 per cent in 2014. External balances will remain positive, despite deceleration, in oil-exporting African countries, but will be negative and improving in oil-importing countries, mineral-rich countries, and non-mineral-non-oil-rich countries.

Africa's total exports are expected to decline in 2014 to 29.6 per cent of GDP from 30.9 per cent in 2013, mainly due to the weakening global commodity markets, although oil and other commodity exports will continue to dominate. At a subregional level, exports are expected to decline in all the regions except East Africa, where exports will slightly increase from 15.5 per cent of GDP in 2013 to 15.7 per cent in 2014. This increase can be accounted for by a rise in non-traditional exports, such as floriculture and trade in services, especially in Ethiopia, Kenya and the United Republic of Tanzania. Along with exports, total imports are expected to decline as a percentage of GDP across all subregions, with the largest decline occurring in Southern Africa, from 29.5 per cent of GDP in 2013 to 27.3 per cent of GDP in 2014. This significant drop in imports is associated with an expected decline in Botswana, South Africa and Zambia, some of the regions' larger economies.

Unemployment continues to be a pressing issue

Despite the positive growth picture for many countries, the employment situation remains a major problem across the region, both in terms of the level of employment as well as the quality of jobs that are generated, especially in North Africa (see annex table A.8). High youth unemployment remains a concern for the region and continues to contribute to social pressures. Wide gender disparities in employment and earnings are also a significant issue. Women face unemployment rates at least double that of men in countries such as Algeria and Egypt. With the labour force growing at a rapid pace, the solid rates of GDP growth have proven far from sufficient to absorb all new labour market entrants, given the current pattern of production and employment generation. The lack of economic diversification away from the heavy dependence on resource extraction or agriculture is a key reason why labour demand is not more dynamic, but continued growth in other sectors such as telecommunications, financial services, transport and construction in countries such as Ghana, Kenya and Nigeria is helping to change this situation.

Downside risks and uncertainties include a global economic slowdown, lower commodity prices, political instability and adverse weather conditions

Despite the expected robust medium-term growth prospects, some significant internal and external downside risks and uncertainties exist in the region. On the external front, a global economic slowdown encompassing the euro area and the emerging economies would have a significant negative impact on Africa's performance through the impact on trade, FDI and ODA flows, tourism, and remittances to the region. Changes in global commodity prices and terms of trade are among the key risk factors Africa will face in the medium-term.

Declining global oil prices, while having a significantly positive impact on current-account balances in oil-importing countries, are expected to further reduce current-account surpluses in oil-exporting countries, exerting pressure on their fiscal balances as their export revenues decline. Political, civil and labour unrest still pose a significant threat to production in several African countries (such as Central African Republic, the Congo, Democratic Republic of the Congo, Egypt, Libya, Mali, Somalia, South Africa and Tunisia), especially through their negative effects on investment, trade and tourism. Developments in these countries continue to pose a significant downside risk to Africa's overall economic outlook. Furthermore, since most of the economies in the region are agriculture-based, weather-related shocks represent a key downside risk for economic growth and a key upside risk for agricultural prices in Africa.

East Asia: growth projected to pick up slightly

After slowing markedly in 2011 and 2012, economic growth in East Asia has stabilized over the past year. While East Asia remained the fastest-growing region in the world in 2013, economic activity was adversely affected by continued sluggish external demand in developed economies and an adjustment to lower growth in China. In addition, domestic demand weakened in several of the region's economies, including Indonesia, Malaysia and Thailand. Average GDP growth in the region stood at 6.0 per cent in 2013, slightly up from 5.9 per cent in 2012. A further mild pickup in regional growth to 6.1 per cent is projected for 2014 and 2015, mainly driven by a gradual recovery in exports amid improving conditions in developed countries. In most East Asian economies, private consumption and investment will continue to expand robustly, supported by stable labour market conditions, low inflation and fairly accommodative monetary policies. Fiscal policies will remain moderately expansionary, providing support for growth.

Consumption demand remains a main driver of growth; mild recovery in exports is expected

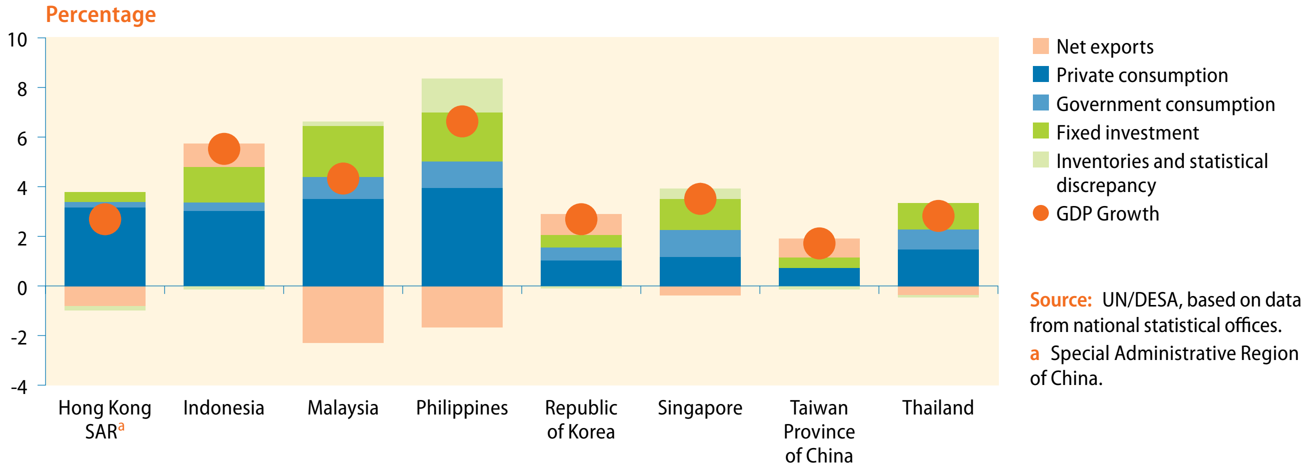
Slow export growth persisted across East Asia in 2013 as demand in its major trading partners—particularly Europe and the United States—remained sluggish. In most economies, net exports did not contribute significantly to overall growth (figure IV.7). Household consumption remained the main growth driver, whereas the contribution from investment declined moderately. While no significant change to this growth pattern is expected in 2014 and 2015, a gradual pickup in external demand is likely to provide some support.

After weakening in the first half of 2013, China's economy gained momentum in the second half, driven by stronger domestic demand. Investment was supported by minor fiscal stimulus measures, including tax breaks for small businesses and accelerated construction spending. Full-year growth in China is estimated at 7.7 per cent in 2013, the same pace as 2012. Looking ahead, a further gradual slowdown to 7.5 per cent in 2014 and 7.3 per cent in 2015 is projected, in line with the Government's objective of a more sustainable growth path.

The high-income and strong export-oriented economies of Hong Kong Special Administrative Region of China, the Republic of Korea, Singapore and Taiwan Province of China saw a moderate recovery over the past year, which is expected to continue in 2014 and 2015. However, the strength of this recovery depends heavily on global conditions as well as specific domestic factors. Household debt, for example, has steadily increased since the global financial crisis and could weigh on growth if monetary conditions are tightened.

After a strong performance in 2012, growth in Indonesia, Malaysia and Thailand decelerated markedly in 2013, mainly owing to a moderation in consumption and invest-

Figure IV.7
Contributions to growth by demand component in selected East Asian countries, 2013



Source: UN/DESA, based on data from national statistical offices.
a Special Administrative Region of China.

ment demand. Stronger exports should support a mild pickup in growth in Malaysia and Thailand in 2014. In Indonesia, growth is forecast to weaken slightly further in 2014 as lower commodity prices and the recent monetary tightening—introduced in response to rising inflation, a widening current-account deficit and large capital outflows—weigh on economic activity. The economy of the Philippines continued to expand at a robust pace of close to 7 per cent over the past year, driven by strong consumption and a boom in construction. In November 2013, the country was hit by a severe storm and flooding, which caused many deaths and widespread destruction. In economic terms, the effect is a small reduction in growth in 2013, with reconstruction possibly adding to growth in 2014.

Labour markets have remained broadly stable

East Asia's labour markets have remained broadly stable in 2013. Unemployment rates are generally low, although considerable differences between and within countries exist. In the high-income economies, unemployment rates range from about 2.0 per cent in Singapore to 4.2 per cent in Taiwan Province of China. In the Republic of Korea, the unemployment rate declined to 2.7 per cent in September 2013, down from 2.9 per cent in 2012, mainly owing to expansion in service sectors. Over the same period, however, the jobless rate for those aged 25 to 29 increased from 6.7 per cent to 7.7 per cent. Official unemployment rates are also relatively low in China, Malaysia, Thailand and Viet Nam. In China, the unemployment rate for urban registered workers declined marginally to 4.04 per cent in September 2013. Conversely, translating economic growth into employment opportunities remains a significant challenge in the Philippines. Despite growth of 7.6 per cent in the first half of 2013, the unemployment rate rose to 7.3 per cent in July as the economy failed to create sufficient full-time jobs to accommodate the rapidly growing labour force. In Indonesia, the positive trend of the past few years continued in early 2013, supported by employment growth in manufacturing, construction and services. However, after dropping to 5.9 per cent in the first quarter of 2013, the unemployment rate rose to 6.3 per cent in the third quarter amid slowing economic growth and increased labour supply. In 2014 and 2015, unemployment rates across East Asia are expected to remain fairly stable, given the expected moderate growth in most countries. A pressing concern, particularly in some South-East Asian countries, is continuing widespread informal employment, which tends to suffer from low wages, weak productivity, and lack of benefits and job security.

Consumer price inflation continues to be mild

Consumer and producer price inflation is generally mild across East Asia, owing to reduced pressure from international commodity prices. Food prices remained fairly stable in 2013, thanks to favourable weather conditions and robust agricultural production. Average consumer price inflation is projected at 2.5 per cent in 2013, slightly down from 2.8 per cent in 2012. In most countries, inflationary pressures will likely remain muted as commodity prices are projected to further ease. In line with a gradual pickup in growth, average inflation is forecast to accelerate to 3.1 per cent in 2014, ranging from 1.8 per cent in Taiwan Province of China to 7.1 per cent in Viet Nam. In China, consumer price inflation stands at about 3 per cent and producer prices remained in deflationary territory in 2013, despite persistent increase in both food prices (particularly pork and vegetables) and private-sector wages. Falling commodity prices, significant overcapacities and weakening domestic demand put downward pressure on prices in China. Conversely, inflation accelerated sharply in Indonesia in the third quarter of 2013 after the Government hiked the administered prices of gasoline and diesel significantly. The sharp depreciation of the rupiah since June further spurred inflation, which is estimated to average about 7 per cent in 2013, before easing slightly in 2014 and 2015. Malaysia's Government also reduced fuel subsidies, but the impact on overall prices was more limited, with year-on-year inflation projected at about 3 per cent in late 2013.

Monetary policy remains fairly accommodative; some tightening is expected in 2014-2015

Monetary policy remains generally supportive of economic growth across East Asia, in line with low inflation and subdued external demand. Several central banks (including those of Papua New Guinea, the Republic of Korea, Thailand and Viet Nam) reduced their policy interest rates during the first half of 2013 in response to decelerating domestic demand and lower inflationary pressures. Further easing is, however, unlikely, and some central banks may tighten monetary conditions in 2014, provided that growth picks up and the Fed tapers its large-scale asset purchase programme. The Bank of Indonesia already hiked interest rates four times by a total of 175 basis points between June and November 2013, while also strengthening macroprudential measures. These policies were implemented to control inflation, maintain financial stability, halt the depreciation of the rupiah and reduce the current-account deficit. Financial stability has also gained increased attention in other East Asian economies. The People's Bank of China (PBC) responded to a temporary liquidity squeeze in June by providing additional liquidity to financial institutions that faced funding shortages and complied with macroprudential requirements. Going forward, the PBC will likely maintain its focus on adjusting liquidity in the banking system and ensuring steady credit growth. Continued financial reform, especially further liberalization of interest rates, and increased regulation of the shadow banking sector will have a significant impact on the liquidity conditions in the economy. In addition to national measures, East Asian countries are also increasingly looking to regional monetary and financial cooperation, such as the extension of bilateral swap arrangements, in response to financial market volatility.

Fiscal policy remains supportive of growth

Fiscal policy has continued to support growth across East Asia as many Governments are trying to counter the slowdown in domestic demand. The Chinese Government implemented several targeted measures, including scrapping taxes for small firms and boosting investment in infrastructure and railways. The Government in the Republic of Korea passed a supplementary budget in May 2013, which includes expenditure on public-sector jobs, business start-ups, mortgage subsidies and trade financing for small exporters. Malaysia, the Philippines and Thailand are pushing for large infrastructure projects, although delays in implementation have so far limited their impact. These expansionary fiscal policies, combined with costly subsidy schemes in some countries, have led to a slight dete-

Box IV.3

Social welfare programmes to promote inclusive development in the Asia-Pacific region

Despite rapid growth and a steady decline in extreme poverty, a large number of countries in the Asia-Pacific region are experiencing greater levels of economic and social inequality. However, since the beginning of the Great Recession, the region has unveiled several economic and social policy measures aimed at boosting domestic consumption and aggregate demand, while also reducing inequality.

The 2013 ESCAP survey[a] cautioned that if the current economic growth slowdown continues, the region would face stalled progress towards reaching the Millennium Development Goals (MDGs).[b] Faced with a new normal of lower growth, several countries in the region have initiated targeted social welfare enhancing policies and programmes to promote inclusive economic growth and sustainable development. For instance, the region has witnessed initiatives of welfare programmes addressing health in Indonesia, food security in India, employment in the Republic of Korea and Thailand, and more generally, economic and social development in China.

By implementing the universal health care coverage plan on 1 January 2014, Indonesia has embarked on a road map that seeks to provide access to health care for the entire population by 2019. This will be important in targeting poor segments of the society. Similarly, India's National Food Security Act, 2013, an attempt to ensure food and nutritional security, is expected to provide an entitlement of food grains at highly subsidized prices to about two thirds of the population. The Republic of Korea has implemented several new employment and labour market policies in 2013 as part of its employment-for-all agenda. These policies seek to improve the quality of jobs by setting up institutions for upgrading skills, knowledge and training programmes, especially for young people, and to enhance labour productivity and wage stability. China is implementing a national development policy agenda to boost social welfare programmes that will improve levels of social security benefits. This agenda is expected to stimulate economic transformation by promoting a targeted emphasis on productive employment generation. Thailand further increased the minimum national wage in January 2013 to 300 Thai baht (about 10 dollars) per day. This increase is expected to help reduce inequalities by increasing the incomes of low-wage workers.

These policies and measures constitute an important step towards a more inclusive development model, which ensures that the benefits of rapid growth are shared more equitably than in the past.

a See *Economic and Social Survey of Asia and the Pacific 2013: Forward-looking Macroeconomic Policies for Inclusive and Sustainable Development* (United Nations publication, Sales No. E.13.II.F.2).

b Asian Development Bank, United Nations Economic and Social Commission for Asia and the Pacific and United Nations Development Programme, "Asia-Pacific Aspirations: Perspectives for a Post-2015 Development Agenda", Bangkok, August 2013.

Source: UN/ESCAP.

rioration of fiscal positions in 2013. In most economies (except Malaysia and Viet Nam) budget deficits and government debt levels as a share of GDP are still low. However, debt levels of local governments and state-owned enterprises, which are generally not recorded in government balance sheets, have been rising rapidly in some cases, most notably in China. Accordingly, total debt might exceed official government statistics and vulnerability to international monetary conditions is probably higher. In 2014 and 2015, fiscal balances are likely to improve slightly in most economies, given fairly robust growth expectations. In Indonesia and Malaysia, a gradual reduction of fuel subsidies will help narrow the budget shortfall. Several Governments (for example those in Malaysia and the Republic of Korea) have also developed tax reform plans with a view to widening the tax base and diversifying the revenue sources.

Exports and imports projected to pick up mildly in 2014

East Asia's trade and current-account surpluses have narrowed since the global financial crisis. In 2013, the region's combined current-account surplus stood at about 3 per cent of GDP, compared with a high of 8.3 per cent in 2007. This significant decline can be attributed to the protracted weak demand in developed economies and the robust growth in consumption and investment demand across East Asia during the initial recovery from the crisis. In 2013, East Asia's exports and imports grew slowly, in line with the subdued conditions in the key destination markets, notably Europe and the United States, and the less dynamic expansion in the region. Looking ahead, trade growth is projected to recover mildly in 2014 and 2015, but will remain well below the pre-crisis level. In some economies, such as Indonesia and Malaysia, export sectors may benefit in the short run from the recent depreciation of the national currencies. Current-account balances as a share of GDP are expected to remain relatively stable in most countries. China's current-account surplus is forecast to further narrow gradually from about 2.0 per cent in 2013 to 1.6 per cent in 2014 and 1.2 per cent in 2015. This can be attributed to a steady decline in the trade surplus and a widening service balance deficit.

Significant capital flow and exchange rate volatility were widespread in the region in 2013

Many East Asian economies experienced significant capital flow and exchange-rate volatility in 2013—particularly in the middle of the year, when fears among investors of reduced global liquidity led to massive capital outflows and a sharp depreciation of some national currencies against the dollar. Between May and September 2013, the Indonesian rupiah depreciated by about 17 per cent, the Malaysian ringgit by 7 per cent, and the Philippine peso and Thai baht by about 5 per cent against the dollar. In September, the decision by the Fed to delay the tapering of its asset-purchasing programme temporarily eased the pressures on the region's capital markets, but significant risks of further financial turbulence remains.

Fed tapering and sharper-than-expected slowdown in China pose considerable downside risks

In some cases, renewed strong capital outflows may add pressure on central banks to raise domestic interest rates, thereby dampening economic growth. Tighter liquidity conditions and higher global and regional interest rates could pose considerable challenges, particularly for countries with high levels of household debt, such as Malaysia, the Republic of Korea and Thailand. At the regional level, a sharper-than-expected slowdown in China could severely impact growth across East Asia.

South Asia: lack-lustre growth in 2013, but gradual recovery projected

Economic growth in South Asia remained lack-lustre in 2013 as a combination of internal and external factors hampered activity, particularly in the region's large economies (India, the Islamic Republic of Iran and Pakistan). The region's total gross domestic product grew by 3.9 per cent in 2013, after increasing by 4.2 per cent in 2012, the slowest pace in almost two decades. Growth is forecast to pick up gradually to 4.6 per cent in 2014 and 5.1 per cent in 2015, supported by stronger external demand, a mild recovery in domestic demand in India and improved economic conditions in the Islamic Republic of Iran. The region's economic performance will greatly depend on the progress in tackling growth bottlenecks—such as energy and transport constraints and volatile security conditions—and macroeconomic imbalances. The room for monetary and fiscal policies to stimulate domestic demand is limited by elevated inflation, large fiscal and current-account deficits, and volatile global financial conditions.

India's economic woes continued in 2013

South Asia's subdued growth performance masks significant differences between individual countries. India's economy, which accounts for over 70 per cent of total output in South Asia, slowed further in 2013, held back by weak household consumption and sluggish investment. Full-year growth decelerated from 5.1 per cent in the calendar year 2012 to 4.8 per cent in 2013. External conditions continued to be challenging as the economy experienced significant capital outflows, particularly between June and August 2013. These outflows, which led to a sharp depreciation of the rupee, were triggered by expectations of an upcoming tapering of the Fed bond-buying programme, combined with concerns over India's large current-account deficit. While India's slowdown may have bottomed out, the recovery is likely to be slower than previously expected. Economic activity is forecast to expand by 5.3 per cent in 2014 and 5.7 per cent in 2015. This gradual pickup in GDP growth is likely to be supported by a good monsoon season, a mild recovery in investment, and stronger export growth on the back of improved global conditions and a weaker rupee. The Islamic Republic of Iran continues to face severe international sanctions, which have led to a sharp drop in oil exports and serious supply shortages. As a result, economic activity contracted further in 2013. The economy is expected to emerge from recession in 2014, with the possibility of a more pronounced recovery should the sanctions be gradually lifted. Nepal and Pakistan also continue to face significant macroeconomic challenges and subpar growth as political uncertainty, volatile security conditions and severe supply-side bottlenecks hamper household consumption and investment. In Pakistan, the newly elected Government finalized a loan agreement with the IMF in the third quarter of 2013 that aims at stabilizing macroeconomic conditions and solving the balance-of-payments problems; the programme comes with several conditions attached. Increased fiscal consolidation efforts and monetary tightening by the State Bank of Pakistan may weigh on activity in the short run, but some improvement is expected for 2015. The current economic situation and the outlook are more favourable in Bangladesh, where growth has remained fairly robust at about 6 per cent, and in Sri Lanka, the region's fastest growing economy in recent years. In both countries, household consumption will remain the main driver of growth, fuelled by rising incomes and remittance inflows.

The economic slowdown has taken its toll on labour markets

Recent employment surveys in South Asian countries suggest that the economic slowdown has taken its toll on the region's labour markets. The latest figures for India, the Islamic Republic of Iran and Pakistan indicate that unemployment increased in the past year and the labour force participation declined slightly. According to India's Employment-Unemployment Survey, the average unemployment rate rose from 3.8 per cent in the fiscal year 2011/12 to 4.7 per cent in 2012/13, with large differences by region, gender and age group. Unemployment is estimated to be higher among women (7.2 per cent) than men (4.0 per cent), higher in urban areas (5.7 per cent) than rural areas (4.4 per cent) and much higher for the age group 15-29 (13.3 per cent) than for those 30 and above (1.0 per cent). Similar unemployment patterns prevail in other South Asian countries. In Pakistan, the structural weakness of the economy seems to have exacerbated the employment gaps. In the second quarter of 2013, an estimated 18.7 per cent of women living in urban areas were unemployed compared to only 6.3 per cent of men. Moreover, the female labour force participation rate in urban areas was only 7.3 per cent, down from 8.4 per cent two years earlier. However, available unemployment data only provide a partial picture of the actual situation as the majority of South Asian workers are employed in the informal sector. The share of vulnerable employment (defined as unpaid family workers and own-account workers) in total employment is estimated to range from about 40 per cent in the Islamic Republic of Iran and Sri Lanka to about 60 per cent in Pakistan and 80 per cent in Bangladesh and India. Given that economic growth in South Asia is expected to remain below potential and the labour force will increase rapidly, the labour market pressures are likely to further intensify in the years ahead.

Inflation trends diverge across South Asia

In most South Asian countries, consumer price inflation moderated slightly over the past year as aggregate demand pressures declined and international commodity prices eased. Inflation remains, however, significantly higher than in other world regions and, in most cases, well above the respective central bank's comfort zone. The continued strong upward pressures on prices can be attributed to several factors, including persistent supply bottlenecks, entrenched inflationary expectations, ongoing weakness of local currencies (particularly in India, the Islamic Republic of Iran and Pakistan), and the attempts by several Governments (India and Pakistan, for example) to reduce their food and fuel subsidy bills. Because of a surge in inflation in the Islamic Republic of Iran, average annual consumer price inflation in South Asia increased from 12.5 per cent in 2012 to an estimated 13.9 per cent in 2013. A gradual moderation to 11.3 per cent in 2014 and 9.4 per cent in 2015 is forecast. In the Islamic Republic of Iran, severe supply shortages and a sharp devaluation of the rial pushed consumer price inflation sharply up to about 40 per cent in 2013. Inflation is projected to decelerate slowly in 2014 and 2015, but an easing of the sanctions could lead to a more rapid decline. In India, consumer price inflation has remained stubbornly high at close to 10 per cent, even as domestic demand weakened further. By contrast, inflation slowed moderately in Bangladesh, Nepal, Pakistan and Sri Lanka during 2013, with full-year averages ranging from 7 per cent to 9 per cent. While the baseline scenario foresees a gradual decline in inflation across South Asia in 2014 and 2015, upside risks remain. Those include poor harvests, further depreciation of national currencies, and pressures stemming from significant subsidy reductions (particularly in India, Pakistan and Sri Lanka).

Monetary policy focus in India and Pakistan has shifted towards lowering inflation

Recent monetary policy actions in South Asia reflect the considerable differences in macroeconomic conditions between countries. On the one hand, the monetary authorities in India and Pakistan recently hiked their benchmark interest rates. In doing so, they have shifted the policy focus towards lowering inflation and easing external pressures amid volatile global financial conditions. The Reserve Bank of India (RBI) raised its main policy rate by 50 basis points, although GDP growth hit a multi-year low in 2013. This marks a turnaround from the first half of the year, when policy rates were cut three times. The RBI also recently rolled back the exceptional liquidity tightening measures introduced in July and August 2013 in response to the massive capital outflows and the sharp drop in the value of the rupee. While the RBI is expected to maintain its focus on inflation, it is unlikely to raise policy rates considerably given the ongoing weakness in investment and growth. Should inflationary pressures ease in 2014 and the external financial environment stabilize, the RBI is likely to loosen monetary conditions. The State Bank of Pakistan also changed course in the second half of 2013, raising its benchmark interest rates in September and November. The path of Pakistan's monetary policy in the quarters ahead will be mainly determined by the trend in inflation, which has recently accelerated again. The central banks in Bangladesh and Sri Lanka, by contrast, have maintained their accommodative monetary policy stances as consumer price inflation moderated and exchange rates were fairly stable. In both countries, monetary conditions are expected to remain unchanged over the next few quarters, with the possibility of some tightening later in the forecast period.

Economic slowdown puts further strains on government finances

The current economic slowdown in South Asia put further pressure on government finances, which were already strained by very low tax bases and rising expenditure needs as the authorities confront many development challenges. In recent years, the Governments regularly missed their deficit-reduction targets by a wide margin. Growth projections proved too optimistic and expenditures on food, fuel and fertilizer subsidies were significantly higher than anticipated. In the past fiscal year, the budget deficit reached nearly 5.0 per cent of GDP in Bangladesh, India and the Islamic Republic of Iran, 6.7 per cent in Sri Lanka and 8.0 per cent in Pakistan. Given the weak growth momentum in the region and the difficulties in raising tax revenues and curbing expenditure growth, fiscal deficits will remain substantial in the near term. In India, the Government is unlikely to meet its target of reducing the deficit to 4.8 per cent of GDP in the current fiscal year 2013/14, since growth is below projections and the depreciation of the rupee pushes up the subsidy bill. In Pakistan, the new agreement between the Government and the IMF includes a strong commitment to consolidate public finances. The programme envisages a gradual decline in the deficit from about 8.0 per cent of GDP in 2012/13 to 5.8 per cent in 2013/14 and 3.5 per cent in 2015/16.

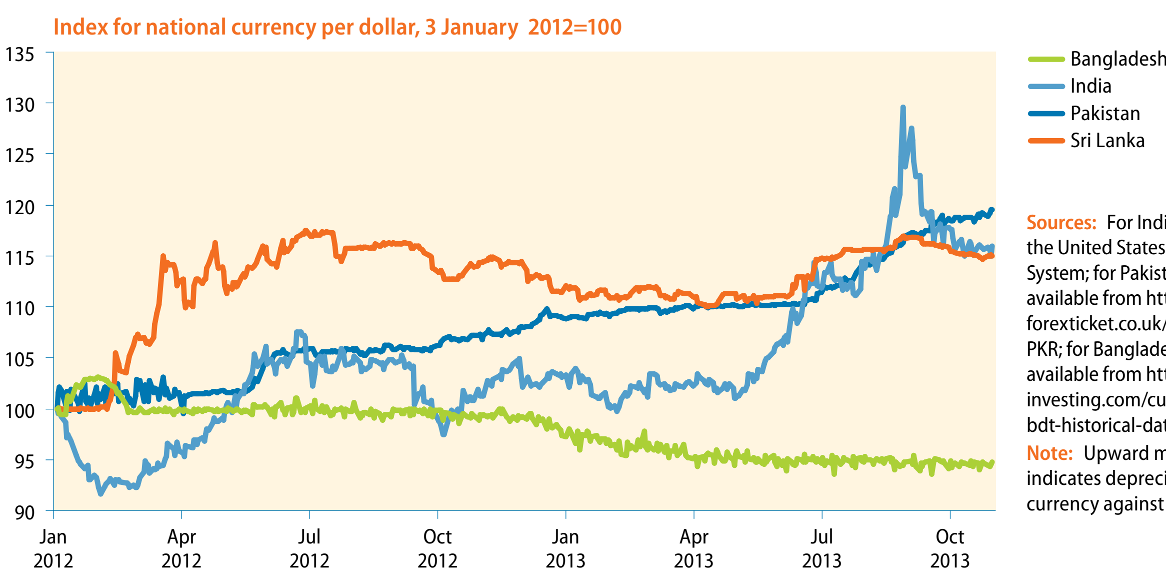
Moderate improvement in export performance projected

South Asia's merchandise exports continue to be affected by relatively weak demand in key destination markets, including the EU and the United States. However, several countries, notably Bangladesh and India, saw external demand improve significantly in the course of 2013. This positive trend is likely to persist in the quarters ahead as demand in developed economies strengthens. In addition, the export industries in India, Pakistan and Sri Lanka may benefit from the recent depreciation of national currencies, which lost significant value against the dollar in mid-2013 (figure IV.8). In Bangladesh, garment exports rose rapidly in the second and third quarter of 2013, even as the domestic currency appreciated gradually against the dollar and several deadly industrial accidents exacerbated international concerns over workers' rights. Exports from the Islamic Republic of Iran, by contrast, contracted further over the past year owing to the ongoing international sanctions. South Asia's imports have been weighed down by slowing domestic demand, depreciating national currencies and lower international commodity prices. Accordingly, trade and current-account balances as a percentage of GDP improved in 2013, especially in India. Workers' remittance inflows have continued to grow strongly in most economies, providing support for household consumption and current-account balances.

Tighter global liquidity could prove challenging, particularly for India

Downside risks to the economic outlook for South Asia are related to a likely tightening in global liquidity conditions and to regional or domestic vulnerabilities. The tapering of QE by the Fed could lead to renewed turbulence in financial markets and significant capital outflows, particularly for India. This, in turn, could require monetary tightening and emergency measures that would weigh on economic growth. Protracted sluggish growth in India would likely have a negative impact on some of its neighbour countries. On the domestic front, higher consumer price inflation, resulting, for example, from subsidy cuts and weaker currencies, could constrain household spending and limit room for monetary policy easing.

Figure IV.8
Daily exchange rates in selected South Asian countries, 3 January 2012-1 November 2013



Sources: For India and Sri Lanka: the United States Federal Reserve System; for Pakistan: ForexTicket, available from http://www.forexticket.co.uk/en/histo/USD-PKR; for Bangladesh: Investing, available from http://www.investing.com/currencies/usd-bdt-historical-data.
Note: Upward movement indicates depreciation of the currency against the dollar.

Western Asia: solid growth overall despite the fallout from military conflicts

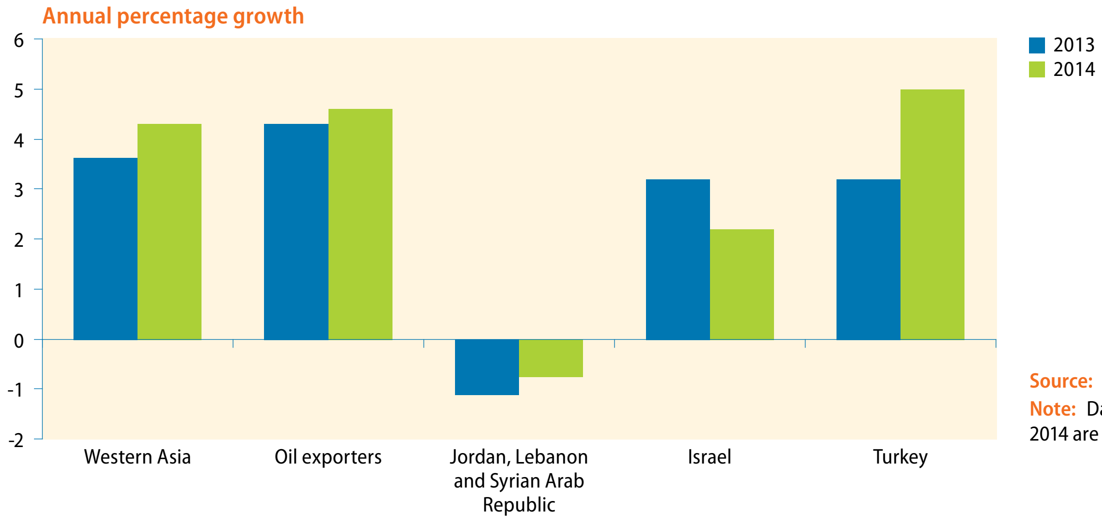
Western Asia has seen slightly slower aggregate growth of 3.6 per cent in 2013 than in 2012, projected to accelerate to 4.3 per cent in 2014, but moderating to 3.9 per cent in 2015 (figure IV.9). However, Arab countries in Western Asia (Western Asia excluding Israel and Turkey) exhibited further divergence in their economic performances. While the member countries of the Gulf Cooperation Council (GCC), namely Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates, have been on a stable recovery path, the economies of Iraq, Jordan, Lebanon, Syrian Arab Republic and Yemen have been hampered by continuing political instability, social unrest, security incidents and geopolitical tensions. For example, the Syrian crisis has led to a severe refugee crisis across the subregion, leading to population increases of 25 per cent in Lebanon and 15 per cent in Jordan. Growth in GCC member countries is expected to have tapered off in 2013 mainly owing to the moderate decline in oil export revenues, which marked a historical high in 2012. Non-oil sectors, particularly the real estate sector, regained their strength, partly owing to active fiscal policy in the subregion. Iraq's growth is also expected to decline moderately in line with its oil export revenues, while growth in Jordan, Lebanon and Yemen remains relatively weak, ranging from 1.3 per cent to 4.8 per cent during 2013-2014.

In Turkey, financial markets have been under pressure since May 2013, with the currency depreciating and interbank interest rates rising as a result of a reversal in international capital inflows. This was triggered by the anticipated tapering in global liquidity, as well as concerns about the large public debt and the current-account deficit in the country. The devaluation of the currency has in turn added to inflation pressures, with CPI inflation running at about 8 per cent. These unfavourable factors are expected to weigh on real economic growth in the near term. GDP is estimated to grow by 3.2 per cent in 2013 and by 5.0 per cent in 2014, before decelerating to 3.0 per cent in 2015. The GDP of Israel is estimated to grow at a pace of 3.2 per cent in 2013, driven mainly by consumer demand and net exports. In the outlook, GDP is forecast to grow by 2.2 per cent in 2014 and 3.3 per cent in 2015.

High unemployment remains a major policy challenge in many countries in Western Asia

The GCC countries have seen a recovery in employment in line with the consistent growth of non-oil sectors, while employment creation was subdued in other economies in the region. However, the issue of employment has remained one of the region's most important policy challenges, including in GCC countries, given high chronic unemployment among nationals. Several GCC countries, most notably Saudi Arabia, shifted to a more stringent labour nationalization policy, rigorously promoting employment of nationals in the private sector where the labour force consists mostly of foreign expatriates. Since March 2013, the Saudi Government has encouraged foreign expatriates to rectify their sponsorship status or to voluntarily leave the country. A significant number of foreign workers have left Saudi Arabia voluntarily, which especially affected the parts of the private sector with low skill requirements. In Iraq, Jordan, Lebanon, the State of Palestine and Yemen, chronic high unemployment was exacerbated by low domestic demand growth. Where official statistics are available, the unemployment rate stood at 12.6 per cent in Jordan in the second quarter of 2013, compared to 12.5 per cent in 2012. In the same period, the unemployment rate of the State of Palestine was 20.6 per cent, compared to 23.0 per cent in 2012. Although no official statistics were released, a large portion of the labour force in the Syrian Arab Republic is estimated to have become unemployed, underemployed or economically inactive. Most Syrian refugees competed with domestic low-skilled workers for jobs in the informal sector in host countries.

Figure IV.9
Western Asia: GDP growth by subregion



Source: UN/DESA.
Note: Data for both 2013 and 2014 are forecast.

Inflation is increasing due to recovering domestic demand

Although international commodity prices were stable, the inflation rate crept up in the region. For GCC countries, the upward trend in the inflation rate is due to recovering domestic demand. The price of housing-related items, including property rents, showed a robust recovery. Wage increases were observed in several high-skill sectors in GCC countries, but its impact on the general price level is projected to be limited. For Iraq, Jordan and Lebanon, upward creeping inflation stems from modestly binding foreign-exchange constraints and a significantly increased number of residents, including Syrian refugees. The depletion of foreign reserves and a substantial devaluation of the national currency caused a state of hyperinflation in the Syrian Arab Republic. According to estimates, the consumer inflation rate went beyond the 100 per cent mark in August 2013. In the area of monetary policy, Arab countries in Western Asia utilize the stable exchange rate as a main monetary anchor. Therefore, monetary policy is rather passive as it follows that of the Fed. In Turkey, despite depreciation pressure on the currency, the central bank has refrained from raising interest rates. Instead, it adopted an unorthodox policy scheme by creating an interest-rate corridor between 6.75 per cent and 7.75 per cent without increasing the policy interest rate. In Israel, with inflation subdued, the central bank has been cutting interest rates during 2013, but monetary policy is expected to tighten in late 2014.

Oil exporters maintain active fiscal policy, while the non-oil exporters face more pronounced fiscal constraints

The GCC countries and Iraq retained active fiscal policies, following growing oil export revenues in the fiscal year covering 2013. This trend is projected to continue in 2014. The focus has been on a shift to capital expenditure and large public-sector led infrastructure projects, although the actual fiscal impact on respective economies depends heavily on the implementation rate of budgeted fiscal items. A case in point is Kuwait, where the postponement of planned large, public-sector-led projects negatively affected overall economic growth. A tightened fiscal policy stance continued in Jordan, Lebanon and Yemen, owing to decreasing revenues and increasing deficits.

In Turkey, fiscal policy has been somewhat restrictive, with government expenditure growing at a much slower pace than government revenue. In Israel, fiscal policy is neutral, with the budget deficit standing at above 3 per cent of GDP. Government spending is expected to grow only moderately in 2014-2015 in order to curb the deficit further.

External balances are decreasing in the oil-exporting countries due to weaker oil export revenues and robust domestic demand for imports

The current-account surpluses of GCC countries and Iraq are estimated to have declined moderately in 2013. Oil export revenues edged down, while imports increased because of robust domestic demand growth. Meanwhile, the current-account deficits of Jordan, Lebanon and Yemen are estimated to have narrowed. Without any sign of improvement in export performances, the level of imports declined owing to weak domestic demand. In Turkey, real exports decelerated significantly in 2013 to a growth rate of about 3.0 per cent, compared with growth of 16.7 per cent in 2012. Export growth is expected to improve in the outlook, as external demand from Europe starts to recover. Real imports have accelerated from zero growth in 2012 to 8 per cent growth in 2013, but the pace of growth is projected to moderate in the outlook, partly owing to the recent depreciation. In Israel, both exports and imports declined in 2013, but the drop in the former was less than in the latter, leaving the current account in moderate surplus. The start of natural gas output is expected to boost exports further.

Risks during the outlook period include a fall in oil prices and the impact from a change in monetary policy in the United States

A rise in geopolitical tensions can easily affect the region's economic prospects. Nevertheless, as the region's geopolitical tensions are projected to remain focused around the situation in the Syrian Arab Republic, GCC countries are projected to be less affected. The division is to a large extent reflected in the different performance among stock markets in the region: in dollar-adjusted terms, stock price indices rose significantly in all GCC countries over the first three quarters of 2013, while those of the Syrian Arab Republic and its neighbouring countries declined. For GCC countries, the risk lies more in a sudden plunge in oil prices, as in 2008. Oil prices are crucial not only for export revenues, but also for economic sentiment and confidence of non-oil sectors in GCC countries. If oil prices fell below $80 per barrel, it would dent the growth of domestic demand. As the source of revenues depends on oil, countercyclical fiscal measures may not be sufficient for such contingency. With exchange rates pegged mostly to the United States dollar, the region will be impacted by any change in the monetary policy stance of the Fed. The looming reduction of bond purchases by the Fed will affect the yields of United States Treasury bonds; any rise in yields will affect the borrowing costs in the region, particularly in GCC countries.

Latin America and the Caribbean: growth to accelerate in 2014-2015

In Latin America and the Caribbean, economic growth is estimated to be 2.6 per cent in 2013. All economies in the region achieved positive growth, mainly supported by resilient domestic demand, although weak global economic conditions have indeed hampered the region's growth. In 2014 and 2015, GDP growth is expected to pick up to 3.6 per cent and 4.1 per cent, respectively, underpinned mainly by a gradual recovery in developed economies, sound macroeconomic policies, and resilient domestic demand.

South America registered the strongest GDP growth in 2013, while Mexico and Central America are expected to rebound more strongly in 2014

The economic expansion has been uneven across the region. In South America, economic growth is estimated to have accelerated in 2013 to 3.2 per cent, up from 2.5 per cent in 2012, owing to a rebound in Argentina and Brazil, and also supported by growing domestic demand, which partially compensated for the bleak external environment. Other agricultural exporters (Paraguay and Uruguay) also recorded higher growth rates in 2013, fostered by the recovery of the agricultural harvests so hard hit during 2012. In 2014 and 2015, the subregional economy should benefit from stronger external demand, along with the economic recovery in the United States and Europe. In 2014 and 2015, GDP growth in the subregion is expected to accelerate to 3.4 per cent and 4.1 per cent, respectively.

In Mexico and Central America, economic activity in 2013 is estimated to slow down to 1.5 per cent from 4.0 per cent in 2012. The Mexican economy has faced structural constraints and GDP growth decelerated significantly. In 2013, the economy is expected to have expanded only by 1.2 per cent, but the economic outlook is positive for the period covering 2014-2015. The Mexican Government has announced a set of reforms that should address part of the current structural weakness—including inefficient technology in the energy sector—and should potentially stimulate private investment. By contrast, several Central American economies will continue to grow at a fast pace, particularly Guatemala, Nicaragua, and Panama. In the forecast period, Mexico, and also Central America, should benefit from anticipated higher growth rates in the United States economy, their main economic partner. The Mexican economy is expected to expand by 4.0 per cent in 2014 and 4.2 per cent in 2015.

The Caribbean region is still struggling to recover from the impact of the global financial crisis in 2008, experiencing relatively low GDP growth and large current-account deficits. External demand has been subdued, in particular for the tourism sector, given the relatively slow economic recovery in the United States and Europe. Weaker commodity prices have also affected net exporters of commodities in the region, while domestic demand has been relatively weak following fiscal austerity measures and high levels of unemployment. Public debt increased substantially since the Great Recession in 2008 as a result of expansive fiscal policies, thus limiting fiscal space in the region to support economic growth. In 2013, the Caribbean economy is estimated to have expanded by 2.4 per cent, a slightly slower pace than in the past two years. However, the anticipated economic recovery in developed economies is expected to boost the tourism sector and have indirect spillover into other sectors, bringing the Caribbean GDP growth to 3.3 per cent and 3.8 per cent in 2014 and 2015, respectively.

Low unemployment and higher real wages continue to support private consumption…

A continued buoyant labour market in South America, with low unemployment rates, along with modest increases in real wages, maintained support for private consumption throughout 2013; further improvements, such as additional reductions in unemployment or faster job creation, will be more difficult to achieve in the years ahead, however. For the region as a whole, urban unemployment remains at similar levels to those recorded in 2012—about 6.2 per cent—although it has been relatively higher in several Central American and Caribbean countries. As in previous years, employment generation has been concentrated in the non-tradable sector, reflecting the role of domestic demand as the main driver of growth.

…while inflation is expected to remain fairly stable throughout the forecast period

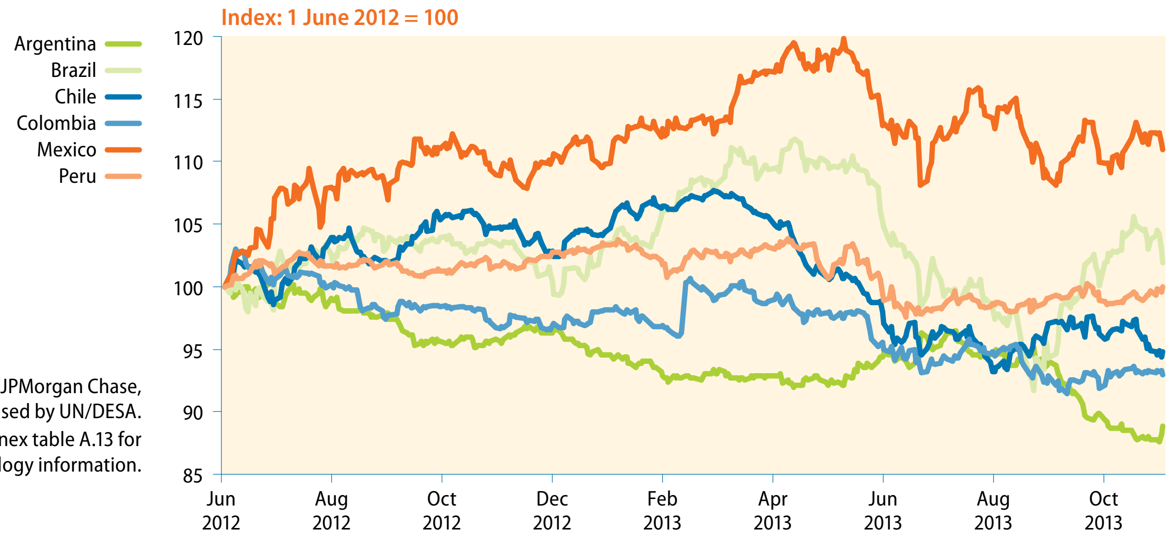
The outlook for inflation is fairly stable. Inflation increased slightly in 2013 as a result of higher food prices and accommodative monetary policies in some countries since the second half of 2012. In the second half of 2013, the median inflation rate was up slightly, bringing the overall regional inflation rate to about 6.7 per cent for the year. Despite relatively stable consumer prices for the region as a whole, inflation has been high in a number of countries. For instance, the Bolivarian Republic of Venezuela registered the highest inflation rate in the region in 2013, as a result of sharp currency devaluation and increased supply constraints in certain products. For the rest of the region, inflation is expected to remain relatively stable in 2014, while picking up moderately in Mexico and Central America.

Several countries started to tighten their monetary policy, in the light of currency depreciations and inflation pressures

A wide range of monetary policies were adopted in 2013, both in inflation-targeting countries and countries with other monetary policy regimes. In 2012, several countries had modified their monetary stance with the goal of promoting economic activity that would close the output gap. But as inflationary pressures increased and nominal exchange rates depreciated (figure IV.10)—particularly following the May 2013 announcement by the Fed that it would gradually taper its QE programme—a tightening monetary policy cycle started in several countries, such as Brazil, the Dominican Republic and Guatemala. In a large number of countries, a relatively expansionary monetary policy stance in 2013 is expected to be gradually reversed throughout 2014 as inflationary pressures mount.

The impact of the Fed announcement also led to heightened volatility in the region's main stock markets and a decline in capital inflows to some countries. As the Fed pre-

Figure IV.10
Daily real effective exchange rate of selected Latin American currencies, 1 June 2012-1 November 2013



Source: JPMorgan Chase, rebased by UN/DESA.
Note: See annex table A.13 for methodology information.

pares to exit from expansive monetary conditions, capital inflows from private creditors are expected to suffer particularly. As a result, less favourable financing for private investment, but also for countries with larger current-account deficits, such as Brazil, are potential challenges for the region. On a positive note, the region has accumulated abundant international reserves, providing monetary authorities with some room to deal with currency volatility. Although currency depreciations may cause imported inflation, they may also support the manufacturing sector in the medium term, particularly in Mexico and other Central American economies. However, structural reforms, such as the modernization of transportation and energy sectors, as well as easing the regulatory environment, are needed to increase productivity and to take advantage of additional export opportunities.

Lower commodity prices affected fiscal revenues in many countries, while fiscal reforms were implemented to broaden the tax base

Fiscal revenues in many countries in the region have been mainly hit by falling prices of export commodities, but also by lower economic activity and the drop in tourism, especially in the Caribbean. A great number of countries, such as Argentina, Chile, the Dominican Republic, Ecuador, El Salvador, Guatemala, Mexico, Panama and Peru, have implemented fiscal reforms in 2012-2103 in an attempt to broaden the tax base and to increase fiscal revenues. These reforms were crucial, but not yet sufficient. At the same time, public spending trended upwards during 2013, especially in South America, as a component of efforts to invigorate domestic demand. Expenditure rose above GDP growth rates in Argentina, Chile, Colombia, Ecuador, Peru, Paraguay, the Plurinational State of Bolivia and Uruguay. Despite important reforms in the tax system, fiscal balances are expected to deteriorate in 2013 (box IV.4) and some Governments may find it more difficult to provide stimulus if global economic conditions deteriorate further during the outlook period.

In the English-speaking Caribbean, public debt-to-GDP ratios are traditionally high, but since the Great Recession in 2008, several countries have increased public expenditure to support the economy, increasing new borrowing, which resulted in higher public debt. In 2013, fiscal deficits are expected to shrink, as serious efforts have been made to reduce spending (in Jamaica, for instance) and tax revenues should increase along with a better economic outlook.

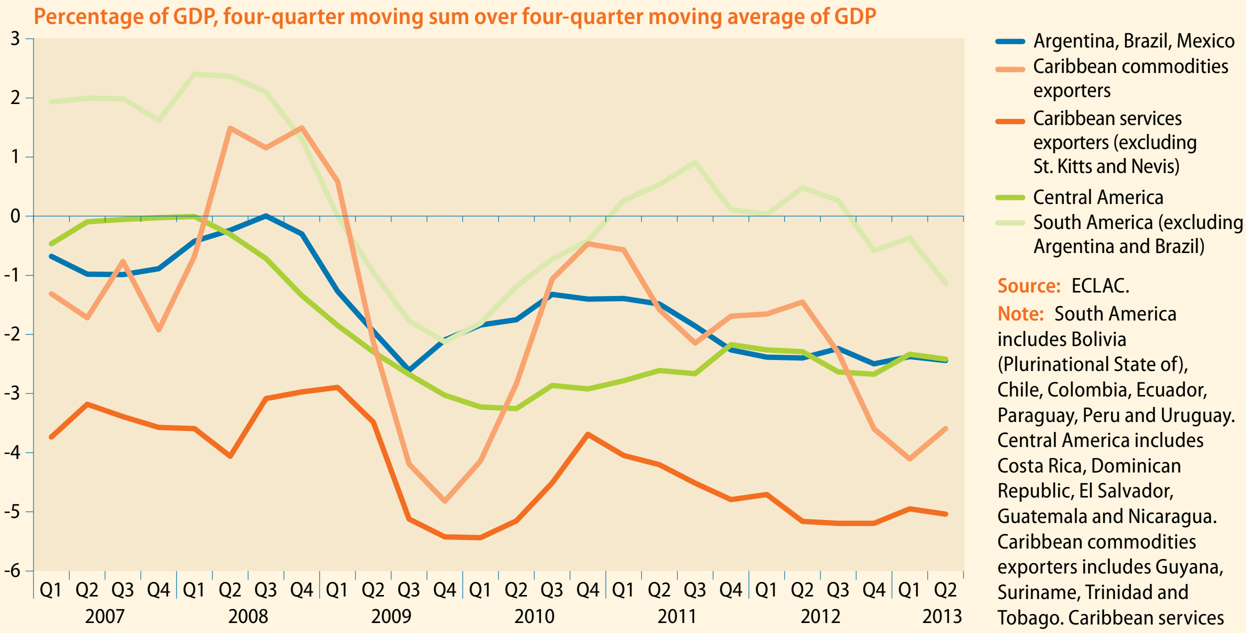
Box IV.4

Twin deficits in Latin America and the Caribbean

The region of Latin America and the Caribbean is facing higher economic vulnerability as the current-account deficit, which is projected to widen in 2013 to more than 2 per cent of GDP, is now being coupled with greater fiscal deficits (figure IV.4.1). Slower GDP growth and a drop in commodity prices have hampered public revenues, narrowing the fiscal space in many countries. Under these circumstances, Governments are dealing with conflicting demands. On the one hand, market pressure will require strengthening fiscal accounts, while on the other hand, social pressure for better public services is growing, as witnessed by large-scale protests in some countries of the region.

Figure IV.4.1

Latin America and the Caribbean: overall budget balance, 2007-2013



Source: ECLAC.

Note: South America includes Bolivia (Plurinational State of), Chile, Colombia, Ecuador, Paraguay, Peru and Uruguay. Central America includes Costa Rica, Dominican Republic, El Salvador, Guatemala and Nicaragua. Caribbean commodities exporters includes Guyana, Suriname, Trinidad and Tobago. Caribbean services exporters includes Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Jamaica, St. Lucia and St. Vincent and the Grenadines. Data are for the central Government, except in the cases of Bolivia (Plurinational State of), Ecuador and Uruguay where data refer to the non-financial public sector.

The fiscal balance of the region's major economies—Argentina, Brazil and Mexico—deteriorated in the second half of 2011, an outcome that can be attributed to slower growth and the consequent impact of automatic stabilizers, as well as specific countercyclical measures adopted in Argentina and Brazil. Since then, the fiscal situation remained relatively stable in Brazil and Mexico, but it deteriorated further in Argentina in 2012 and 2013 (swinging from a slight surplus to a deficit of more than 2 per cent of GDP). This is becoming a matter of concern going forward, as Argentina has limited access to external sources of financing. In Brazil, the relative economic recovery in 2013 will likely soften the impact of any increases in public spending on the fiscal balance. In contrast, sharp cuts in public spending in Mexico have reigned in the deficit.

In the rest of South America (excluding Argentina and Brazil), higher deficits have largely come hand-in-hand with declining commodities prices. In Chile and Peru, fiscal conditions deteriorated in 2012 and 2013 as public expenditures grew rapidly, while corporate tax receipts, especially those in the mining sector, plummeted owing to higher production costs and lower global commodity prices. In some countries, such as Ecuador, the Plurinational State of Bolivia and Uruguay, strong growth in domestic demand partially offset lower public revenues from the trade sector.

In Central America, low levels of public revenues—on average 14.8 per cent of GDP, as compared to 27.4 per cent in South America[a]—coupled with persistent deficits, represent their greatest fiscal vulnerability. Nevertheless, recent tax reforms, which enlarged domestic tax bases increased public revenues in a number of countries, bolstering fiscal balances.

Box IV.4

Twin deficits in Latin America and the Caribbean (*continued*)

In the Caribbean, fiscal vulnerability and risks of debt distress are much more acute. In services-exporting countries, some efforts have been made to reduce deficits—including fiscal reforms that raised taxes and curtailed spending—but high public debt levels give little space to manoeuvre. The situation remains particularly grave in the Bahamas, Barbados, Dominica, and St. Lucia, each of which is expected to have a deficit of over 7 per cent of GDP in 2013 (according to preliminary data). The anticipated faster economic growth in the United States and a return to growth in Europe should bolster the fiscal situation in these countries, although recent tourist arrivals data suggests that this important sector has yet to recover before contributing more significantly to fiscal revenues.

Commodities-exporting countries in the Caribbean, like their Latin American counterparts, have also seen their fiscal balances affected by swings in global commodity prices. However, in contrast, their ability to withstand these shocks is limited by their relatively smaller tax bases. Guyana, Suriname and Trinidad and Tobago have all registered an increase in their budget deficits since mid-2012 as their expenditures grew sharply while revenues slumped. Downside risks remain high for these countries as commodity prices cool in the short-term.

The deterioration of the fiscal balance in South America has put significant pressure on Latin America's fiscal space. Even though most countries register low debt levels and, in many cases, hold high international reserves, the number of countries that must make an additional fiscal effort to maintain stable public debt levels has grown since 2012. However, considering alternative sustainability rules, such as maintaining a debt level of 40 per cent of GDP, many Latin American countries still enjoy significant fiscal space. Caribbean countries, in contrast with their Latin American peers, enjoy little if no fiscal space to implement countercyclical measures. The situation is especially acute in a number of services-exporting countries, where high debt levels and persistent budget deficits have led to austerity programmes supervised by the International Monetary Fund.

a This is a simple average of countries under review. See figure IV.4.1 for definitions and coverage of data.

Source: ECLAC.

The downturn in the region's exports seems to have bottomed out during 2013 and exports should benefit from the recovery in developed economies

Throughout 2013, prices for the region's export commodities have fallen across the board. For the region as a whole, the terms of trade will remain at the same level as 2012—thanks in part to Brazil and Mexico, the two major export countries in the region where the terms of trade remained stable. The downturn in the region's total exports seems to have bottomed out during 2013, as export values picked up during the second half of the year. In 2014 and 2015, an increase in export volumes is expected to follow economic recovery in developed economies. In addition, a price recovery of key commodities is anticipated for the region's exports, as international demand is expected to improve in 2014. However, despite anticipated improvement for the external sector in the near future, the deceleration of economic activity in China—the main commodity importer for the region—may reduce the annual trade gains of previous years. This could particularly affect several countries in South America.

The current-account deficit will widen slightly, mainly because of the deterioration in the trade balance

The current-account deficit is expected to have reached 2.0 per cent of GDP in 2013, up from 1.8 per cent in 2012. The widening of the current-account deficit is explained mainly by the deterioration of the balance of the trade in goods, as imports have increased faster than exports in the past few years and eroded the trade surplus. In addition, the sluggish performance of the inbound tourism market has worsened the deficit of the trade in services, particularly in the Caribbean countries. Furthermore, the surplus in the current transfers balance is expected to decline in 2013, as a result of the reduction in remittance flows to Mexico, despite the fact that remittance flows increased in most countries of the region. In 2014 and 2015, as developed economies are expected to perform better economically, demand for Latin American and Caribbean exports, including for the tourism sector, should generate higher revenues and narrow current-account deficits in the region.

The region will continue to attract FDI, funding a large part of the current-account deficit

As in 2012, the current-account deficit in 2013 was mainly funded by net foreign direct investment inflows, followed by net portfolio investment. Infrastructural investments, including in the commodity sector, should continue to attract FDI in the region during the forecast period, particularly in Brazil, Chile, Colombia, Peru and Guyana. Solid macroeconomic fundamentals and an expanding middle class should also reinforce the attractiveness of Latin America for international investors. However, FDI would need to be channelled towards non-commodity sectors in order to diversify the economies in the region. In 2013, the number of Latin American countries present in international debt markets increased with issuances of sovereign, corporate, and bank bonds by Guatemala, Honduras and the Plurinational State of Bolivia. The region reported slower growth in international reserves accumulation in a context of greater volatility in the international financial markets.

Serious risks on the downside are related to uncertainties in developed economies

This forecast is subject to various downside risks that are related to economic uncertainties in the economic prospects for the euro area and the United States, but also in China, which is now targeting slower growth than in previous years. Tighter monetary policy in the United States would lead to higher costs of external financing in a context of increasing fiscal and external imbalances in several economies in the region. In addition to external risks, domestic policies to support economic activity face a number of challenges. In the current context of high volatility of capital inflows and significant uncertainties in developed countries, the region will face the challenge of coordinating fiscal, monetary, and exchange-rate policies in order to preserve financial stability and stimulate economic growth. Some countries also face country-specific risks. A case in point is the Bolivarian Republic of Venezuela, where policymakers are challenged to deal with soaring inflation driven by supply constraints and currency devaluation.