Chapter IV
Regional developments and outlook

Developed economies

Developed economies are expected to see a slight increase in economic growth from 1.5 per cent in 2016 to 1.7 per cent in 2017 and 1.8 per cent in 2018, driven by relatively strong private consumption. Improvement in employment and subdued inflation continue to support households' purchasing power. At the same time, accommodative monetary policy stances will support economic activity, especially in Europe and Japan, although the limitations of unconventional monetary policy measures increasingly illustrate the need for a broader policy approach to create a more dynamic growth trajectory.

This is especially relevant in view of the continued drag on growth stemming from a number of factors. Investment remains weak, as commodity-related sectors continue to face pressure from generally low prices; in addition, businesses are confronted with major uncertainties related to the future direction of policy in the United States of America, the looming exit of the United Kingdom of Great Britain and Northern Ireland from the European Union (EU) and various geopolitical crises. Relatively high unemployment, including among youth, in numerous developed countries not only hampers economic growth, but also represents a major policy challenge as it threatens to increase structural unemployment, which in turn makes integration into the labour market increasingly difficult and costly.

In the monetary policy area, the United States Federal Reserve (Fed) is expected to continue to gradually raise interest rates, resulting in a widening divergence in interest rates relative to Europe and Japan. Inflation in the developed economies will pick up to 1.6 per cent in 2017 and 2.0 per cent in 2018, although some of this increase is less an indication of solid demand than the consequence of a base effect caused by the previous sharp fall in commodity prices.

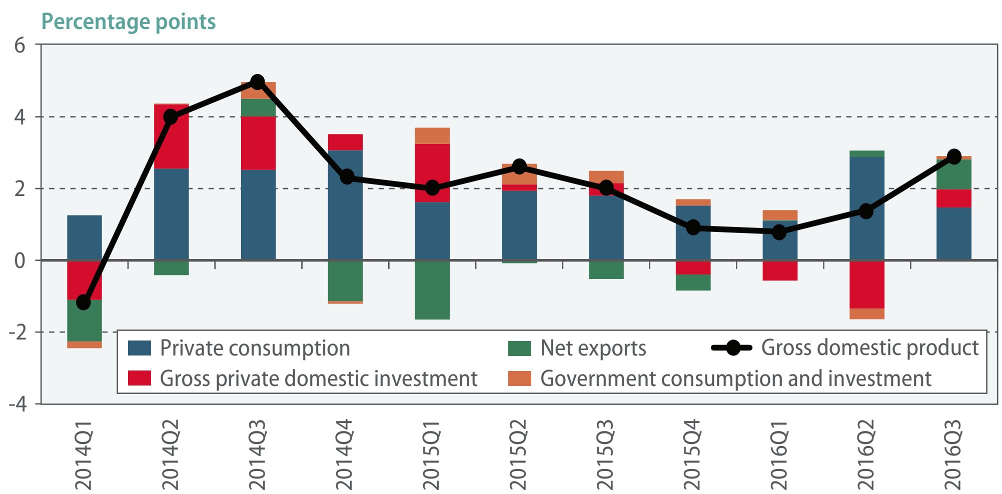
North America: inventory destocking restricted growth in the United States in 2016

The United States economy is estimated to have expanded at a modest pace of 1.5 per cent in 2016. This growth momentum was considerably weaker than had been anticipated when the Fed raised interest rates in December 2015 — the first rise since rates were reduced to near zero levels at the height of the global financial crisis in December 2008. The sharper-than-expected deterioration in growth from the last quarter of 2015 to mid-2016 primarily reflected a steep downward adjustment in non-farm inventories and a contraction in private non-residential investment, especially in oil-related sectors (figure IV.1). As the temporary impact of inventory destocking eases, more solid growth of 1.9 per cent is expected in 2017. With the change in Administration in January 2017, however, there is considerable uncertainty regarding the future direction of policy in the United States — including monetary, fiscal, trade, immigration, environmental and foreign policy prospects. This uncertainty is expected to have restrained investment in the short run. The potentially far-reaching spillover effects on both domestic and global economic prospects have increased the margin of uncertainty around the baseline forecasts for the United States and many other economies.

Uncertainty regarding trade policy may delay investment decisions by Canadian exporting firms

Canada, which exports roughly three-quarters of its goods and services to the United States, is highly sensitive to economic conditions across the border. The outcome of elections in the United States has heightened uncertainty in Canada, especially for exporting firms that would be impacted if the United States were to introduce any changes to existing trade agreements. This heightened uncertainty is expected to delay a recovery in investment in Canada. Real non-residential investment in Canada dropped by 10 per cent in 2015 and by a similar magnitude in the first half of 2016 (figure IV.2), largely driven by cutbacks in extraction and oil-related sectors.

Figure IV.1
Contribution to GDP growth in the United States, 2014Q1–2016Q3



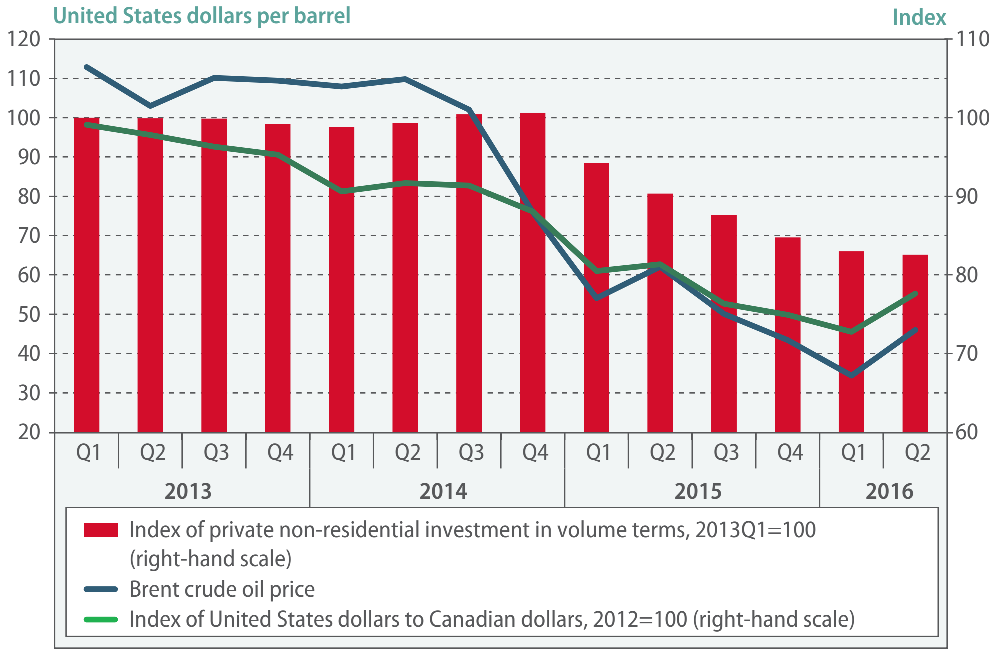
Source: US Bureau of Economic Analysis.

The persistent weakness of investment in both the United States and Canada is symptomatic of the broader global trend that continues to hamper productivity growth. Labour productivity in the United States, measured as output per hour in the non-farm business sector, rose by less than 1 per cent in 2015 and declined at an annual rate of 0.6 per cent in the first half of 2016. Given the protracted period of weak investment in the United States and other large developed economies, as discussed in chapter I, a substantial rebound in productivity growth is not anticipated in the forecasting period. This will continue to restrain short-term growth prospects.

Consumer spending in North America remains firm

Household consumption has been the sustaining force behind otherwise lackluster gross domestic product (GDP) growth in North America. Private consumption is estimated to have expanded by 2.5 per cent in the United States in 2016, and is projected to grow by 2.0 per cent in 2017, supported by the low level of unemployment and rising household incomes. Since October 2015, unemployment in the United States has fluctuated within

Figure IV.2
Oil price, investment and exchange rate in Canada, 2013Q1–2016Q2



Source: UN/DESA, based on data from Statistics Canada and IMF International Financial Statistics.

the range of 4.7-5.0 per cent, which is the "central tendency" of the Fed's estimates of its longer-run level.

In Canada, household consumption has also held up relatively well, despite a sharp deterioration in terms of trade and loss of export revenue. Private consumption is expected to grow by 2.1 per cent per annum in 2016-2017. The unemployment rate, at 7.0 per cent, remains in line with its average level in 2014. Unemployment is expected to average 7.1 per cent in 2017 and 6.9 per cent in 2018.

The United States dollar has appreciated by 20 per cent against the Canadian dollar since 2014

Given the deterioration in short-term economic prospects and concerns related to various global uncertainties, the Fed held interest rates unchanged throughout most of 2016. The postponement of expected interest rate rises in the United States eased some of the upward pressure on the United States dollar, and supported a recovery of capital flows to developing countries, from investors seeking higher rates of return. Nonetheless, over the last two years, the United States dollar has appreciated considerably against all major currencies, including by roughly 20 per cent against the euro and the Canadian dollar. The sharp depreciation of the Canadian dollar illustrates the close correlation between the oil price and this bilateral rate (figure IV.2).

Inflation is expected to meet or exceed central bank targets in 2017

The Bank of Canada has kept monetary policy unchanged since July 2015, and considers inflation on track to reach its 2 per cent target in 2017. Inflation in the United States has remained below the Fed's medium-term objective of 2 per cent, but has edged up towards the inflation target as the impact of both the decline in the oil price and the rise in the exchange rate recedes. As the contribution of the oil price to inflation becomes positive, consumer price inflation is expected to rise to 2.3 per cent in 2017 and 2.4 per cent in 2018.

Expansionary fiscal policy will lift growth in Canada in 2017

In the budget of March 2016, the Canadian Government set out an ambitious plan of fiscal expansion focused on investment in basic infrastructure. This marked a departure from the previous Government's policy priority of achieving a balanced budget, and singled

Canada out as one of the few developed economies to introduce a more expansive fiscal stance. While the shift in policy will allow the general government deficit to deteriorate towards 3 per cent of GDP in 2016-2017, it will offer support to the flagging economy.

Coupled with the modest revival in commodity prices and some competitiveness gains from the exchange rate depreciation, GDP growth in Canada is forecast to accelerate from 1.2 per cent in 2016 to 2.4 per cent in 2017, although heightened uncertainty will prevent a more pronounced rebound.

A rise in infrastructure spending could accelerate growth in the United States in 2018

The direction of fiscal policy in the United States remains unclear. The new Administration may propose an expansion of infrastructure investment and significant tax cuts, especially for corporations. A rise in infrastructure spending could raise growth prospects for 2018, but may also entail a large increase in the federal deficit. Other potential policy initiatives, such as the introduction of import tariffs and other protective measures, could raise inflation and slow economic growth, especially if met by retaliatory measures.

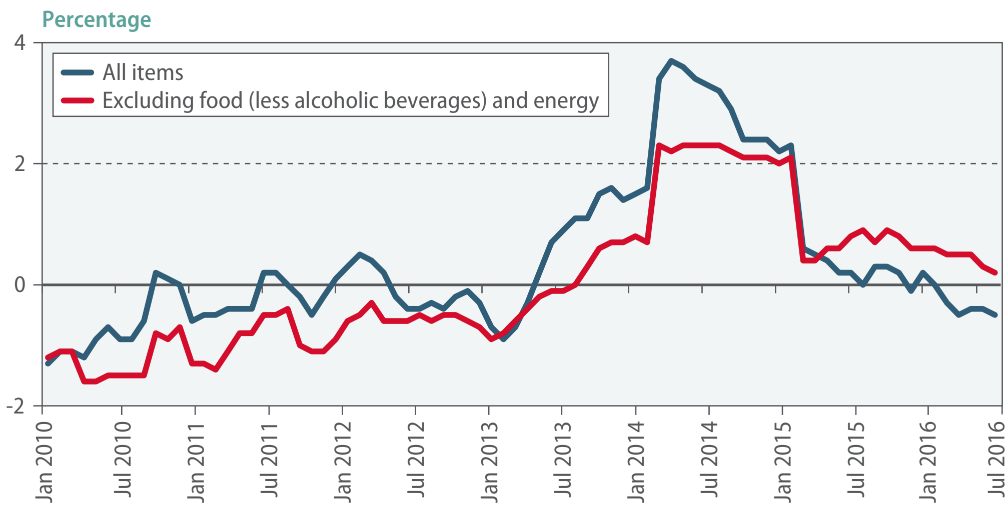
Developed Asia and Pacific: policy easing measures will support growth in Japan in 2017

GDP growth in Japan is projected to improve modestly to 0.9 per cent in 2017 and 2018, from an estimated 0.5 per cent in 2016. Growth is expected to be supported by rising household consumption and higher government investment, which will benefit from the additional fiscal and monetary easing measures introduced in 2016. However, private non-residential investment and exports both declined in the first half of 2016, and the economy remains restrained by the strong exchange rate, which is one of the forces that has pushed the economy back into deflation.

Low unemployment and rising real wages support household demand in Japan

Labour market conditions in Japan have strengthened, and the unemployment rate is expected to continue to hover at about 3 per cent in 2017-2018. In May 2016, the ratio of active job openings to job seekers rose to its highest level in 25 years. While wage pressures remain relatively muted despite the Government's efforts to accelerate pay rises, nominal employee wages have continued to edge upwards. As consumer price inflation has been stagnant or negative since March 2016 (figure IV.3), this has allowed real wages to register more substantial gains.

Figure IV.3
Inflation in Japan, January 2010–August 2016 (*year-on-year*)



Source: Statistics Bureau of Ministry of Internal Affairs and Communication, Japan.

Deflationary pressures ease, but inflation will remain below the Bank of Japan's target

Nationwide consumer price inflation in Japan is estimated to have averaged -0.1 per cent in 2016 and is projected at 0.6 per cent in 2017, and will remain below the central bank's target of 2 per cent in 2018. The significant drag on the overall price level arising from low oil prices — with energy prices reducing the overall consumer price by 1 percentage point in June 2016 — will dissipate towards the end of the year. Nevertheless, the strong yen and weak wage growth will continue to exert downward pressure on inflation.

In reaction to the stalled progress towards achieving the target of 2 per cent inflation, the Bank of Japan (BoJ) announced a new set of unconventional monetary policy measures aimed at boosting inflation and reviving growth. The BoJ's new monetary policy strategy consists of two components. The first is a "quantitative and qualitative monetary easing with yield curve control" framework to anchor 10-year Japanese Government Bond yields at around 0 per cent. The second component is an explicit commitment to increase the monetary base until inflation overshoots the 2 per cent target. Both of these policy strategies are intended to complement the existing quantitative and qualitative easing measures of the BoJ and the negative interest rate of -0.1 per cent applied since January 2016 on a portion of banks' current account balances held at the BoJ.

The BoJ's introduction of its new monetary policy framework came after the Japanese Government announced increased spending in the fiscal year 2016 supplementary budget and introduced a new fiscal stimulus package in August 2016, including 4.6 trillion yen additional spending for the current fiscal year and the postponement of the consumption tax increase planned for April 2017 to October 2019. The stimulus package amounts to 28.1 trillion yen, making it the third-largest ever implemented. It is expected to give a strong boost to government investment spending in 2017, which is forecast to contribute roughly 0.4 percentage points to GDP growth.

Housing investment has been supported by the BoJ's negative interest rate policy

The rise in government investment in Japan will partially compensate for the persistently weak private sector non-residential investment, as export-oriented firms remain under pressure from the strong yen and sharp slowdown in global trade. Service industries have also been affected by the currency appreciation. While international visitor numbers continue to increase steadily, their direct expenditure in Japan has started to decline.

Residential investment, on the other hand, has rebounded. Housing starts have been supported by Japan's negative interest rates, which have allowed home-loan rates to fall to an all-time low. With monetary policy expected to remain accommodative for the foreseeable future, the housing sector is expected to strengthen further.

Longer-term prospects in Japan remain challenging

While the introduction of additional fiscal and monetary easing measures will offer some support to growth in the short term, there is considerable uncertainty regarding the Japanese economy's longer-term growth prospects. Deflation is well-entrenched in expectations, and may persist despite the commitment of the BoJ to an easier monetary stance. The evolution of wages over the next few years will be crucial in this context.

Australian exports remained strong in 2016

In addition, Japan faces some imposing policy challenges, which include addressing the large overhang of government debt amid a lower rate of potential growth. While the slowdown in potential growth is largely driven by demographic developments, it also reflects the slower rate of productivity growth, which may prove persistent.

Australia's economy expanded at an estimated pace of 2.8 per cent in 2016, benefiting from the modest recovery in commodity prices during the year, as well as monetary and fiscal stimulus measures. In contrast to global trends, export volumes from Australia remained strong in 2016, expanding by more than 7 per cent in the first half of the year. However, export growth is expected to decelerate in 2017, reflecting the broad weakness of world trade and continuing rebalancing in China. Import volume growth is expected to improve compared to 2016, resulting in a deteriorating contribution of net trade to growth, and restraining GDP growth to 1.9 per cent in 2017. Growth is expected to pick up somewhat in 2018, on the back of a recovery in fixed investment, following two years of cutbacks in mining investment.

Tax cuts will support business investment in Australia in 2017

Australia has also introduced some fiscal easing measures, including new tax cuts for small and medium-sized businesses, which have been introduced in an effort to stem the decline in private sector investment. While government debt still remains low compared to other developed economies, it is expected to reach over 40 per cent of GDP in 2017, which marks a 10 percentage point rise compared to only four years ago. This reflects the country's continued vulnerability to swings in commodity prices.

Europe: economic activity in Europe will remain subdued

Economic activity in Europe will remain subdued, with growth expected to stay at 1.8 per cent in the EU for the period from 2016 to 2018. This implies a downward revision compared to the previous forecast, primarily due to the expected negative impact from the "Brexit". On the upside, domestic demand will continue to support growth, as low inflation rates and lower unemployment in some countries bolster private consumption, while the expansive monetary policy stance supports business investment.

At the same time, a number of factors will continue to prevent a more vibrant economic revival across the region. These include the major uncertainty stemming from the Brexit, which has already dented business investment in some key sectors both in the United Kingdom and its major European trading partners. In addition, structural issues such as a need for labour market reforms impede the development of small and medium-sized companies in several countries. Linked to this, unemployment still remains high in several countries, with negative effects on overall growth. High public and private debt levels constrain investment in some countries and lingering balance sheet problems in the banking sector put a drag on the proper functioning of the banking system. A number of risk factors could affect this baseline forecast, notably further negative fallout from the Brexit, more severe problems in the banking sector, a recurrence of the debt crisis in Greece and policy uncertainties related to forthcoming elections in numerous countries including France, Germany and the Netherlands in 2017.

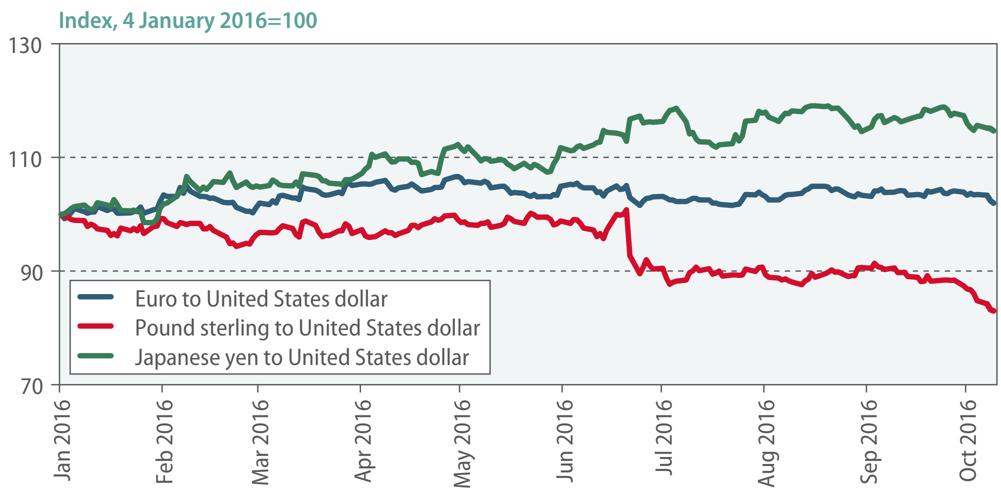
The external sector has remained solid, but Brexit entails significant uncertainty

The external sector has weathered the restrained global economic growth environment so far better than expected, largely owing to more solid intra-European trade. The Brexit and political instability in Turkey have so far had only a limited negative impact on export demand. In the outlook period, this trend of robust export demand will remain intact, as solid private consumption will underpin intra-European trade and some economies will benefit from a competitive euro exchange rate.

However, the economic weakness in Brazil and the Russian Federation and the slowdown in China remain a drag on exports. Linked to this, depressed levels of investment in commodity sectors, notably oil, continue to pose a challenge for exporters of investment goods such as plants and machinery. A major uncertainty will be further developments in the wake of the Brexit. The pound sterling has depreciated sharply (figure IV.4), benefiting exporters but also showing the high level of risk moving forward. For many companies that have invested in the United Kingdom, access to the single EU market has been a major business advantage, but the Brexit has upended the institutional framework for business decisions.

While the United Kingdom has not yet given formal notice of leaving the EU, any such move would require a fundamental rearrangement of the economic relations. A pronounced interest on the United Kingdom side is to remove or at least limit the free movement of EU workers, while at the same time maintaining free access to the single EU market. However, various EU countries have already made clear that free access to the EU market does not come without any obligations in return and that adherence to the free movement of labour remains a core principle of the EU. Consequently, should the United Kingdom start the formal process of exiting from the EU, contentious negotiations would lie ahead with significant uncertainty for businesses, which in turn could lead to a more pronounced decrease in investment levels.

Figure IV.4
Major developed market currencies' exchange rate against the United States dollar, January 2016–October 2016



Source: JPMorgan Markets.

Despite an improvement in labour markets, unemployment remains high in several countries

The employment situation has been improving for the region as a whole, with unemployment in the EU standing at 8.5 per cent and in the euro area at 10.0 per cent in September 2016. However, this overall picture encompasses significant national variations. Greece and Spain continue to register the highest unemployment rates in the region, at 23.2 per cent and 19.3 per cent, respectively, followed by several countries including France, Italy and Portugal that also experience double-digit unemployment rates. Youth unemployment rates are particularly high, averaging over 18 per cent in the EU as a whole. In some countries, this partly reflects barriers that restrict labour market access for young people in certain professions. Relatively high tax burdens and inefficient and complicated administrative procedures in some countries also make it difficult for small and medium-size firms to expand capacities and discourage the creation of new enterprises.

By contrast, other countries are experiencing relatively low unemployment rates, notably Germany, the United Kingdom and Hungary with 4.2 per cent, 5.0 per cent and 5.1 per cent, respectively. Driving factors in these cases include internationally competitive economic sectors, more flexible labour markets and, as in the case of Germany, a more diversified vocational training system that provides a solid basis for promoting youth employment. For several countries, a major challenge will lie in integrating a large number of refugees into the labour market.

Monetary policy continues to play a major role relative to fiscal policy and structural reforms

Given the continued tightening stance of fiscal policy in most countries, which is partly related to the high levels of public debt, and only hesitant structural reforms, monetary policy continues to play a disproportionate role. The European Central Bank (ECB) maintains an extremely accommodative monetary policy stance that comprises three elements: policy interest rates at or below zero, quantitative easing (QE) in the form of asset purchases of 80 billion euros per month; and targeted longer-term refinancing operations (TLTROs) intended to move banks to lend more money.

Despite these policy actions, inflation remains significantly below the ECB's policy target of below but close to 2 per cent, raising questions regarding the effectiveness of monetary policy and its adequacy given the nature of the region's economic challenges.

The ECB faces challenges in implementing its policies and in addressing any additional shock

Under its current policy stance, the ECB is facing two major challenges in the near-term in its policy-making process. The first challenge concerns the ECB's policy operations; the amount of asset purchases by the ECB has already led to a significant reduction and shortage in available assets that satisfy the purchase criteria of the ECB. In addition, commercial participants have been pushed out of the market by the actions of the ECB. Both factors make the implementation of the ECB's stated policy stance increasingly difficult.

The second challenge concerns the ECB's policy instruments; in the case of a new economic shock, the ECB runs the risk of having a reduced policy impact, given its already extremely loose policy stance. One possible scenario in this regard could be a more drastic negative impact of the Brexit on growth in the EU, in which case the EU may find it difficult to deploy meaningful policy instruments.

The Bank of England reacted to the Brexit vote by loosening its policy stance

The Bank of England reacted to the Brexit vote and the negative economic repercussions by cutting its policy interest rates by 25 basis points to 0.25 per cent and by increasing the volume of its QE measures. The lower interest rates and the prospect of additional cuts will put further pressure on the pound, creating the risk of a significant increase in inflation through higher import prices.

The negative growth impact from fiscal consolidation is diminishing, but elevated debt levels remain a risk

Fiscal policy in the region maintains a tightening stance overall, given institutional requirements such as the excessive-deficit mechanism of the EU and because of political preferences. However, the negative impact from fiscal consolidation on growth is diminishing. Some countries, such as Austria and Germany, will have to increase fiscal spending in view of the large number of refugees and the challenge of integrating them into their societies and labour markets.

Moreover, big parts of the major fiscal adjustments that were initiated across the region in the aftermath of the financial crisis have been completed. This is illustrated by the significant improvements in fiscal balances in various countries in the region, notably Greece, Iceland, Ireland and Lithuania. Despite these improvements, relatively high public debt levels remain a challenge and risk factor. The currently low level of interest rates helps in sustaining these debt levels, but higher financing costs, especially if they occur suddenly in the form of a financial shock, may have severe negative effects on national fiscal budgets.

In the United Kingdom, the Brexit will put pressure on fiscal policy

In the United Kingdom, the decision to leave the EU has major implications for fiscal policy. Instead of a significant budget surplus by 2019 as envisaged some time ago, the country is now expected to face a further increase in its budget deficit, which stood at 4.3

per cent in 2015. As the British economy is projected to experience a significant slowdown, tax revenues will likely suffer, while spending requirements will increase, given the dislocations and adjustment needs caused by leaving the EU.

Growth in the EU member States from Eastern Europe and the Baltics region moderated in 2016

In the EU member States from Eastern Europe and the Baltics region, economic growth remains on a higher trajectory than in the EU-15 as the countries continue to catch up through capital accumulation and productivity growth. In 2016, the pace of economic expansion slowed slightly to 3 per cent, following the robust investment cycle of 2014-2015 that was driven by the expedited absorption of the 2007-2013 EU funds.

Credit availability in the region is improving thanks to the continuing accommodative policy of the ECB and the ultra-low policy rates in the countries with flexible currencies (the Czech Republic, Hungary, Poland and Romania). The impact of fiscal policy on growth is largely expansionary, as public spending is increasing in real terms (most noticeably in Poland), benefiting from higher tax intake and exceptionally low financing costs.

In the first half of 2016, Romania recorded the highest growth in Europe at 5 per cent. In Central Europe, the automotive industry, which is well integrated into the EU-15 production chain, saw a strong performance, while attracting further foreign direct investment (FDI) flows. The Baltic States, which are more exposed to trade with the Russian Federation than other countries in the group, exhibit a more modest growth pattern.

Foreign-exchange-denominated consumer loans remain a contentious issue

On the policy front, foreign-exchange-denominated (Swiss franc and the euro) consumer loans remain a major problem. Prior to the global economic crisis of 2008-2009, a large number of households in Eastern Europe had taken such loans, benefiting from low interest rates and expecting a steady appreciation of the domestic currencies, but the situation reversed after the crisis. In Poland and Romania, the resolution of this problem has become a contentious issue as the suggested and implemented solutions shift the burden to the banking sector.

The baseline forecast projects robust growth in 2017-2018

In the outlook period, the EU member States from Eastern Europe and the Baltics region are expected to see average growth of about 3 per cent. The full impact of the Brexit on the region has yet to be assessed, but the economies are likely to be affected by more modest EU funding. The weaker pound is already weighing on the value of remittances they receive. The possible return of migrant workers from the United Kingdom may increase labour market tensions in a number of countries, but could also alleviate the serious demographic pressures in the Baltic States and emerging labour shortages in parts of Eastern Europe and facilitate business start-ups.

Economies in transition

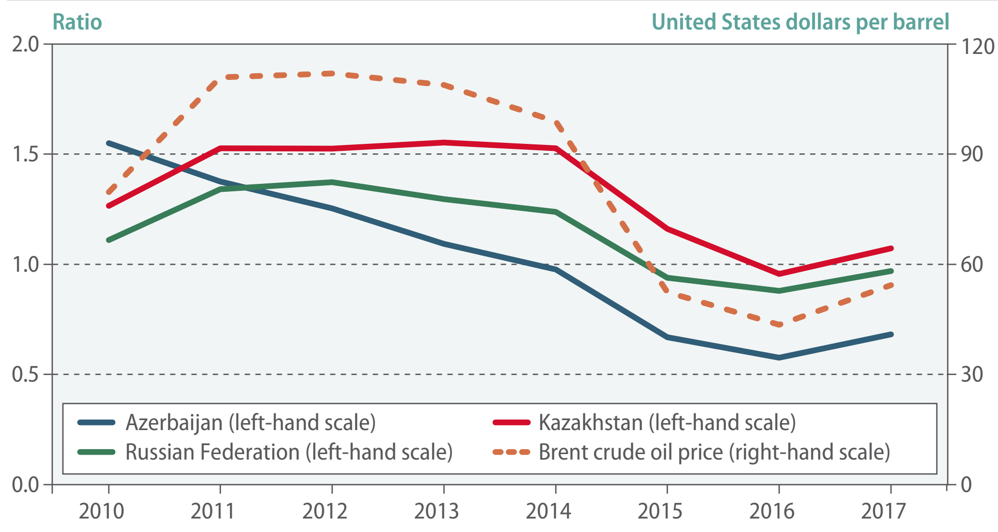
Following a 2.8 per cent contraction in 2015, the aggregate GDP of the Commonwealth of Independent States (CIS) and South-Eastern Europe contracted further by an estimated 0.2 per cent in 2016. Economic activity is expected to recover in 2017 and 2018, with aggregate GDP expanding at 1.4 per cent and 2.0 per cent, respectively. The economies of the CIS have entered a period of tentative stabilization. While output continued to decline in several countries in 2016, the aggregate indicators of the region started to show some improvement. The contraction in GDP in 2016 was much milder than in 2015, and a return to a low growth trajectory is expected for 2017. In South-Eastern Europe, economic growth accelerated further, largely owing to the strength of domestic factors.

The economic outlook is subject to downside risks, especially in the case of the CIS. Since commodity prices are expected to remain fairly low, the region's economies will need to find new drivers of growth. Geopolitical tensions in the region, along with a number of structural constraints, continue to limit countries' ability to reduce dependence on primary commodities and low-tech exports. South-Eastern Europe, in turn, remains heavily dependent on the EU and vulnerable to a possible intensification of the refugee crisis or deterioration in global financing conditions.

The Commonwealth of Independent States: tentative recovery amid persistent uncertainty

Following the severe terms-of-trade shock of 2014/15 and the consequent economic contraction in most of the CIS energy exporters (figure IV.5), the region's economies have entered a period of tentative stabilization. Economic activity in parts of the CIS continued to decline in 2016, but at a much reduced pace. As a result of the more moderate contraction in the Russian Federation and the return to sluggish growth in Ukraine, the aggregate indicators of the region improved. Some Central Asian economies, such as Tajikistan and Uzbekistan, continued to register strong growth. The aggregate GDP of the CIS is estimated to have fallen by 0.3 per cent in 2016, following a decline of 3 per cent in 2015. In 2017, the region is expected to return to growth, but amid continued fragilities the expansion will be muted, projected at 1.4 per cent. Growth is forecast to pick up to 2.0 per cent in 2018. Still depressed commodity prices and persistent geopolitical tensions, along with structural constraints, such as an outdated capital stock, deindustrialization in Ukraine, demographic pressures in the European part of the CIS, inadequate energy generation in Central Asia and the challenging business conditions, will continue to generate an inauspicious growth environment and the region's larger economies are expected to remain on a low-growth trajectory.

Figure IV.5
Oil price and the terms of trade of selected CIS energy exporters, 2010–2017



Source: UN/DESA, based on data from Project LINK. Figures for 2016 are partially estimated and figures for 2017 are forecast.

Note: The terms of trade are calculated as the ratio of the unit value of exports to the unit value of imports.

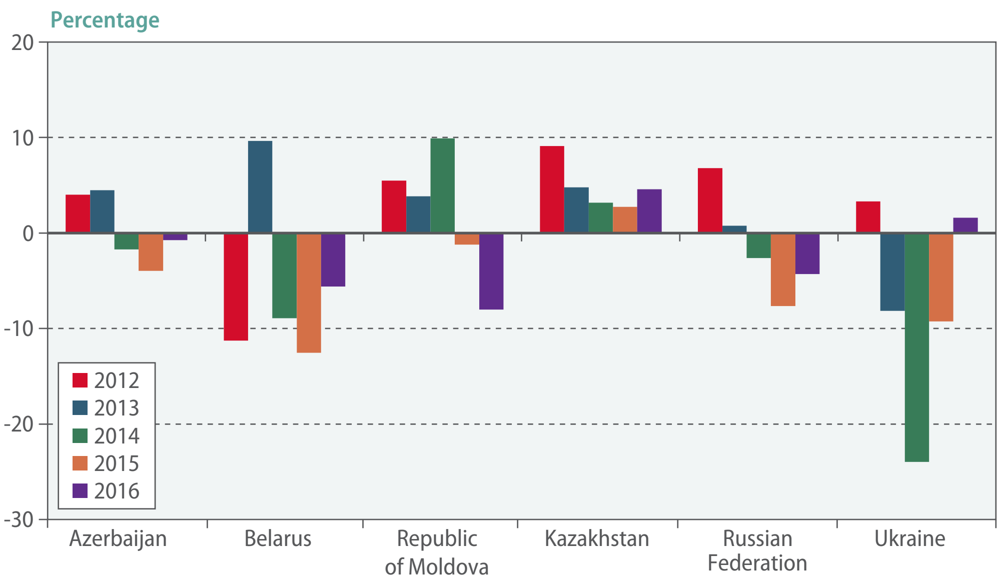
On the positive side, stronger links with China, in particular, within the framework of the "Belt and Road" initiative,[1] will contribute to an upgrade of the Central Asian infrastructure grid and have positive spillover effects. Thanks to continuing robust capital accumulation, growth in Central Asia will exceed the CIS average.

Domestic demand remains subdued

Domestic demand, both consumption and investment, remained very weak in the CIS amid stagnating or declining real wages, poor access to credit and high uncertainty. The continuing international sanctions against the Russian Federation, which limit access to capital markets, weigh on business sentiment and investment prospects. Investment weakened significantly in most countries in 2016, with especially large falls in Azerbaijan, Belarus and the Republic of Moldova, while recovering mildly in Ukraine after three years of precipitous contraction (figure IV.6).

Figure IV.6

Annual change in gross fixed investment in selected CIS economies, 2012–2016



Source: UN/DESA, based on data from Project LINK and National Statistical Offices. Figures for 2016 are partially estimated.

Net external demand was partly able to offset these negative trends. The ongoing fiscal adjustment in energy-exporting countries added to contractionary forces. Falling remittances from the Russian Federation, which are estimated to have further declined in 2016 despite the recovery of the rouble, have depressed incomes in the region's small energy-importing countries. On the positive side, import-substitution policies and a weaker currency in the Russian Federation have supported the performance of certain sectors, namely the agriculture and the chemical industries.

In 2015, Ukraine signed the Deep and Comprehensive Free Trade Area (DCFTA) agreement with the EU, which entered into force in January 2016. In response, the Russian Federation suspended its free trade agreement with Ukraine. This has led to a further col-

1 The initiative of jointly building the Silk Road Economic Belt and the 21st Century Maritime Silk Road was launched in 2013 by China.

lapse in bilateral trade. A similar agreement with the EU for Georgia (not a CIS member) and the Republic of Moldova came into force in July 2016. This leads to further fragmentation of trade in the CIS area. Armenia, Belarus, Kazakhstan, Kyrgyzstan and the Russian Federation are members of the Eurasian Economic Union (EEU) — a free trade area and a customs union aiming at free movement of production factors (including labour) and policy harmonization.

Inflation declines further amid more stable currencies and subdued demand

Inflation subsided throughout the CIS in 2016, as the impact of past currency depreciations wore off, exchange rates stabilized and aggregate demand remained subdued. Strong harvests in the Russian Federation and Ukraine contributed to disinflation. In Ukraine, inflation declined sharply from over 48 per cent in 2015 to single digits in mid-2016 as base year effects wore out; the forthcoming utility price increases and possible currency depreciation will sustain inflationary pressure. In Belarus, despite a large increase in regulated tariffs in early 2016, inflation stabilized but remains high relative to other countries. In several small countries, including Armenia, Kyrgyzstan and the Republic of Moldova, price growth remained subdued. On average, a further slowdown in inflation is projected for 2017-2018.

Labour market shows resilience, but headline figures may be misleading

Labour markets in the region were relatively resilient in view of ongoing output trends. In the Russian Federation, unemployment remained virtually at the level of 2015 despite the ongoing recession. However, the headline figure masks a sharp adjustment of real wages that took place in 2015, frequent shifts to part-time work and widespread wage arrears. In Ukraine, the muted recovery failed to make a dent in unemployment figures. In Belarus, the number of employed has continued to decline, although the unemployment rate remains low. In Kazakhstan, unemployment edged higher but remains low, as the economically active population continues to shrink. Returning migrant workers have put pressure on local labour markets in the small Central Asian countries.

Conditions for economic policymaking are challenging

In the challenging new environment, finding the right policy mix has presented a difficult choice for the energy exporters, which are faced with currency and fiscal pressures, high inflation and banking sector fragilities. In 2014-2015, Governments generally tightened monetary and fiscal policies, while also implementing some targeted stimulus measures.

Monetary policy has been loosened, with some exceptions

Monetary policy was generally loosened throughout the CIS in 2016, against the backdrop of slowing inflation. However, in the larger countries, interest rates remain relatively high. While the shift towards inflation-targeting (following the introduction of free-floating regimes in some countries) facilitates adjustment to external shocks, it has also created new challenges, limiting the room for monetary easing. Persistent concerns over exchange rate stability and inflation limit the scope for countercyclical monetary policy. In the Russian Federation, the policy rate was cut by a total of 100 basis points in 2016; as inflation still far exceeds the official target, further rate cuts are likely to be cautious. By contrast, the Republic of Moldova cut rates rapidly as inflation declined sharply. In Armenia and Kazakhstan, despite ongoing disinflationary trends and continued cuts, rates remain high. Monetary policy was tightened in Azerbaijan and Tajikistan, where the currencies came under severe pressure as a result of lower oil revenues and falling remittance inflows, respectively. Some CIS countries have put in place tight restrictions on the foreign exchange operations of businesses and households and cross-border transactions.

Fiscal adjustment adds to contractionary forces

On the fiscal policy front, even in those CIS energy producers that entered the downturn with significant fiscal buffers, consolidation measures were required to maintain stability of public finances and slow down the depletion of accumulated reserve funds.

In the Russian Federation, public wages remained frozen and benefits were indexed below the inflation rate. Spending in the 2017-2019 budget is likely to decline in real terms. On the positive side, public debt remains low and the country was able to issue a sovereign Eurobond in 2016 despite non-cooperation of foreign banks. Fiscal spending has also been tightened in Azerbaijan.

In Kazakhstan, the adjustment, including the reduction of lending activities by the oil fund, has been accompanied by fiscal reforms to boost non-oil income. To compensate for the budgetary shortfall, as well as to attract FDI and to revitalize growth, partial privatization of state-owned assets is planned in several countries. In the energy-importers, fiscal policy remains largely neutral or slightly expansionary, although the weaker remittance inflows from the Russian Federation exerted pressure on import tariff and indirect tax revenues through weak private consumption. Large public debt is limiting fiscal options in Kyrgyzstan. The banking sector may remain a source of continued fiscal outlays in some countries.

The aggregate current account surplus narrowed

External balances deteriorated in most CIS countries. The region's aggregate current account surplus shrank sharply, driven by trends in the Russian Federation. The contraction of exports in 2016 exceeded the observed fall in imports. The region's terms of trade continued to deteriorate, albeit at a much reduced pace and an improvement is expected in 2017-2018 (figure IV.5).

In the Russian Federation, imports have started to pick up while exports remain subdued. The resulting pressure on the balance of payment was offset by a reduction in capital outflows (box IV.1). A major external adjustment has taken place in recent years in Ukraine as a consequence of the currency depreciation. In the small Central Asian countries, current account deficits remain very large. After plummeting in 2015, remittances have continued to fall, albeit at a reduced pace. There are signs of recovery in remittances in Kyrgyzstan, perhaps linked to the country's membership in the EEU.

Fragilities and downside risks persist

The economic outlook is facing continued downside risks as the recovery of commodity prices is expected to be limited and the region's economies will need to search for new drivers of growth. The ability to overcome the dependence on primary commodities and low-tech exports is constrained by inadequate access to modern technology and limited resources for investment. Currency depreciations have, in part, been harmful and their full consequences have yet to be seen. On the other hand, weaker currencies have provided opportunities for economic diversification, but the supply response will be limited by sluggish domestic and external demand, credit rationing, and subdued investment. The banking system remains fragile, although concerns about financial stability have receded. Geopolitical risks are undermining confidence and business sentiment in the region. For the smaller CIS economies, diversification of their export markets remains an important challenge.

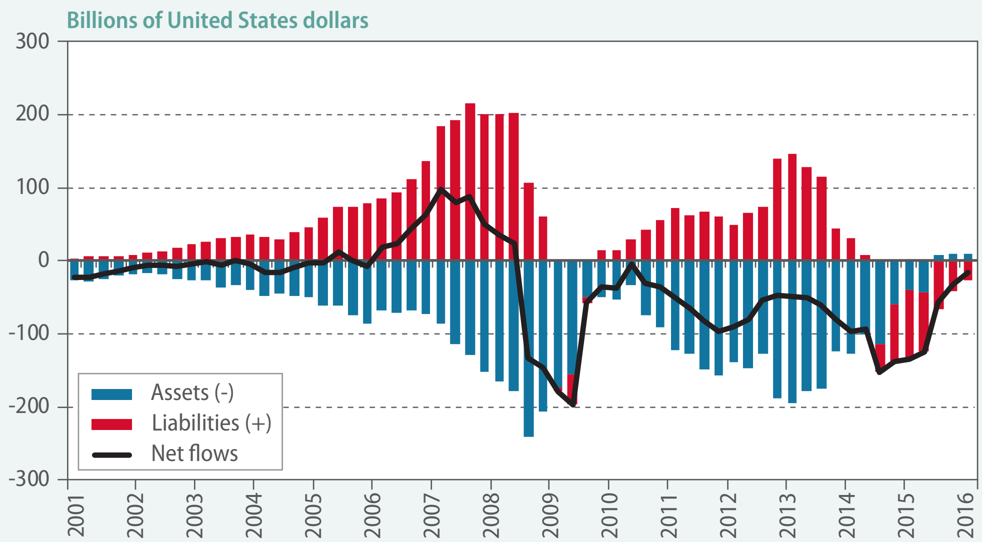
Box IV.1

The "de-offshorisation" of the Russian economy

The Russian economy has experienced large fluctuations in private capital flows over the last decade, driven by external and domestic developments. Prior to the 2008 global financial crisis, both capital inflows and outflows (net acquisition of Russian assets by foreigners and net investments by Russians abroad) grew steadily (figure IV.1.1), with the net balance registering a strong positive value in 2006-2007 (an annual average of 5.2 per cent of GDP). The 2008 crisis brought a sudden stop in capital inflows, while the appetite of Russian residents for foreign assets only gradually diminished. This resulted in large net outflows since 2008 despite some recovery in inflows in the post-crisis period. A specific model of exporting capital and afterwards borrowing overseas prevailed. In 2008, net private capital outflows from the Russian Federation were over $130 billion, while in 2014 the amount exceeded $150 billion.

Figure IV.1.1

Net private capital flows in the Russian Federation, rolling four quarters, 2001Q1-2016Q2



Source: Central Bank of the Russian Federation.

Note: Increases in assets appear with a negative sign, increases in liabilities have a positive sign.

Some of those capital flows reflected de-facto transactions between Russian companies. The share of net inward FDI from the jurisdictions where "round-tripping" investment is more likely to originate reached more than 50 per cent of the total in 2014.

Partially as a result of those developments, the period of high oil prices between 2011 and 2014 was accompanied by a shrinking current account surplus (figure IV.1.2), both in United States dollar terms and as a share of GDP, which is generally not typical for an oil-exporting country. The current account surplus was accompanied by large net private capital inflows and concealed a high deficit on investment income (including that derived from "round-tripping" investments, where interest was paid on the borrowed funds or profit was repatriated back to the offshore locations that acted as a source for FDI).

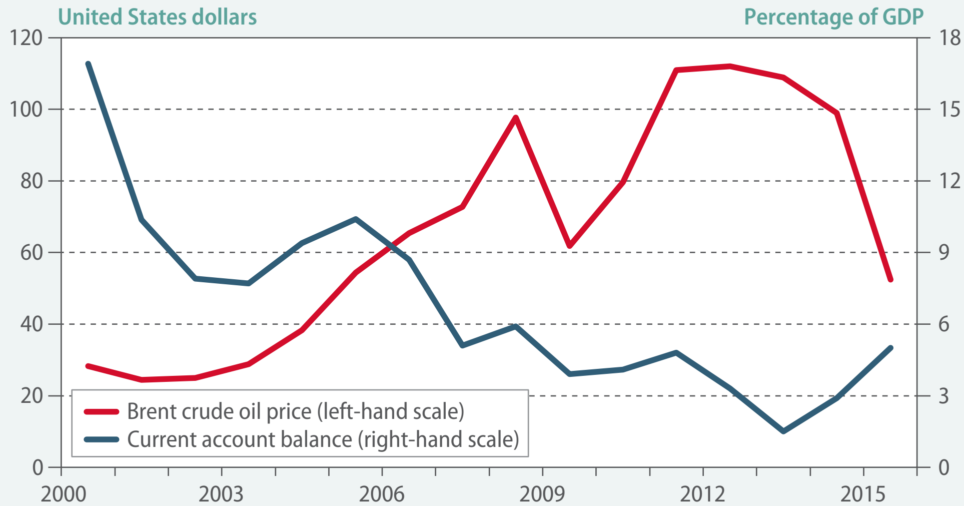
In 2014, both private capital inflows and outflows fell drastically, amid the collapse in global oil prices and the imposition of international sanctions, which curtailed access to capital markets (figure IV.1.3). Net acquisition of Russian assets by foreigners turned negative in the third quarter of 2014 as investors pulled out of the Russian economy.

Russian companies reduced their debt, which was refinanced only partly, while other sources of financing also dried up. Given increased difficulties in raising external finance, the Russian private sector, particularly banks, drew down on earlier accumulated foreign assets. Consequently, net private capital flows (increases in assets minus increases in liabilities) have been declining sharply since late 2015. The

(*continued*)

Box IV.1 (*continued*)

Figure IV.1.2
Oil price and current account balance of the Russian Federation, 2000–2015



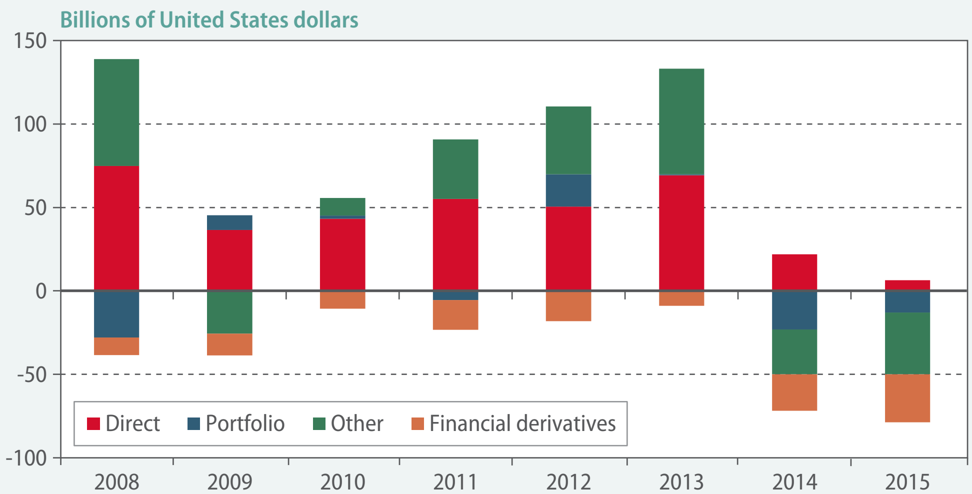
Source: International Monetary Fund and Central Bank of the Russian Federation.

typical strong correlation between foreign inflows and outflows of Russian money has now been broken for some time.

The deterioration in the terms of trade since 2014 has taken place together with a widening of the current account surplus. This is partly explained by the weaker rouble and contraction in imports; however, the reduction of the investment income deficit in 2014-2015 accounts for most of the observed increase in the current account surplus. In 2016, a smaller current account surplus was accompanied by much lower net private capital outflows.

The initiatives to "de-offshorise" the Russian economy and the measures to reduce shadow capital transactions have also played an important role in reducing outflows, resulting in lower dependency on external financing. The Central Bank of the Russian Federation provides estimates of fictitious transac-

Figure IV.1.3
Net incurrence of liabilities by Russian residents, by investment category, 2008–2015



Source: Central Bank of the Russian Federation.

(*continued*)

Box IV.1 (*continued*)

tions to transfer funds abroad. These irregular transactions have been traditionally quite high, reaching about 10 per cent of exports in 2008. They have been on a declining trend since then, dropping sharply since late 2013, and are now less than 1 per cent. Tighter banking sector rules have also reduced the outflow of illicit capital.

The ongoing deleveraging process has contributed to a reduction in total foreign debt by around 30 per cent between the end of 2013 and the first half of 2016. Exchange rate depreciation amplified the decline (approximately one quarter of this stock was initially rouble-denominated). However, the reduction of liabilities has slowed down in recent quarters, as debt refinancing ratios improved, in particular in the non-financial sector, with liabilities increasing again in the second quarter of 2016.

Regardless of the continuation of international sanctions, the accumulation of assets abroad is unlikely to take place at the same pace as in the past. As a result, lower liabilities will reduce the traditional but volatile deficit of the investment income balance. Debt refinancing ratios have improved, but the persistence of difficulties in accessing external finance will continue to spur the search for domestic alternatives. Thus the "de-offshoring" trend of the Russian economy is expected to continue.

Authors: José Palacín (UN/ECE) and Grigor Agabekian (UN/DESA)

South-Eastern Europe: economic growth accelerates

Economic activity in South-Eastern Europe gained further strength in 2016, driven by the strong pick-up in Serbia, the region's largest economy. The improved performance reflects largely domestic factors. However, there are marked differences across the region, with some countries, in particular the former Yugoslav Republic of Macedonia, losing momentum.

The region's GDP growth is projected to strengthen from an estimated 2.6 per cent in 2016 to 3.1 per cent in 2017 and 3.3 per cent in 2018. However, average growth will remain weaker than in the pre-crisis period, when it was accompanied by heavy private and public borrowing.

Domestic demand drives the expansion

Investment has been a main driver of growth in the region. Albania, Bosnia and Herzegovina and Serbia have seen large public investments in infrastructure. Improved labour market dynamics have boosted private consumption, following years of moderation. In some countries, in particular Albania and Serbia, domestic demand was supported by higher growth. By contrast, net external demand contributed negatively to growth in most economies in the region, with the exception of Serbia and, notably, Montenegro, where the external sector performance was supported by tourism revenues.

Low inflation persists

Despite stronger growth, inflationary pressures remained very low. Consumer price inflation was negative in Bosnia and Herzegovina, and close to zero in the former Yugoslav Republic of Macedonia. While domestic demand has strengthened, there is still significant slack in the labour market. The external environment with low oil and food prices contributes to persistently low inflation. In 2017, consumer price inflation is projected to accelerate to 1.7 per cent, in line with the expected strengthening of energy prices.

Labour market conditions improve

Sustained economic growth and, in a number of countries, labour market reforms have resulted in rapid job creation. Despite recent progress, unemployment still remains high, exceeding the pre-2008 crisis levels, with the exception of the former Yugoslav Republic of Macedonia and Montenegro. Long-term and youth unemployment are particularly high, aggravating social problems.

Fiscal consolidation advances

Fiscal consolidation efforts are ongoing as the region addresses the high level of public debt. The results of these efforts have so far been mixed. Albania, Bosnia and Herzegovina and Serbia have made some progress; other countries have seen further deterioration.

Financing of infrastructure remains a significant source of outlays in the former Yugoslav Republic of Macedonia and Montenegro.

Large external imbalances remain

With the notable exception of Serbia, the current account deficit widened in almost all countries; in Albania (where low oil prices continued to weigh on the value of exports) and Montenegro, the deficit-to-GDP ratios reached double-digit figures. Growing foreign investment in the region translates into large profit repatriation. At the same time, remittance inflows are on a declining trend as the ties between emigrant workers and their countries of origin continue to weaken. FDI remains the main source of financing for the current account deficits.

Improved prospects are accompanied by lingering uncertainties

The region remains closely linked with the EU, which will continue to influence economic prospects. A possible intensification of the refugee crisis would have negative implications, as it may result in disrupting trade flows. The region still remains highly dependent on external financing. In the aftermath of the Brexit vote, there is a risk that funding from the EU may diminish if the United Kingdom eventually exits the EU. In addition, the weaker pound sterling associated with the increased uncertainty will continue to weigh on the value of remittances received by the region.

Developing economies

Growth in developing economies slowed to a meagre 3.6 per cent in 2016, the slowest pace of expansion since the global financial crisis. The causes for this subdued performance are numerous, ranging from international factors such as lower commodity prices, weak global trade and persistent uncertainties in the world economy, to domestic vulnerabilities, reduced macroeconomic policy space and, in some cases, political instability. Several large economies in Latin America and the Caribbean suffered contractions in 2016, while growth in Africa and Western Asia slowed markedly.

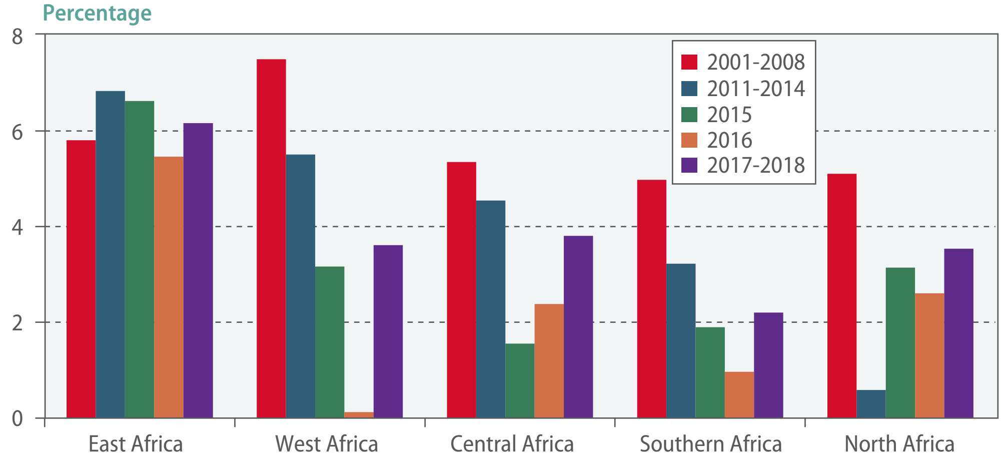
In contrast, most economies in East Asia and South Asia, led by China and India, saw robust growth driven by strong expansion of domestic demand. Going forward, average growth in developing economies is expected to pick up to 4.4 per cent in 2017 and 4.7 per cent in 2018 on the back of a moderate recovery in Africa, Latin America and the Caribbean and Western Asia. A pick-up in demand from developed economies will likely support stronger export growth. Higher commodity prices will somewhat alleviate fiscal and external pressures in commodity-exporting countries. While the room for more expansionary monetary and fiscal policies is generally limited, it varies considerably by region and country.

Africa: growth expected to recover at a moderate pace

Following a sharp growth deceleration in 2016, growth in Africa is expected to recover at a moderate pace going forward. Regional GDP is projected to expand by 3.2 per cent in 2017 and 3.8 per cent in 2018, up from an estimated 1.7 per cent in 2016. The aggregate growth figures, however, mask a marked divergence in the growth prospects of the different African subregions (figure IV.7) and economies.

The anticipated upward trend in global oil and non-oil commodity prices for the next two years will, to a certain extent, ease fiscal and external pressures for the commodity exporters. Nevertheless, given that global commodity prices are expected to remain well below pre-2014 levels, a strong growth rebound in the highly commodity-dependent coun-

Figure IV.7
Average annual GDP growth in Africa, by subregion, 2001–2018



Source: UN/DESA, based on United Nations Statistics Division National Accounts Main Aggregates Database.
Note: Excluding the global financial crisis in 2009 and 2010, for periods of more than one year, growth numbers refer to the arithmetic mean. Figures for 2016 are partly estimated. Figures for 2017 and 2018 are forecasts.

tries, including Algeria, Angola and Nigeria, appears unlikely. In contrast, the growth outlook is more favourable for countries in the East African Community, including Ethiopia, Kenya and the United Republic of Tanzania, as well as the Western African economies of Côte d'Ivoire, Ghana and Senegal. Growth in these economies will continue to be driven by robust private consumption and the continued implementation and completion of large infrastructure projects.

Low commodity prices contributed to a significant growth slowdown

Buffeted by strong external and domestic headwinds, growth in Africa experienced a significant slowdown in 2016. For the highly commodity-dependent economies in the region, persistently low commodity prices weighed on economic activity. Modest global growth and fragile investor sentiments worldwide also contributed to weaker external demand for the region. These global headwinds were compounded by an increasingly challenging domestic climate in several African countries, including unfavourable weather conditions, higher political and policy uncertainty and an escalation of security concerns.

Africa as a whole is expected to have expanded by a modest 1.7 per cent in 2016, marking one of the slowest rates of expansion in more than two decades. The economic picture, however, was one of multi-speed growth. While growth in the oil-exporting and mineral-rich countries weakened, there were bright spots in the region as several economies, including Côte d'Ivoire, Kenya and Senegal, continued to grow at a strong pace. Amid a more favourable business climate, ongoing infrastructure development and improved macroeconomic management, growth in these economies was driven by resilient private consumption and investment activity.

Rapid expansion of domestic markets and strong infrastructure spending drive East Africa's growth

Following robust growth of 5.5 per cent in 2016, East Africa is positioned to remain the fastest growing African subregion in 2017 and 2018. Growth is projected to accelerate to about 6 per cent in both years, reflecting the subregion's favourable macroeconomic fundamentals. Growth in Ethiopia, Kenya, Rwanda and the United Republic of Tanzania in the next two years will remain driven by the rapid expansion of domestic markets and strong infrastructure spending, particularly in the energy and transport sectors. In the subregion's net oil importers such as Kenya and Rwanda, economic activity will continue to benefit from low inflationary pressures, amid a sluggish recovery in oil prices. In addition, the adverse effect of prolonged droughts that dampened 2016 growth in countries such as

Ethiopia and Uganda is expected to dissipate in 2017. A potential escalation of social unrest in Ethiopia may however weigh on the short-term growth outlook.

Modest growth rebound in West Africa as oil prices recover

Growth in West Africa is expected to rebound modestly to 3.1 per cent in 2017, as the projected increase in oil prices eases severe fiscal and external pressures in Nigeria. In 2016, the subregion's aggregate GDP virtually stagnated, growing only by 0.1 per cent due to a contraction in the Nigerian economy. Nigeria's growth was adversely affected by declining oil revenues, amid low oil prices and disruptions to oil production. Heightened financial market volatility and an escalation of security issues also affected investment flows. In contrast, the growth outlook for Côte d'Ivoire, Ghana and Senegal remains strong, underpinned by ongoing large infrastructure investments and progress on structural policies to improve the domestic business climate. In Guinea and Liberia, growth in 2017 is expected to strengthen further given the diminishing impact of the Ebola outbreak on economic activity.

Growth in North Africa is contingent on improved security situation

Growth in North Africa is projected to increase to 3.5 per cent in 2017, contingent on a gradual improvement in the security situation. In 2016, growth in the subregion slowed to 2.6 per cent. Security threats and social unrest weighed on investor sentiments and adversely affected the subregion's vital tourism industry, particularly in Egypt and Tunisia. In Egypt, the sharp decline in tourism revenues contributed to a severe foreign currency shortage. This prompted the Central Bank of Egypt to devalue the Egyptian pound by more than 30 per cent against the United States dollar and announce a free-float of the currency. The Libyan economy also continued to face significant political challenges and unrest, with spillover effects to its neighbouring countries. Given its high dependence on crude oil revenues, Algeria's growth slowed in 2016. Growth in the Algerian economy is expected to remain subdued in 2017 as planned cuts to government spending offset the boost from higher oil prices. Going forward, greater stability in the subregion will support a rebound in exports and a recovery in tourist arrivals.

Southern Africa's growth is projected to pick up as commodity prices increase and drought effects dissipate

The growth outlook for Southern Africa is relatively subdued, with economic activity projected to improve modestly to 1.8 per cent in 2017 and 2.6 per cent in 2018. In 2016, growth in the subregion slowed to 1.0 per cent, as severe droughts adversely affected growth in several countries, including Botswana, Lesotho, Malawi, Namibia and South Africa. In South Africa, growth is projected to improve going forward as the agriculture and mining sectors recover while inflationary pressures subside. However, renewed global financial market volatility may dampen investor sentiments in the short term. Domestically, higher political uncertainty may also weigh on investment in South Africa. Meanwhile, an improvement in oil revenues will support a modest recovery in Angola.

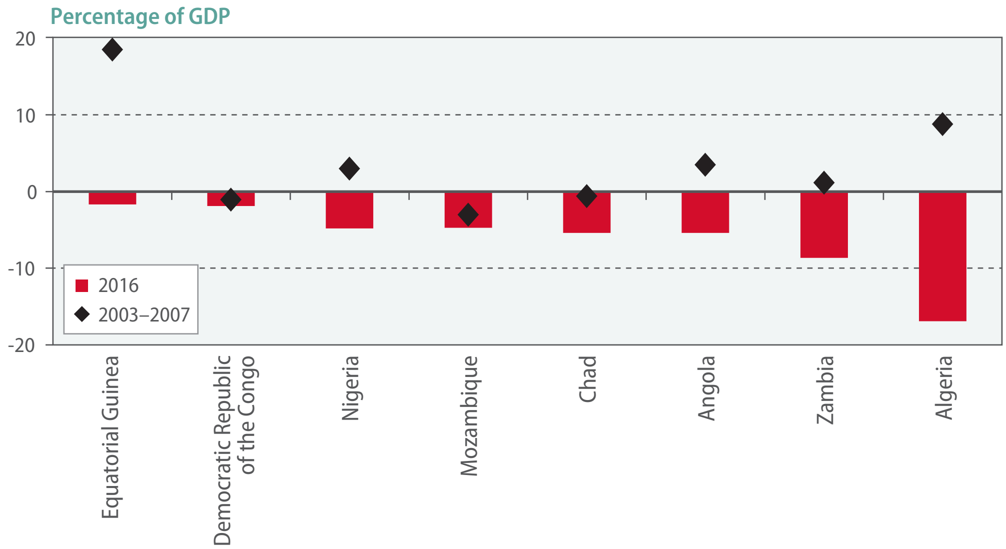
Central Africa's growth is expected to improve even as political uncertainty persists

In the Central Africa subregion, growth is expected to strengthen from 2.4 per cent in 2016 to 3.4 per cent in 2017 and improve further to 4.2 per cent in 2018. The recovery in oil prices will revive export revenues and growth, particularly in Congo, Equatorial Guinea and Gabon. However, ongoing domestic political unrest in the Central African Republic and Gabon will restrain economic activity in these economies. In Cameroon, the diminishing impact of lower oil revenues and continued strong public investment in infrastructure will support growth going forward.

Low commodity prices have resulted in a deterioration of fiscal positions in Africa

External shocks compounded by adverse domestic developments have collectively contributed to rising vulnerabilities in many African countries. The prolonged low commodity price environment has intensified fiscal pressures in the region, particularly for the oil and metal exporters, as evidenced in the considerable widening of fiscal deficits in these economies (figure IV.8).

Figure IV.8
Fiscal deficits of selected oil and metal-exporting African economies, 2003–2007 vs. 2016



Source: UN/DESA; International Monetary Fund (2016a).
Note: Figures for 2016 are estimates.

For a few countries, the rapid deterioration in public finances has prompted Governments to introduce measures to preserve fiscal sustainability. Large oil exporters, including Algeria and Angola announced significant cuts to budget plans, while Nigeria removed fuel subsidies. In addition, countries such as Nigeria and Zambia sought financial assistance from international organisations to alleviate growing budget shortfalls.

Against a backdrop of high capital flow volatility and declining international reserves, exchange rates of commodity-dependent countries faced downward pressure in 2016. Reflecting the collapse in export income and rising concerns over fiscal sustainability, the domestic currencies of Angola, Mozambique and Zambia depreciated significantly during the year. For South Africa, global financial market volatility, domestic political uncertainty and concerns over the risk of a sovereign rating downgrade contributed to a further weakening of the rand. Faced with severe foreign currency shortages, Nigeria removed its currency peg to the United States dollar in June. The Nigerian naira subsequently depreciated sharply, losing more than 40 per cent of its value over just a few months.

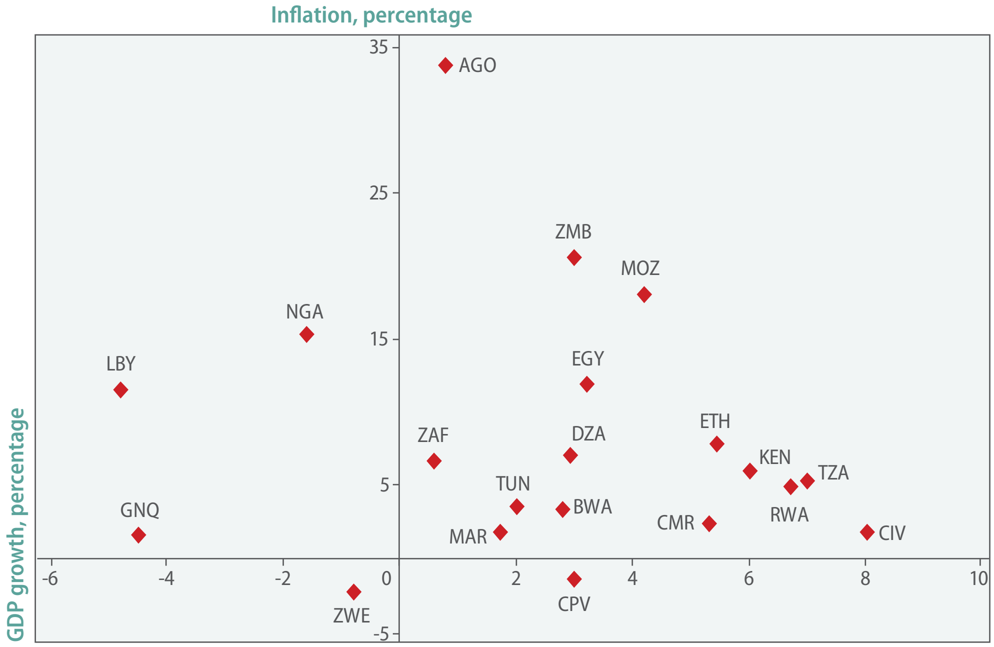
Growth and inflation dynamics vary considerably across the region

Across the African region, growth and inflation dynamics varied considerably in 2016 (figure IV.9). The weakening of domestic currencies fuelled inflationary pressures, particularly in the less diversified economies.

The adverse impact of drought conditions on agricultural production and rising electricity tariffs also exerted upward pressure on consumer prices. Inflation accelerated to multi-year highs in Angola, Mozambique and Nigeria, with domestic prices growing at double-digit rates during the year. For Nigeria, the removal of fuel subsidies resulted in a sharp increase in retail petrol prices, exacerbating inflationary pressures.

Amid rising consumer prices and production costs, several central banks increased key policy rates in 2016. Looking ahead, as high inflationary pressures are expected to persist for these economies, monetary policy stances will remain tight. Given the weakening growth momentum, however, the increase in domestic borrowing costs will likely further constrain private consumption and investment activity, reflecting a rising dilemma

Figure IV.9
GDP growth and inflation in selected African economies, 2016



Source: UN/DESA estimates, based on data from National Statistical Offices and Central Banks.

Note: See Table J in the Statistical Annex for definitions of country codes.

in the conduct of monetary policy in these economies. In contrast, inflation in the net oil importers in the region stabilised or declined in 2016, with inflationary pressures expected to remain subdued going forward. In a few of these countries, such as Botswana, Kenya and Morocco, central banks reduced policy rates during the year, reflecting the availability of policy space.

The growth outlook for Africa faces high domestic and external risks

Several risks and challenges remain to the growth outlook for the African region. On the external front, a reversal of the recent upward trend in global oil prices would result in further growth deterioration in oil-exporting countries. A sharper-than-expected growth moderation in China would weigh on the region's commodity exports (box IV.2). In addition, the uncertainties associated with the coming process of Brexit, with deterioration in the growth outlook for the United Kingdom and Europe, would pose a risk to the trade performance of countries such as Kenya and South Africa, given the importance of Europe as a major export destination.

Domestically, an escalation of security concerns, particularly in the Central, North and West African subregions could deter foreign investment and severely disrupt economic activity. Growing political unrest such as in Burundi, the Democratic Republic of the Congo, Gabon and Zimbabwe could also impact growth. For the highly agriculture-dependent economies such as Ethiopia and Malawi, growth will remain susceptible to weather-related shocks.

Importantly, the growth outlook for Africa is contingent on the ability of countries to mitigate the impact of external risks while containing domestic vulnerabilities. Although debt levels in Africa are still relatively low, the sharp widening of fiscal deficits has contributed to rising concerns over the pace of debt accumulation in the region. In particular, tighter international financial conditions and further weakening of domestic currencies could lead to higher borrowing costs, given the structure of Africa's external debt that

Box IV.2

The impact of China's economic slowdown on Africa

The Chinese economy has been on a moderating growth path since 2010. Ongoing structural reform measures to rebalance growth have resulted in slower investment, particularly in the industrial sectors with excess capacity. China's economic transition from investment to consumption-led growth will contribute to more robust and more sustainable growth prospects going forward. Nevertheless, the Chinese economy is projected to expand at a pace well below the double-digit growth rates experienced in the past decades. Given China's significant influence on global growth and trade developments, the slowdown in China's economic growth and changing demand composition have important implications for the rest of the world, including Africa.

China's economic rebalancing is affecting the growth outlook for the African economies through three key transmission channels. The first and most important channel is the trade channel. Slowing growth in China has been accompanied by deceleration in its overall import volume growth in recent years (figure IV.2.1).

Figure IV.2.1

Growth of China's imports of goods and services in constant 2010 prices, 1996–2016 (*year-on-year*)

Source: UN/DESA, based on national data.

Note: Figure for 2016 is estimated.

In the last decade, the value of China's imports from Africa has risen more than 20–fold, reaching a peak of $116 billion in 2013 (figure IV.2.2). The rapid expansion in trade activity between China and the African economies was largely fuelled by China's trade liberalisation measures as well as its rapid growth in demand for natural resources and primary commodities. Amid the collapse in global commodity prices, the value of China's imports from Africa has contracted since 2013, falling by almost 50 per cent to $69 billion in 2015.

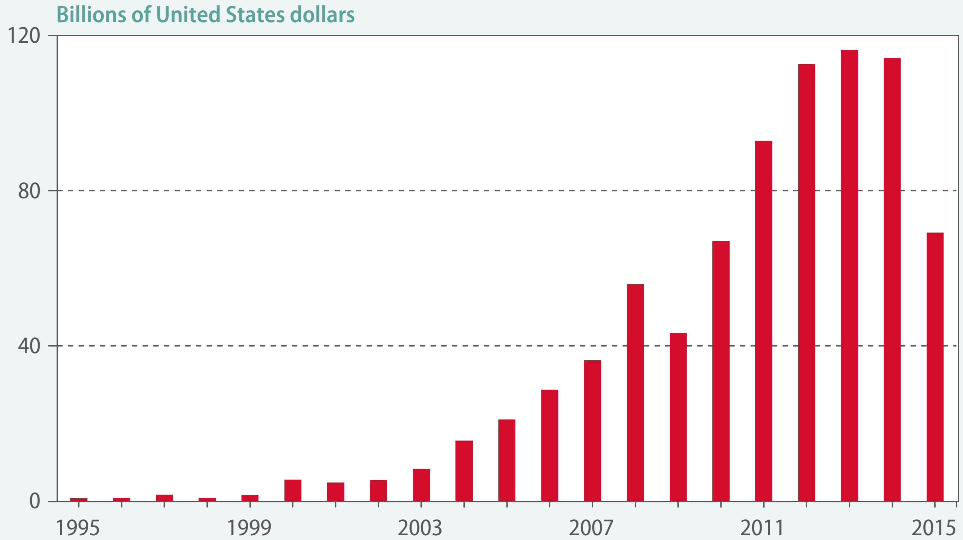
While this to a certain extent reflects the large decline in commodity prices, it is also indicative of weaker Chinese demand, given that China's import volume growth has also slowed. The sharp decline in trade value is also associated with a fall in income for the African economies, with adverse effects on both the public and private sectors.

The impact of China's slowdown will vary from country to country. For several economies, including Angola, Congo, Mauritania, South Africa and Zambia, weaker Chinese demand significantly affects their trade outlook, given that China is the largest export destination for these economies, representing

(*continued*)

Box IV.2 (*continued*)

Figure IV.2.2
China's imports from Africa, 1995–2015



Source: UN Comtrade.

between 8 and 44 per cent of total exports. In addition, China's shift away from imports of investment-related goods will lower its demand for raw materials and intermediate inputs for the industrial sector. This will have a disproportionately large negative impact on the African economies given that about 90 per cent of Africa's total exports to China are composed of primary commodities, in particular mineral fuel and oils (64 per cent), ores (14 per cent) and copper (6 per cent).

China's slower growth is also exerting downward pressure on global commodity prices, indirectly affecting the growth performance of the African economies. China constitutes around 50 per cent of total global consumption for several base metals, including aluminium, copper, nickel and zinc. Weaker Chinese demand for these commodities will dampen global prices, weighing on income of the metal exporters in Africa. For example, copper and copper-related products constitute 57 per cent and 78 per cent of total exports in the Democratic Republic of the Congo and Zambia, respectively. In Madagascar, nickel accounts for 23 per cent of total exports, while in Mozambique, aluminium represents 34 per cent of total exports.

Through the investment channel, slower growth in China may weigh on the capacity of Chinese firms to engage in overseas direct investment activity, including in Africa. While the stock of Chinese foreign direct investment in Africa is still relatively small, it has been growing at a rapid pace. Data from The China-Africa Research Initiative (CARI) at the Johns Hopkins University School of Advanced International Studies (SAIS) showed that China's stock of FDI into Africa has grown from $0.3 billion in 2003 to $32 billion in 2014, with investments mainly concentrated in the extractive industries.

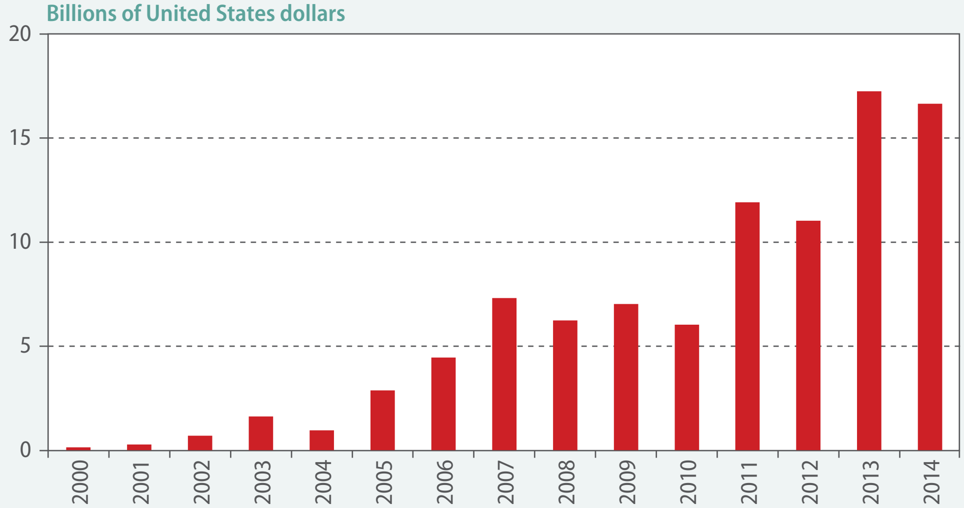
Finally, through the financing channel, slower growth in China may lead to a decline in loans, aid and grants that are extended to African countries, potentially affecting financing for development, including much-needed infrastructure. According to SAIS—CARI, the Chinese Government, banks and contractors extended a total of $86.3 billion between 2000 and 2014 to African Governments and state-owned enterprises, with Angola, Ethiopia, Kenya and Sudan among the largest recipients of these loans. Data from the research institute also revealed that between 2000 and 2013, loans to African Governments and state-owned enterprises increased from $0.13 billion to $17 billion. In 2014, however, the value of loans declined to $16.7 billion (figure IV.2.3).

Amid declining commodity-related revenue and rising domestic vulnerabilities, the slower growth in China is adding to the strong headwinds already faced by African economies. In this environment, African economies have to adapt to the rapidly changing global economic and trade landscape.

(*continued*)

Box IV.2 (*continued*)

Figure IV.2.3
Chinese loans to Africa, 2000–2014



Source: Johns Hopkins School of Advanced International Studies – China-Africa Research Institute (SAIS –CARI) dataset. Available from http://www.sais-cari.org/data-chinese-loans-and-aid-to-africa.

Note: Chinese loans refer to loans by the Chinese Government, banks and contractors to African Governments and state-owned enterprises.

China's growing middle class represents an opportunity for other economies to tap into its large domestic market and rising demand for consumption goods. To leverage this opportunity, African economies need not only diversify their export product structures, but also prioritize policy measures to enhance productivity growth and competitiveness in order to move up the value chain.

Authors: Yesuf Awel (UN/ECA), Hopestone Chavula (UN/ECA) and Poh Lynn Ng (UN/DESA)

is largely denoted in foreign currency, with relatively short maturities and in some cases, floating interest rates.

For many African economies, growth prospects going forward are dependent on the effectiveness of policy measures taken in adjusting to lower commodity prices. Amid increased pressure for fiscal consolidation, there is a risk that countries will resort to cutting expenditure on critical infrastructure such as in the areas of energy, transport and healthcare. This could lead to a worsening of existing structural bottlenecks and constrain productivity growth, undermining medium-term growth prospects and sustainable development.

African economies need to advance structural reforms to boost growth prospects

Amid declining monetary and fiscal policy space, African economies will need to make substantial progress on reform measures in order to address domestic structural weaknesses. For the highly commodity-dependent economies, there is an urgent need to accelerate economic diversification and rebuild policy buffers in order to enhance resilience to external shocks. In addition, double-digit unemployment rates in many African economies, including Algeria, Egypt, South Africa and Tunisia significantly undermine progress towards sustainable and inclusive growth. In this respect, policy initiatives to promote FDI in high value-added industries can help to create better quality jobs in the economy. Ongoing initiatives to foster closer regional economic integration, such as the Northern Corridor Integration Projects (NCIP) framework will not only improve connectivity and lower the cost of doing business between countries, but will also generate positive spillovers to growth and employment.

East Asia: domestic demand continues to drive positive near-term outlook amid weak export performance

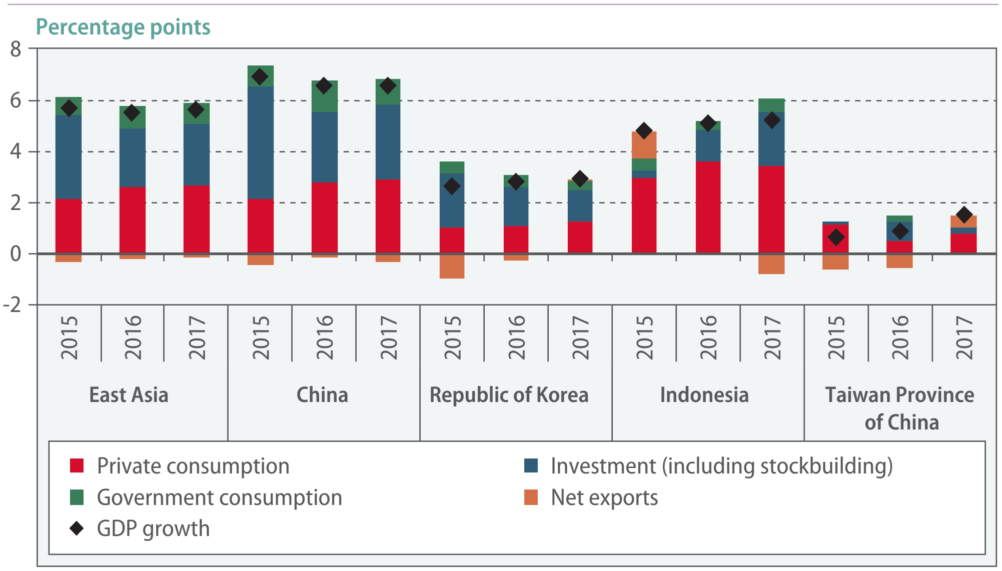
Growth in East Asia is estimated to have moderated slightly to 5.5 per cent in 2016, from 5.7 per cent in 2015 (figure IV.10), with a marginal pick up to 5.6 per cent projected for both 2017 and 2018. Domestic demand, in particular private consumption and public investment, remained the key driver of regional growth. However, the region continued to experience exceptionally weak export growth in 2016, contributing to the underperformance of several larger economies. The prolonged sluggish performance of the external sector has had negative spillover effects on consumer sentiments, which is weighing on household spending in several economies in the region. Inflation remains generally subdued, largely as a result of low energy and food prices. There are however encouraging signs of the region emerging from the two-year stretch of producer-price deflation. This could have a positive impact on corporate profits and investment.

China's output growth stabilizes

China's growth figures for the first three quarters of 2016 have somewhat alleviated near-term concerns over a drastic output slowdown. The Chinese economy is estimated to have grown by 6.6 per cent in 2016, which is 0.2 percentage points above the forecast in WESP 2016 (United Nations, 2016a). Growth has been supported by robust private consumption, as reflected in stable retail sales growth throughout the year. Growth of fixed investment, particularly infrastructure investment, also provided solid support to overall growth.

A notable development is that fixed investment has been predominately driven by state-owned enterprises. Private investment decelerated due to overcapacity in several industrial sectors, sluggish market demand, and higher corporate financing costs. While industrial profits have seen some overall recovery, there are also rising defaults on corporate debt. The Chinese economy is expected to grow by 6.5 per cent in both 2017 and 2018, supported by favourable domestic demand and accommodative fiscal measures, including off-budget fiscal support through policy banks and public-private partnerships. Neverthe-

Figure IV.10
Contributions to real GDP growth in East Asia and selected economies, 2015–2017



Source: UN/DESA, based on United Nations Statistics Division National Accounts Main Aggregates Database.
Note: Figures for 2015 and 2016 are partially estimated and figures for 2017 are forecast.

less, the implications of China's ongoing economic rebalancing will inevitably be felt by the region in the medium and long-run through trade (including commodity prices) and financial channels, albeit to a varied extent across countries.

Domestic demand growth in the Republic of Korea is restrained by weak employment and corporate restructuring

The Republic of Korea's growth is estimated to have improved moderately from 2.6 per cent in 2015 to 2.8 per cent in 2016. Domestic demand remains relatively robust, with construction investment being a main growth driver. Construction investment is expected to maintain its favourable momentum in 2017. Export growth has remained sluggish owing to low global investment and weaker external competitiveness. Looking ahead, the Republic of Korea is projected to grow by 2.8 per cent to 2.9 per cent annually during 2017-2018, supported by the continued expansion of domestic demand. Economic activity will, however, be weighed down by weak employment growth and corporate restructuring of distressed firms that are facing rising insolvency risks.

Output growth in Indonesia, the Philippines and Thailand accelerated

Among the larger Association of Southeast Asian Nations (ASEAN) economies, output growth in Indonesia, the Philippines and Thailand is estimated to have accelerated in 2016, driven by stronger domestic demand. Indonesia is expected to grow by 5.1 per cent to 5.3 per cent annually during 2016-2018, up from 4.8 per cent in 2015. Private consumption has benefited from lower inflation, which also allowed the Central Bank of Indonesia to make multiple rate cuts. Policy measures, such as higher minimum wages and an increase in the tax-free threshold, were also introduced to support household incomes. Meanwhile, the Philippines is estimated to have grown by 6.3 per cent in 2016, up from 5.9 per cent in 2015, and is expected to expand by 6.0 per cent to 6.1 per cent annually during 2017-2018. Household spending grew at a strong pace, underpinned by favourable employment conditions, larger remittance inflows, higher public sector salaries and an increase in government spending, particularly preceding the general election in May 2016. In Thailand, the economy is estimated to grow at an annual pace of 3.1 per cent to 3.4 per cent between 2016 and 2018, up from 2.8 per cent in 2015. Both public consumption and investment rose considerably, as a result of an increase in public sector salaries, higher social transfers and the implementation of large-scale infrastructure projects. The transition related to the royal succession could lead to some temporary slowdown of economic activities, but the impacts are not expected to be significant. In contrast, growth in Malaysia is estimated to have moderated to 4.4 per cent in 2016 from 5 per cent in 2015. The slowdown is a result of subdued domestic demand and worsening net exports. In particular, consumer spending — the main growth driver in recent years — was held back by less robust job markets and households' adjustment to the higher cost of living, especially since the introduction of the goods and services tax in 2015.

Growth in Singapore is also expected to have decelerated to 1.7 per cent in 2016, down from 2.0 per cent in 2015, due to subdued externally-oriented service sectors and manufacturing production. Growth is projected to improve to 2.4 per cent to 2.6 per cent in 2017 and 2018, supported by a modest recovery in global and regional trade.

Hong Kong SAR and Taiwan Province of China saw the slowest growth among larger economies

Hong Kong Special Administrative Region (SAR) of China and Taiwan Province of China are estimated to have experienced the slowest growth among the larger economies in the region in 2016, growing by 1.4 per cent and 0.9 per cent, respectively. In Hong Kong SAR, prolonged weakness in the external sector and recent asset market corrections undermined business sentiments. Private consumption remains a key growth driver, but retail sector performance was mixed amid a continued slowdown in tourism. In Taiwan Province of China, private investment continued its previous weak trend in 2016 and household consumption growth was dampened by weak or even negative real wage growth during the year. Growth in both economies is expected to recover in 2017 and 2018, conditional on improvements in external demand conditions.

Domestic credit growth has not increased significantly despite loose monetary policy

Policy rates across major economies in the region approached or reached historic low levels in 2016. With few exceptions, there remains some — albeit limited — room for further rate cuts, especially given the overall low inflationary environment. However, concerns regarding large capital outflows have weighed on central banks' rate-cut decisions, as the region saw the greatest annual net capital outflow on record in 2015. High levels of household and corporate debt — and possibly narrowing banks' profit margins — have also factored into central banks' decisions. The effectiveness of monetary easing also appears to be waning as domestic credit growth has not increased significantly despite the overall loose monetary stance across the region.

Financial markets in the region were broadly stable in 2016

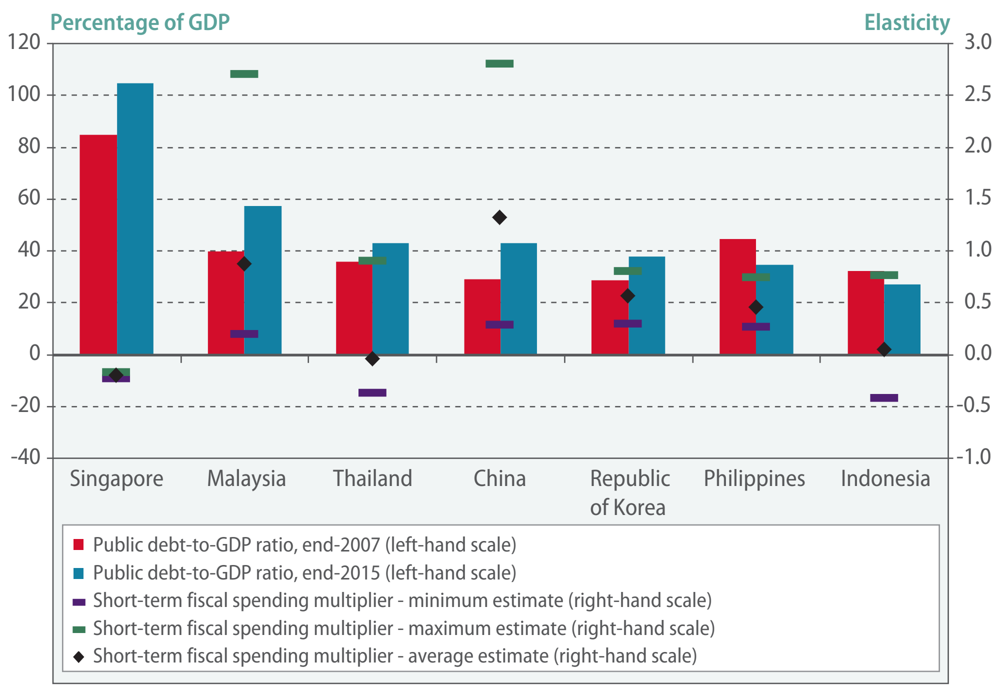
As domestic credit growth did not see much acceleration, regional financial markets were broadly stable in 2016. The Renminbi's exchange rate against the United States dollar and its effective exchange rate depreciated consistently during 2016, with the former reaching the lowest level since 2010. For most of the other major currencies in the region, the effective exchange rate experienced less volatility in 2016 than in 2015.

Room for more active fiscal intervention exists…

With many economies facing relatively limited room for furthering monetary easing, the fiscal stance in East Asia has been mostly expansionary and countercyclical to support growth. Overall fiscal balances worsened in 2015 across the region and this trend is projected to continue going forward, resulting in higher public debt. Nevertheless, given the still relatively low public debt levels (figure IV.11), economies in the region could engage in more active fiscal intervention, particularly in the areas of infrastructure and social spending, which would support the region's long-term potential growth.

Figure IV.11

Public debt and short-term fiscal spending multipliers of selected economies in East Asia (*2007 vs. 2015*)



Source: IMF Fiscal Monitor October 2016 and existing literature on estimates of Asian economies' fiscal multipliers.

Note: Estimates of fiscal multipliers are obtained from a number of studies published during 2006-2013. Short-term multipliers for most studies refer to first-year multipliers in non-recession times. Tax multipliers are not covered in this chart. The range of estimates presented here is intended to be indicative, rather than exhaustive, and estimates are not strictly comparable.

…but effectiveness of fiscal spending in supporting output growth varies across the region

Existing estimates of fiscal multipliers show that the effectiveness of fiscal spending varies significantly across economies in the region (figure IV.11). In particular, fiscal multipliers of a few smaller, open economies are estimated to be possibly negative, which could be a reflection of country-specific characteristics, the phase of economic cycle, the choice of fiscal instruments and the targeted area of fiscal spending. In view of this, economies would have to identify the most effective means of fiscal intervention to maximize its positive impact on growth.

Trade growth has been exceptionally weak in East Asia

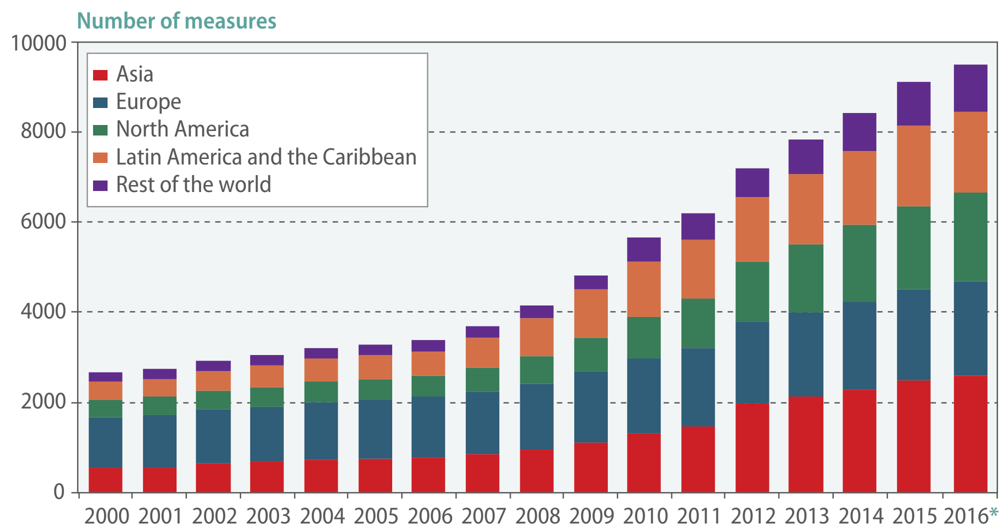
East Asia has until recently been the engine for global trade. However, trade in the region has been exceptionally weak in 2015 and 2016, weighed down by a slowdown in the developed economies and major economies in the region. Structural factors such as economic rebalancing in China are also at play, with the country's import composition expected to gradually shift away from intermediate goods and capital goods, which currently account for over 70 per cent of the region's exports to China. Even though tariff rates have fallen significantly for over a decade, non-tariff measures on goods appear to be on the rise (figure IV.12). While cumulative non-tariff measures imposed on East Asia experienced a steady increase between 2000 and 2015, the pace appears to have accelerated during the post-crisis period. These barriers may have partly contributed to the weak export performance in recent years. Growth in the value of services exports of the region has been declining since 2010 and became negative in 2015 and early 2016, even as global services trade has been gaining relative importance during the same period. This may be a cause for concern considering that the average share of value added by services in total exports is over 55 per cent for the region's top five trading economies (China, Republic of Korea, Hong Kong SAR, Taiwan Province of China and Singapore).

Relatively optimistic regional outlook is clouded by considerable uncertainties

While the economic outlook is relatively more optimistic for East Asia compared to most of the other developing regions, risks for the region remain tilted to the downside. Factors that could drive faster economic growth in 2017, such as stronger demand in developed economies, higher global commodity prices and rising infrastructure investment are subject to considerable uncertainty. High and rising corporate and household debt in several economies in the region, including China, pose downside risks to growth. If not

Figure IV.12

Cumulative total of non-tariff measures imposed on goods from East Asia, by imposing regional group, 2000–2016



Source: WTO Integrated Trade Intelligence Portal.

Note: East Asia here covers 22 of the major trading economies in the region, excluding Japan. Data shows the end-of-year number for each year. Data for 2016 covers the period to 30 September 2016.

adequately addressed, this could further add to Governments' contingent liabilities, curbing engagement in supportive fiscal measures.

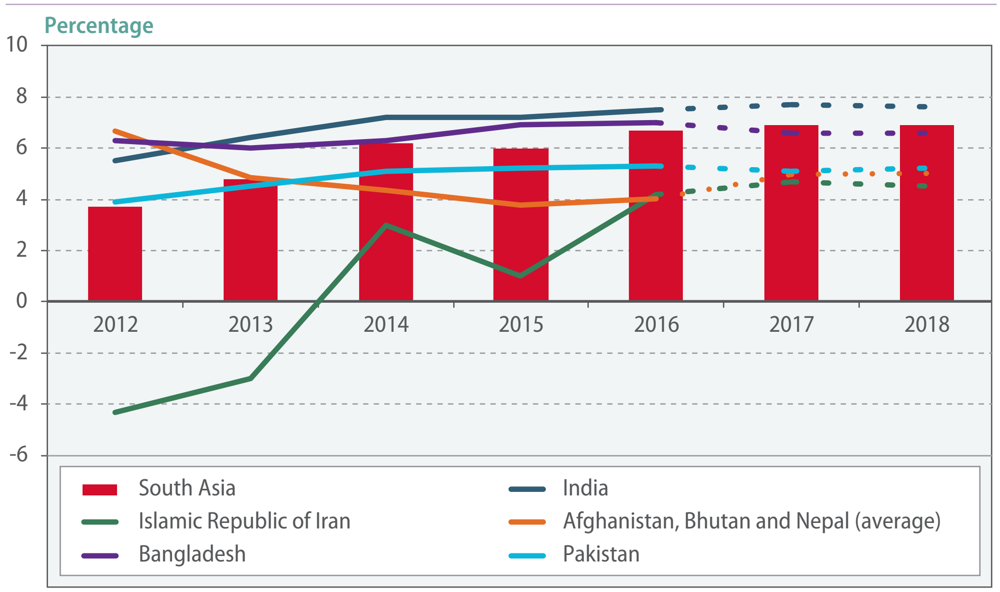
South Asia: positive economic outlook supported by robust private consumption

South Asia is the fastest-growing developing region and its economic outlook remains largely positive, benefiting from robust private consumption, a modest pickup in investment and the continuing implementation of domestic reforms. Macroeconomic policies have also played a positive role: monetary policy continues to provide support to economic activity, while the fiscal policy stance remains moderately tight but with some degrees of flexibility. Against this backdrop, regional GDP growth is expected to remain robust, reaching 6.9 per cent in 2017 and 2018, following 6.7 per cent in 2016 (figure IV.13). However, the relative weakness of investment demand in some countries underscores the need for continuous reform efforts. After slowing to a multiyear-low of 6.2 per cent in 2016, regional inflation is expected to remain relatively low and stable. Overall, the positive economic outlook will likely enable further progress in labour market indicators, albeit gradual and moderate, and a reduction in poverty in the coming years.

Despite vigorous growth, private investment remains subdued in several economies

The favourable outlook is contingent on the continuing strength of private consumption, which has recently been pushed up by accommodative monetary policies and other stimulus measures such as public salary increases in Bangladesh, India and Nepal. However, recent signs of stagnation in remittance flows could negatively affect this trend in some countries, such as Bangladesh, Nepal and Pakistan. Meanwhile, investment demand continues to display an anaemic performance. The transmission mechanism from monetary policy remains weak, and corporates with stressed balance sheets are channelling cash flows towards deleveraging rather than to expansion projects. Against this backdrop, public investments in infrastructure have been critical to avoid a further deterioration in investment demand, notably in India. In the outlook period, a key challenge in this regard

Figure IV.13
GDP growth for selected countries in South Asia, 2012–2018



Source: UN/DESA, based on United Nations Statistics Division National Accounts Main Aggregates Database.
Note: GDP growth rates are adjusted to calendar year. Figures for 2016 are partially estimated. Figures for 2017 and 2018 are forecast.

is to generate a crowding-in of private investment. This is particularly important given the large infrastructure and energy deficits, which remain a major structural barrier to a more inclusive and sustained growth across the region. Meanwhile, exports remain constrained in many countries owing to subdued global growth and trade flows, uncompetitive real exchange rates in smaller economies, and structural impediments to increase production.

Economic activity in India is further benefiting from domestic reforms

Among the largest countries, India has positioned itself as the most dynamic emerging economy. India's economy is projected to expand by 7.7 per cent and 7.6 per cent in 2017 and 2018, respectively, benefiting from strong private consumption. Investment demand is expected to slightly pick up, helped by monetary easing, government efforts towards infrastructure investments and public-private partnerships, and the implementation of domestic reforms such as the introduction of the Goods and Services Tax (GST) Bill. This reform constitutes a major change by establishing a new uniform tax rate, and it should promote investment in the medium term through lower transaction and logistic costs and efficiency gains. Importantly, an effective GST implementation also requires adequate capacity building of the tax administration. Nevertheless, low capacity utilization and stressed balance sheets of banks and businesses will prevent a strong investment revival in the short term.

The outlook for the Islamic Republic of Iran is strengthening visibly. This can be attributed to the strong expansion of oil production and exports (international sanctions were lifted by early 2016), lower inflation, increasing business confidence, and a surge in foreign investments. GDP growth is estimated to have accelerated to 4.3 per cent in 2016, with an expected further pickup to 4.7 per cent and 4.4 per cent in 2017 and 2018, respectively.

In Pakistan, economic growth is also projected to remain robust, above 5.0 per cent. Economic activity will be driven by strong consumption, a supportive monetary policy stance and rising investment and infrastructure projects boosted by the China-Pakistan Economic Corridor. Against this backdrop, youth unemployment is expected to slightly decline in the near term. Among smaller economies, the outlook for Sri Lanka's economy has recently improved after serious balance of payments and debt turbulences in early 2016. Economic activity will, however, likely remain constrained by fiscal consolidation measures and a tight monetary stance implemented to contain external risks.

Accommodative monetary policies are expected to continue in the near term

Amid relatively low inflationary pressures, monetary policies in South Asia are moderately accommodative. The supportive monetary stance is expected to continue in the near term, with potential further easing in India, the Islamic Republic of Iran and Pakistan. However, credit growth remains below trend in several countries, especially in industrial and infrastructure sectors in India. Fragilities in the banking sector and stressed balanced sheets of corporates remain important challenges for some economies. For instance, the Government of India committed to a $3.7 billion package to recapitalize state-owned banks, and various regulations have been introduced in order to reduce banks' financial exposures and to encourage private participation in the banking sector. Although countries should try to avoid a sudden tightening of monetary and liquidity conditions in the outlook period, policy measures will critically depend on the evolution of external factors, such as oil prices.

Despite high deficits, fiscal policy shows some flexibility in several countries…

Most South Asian Governments have announced relatively tight fiscal stances. However, during the implementation, Governments have tended to provide more support for their economies, responding to large development needs and political pressures. In India, in spite of a strong emphasis on rural areas and infrastructure investments on the expenditure side, fiscal policy has largely followed a cautious approach and the budget deficit is expected to further decline gradually. For 2016/17, the deficit is projected to reach 3.5 per cent of GDP and is on track to meet the medium-term target of 3.0 per cent of GDP.

In Bangladesh and Pakistan, fiscal policy is gradually becoming more expansionary, and thus deficits are expected to remain elevated. In Sri Lanka, the fiscal deficit is relatively high and the efforts to reduce it are tilted to the revenue side, as the country has one of the lowest tax-to-GDP ratios in the world. Sri Lanka recently received a three-year Extended Fund Facility (EFF) of $1.5 billion from the International Monetary Fund (IMF) to support the reform agenda.

…but raising tax-to-GDP ratios remains a key challenge across the region

Against this backdrop, fiscal deficits are expected to remain elevated in most economies, and recent large increases in wages and other benefits in the public sector are likely to further reduce fiscal space. From a medium-term perspective, key fiscal challenges for the region are to improve tax revenues and to promote a supportive environment for the private sector, which together can enhance the capacity to implement counter-cyclical policies.

In fact, most economies are constrained by very low tax-to-GDP ratios in comparison to other developing regions and high debt-to-GDP ratios (figure IV.14). Despite increasing efforts to strengthen tax revenues and the efficiency of the whole tax system, significant delays and problems remain. For instance, high levels of informality represent a major challenge to the implementation and potential benefits of tax reforms across the region.

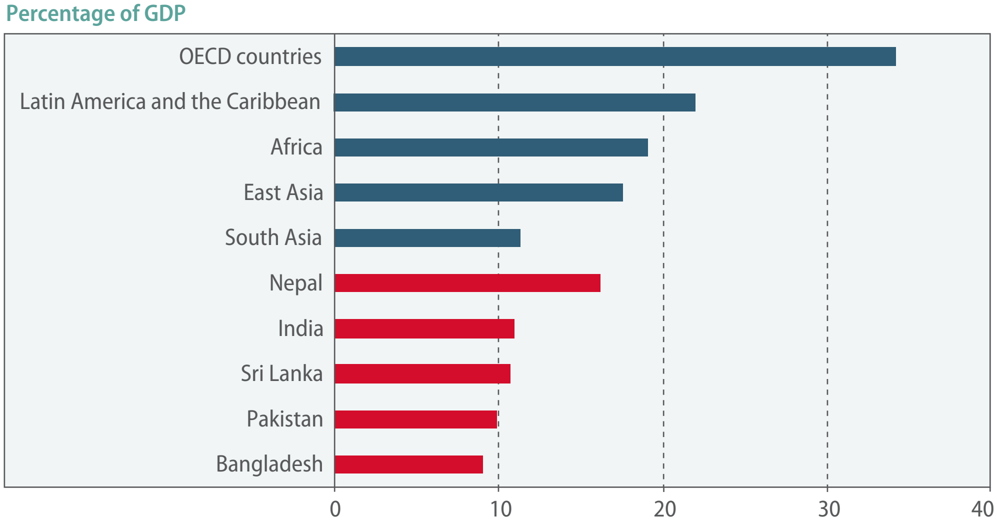
Domestic reforms should prioritize productivity growth

Despite the favourable outlook, South Asian economies face several downside risks. On the domestic front, the reform agenda could experience setbacks in some countries, while political instabilities might dampen investment prospects. Structural reforms in labour markets, financial sectors, public finances and competition are crucial to increase productivity growth across the region. Heightened regional geopolitical tensions could also weigh on the outlook. For example, intra-regional trade facilitation and integration projects could experience delays and obstacles, while large infrastructure investments to improve connectivity may face institutional uncertainty. On the external front, potential renewed episodes of high financial volatility, including a sudden surge in external borrowing costs and large capital outflows, could significantly increase the difficulties to roll over debt, especially in countries with relatively low financial buffers and high debt denominated in United States dollars.

Figure IV.14

Tax revenues in South Asia and world regions, latest available year

Percentage of GDP



Source: UN/DESA, based on data from IMF Government Finance Statistics and OECD.

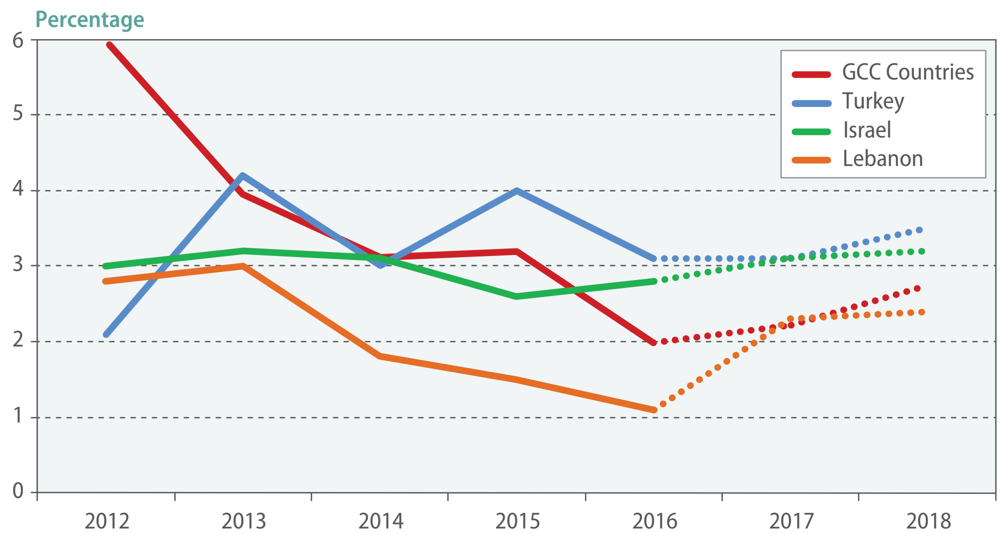
Note: Figures for Nepal, Pakistan and Sri Lanka are for FY2014; and figures for Bangladesh and India are for FY2013.

Western Asia: subdued growth and continuing macroeconomic adjustments

The economic outlook for Western Asia remains weak and turbulent amid macroeconomic adjustments in oil-dependent economies, ongoing conflicts and long-lasting geopolitical concerns. Regional GDP growth declined from 2.7 per cent in 2015 to an estimated 2.1 per cent in 2016, mainly due to deteriorating economic conditions in the countries of the Cooperation Council for the Arab States of the Gulf (GCC). In these economies, lower oil prices have seriously affected investment and government budgets, prompting Governments to undertake major reforms towards fiscal consolidation. While non-oil exporting economies exhibited a more heterogeneous outlook, military conflicts and geopolitical tensions continue to curb investment and restrain economic activity (box IV.3). Going forward, regional GDP growth is expected to remain subdued in 2017, but is likely to improve more visibly in 2018 as international oil prices and domestic demand recover. Average economic growth in the region is expected to reach 2.5 per cent in 2017 and 3.0 per cent in 2018. GCC countries have been experiencing a noticeable growth slowdown, with average GDP growth declining from 3.2 per cent in 2015 to 2.0 per cent in 2016 (figure IV.15).

The weakening of economic activity was especially pronounced in Oman, Saudi Arabia and the United Arab Emirates. Saudi Arabia is estimated to have grown by a meagre 1.1 per cent in 2016 — its slowest growth rate since the global financial crisis — as economic activity was dragged down by fiscal austerity, tumbling investment and a severe contraction in non-oil sectors. In 2017, investment and overall economic activity in the GCC countries are expected to remain largely subdued, amid slower growth in bank lending, increasing dependence of Governments on debt financing and rising interest rates in line with the Fed's tightening path. Alongside fiscal consolidation, these challenging conditions are likely to constrain and delay the recovery. As a result, GDP growth in GCC countries is projected to grow at a modest pace of 2.2 per cent and 2.8 per cent in 2017 and 2018, respectively.

Figure IV.15
GDP growth for selected countries in Western Asia, 2012–2018



Source: UN/DESA, based on United Nations Statistics Division National Accounts Main Aggregates Database.
Note: Figures for 2016 are partially estimated. Figures for 2017 and 2018 are forecast.

Conflicts and geopolitical concerns continue to restrain economic activity in several countries

Among the more diversified economies, Turkey is projected to continue growing at a moderate pace, expanding by 3.1 per cent in 2017 and 3.5 per cent in 2018, supported by resilient domestic demand. Nevertheless, the Turkish economy faces considerable headwinds arising from pressures on fiscal and monetary policy stances, as well as security and political concerns. Likewise, Israel's economy is expected to continue on a moderate growth trend, with GDP expanding above 3.0 per cent per annum in the outlook period, underpinned by relatively robust domestic demand.

Despite recent improvements in the terms of trade, weak economic conditions have prevailed in Jordan and Lebanon as the impact of the Syrian crisis became more widespread. In countries experiencing military conflicts such as Iraq, the Syrian Arab Republic and Yemen, the economy is in a perilous state. The economies of the Syrian Arab Republic and Yemen are estimated to have contracted further in 2016, due to the intensification of armed conflicts and severe foreign exchange constraints.

Meanwhile, Iraq is expected to continue experiencing positive growth, but this will be entirely driven by the expansion of oil production. So far, Iraq has shown little progress on the appropriate use of oil rents to promote non-oil productive sectors and the diversification of its economic structure.

High youth unemployment remains a key labour market challenge

Labour markets have deteriorated in both the GCC countries and the more diversified economies of the region. Unemployment rates have risen, while job creation has been hampered by the growth slowdown, particularly in the GCC countries. Consequently, several countries are implementing labour market reforms to adjust to the more challenging economic conditions. Some labour market reforms in Bahrain, Oman, and Saudi Arabia have been mainly aimed at prioritizing national workers. These measures are likely to affect the dominance of expatriate workers in the service sector. In Saudi Arabia, a slight decline in youth unemployment of national workers has recently been observed. Kuwait, Qatar and the United Arab Emirates have undertaken reforms to increase labour market flexibility, including measures to ease the mobility of foreign workers.

In addition, non-economic factors continue to hamper labour markets across the region. Conflicts have caused large-scale unemployment in Iraq, the Syrian Arab Republic and Yemen, with some negative spillover effects to the labour markets of Jordan, Lebanon and Turkey. Overall, the labour market situation in the region is not expected to improve significantly in the near term; structural unemployment is expected to remain high, particularly among the youth, amid a widespread lack of decent work.

Relatively high inflation constrains Turkey's monetary policy space

The inflation outlook remains tame in most economies, given subdued domestic demand and the relatively low level of commodity prices. In the GCC countries, inflation is expected to remain low and stable, below 4.0 per cent, following the trend of previous years. In contrast, inflation in Turkey has remained relatively high, well above the official target of 5.0 per cent, as the lira continued to depreciate, offsetting the effect of lower commodity prices. In the outlook period, inflation in Turkey is expected to remain relatively high, limiting space for monetary policy to support growth. Inflationary pressures in the Syrian Arab Republic and Yemen will also remain elevated, due to the significant shortages of goods, the depreciation of domestic currencies and the monetization of fiscal budgets.

Monetary policy is gradually tightening in GCC countries

A gradual tightening of monetary policy stances has been observed across the region. This trend is expected to continue following the expected increase in the Fed funds rate. Furthermore, liquidity conditions have deteriorated in most GCC countries throughout 2016, and borrowing costs have risen visibly. In August, the interbank interest rate in Saudi Arabia reached the highest level since the financial crisis. Credit growth has also decelerat-

Box IV.3

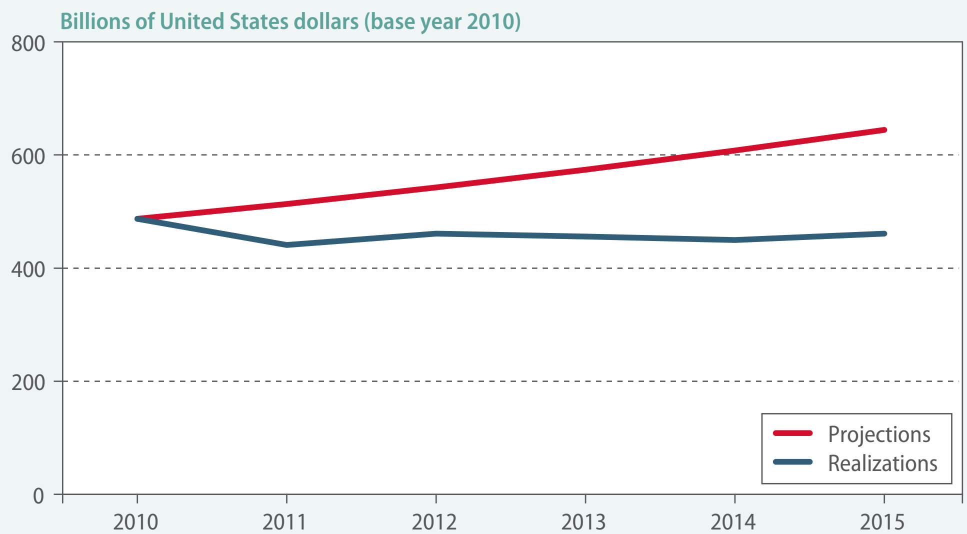
The impact of unrest and conflict in the Arab region

The collective political changes and movements that began across the Arab region in 2011 have had significant economic, social and institutional impacts over the course of the past five years. Furthermore, the region is still undergoing strong political turbulence, replete with uncertainty, insecurity and, in some cases, conflict. Many of these conflicts, in the Syrian Arab Republic and also in Yemen, have witnessed an increasing intensity in terms of violence, deaths, forced migration and displacement and the destruction of economic capital, with significant spillover effects on neighbours across the region. Economic literature has demonstrated the long-term economic impact of conflict. For instance, Gates and others (2010) note that conflict can not only knock a country off its growth path, but also prevent the country from returning to its previous growth trajectory long after the conflict ends. Similarly, Collier and others (2003) emphasize that conflicts reduce both the rate of growth and the level of GDP.

In order to examine the lasting economic impact of conflict on the countries of the Arab region, the Economic and Social Commission for Western Asia (ESCWA, 2016) compares pre-crisis projections made in 2010 by the IMF and national Governments for a number of macroeconomic variables — namely GDP and fiscal balance — with observations as of end-2015 (figure IV.3.1 and figure IV.3.2). Countries are classified in two groups: those engaged in ongoing conflict since 2011 (Libya, the Syrian Arab Republic and Yemen) and countries affected by spillover effects of conflicts (Egypt, Jordan, Lebanon and Tunisia). Together these two groups constitute "countries in and affected by conflicts".

Figure IV.3.1

Level of GDP: countries in and affected by conflicts, 2010–2015



Source: ESCWA, based on IMF Article IV consultations (2008-2014).

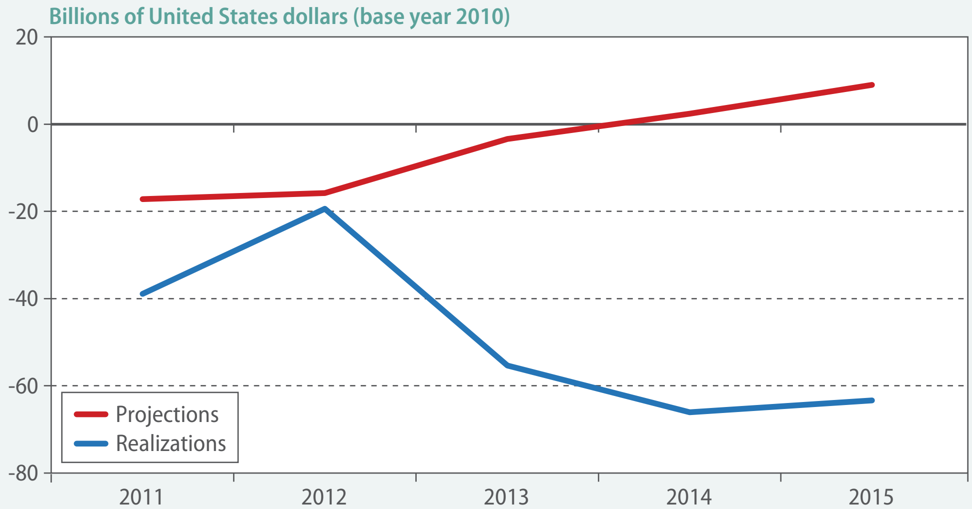
Note: Countries engaged in conflict since 2011: Libya, the Syrian Arab Republic and Yemen; countries affected by conflicts: Egypt, Jordan, Lebanon and Tunisia.

The aggregate results from this analysis indicate that as compared with pre-crisis projections, countries in and affected by conflict have lost a cumulative $613.8 billion in foregone GDP since 2010, representing 6 per cent of the Arab region's GDP. More specifically, Libya and the Syrian Arab Republic witnessed the greatest cumulative losses, at $227 billion and $169 billion, respectively. The main channels are the lower production activities and trade, weak investment as a result of large uncertainties plaguing the political and business environments, the flight of human capital and the significant destruction of physical capital. At the country level, some specific challenges are, for instance, the stoppage of energy exports and the damage to the agricultural sector in Yemen; the capital flight and subsequent pressure

(*continued*)

Box IV.3 (*continued*)

Figure IV.3.2
Fiscal balance: countries in and affected by conflicts, 2011–2015



Source: ESCWA, based on IMF Article IV consultations (2008-2014).
Note: Countries engaged in conflict since 2011: Libya, the Syrian Arab Republic and Yemen; countries affected by conflicts: Egypt, Jordan, Lebanon and Tunisia.

on the balance-of-payments in Egypt; falling oil revenues, weaker domestic demand and exodus of foreign labour in Libya; and insufficient financial resources to host refugees in Jordan and Lebanon.

The fiscal accounts have also been severely affected. In particular, the cumulative fiscal deficit for countries in and affected by conflicts is $218 billion larger than was previously projected. The fiscal balance had been projected to achieve a 1.1 per cent surplus in terms of nominal GDP in 2015, but actually registered a deficit of 11.7 per cent of GDP. Budget difficulties arise for a number of reasons, including the need for higher spending to mitigate the effects of conflicts on security and to provide services for vulnerable and displaced populations. Tax revenues declined due to uncertainties, and a poor business climate also came into play.

The negative economic impact has been compounded by a large-scale displacement of the population in Iraq, Libya, the Syrian Arab Republic and Yemen. Matching skills and production facilities became immensely difficult due to the dislocation of talented workers and the destruction of factories and infrastructure. In short, the labour market ceased functioning, negatively impacting the level and growth of productivity of economic sectors and activities that have managed to survive. Thus, in addition to the humanitarian sufferings of individual refugees and the internally displaced population, the productive sector has severely suffered from labour market disruptions.

Besides these direct impacts, conflicts have halted progress across the Arab world in pursuing regional integration, such as implementing the Greater Arab Free Trade Agreement, breaking ground and completing regional infrastructure for transport, water, electricity, oil and gas through various multilateral and bilateral initiatives within the region. However, regional integration does represent a policy option for strengthening cross-country ties and helping to prevent future conflicts and economic disruptions. Regional trade is in fact increasingly important for countries in conflict such as the Syrian Arab Republic, where informal cross-border trade with its immediate neighbours fills in for falling trade with other partners.

Plans for post-conflict reconstruction have been formulated, such as the National Agenda for the Future of the Syrian Arab Republic. This plan encompasses $183.5 billion in public investments, which is equal to the sum of cumulative capital loss during the conflict and the investments intended under the pre-conflict national growth plan. A key aspect of the plan is to boost economic growth through multiplier effects and to crowd-in large private investments. Given the destruction and disruptions experienced across the region, bridging the enormous financing gap for reconstruction will certainly require a combination of different sources: Official Development Assistance (ODA) from donors and external partners, private and public financial resources and surpluses from the Arab region.

Author: John Robert Sloan (UN/ESCWA)

ed, particularly in Oman, Saudi Arabia and the United Arab Emirates. As GCC economies are projected to follow the Fed's interest rate decisions, given their pegs to the United States dollar, monetary authorities may introduce different measures to boost liquidity, including changes in reserve requirements. Most of these economies continue to benefit from large international reserves and, despite increasing current account deficits, there are no signs of severe external constraints. Saudi Arabia's foreign reserves stood in the first half of 2016 at the equivalent of 29 months of imports of goods and services. Countries with lower reserve levels, such as the United Arab Emirates, have already seen improvements in their current accounts.

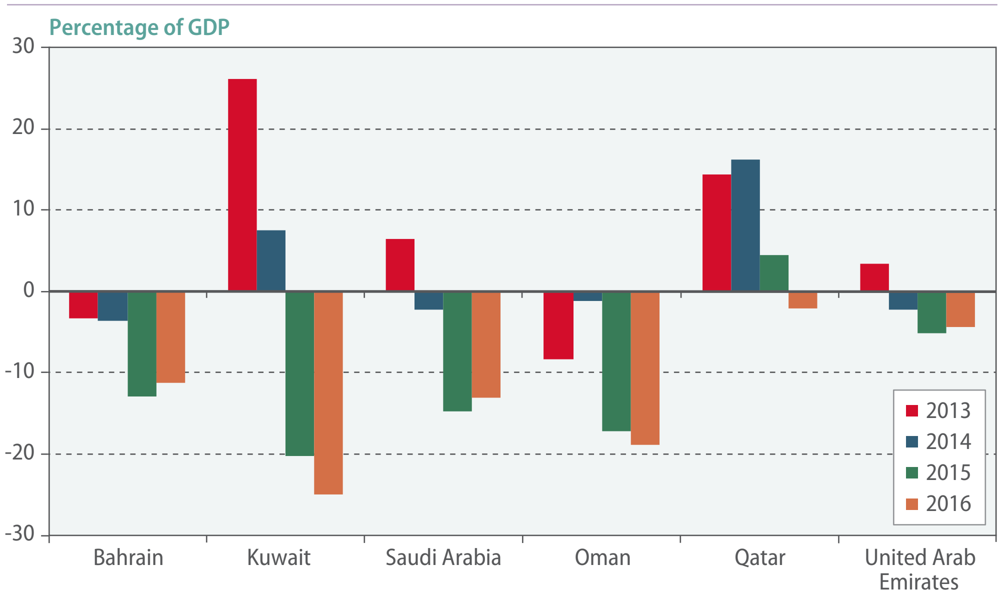
Despite higher fiscal deficits, public debt in GCC countries remains sustainable

Against a backdrop of lower oil prices, the GCC countries are currently undertaking fiscal consolidation. Several policy measures have been introduced in order to address the rising deficits, including spending and subsidy cuts, tax increases and new issuances of debt. Notably, capital expenditures have been less affected, illustrating the priority given to large infrastructure projects. With respect to new debt issuance, Saudi Arabia recently raised $17.5 billion, the largest-ever bond sale made by an emerging economy. The introduction of a regional value-added tax and privatization plans in some economies are also on the agenda. Despite these efforts, fiscal deficits have widened in most GCC countries (figure IV.16), but public debt remains at a sustainable level. Policymakers face the challenge of striking a balance between the use of sovereign wealth funds, the level and composition of further expenditure cuts and the introduction of direct and indirect taxes to increase non-oil fiscal revenues. In Turkey, fiscal policy is expected to remain tight, in order to maintain public debt levels and contain renewed pressures on the current account. The fiscal situation in Iraq, the Syrian Arab Republic and Yemen has further worsened owing to fragile revenues, increasing expenditures and over-reliance on debt financing.

Progress towards the SDGs is severely affected by armed conflicts

There are a number of risks to the regional outlook. The expansion of armed conflicts and the escalation of geopolitical tensions will worsen the already severe impact on the short and medium-term economic and development prospects, hindering progress towards the Sustainable Development Goals (SDGs). A potential sharp decline in oil prices will serious-

Figure IV.16
Fiscal deficits in GCC countries, 2013–2016



Source: UN/DESA and UN/ESCWA.
Note: Figures for 2016 are estimates.

ly affect the economic situation in the oil-exporting economies. The regional outlook will also be affected by external developments. For instance, higher interest rates in the United States might lead to tighter global credit conditions, making it even more difficult to revive investment demand in the GCC countries.

Latin America and the Caribbean: a return to positive growth is projected for 2017

After contracting for two consecutive years, the economy of Latin America and the Caribbean is expected to return to positive growth in 2017. The region's aggregate GDP is projected to increase by 1.3 per cent in 2017 and by 2.1 per cent in 2018, following an estimated decline of 1.0 per cent in 2016. While the region continues to face significant internal and external headwinds, economic growth is forecast to gradually pick up in most countries. South America is expected to see a modest cyclical recovery from the severe downturn of 2015 and 2016, with Argentina and Brazil, the subregion's two largest economies, set to emerge from recession. Several factors are likely to support this recovery, including a strengthening of external demand, an increase in international commodity prices, a decline in political uncertainty, and some monetary easing amid lower inflation. Average growth in South America will, however, remain fairly weak, weighed down by a rise in unemployment and ongoing fiscal consolidation (box IV.4).

The economic situation and prospects in Mexico and Central America and the Caribbean are generally more favourable as most countries depend less on commodity exports. However, growth projections for both subregions have been downgraded from earlier forecasts in the face of weaker-than-expected activity in the United States, persistent structural constraints (including high debt and unemployment, low productivity growth, and weak institutional capacity) and limited macroeconomic policy space.

The region continues to face significant external risks

The outlook for Latin America and the Caribbean is subject to significant downside risks. These include a sharper-than-expected deceleration in China, the adoption of protectionist measures by the new Administration in the United States and renewed financial market turbulences. The latter could, for example, be triggered by a faster-than-expected pace of interest rate hikes in the United States. A rebound in commodity prices and unexpectedly strong demand from developed economies, in particular the United States, present upside risks for many countries.

Subdued medium-term outlook could hamper progress towards the SDGs

The subdued medium-term outlook for Latin America and the Caribbean poses a threat to the social achievements of the past decade and could significantly complicate the region's path towards the realization of the SDGs. These challenges underscore the importance of reorienting macroeconomic and other policies, with a view to promote investment in physical and human capital and strengthen the innovative capacities across the region.

Several South American economies experienced contractions in 2016

In the face of ongoing global uncertainty and a slump in domestic demand, South America's GDP contracted for a second consecutive year in 2016. After declining by 1.9 per cent in 2015, the subregion's output is estimated to have fallen by 2.3 per cent in 2016 amid recessions in Argentina, Brazil, Ecuador and the Bolivarian Republic of Venezuela, and slow growth in Chile and Colombia. Brazil has witnessed the deepest recession on record during the past two years. The cumulative decline in Brazil's economic output since late 2014 exceeds 8 per cent as severe macroeconomic imbalances and a political crisis led to a sharp contraction of domestic demand. The Venezuelan economy faces an even deeper crisis amid large financing needs, shortages of basic goods, and spiralling inflation. GDP is estimated to have fallen by about 8 per cent in 2016, bringing the cumulative output contraction since 2013 to almost 20 per cent. Among the few bright spots in the sub-

Box IV. 4

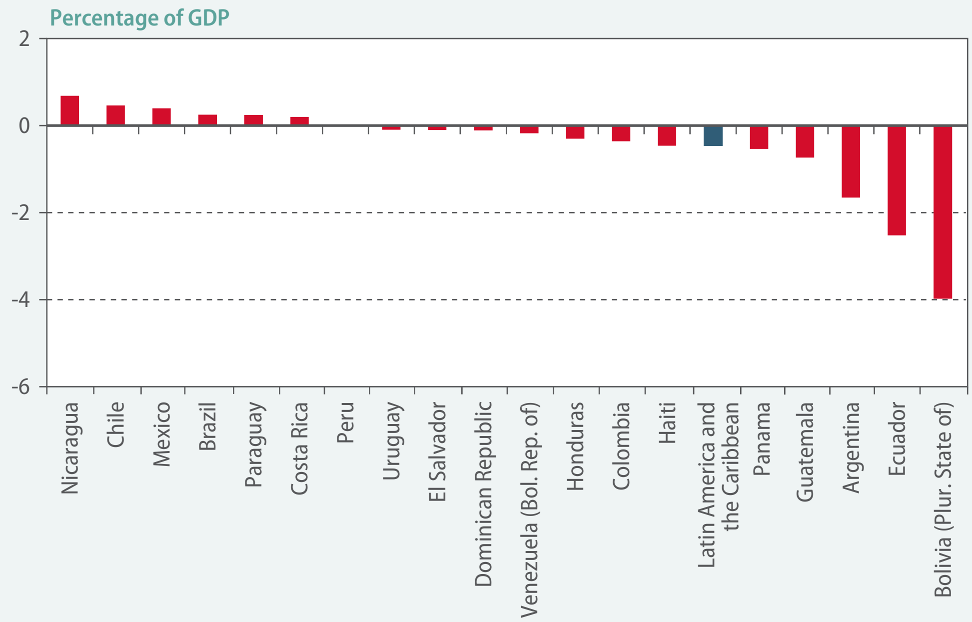
Fiscal challenges in Latin America and the Caribbean

Fiscal positions in Latin America and the Caribbean diverged in 2015 and 2016. In the South American countries, fiscal deficits increased as reductions in public expenditures were more than offset by declines in revenues amid faltering economic growth and plummeting commodity-related revenues. In contrast, in Central America and parts of the Caribbean, including the Dominican Republic, fiscal deficits declined moderately from 2014 to 2016 owing to reduced government outlays and slightly higher revenues. Public debt levels have generally been on the rise, especially in South American countries.

A key concern arising from fiscal consolidation measures that were introduced in 2015 and 2016 has been their impact on public investment. Capital expenditures at the central government level were down by 0.5 percentage points of GDP in 2015 from a year ago, with some countries registering large reductions (figure IV.4.1). The marked declines in the Plurinational State of Bolivia and Ecuador were largely the result of significantly lower hydrocarbon-related revenues, which in previous years had boosted public investment levels to historic levels. Preliminary data for 2016 suggests that lower commodity-related revenues have also weighed on public investment in several other countries, including Colombia and Peru.

Figures IV.4.1

Change in central government capital expenditures in Latin America and the Caribbean, 2014–2015 (*year-on-year*)



Source: UN/ECLAC, based on official national data.

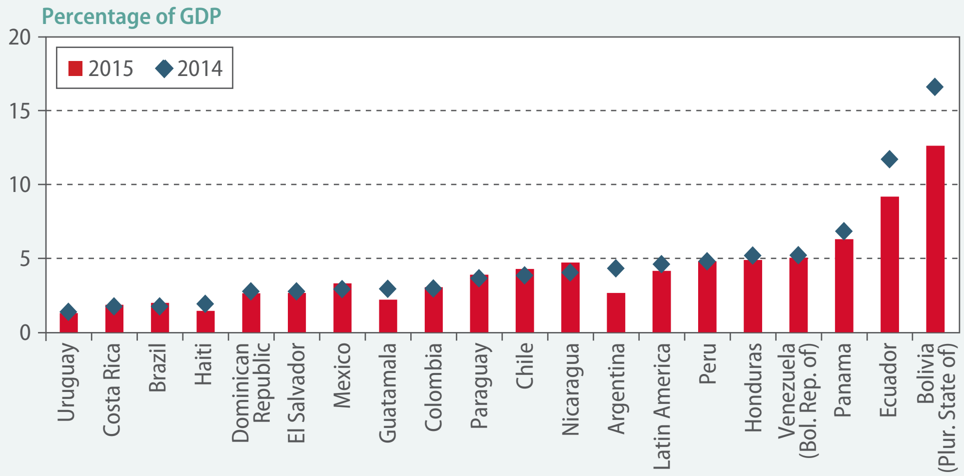
Declining public investment is of particular concern given its already modest level in Latin America and the Caribbean, relative to GDP (figure IV.4.2). This is especially true for the region's largest economies, where capital expenditures are generally well below the regional average. Despite modest gains in 2015, Brazil and Mexico continued to rank among the region's countries with the lowest levels of public capital expenditures as a proportion of GDP. Persistently low levels of public investment, particularly in much-needed infrastructure and human capital development poses a risk to the medium-term and long-term potential growth of the Latin American economies. Austerity measures that involve deep capital expenditure cuts therefore threaten to undermine future fiscal sustainability by creating a vicious cycle: investment cuts engender lower growth, which in turn leads to greater reduction in public expenditures (ECLAC, 2016b).

In the context of a new "normal" of relatively slow economic growth, breaking the aforementioned vicious cycle and raising public investment to levels that are more in line with the commitments

(*continued*)

Box IV.4 (*continued*)

Figure IV.4.2
Central government capital expenditures in Latin America and the Caribbean, 2014–2015



Source: ECLAC (2016a).

embodied in the 2030 Agenda for Sustainable Development will require Latin America and the Caribbean countries to boost their tax revenues. Over the past decade, the region has made significant progress in increasing tax revenues, although in several countries, overall tax revenues remain below 20 per cent of GDP. Direct taxation remains very low when compared with other countries at a similar level of development. This is due to a number of factors, including structural deficiencies, such as low marginal tax rates and tax bases that have been hollowed out by exceptionally generous tax breaks, and harmful tax competition, among others. In addition, elevated tax evasion plays a pernicious role.

While tax evasion is not unique to Latin America and the Caribbean, it is particularly rampant in the region's largely informal economies and deprives national Governments of significant revenues that could be used to finance public investment and services. Latin American and the Caribbean countries on average collect only about 50 per cent of the revenues that their personal and corporate income tax systems should theoretically generate (ECLAC, 2016b). Evasion of the personal income tax ranges from 33 per cent in Peru to 70 per cent in Guatemala. Likewise, corporate tax evasion is estimated to span a range from 27 per cent in Brazil to over 60 per cent in Costa Rica, Ecuador and Guatemala. In 2015, it is estimated that the revenues foregone due to the evasion of these two taxes accounted for $220 billion, or 4.3 per cent of the region's GDP.

In this context, there has been growing understanding in recent years of the role that multinational enterprises and high net-worth individuals play in eroding the region's tax revenues. ECLAC (2016a) estimated that between 2004 and 2013, trade price manipulation resulted in a gross outflow of capital on the order of $765 billion. These illicit financial flows were found to be highly concentrated in products associated with global value chains, highlighting the potentially significant role of transfer pricing between associated enterprises in artificially reducing taxable income. Latin America and the Caribbean high net-worth individuals have also made extensive use of offshore finance to reduce their tax payments to their governments.

While estimates of the share of the region's wealth held abroad differ, Chile's recent partial tax amnesty for undeclared wealth abroad is an indication that this value is substantial. By the end of 2015, 7,832 declarations had been filed with the country's tax authority, registering approximately $20 billion in assets abroad and resulting in a tax payment of $1.5 billion.

Taken together, the evasion of personal and corporate income taxes as well as value-added taxes, have cost the region's Governments an estimated $340 billion in potential revenues in 2015 (ECLAC, 2016a). To put that number into context, total central government capital expenditures — including public investment in fixed capital and capital transfers — in Latin America and the Caribbean amounted to $154 billion in the same year. Closing the revenue gaps associated with tax evasion and avoidance would provide an important sustainable revenue stream for financing investments associated with the 2030 Agenda for Sustainable Development. While in past decades, tax reforms have favoured indirect taxes, such as value-added and commodity taxes, making progress towards the Sustainable Development Goals demands a strengthening of direct taxes, especially those on income and wealth.

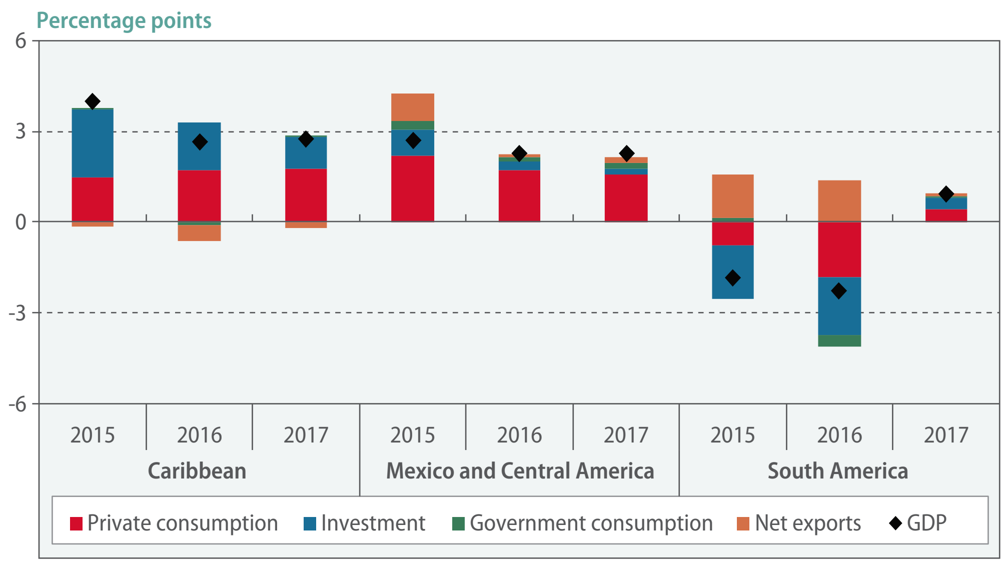
Author: Economic Development Division of UN/ECLAC

region are the Plurinational State of Bolivia and Peru, which defied the regional downturn, largely owing to strong private and government consumption.

The slump in investment in South America continued in 2016

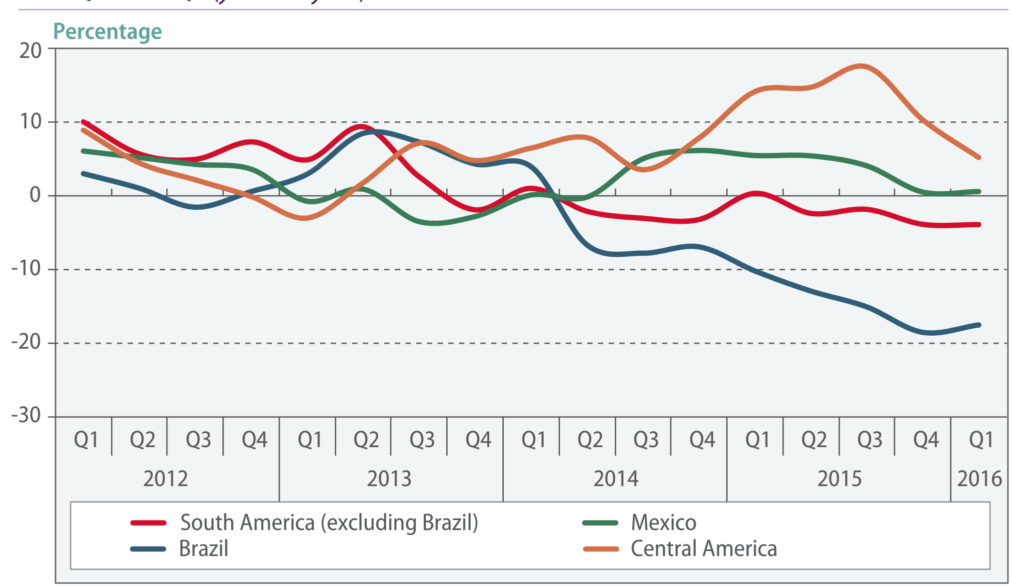
A closer examination of the expenditure components across South America reveals broad-based weakness, underscoring the challenges for the subregion going forward (figure IV.17). In most countries, fixed capital formation fell sharply in both 2015 and 2016 (figure IV.18), mainly due to a downturn in investment in the extractive industries and lower

Figure IV.17
Contributions to real GDP growth in Latin America and the Caribbean subregions, 2015–2017



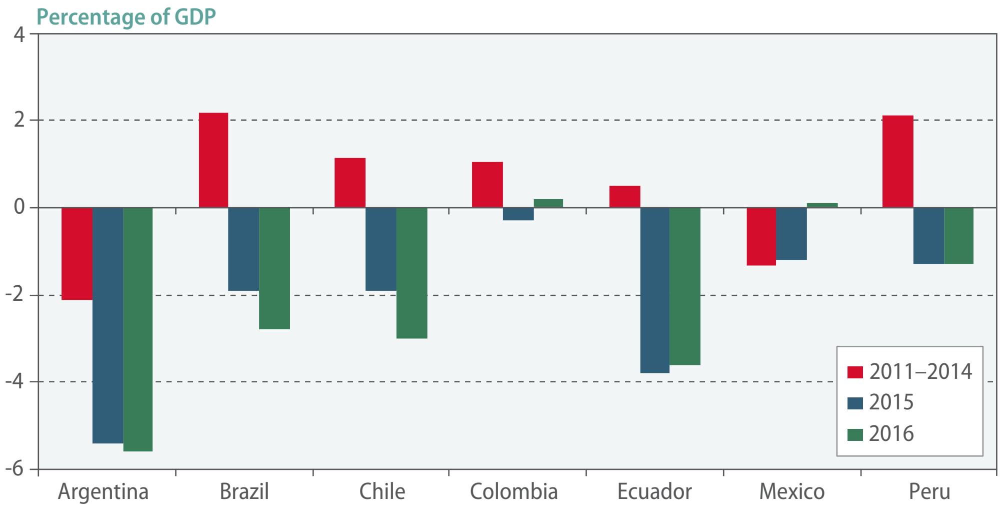
Source: UN/DESA, based on United Nations Statistics Division National Accounts Main Aggregates Database.
Note: Inventories and residual components are excluded, so individual components do not sum up to GDP growth. Figures for 2015 and 2016 are partially estimated. Figures for 2017 are forecast.

Figure IV.18
Changes in gross fixed capital formation in Latin America, 2012Q1–2016Q1 (*year-on-year*)



Source: UN/ECLAC, based on official figures.

Figure IV.19
General government primary balance in selected Latin American economies, 2011–2016



Source: UN/DESA, based on data from IMF Fiscal Monitor October 2016.

public investment. Tight monetary policies, elevated corporate debt levels as well as weak business and consumer sentiments have also weighed on investment activity in the region.

Regional unemployment has risen notably amid deterioration in South America's labour markets

In addition, South America's labour markets, which had shown some resilience in the early stages of the economic downturn, deteriorated considerably in 2016. Brazil's unemployment rate reached 11.8 per cent in the third quarter of 2016, up from 6.5 per cent in late 2014. Argentina, Chile, Colombia and Ecuador also registered increases in unemployment. Although unemployment declined in Mexico and most Central American and Caribbean countries, the average urban unemployment rate in the region rose sharply from 7.6 per cent in the first half of 2015 to 9.2 per cent in the first half of 2016. In the face of rising unemployment, elevated inflation and restrictive credit conditions, household consumption in South America weakened notably. Brazil suffered a particularly severe contraction in private consumption of about 5 per cent in 2016.

Fiscal tightening has compounded the slump in private demand

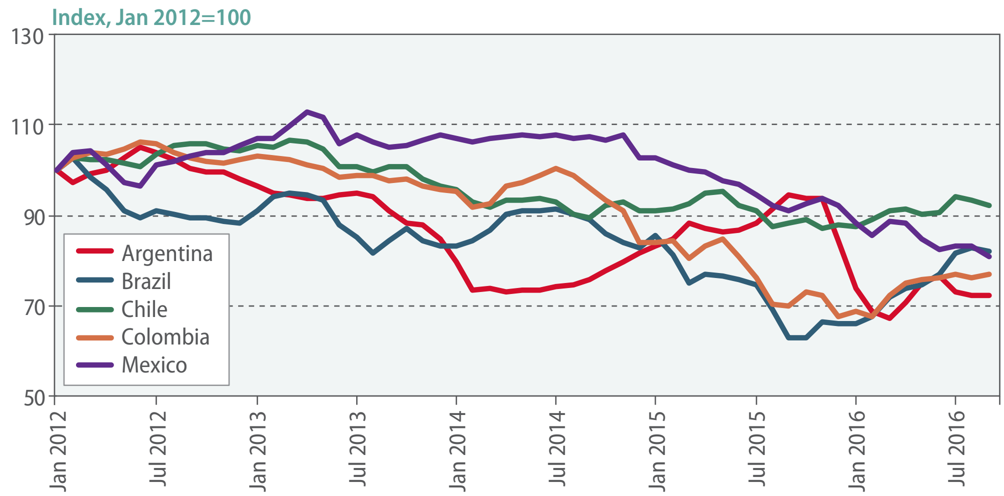
Since the commodity super cycle has come to an end, government budgets across Latin America have been under significant pressure, with primary deficits rising rapidly (figure IV.19). To offset declining revenues, several Governments, particularly in South America, implemented fiscal tightening measures in 2016, compounding the slump in private demand (figure IV.17).

Given the large decline in domestic demand — both private and public —, only a positive contribution from net trade prevented an even sharper downturn. Supported by more competitive national currencies, following large depreciations in 2013-15 (figure IV.20), exports showed some modest growth over the past year, whereas imports declined — in some cases steeply. In Brazil, for example, real exports of goods and services grew by an estimated 6 per cent in 2016, while real imports fell by about 10 per cent.

South America is expected to see a mild recovery

Looking ahead, South America is projected to see a mild — largely cyclical — recovery in 2017 and 2018. While economic activity has generally remained weak in 2016, some positive signs — both on the domestic and the external front — have started to emerge. In several countries, including Brazil and Colombia, consumer and business confidence have shown improvements. At the same time, net capital inflows and asset prices, including

Figure IV.20
Real effective exchange rates of selected economies in Latin America, January 2012–September 2016



Source: UN/DESA, based on data from the Bank for International Settlements.
Note: A reduction in the index value reflects a real effective depreciation of the currency.

domestic currencies, have recovered, following the slump in 2015. These positive trends reflect firmer commodity prices and a search for yield among international investors. At the same time, inflation has started to moderate in almost all South American countries owing to stronger domestic currencies, a diminishing impact of El Niño and the lack of demand pressures. With inflationary pressures in South America declining, average consumer price inflation in Latin America and the Caribbean is projected to slow from 9.2 per cent in 2016 to 6.1 per cent in 2017 (excluding the Bolivarian Republic of Venezuela).

Some monetary easing in South America is expected

Given lower inflationary pressures and more stable financial market conditions, the monetary tightening cycle in South America appears to be mostly over and some easing is projected for 2017 and 2018. In Argentina, the benchmark policy rate has already been lowered from 38 per cent in April 2016 to 26.75 per cent in early November. Brazil's central bank cut its main policy rate in October for the first time in four years to 14 per cent. In both countries, further easing is expected over the outlook period. A key question for South America, and in particular the recession-hit economies of Argentina and Brazil, is whether the positive trends on the monetary side (i.e. lower inflation and lower interest rates) can offset the negative impact on domestic demand associated with fiscal consolidation and rising unemployment. In most South American countries, fiscal policy will remain contractionary during the forecast period, but the adjustment is expected to be gradual in order to avoid strong downward pressure on aggregate demand. In some cases, notably Argentina and Brazil, a more credible and stringent fiscal policy, including forward guidance, could help support business confidence and investment.

Overall, the baseline forecast predicts a return to positive growth in Argentina and Brazil in 2017. The recovery is, however, expected to be relatively shallow, especially in Brazil, which continues to face macroeconomic imbalances (including high stocks of public and private debt) and major policy challenges such as reforming the pension system. The Bolivarian Republic of Venezuela is projected to remain in recession until at least 2017. Although growth in most other economies, including Chile and Colombia, is expected to gradually strengthen on the back of a recovery in domestic demand, the medium-term outlook remains clouded by long-standing structural weaknesses, including a strong dependence on commodities and low productivity growth.

Mexico's growth is projected to remain weak amid significant uncertainty

Average growth in Mexico and Central America is projected to remain subdued in the forecast period. The subregion's GDP is projected to grow by 2.3 per cent in 2017 and 2.2 per cent in 2018, following estimated growth of 2.3 per cent in 2016. The slow growth trajectory primarily reflects a weak performance of the Mexican economy. Amid low oil prices, sluggish industrial production in the United States and tight monetary and fiscal policy, Mexico's GDP is estimated to have grown by only 2 per cent in 2016. The outcome of the elections in the United States has further complicated the short to medium-term outlook for Mexico's economy, raising the uncertainty around the baseline forecasts. Since nearly 80 per cent of Mexico's exports are destined for the United States, any protectionist trade measures by the new Administration in the United States would have a severe impact on growth. Remittance inflows could also take a hit if the new Administration were to introduce a tax on outward remittance flows.

Outcome of election in the United States has reinforced downward pressure on the peso

Increasing concerns over the outlook for Mexico's economy reinforced downward pressure on the peso, causing a sharp decline in the aftermath of the election in the United States. The peso's weakness could further drive up inflation, which has increased steadily since mid-2016, exceeding the central inflation target level of 3 per cent in October. The combination of a weaker peso, rising inflation and a subdued growth outlook poses a major challenge for Mexico's central bank. After raising interest rates considerably over the past year, further tightening is expected for 2017. Given a high degree of macroeconomic uncertainty and tight fiscal and monetary policy, investment growth is projected to further slow during the outlook period. As a result, GDP growth in Mexico is forecast to remain subdued at about 2 per cent in 2017 and 2018 amid a still negative output gap.

Prospects vary widely across Central American and Caribbean economies

In Central America and the Caribbean, the economic situation and prospects vary widely across countries. Strong domestic demand continues to boost economic activity in Costa Rica, the Dominican Republic, Nicaragua and Panama. To varying degrees, these countries are benefiting from buoyant public investment (particularly in infrastructure), robust private consumption (supported by remittance inflows), and dynamic tourism industries. During the forecast period, they will remain among the region's fastest-growing countries, with annual growth projected to exceed 4 per cent.

In contrast, Cuba, Haiti and Jamaica recorded weak growth in 2016. Cuba's economy has suffered from reduced support from the Bolivarian Republic of Venezuela and low prices for major export goods, including petroleum and nickel. Economic activity in Haiti and Jamaica was adversely affected by drought conditions as well as structural obstacles, including institutional weaknesses, tight fiscal budgets and high unemployment and underemployment. Suriname and Trinidad and Tobago experienced significant contractions of GDP in 2016 as both countries suffered the consequences of the sharp drop in energy prices. All of these countries are projected to see a mild pickup in growth during the forecast period. Nevertheless, deep-rooted structural impediments and high vulnerability to external developments will continue to cloud their growth prospects.