World Economic Situation and Prospects

Monthly Briefing

No. 70 September 2014

Summary

- Russian Federation and European Union economies affected by reciprocal economic sanctions
- U.S. labour market situation presents challenge to setting monetary policy
- Brazil falls into recession, while India expands faster than expected

Global issues

Reciprocal economic sanctions weigh on the Russian Federation and European Union economies

The unfolding geopolitical crisis caused by the situation in Ukraine has led to an imposition of reciprocal economic sanctions and disruptions in the established trade flows between the Russian Federation and many leading Organization for Economic Cooperation and Development (OECD) countries. Those countries have introduced a series of increasingly tough sanctions (moving from the relatively mild "stage one" in early 2014 to "stage three" in late July) against the Russian economy, affecting the defence, finance and energy sectors by restricting exports of arms, double-use technology and selected equipment for the oil industry, while curbing access by Russian banks and companies to international capital markets. Although it is not yet clear if the business sector will fully comply with those restrictions, they have already taken a serious toll on the Russian economy by worsening business sentiment and capital outflows. In retaliation, the Government of the Russian Federation decided in August to impose reciprocal sanctions against those countries—in particular, banning imports of their food products for one year, despite the risk of higher inflation, which currently poses a serious macroeconomic threat to the Russian economy.

Although the "sanctions war" between major OECD countries and the Russian Federation is not expected to lead to an economic slowdown at the global level, the effects are significant for a number of countries. Weaker Russian import demand has already affected several European Union (EU) economies, as the Russian market absorbs almost 5 per cent of euro area exports. The slowdown in the German economy in the second quarter is partially attributed to lower exports of automotive components to the Russian Federation.

The Russian Federation's ban on food imports will hurt countries that are strongly exposed to trade with the Russian Federation. Total EU food exports to the Russian market amount to $11 billion annually. The lost revenue from these exports will impact the entire logistics sector (including transport), put pressure on the states' budgets to compensate for farmers' losses, put banks exposed to agricultural borrowers at risk by increasing the number of non-performing loans, and constrain credit extended to farmers. The Russian Federation absorbs a significant share of the food exports of some East European countries (especially Poland and the Baltic States), as well as of Finland and Norway. The loss of the Russian market would also have spillover effects on Eastern Europe through weaker intraregional trade. Although the EU members are able to file compensation claims with the European Commission, full coverage of losses is unlikely. On the other hand, some countries, Argentina, Brazil and Serbia among them, as well as some Commonwealth of Independent States (CIS) economies, may benefit from the current situation, by becoming alternative suppliers of banned food products.

Challenges for African oil producers, despite solid oil prices

Africa has a number of significant oil-producing countries. The biggest of these are Nigeria, with output of 2.3 million barrels per day (bpd); Angola, with 1.8 million bpd; and Algeria, with 1.6 million bpd.[1] In aggregate, Africa provides 10.1 per cent of global oil production, exceeding the shares of Central and South America and the Asia and Pacific region who provide slightly less than 10 per cent. For many African oil producers, oil production is a leading determinant of public revenues and exports.[2] But despite this rich endowment, in particular with a continued solid price level for crude, Africa's oil producers have seen increasing erosion in their fiscal policy space. This situation has been limiting their policy options and is setting them up for a more pronounced fiscal crisis in case of any drastic fall in oil prices in the future.

The more than fivefold increase in oil prices between the end of the 1990s and 2013 was accompanied by a trend of increasing fiscal budget balances as a percentage of gross domestic product (GDP) among the major African oil producers, which lasted until about 2006 (figure 1 and 2). Subsequently, fiscal balances deteriorated and, in 2013, all major African oil producers except for Congo registered a fiscal deficit, the highest being that of Egypt at almost 14 per cent of GDP. In parallel, some fiscal buffers built through oil

1 BP Statistical Review of World Energy (June 2014), available from http://www.bp.com/content/dam/bp/pdf/Energy-economics/statistical-review-2014/BP-statistical-review-of-world-energy-2014-full-report.pdf

2 In Nigeria, for example, the oil sector accounts for 75 per cent of government revenue and 95 per cent of exports. See International Monetary Fund, Country Report No. 14/103, p. 10 (April 2014), available from http://www.imf.org/external/pubs/ft/scr/2014/cr14103.pdf.

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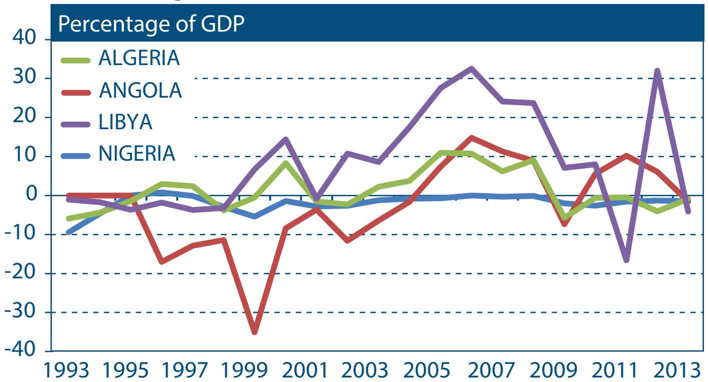
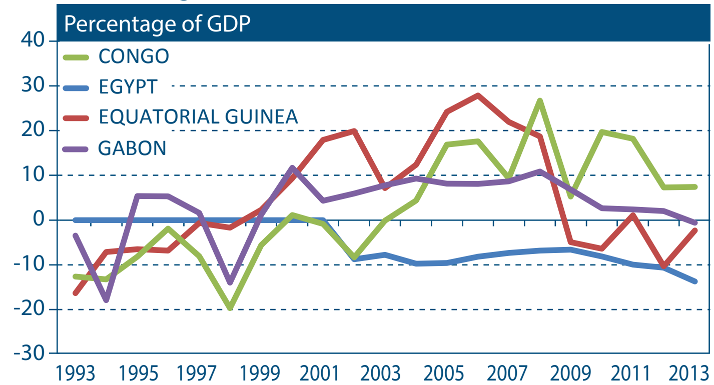
Figure 1
Fiscal budget balances



Source: Economist Intelligence Unit.

Figure 2
Fiscal budget balances



Source: Economist Intelligence Unit.

revenues also declined, with the size of the Excess Crude Account and Sovereign Wealth Fund in Nigeria, for example, declining from $11 billion at the end of 2012 to $3 billion at the end of 2013.[3]

There are various reasons for this negative trend in fiscal balances despite elevated oil prices. At the global level, the contraction in growth at the peak of the global economic crisis also negatively affected oil demand. Second, political turmoil disrupted oil production (in Egypt and Libya, for example), thereby reducing revenues. Third, fiscal spending increased in many oil-exporting countries, although this needs to be differentiated according to the type of spending. Infrastructure investment, for example, can represent an appropriate way to deploy surplus funds to promote economic development. However, the use of state surplus funds becomes questionable when investments do not contribute to alleviating the many basic development problems.

The consequences of fiscal deficits—even at a time of elevated oil prices—are as varied and possibly as far-reaching. For one, fiscal deficits limit policy space, which makes the efficient use of debt financing to address development challenges even more important. In addition, fiscal deficits create major risks in case of a future fall in oil prices. In this scenario, the negative effect on fiscal revenue would come on top of already strained finances, which in turn would further limit the available policy space. This would severely limit the long-term prospects for further progress towards the Millennium Development Goals or the post-2015 development targets.

Developed economies

The United States: a new challenge for monetary policy

The economy of the United States of America has continued on the recovery path. The quarter-over-quarter GDP growth rate for the second quarter of 2014 has been revised upward, to an annualized rate of 4.2 per cent from the original estimate of 4.0 per cent. Most recent survey-based indicators also reveal continuous expansion over the third quarter. Five years since the end of the Great Recession, payroll employment in May 2014 finally exceeded the previous peak in January 2008. Increases in payroll have averaged 230,000 people a month in 2014, up from the 190,000-a-month pace during 2012-2013. The unemployment rate has declined nearly 4 percentage points from its peak in 2009.

However, the decline in the unemployment rate has been accompanied by a steady drop in labor force participation through late 2013 and by involuntary part-time employment, which makes assessment of the slack in the labour market particularly challenging for policymakers. As indicated by the chair of the United States Federal Reserve, the labour market is affected by both cyclical and structural influences, which implies that any monetary policy decision has to take into account a wide range of information in the labor market, as well as inflation and financial developments.

Developed Asia: Australia alters its environment policy

On July 27, Australia became the first country in the world to abolish the carbon tax introduced in 2012. To reach the target of a 5 per cent cut in greenhouse gas emissions by 2020, the Government has proposed replacing the tax with grants to business for environmentally friendly investments.

In Japan, the adjustment to the higher consumption tax rate is still unfolding. In July 2014, the average household consumption expenditure decreased by 2 per cent from one year ago, corresponding to an almost 6 per cent decline in real terms. Housing starts maintained their downward trend of the past seven months, decreasing 14 per cent year on year during this period. Industrial production has not recovered from the impact caused by the tax hike and remained at about 0.8 per cent lower than one year ago. Export volume recovered in July, increasing 2.8 per cent year on year. Import volume declined from the elevated pre-tax hike level, returning to the same level as one year ago. In July 2014, wages increased by 2.6 per cent year on year, representing the highest change since 1994; bonus payments increased by 7.1 per cent, while regular contracted payments increased by 0.9 per cent.

Western Europe: growth stalls in the second quarter

Economic activity stagnated in the euro area in the second quarter of 2014, with no growth of GDP quarter over quarter after growth of only 0.2 per cent in the first quarter of the year. Germany sharply reversed its strong first-quarter gain, contracting by 0.2 per cent. France registered another quarter with no growth. Italy contracted for a second consecutive quarter and thus returned to technical recession. Spain, however, continued to accelerate, growing by 0.6

3 Ibid., p. 5.

per cent after 0.4 per cent in the first quarter and the United Kingdom of Great Britain and Northern Ireland continued its leading pace, growing by 0.8 per cent after 0.8 per cent in the first quarter. To some extent, the poor result reflects the deepening tensions in Ukraine and the resulting economic sanctions, which are affecting both trade and industrial confidence. But it is against a backdrop of a very weak growth environment, which can easily be disturbed by exogenous events. Going forward, prospects are not good. After stalling in July, economic confidence, as measured by the European Commission's Economic Sentiment Indicator, dropped significantly in August, even though it remains above its long-term average, which is consistent with very low positive growth.

The new EU members: geopolitical tensions weigh on the region's economy

Among the new EU member States, the second quarter GDP figures surprised on the upside in Latvia, Hungary, Poland, and Slovenia. The recovery in the region during that period was increasingly driven by domestic demand.

However, the latest weakness in the EU-15 and the geopolitical tensions between the EU and the Russian Federation are challenging the region's growth prospects (see global issues). The sanctions imposed by the United States and the EU on the Russian Federation, and the Russian ban on food imports from the EU countries, raised concerns about the outlook for the second half of 2014. Poland and the Baltic States, whose economies are more exposed to the Russian market, are particularly vulnerable to the lost exports and possible loss of credit by foreign banks. Previous gains in employment in the Baltic States were in fact associated with sectors linked to trade with the Russian Federation.

As a result, in August the overall economic sentiment in Central Europe worsened. The Purchasing Managers' Index (PMI), which is an important forward-looking indicator, exhibited a sharp deterioration in the Czech Republic, Hungary and Poland. In late August, the European Commission announced an assistance package for farmers affected by the sanctions; however, it will only partially compensate for the losses. Governments in the region are also considering additional support measures for farmers.

Economies in transition

CIS: import substitution supports industry in the Russian Federation

According to preliminary figures, the GDP of the Russian Federation increased by 0.8 per cent year on year in the second quarter, stronger than expected. Despite the imposition of international sanctions, industrial production rebounded in July, expanding by 1.5% year on year. This improvement is mainly due to the stronger performance of the manufacturing sector, which was supported by the weaker currency and import substitution effect (imports contracted by over 5 per cent year on year in the first half of 2014). The manufacturing PMI rose in July for the fourth consecutive month, to 51.0 from a low of 48.3 in March, and remained steady in August. However, against the backdrop of possible further sanctions, the Russian currency plunged to a two-year low in August and the stock market weakened. In the second half of 2014, domestic demand is likely to fall, owing to slower wage growth, high interest rates and contracting investment. In Ukraine, the economy shrank by 4.7 per cent year on year in the second quarter. The ongoing internal conflict damaged much of the industrial infrastructure, affecting steel output and machinery sectors. The currency plunged in late August to its weakest level ever versus the dollar, lifting the cost of energy imports, putting strain on the banking sector and complicating repayments of foreign-exchange denominated loans. Among CIS oil-exporters, the economy of Azerbaijan expanded by 2.4 per cent in the first half of 2014, mostly driven by non-energy sectors.

South-Eastern Europe: Serbian economy remains weak

In Serbia, the economy continues to feel the effect of the May floods. In July, industrial production declined by 13 per cent year on year (although it grew marginally on a monthly basis, by 0.2 per cent). The biggest annual contraction was recorded in the mining and energy sectors. By contrast, the economy of the former Yugoslav Republic of Macedonia exhibited more positive trends, with industrial output expanding by 5.9 per cent year on year in July and private credit growing.

Inflation in July modestly accelerated in Serbia to 2.1 per cent, mostly owing to the base-year effect (prices in fact declined on a monthly basis). Consumer prices remained on a deflationary path in Bosnia and Herzegovina, although the pace of deflation slowed to 0.9 per cent in July.

Developing economies

Africa: Ebola outbreak and lower tea prices weigh on Burundi and Kenya economies

The most severe outbreak of Ebola in history has so far has claimed more than 1,000 lives in a number of West African countries. The disease has also had negative economic ramifications, especially in the form of disruptions caused by quarantine measures and additional spending by Governments. In Burundi, revenues from exports of tea, a major source of export earnings, were down by 7 per cent in the first half of 2014 compared to the same period last year. This comes despite a jump in export volumes by 13 per cent, as tea prices are down for the year. Nevertheless, the trade deficit for the first six months of 2014 was down by over 16 per cent, partly owing to a stronger exchange rate. Falling tea prices have also weighed on Kenya's economy, where export revenues were down by 19.3 per cent year on year for the first half of 2014. Kenya has been dealing with pressure on the inflation rate as well, which has risen to 8.36 per cent in August, driven by rising food prices. At the same time, the exchange rate was under pressure, which has brought the shilling to a 31 month low and led the central bank to intervene to support the currency.

In South Africa, the economy grew by 1.0 per cent in the second quarter; the agricultural and financial sectors helped to avoid a worse performance, given the weakness in the mining and manufacturing sectors. At the same time, unemployment edged up to 25.5 per cent in the second quarter. Ghana indicated its willingness to begin economic stabilization talks with the International Monetary Fund, in order to deal with fiscal challenges and the fall in the currency. Egypt announced plans for the construction of an extension of the Suez Canal. The $4 billion to $8 billion project would add a new bypass channel and expand another section of the canal. Economic growth in Tunisia was only 2 per cent year on year in the second quarter. The trade deficit is up 18 per cent in the first seven months of 2014, exacerbated by a weakening dinar, which has fallen by 9 per cent since March.

East Asia: growth in Malaysia and the Philippines strengthens further

Recent data indicate marked differences in growth momentum among East Asian economies. In Malaysia and the Philippines, GDP growth strengthened further in the second quarter of 2014, supported by a substantial increase in net exports. In both countries, GDP rose by 6.4 per cent year on year, up from 6.2 per cent (Malaysia) and 5.6 per cent (Philippines) in the first quarter. Against the backdrop of strong growth and elevated inflation pressures, the central banks of both countries hiked their benchmark interest rates in July. By contrast, GDP growth weakened in other parts of the region, including the high-income economies of Hong Kong Special Administrative Region (SAR) of China, the Republic of Korea and Singapore. On a quarter-on-quarter seasonally adjusted basis, economic activity in Hong Kong SAR declined by 0.1 per cent in the second quarter, the first contraction in three years. This sluggish performance can be largely attributed to weak business investment and a sharp drop in tourist spending, especially from China. The Bank of Korea responded to the economic slowdown in the second quarter by cutting its benchmark interest rate for the first time in 15 months. Thailand's economy returned to growth in the second quarter as GDP expanded by 0.4 per cent year on year, after falling by 0.5 per cent in the first three months. The expansion was largely based on a rebound in household consumption amid a more stable political situation, and a set of fiscal measures implemented by the military Government to revive the economy.

South Asia: stronger-than-expected second quarter growth in India

India's economy has started to recover, with growth in the second quarter exceeding expectations. Gross domestic product rose by 5.7 per cent year on year, the fastest pace since the last quarter of 2011 and well above the 4.6 per cent recorded in the first three months of 2014. Growth was boosted by a rebound in investment, a further increase in government consumption and strong exports. The manufacturing sector expanded by 3.5 per cent year on year, after contracting in the previous two quarters. The recovery in economic activity has been underpinned by a revival in consumer and business confidence as inflation moderated and the general election in May resulted in a strong mandate for the new Government. The regained optimism about the economy has also lifted India's stock market. The benchmark SENSEX index has risen by 27 per cent since the beginning of the year and stands at a record high.

Western Asia: financial costs of the Gaza conflict may reach $8 billion

The financial costs of the Gaza conflict may total $8 billion, according to estimations provided by both the head of the Israeli Tax Authority and the Palestinian Deputy Prime Minister. Three quarters of that total cost represents the rebuilding of Gaza (equivalent to approximately 10 per cent of the Gaza Strip's total GDP), where direct damages on homes, water and electrical infrastructure, as well as public institutions, were more severe. In Israel, there was less direct damage, although many businesses were forced to shut down, while the tourism industry was hit particularly hard (see Monthly Briefing No.69). As a consequence of the conflict, the consumer price index increased sharply in Gaza in July 2014, by 3.14 per cent month on month. The unemployment level is also expected to reach about 50 per cent if the conflict does not escalate further, although the level was already high before the conflict at 41 per cent. In addition to the economic consequences, the human toll has been particularly severe in Gaza, with 485,000 people displaced. This represents one third of the total Gaza population, according to the Palestine Liberation Organization.

In Yemen, a reform to lift oil subsidies was approved as part of the plan to address the state budget deficit. Oil subsidies used to represent 21 per cent of public spending, reaching more than $24 billion during the period 2000-2013. Nevertheless, such a reform will need to be complemented by other sound economic and administrative reforms, in order to help the country to avoid continuous dependence on foreign aid and to implement the public investment programme. Demonstrations against the reform took place in August, which could become an additional challenge for the Government.

Latin America and the Caribbean: Brazil's economy falls into recession

The Brazilian economy slipped into a technical recession in the first half of 2014. In the first and second quarters, the GDP contracted by 0.2 and 0.6 per cent, respectively. A sharp fall in investment demand is one of the key features of the current economic situation. During the second quarter of 2014, gross fixed capital formation shrank by 5.3 per cent quarter-on-quarter and 11.2 per cent year-on-year. In mid-August, Chile's Senate approved a tax reform bill which introduces major structural changes to the taxation system by establishing a dual tax scheme, gradually increasing corporate tax rates, eliminating tax exceptions for reinvestment of corporate profits, and lowering personal income taxes, among other provisions. In the medium term, the reform is expected to promote tax equity and to boost tax revenues by $8.3 billion (nearly 3 per cent of GDP), a crucial step in financing a major education overhaul and other social policies on the government agenda to address income inequality. Despite the almost complete political support of the tax reform, there are concerns among some experts regarding the real effect that the tax reform will have on fiscal revenues and the potential negative impacts on investment, especially for small and medium-sized enterprises.