World Economic Situation and Prospects

2016

United Nations

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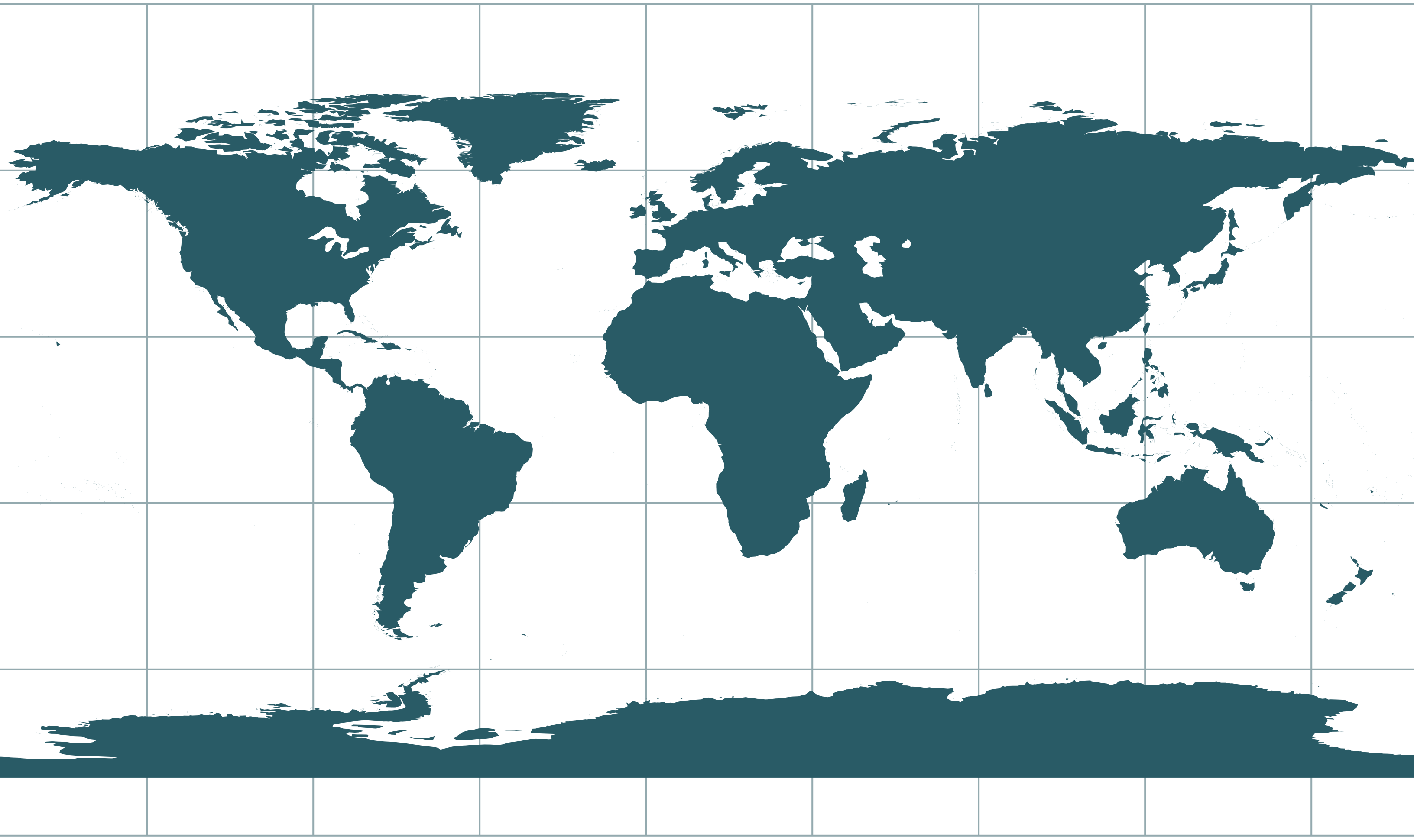


United Nations
New York, 2016

Chapter IV

Regional developments and outlook

Developed economies

The developed economies, particularly the United States of America, are expected to contribute more to global growth in the near term than they did in 2011-2014. Economic growth in developed economies as a whole accelerated from 1.7 per cent in 2014 to an estimated 1.9 per cent in 2015, and growth is expected to strengthen further to 2.2 per cent in 2016 (see annex table A.1). The expected acceleration in 2016 is partly attributable to a stronger outlook for Japan, which is expected to be cut short by a planned increase in the consumption tax in April 2017. The developed economies continued to rely on accommodative monetary policy to deliver growth in 2015. Over the forecast period, the majority of central banks in developed countries, with the exception of the United States Federal Reserve (Fed) and the Bank of England, are expected to maintain their highly accommodative monetary policies. This divergence in monetary stance has been associated with a strong appreciation of the United States dollar relative to other developed-economy currencies, and is expected to lead to a significant redistribution of real net exports from the United States to Japan and Europe.

Low commodity prices have generally supported the outlook in developed economies. The exceptions are the commodity-reliant economies of Australia, Canada and Norway, where investment in the commodity sectors has stalled and economic prospects have deteriorated significantly. Low commodity prices have introduced deflationary pressures in many developed economies, with annual inflation in 2015 expected to average just 0.3 per cent in the developed-market economies. While the highly accommodative monetary policy stances in developed economies have prevented deflation from becoming entrenched in expectations, the persistent near-zero inflation will do little to boost consumer spending or ease the debt burden that remains a legacy of the financial crisis.

North America

The United States: monetary policy stance is shifting

Economic conditions in the United States have strengthened sufficiently for the Fed to signal its intention to raise its policy rates. As monetary accommodation is withdrawn, the fiscal stance will become slightly less restrictive, signalling a gradual shift towards a more balanced policy mix. Gross domestic product (GDP) growth in the United States is expected to be 2.4 per cent in 2015, the same rate as in 2014. However, the contribution of the external sector has shifted, as export growth is expected to have decelerated from 3.4 per cent in 2014 to 2.7 per cent in 2015, while import growth accelerated from 3.8 per cent to 5.5 per cent over the same period. This shift reflects both the appreciation of the United States dollar and the deteriorating demand from major emerging economies. The shift in net trade is offset by a less restrictive fiscal position.

Less restrictive fiscal stance supports GDP growth

In the outlook period, GDP is expected to grow by 2.6 per cent and 2.8 per cent in 2016 and 2017, respectively (see annex table A.1). This modest improvement will be supported by somewhat stronger expansions in private fixed investment and in government spending. Following several years of austerity, the stance of fiscal policy has become marginally expansionary and this is expected to continue in the near term. The accord reached between the legislative and executive branches of the United States Government in October 2015 made this possible. The expected increase in government consumption is concentrated at the state and local level, reflecting an improvement in their fiscal balance. In total, real government consumption is assumed to increase by 0.9 per cent in both 2016 and 2017. At the federal level, government consumption growth will remain tepid, allowing the federal deficit to stabilize relative to GDP. Publicly held federal debt is expected to remain at about 74 per cent of GDP over the outlook period.

Dollar appreciation and low commodity prices stabilize external balance

The sharp appreciation of the United States dollar (vis-à-vis almost all major currencies) that started in mid-2014 has stabilized in recent quarters; no significant reversal of the appreciation is expected for the outlook period. As a consequence, growth of real imports is projected to remain higher than real export growth. Meanwhile, the appreciation of the United States dollar has led to a significant drop in the dollar value of non-oil merchandise goods; the non-oil import price declined year on year by more than 2.5 per cent in the first nine months of 2015. At the same time, the lower oil price has pushed down the value of crude oil imports, which have also fallen in volume terms. As a result, the trade deficit is expected to stabilize at about 2.5 per cent of GDP through 2017.

Low wage growth complicates monetary policymaking

By late 2015, the unemployment rate had declined to about 5 per cent, close to the pre-crisis level. However, nominal wage growth actually slowed marginally in 2015, posing a challenge to the Fed regarding the speed and timing of interest-rate normalization. The belief that reduced slack in the economy (including the labour market) would cause higher inflation has served as a key foundation for monetary policy decisions. However, statistics for 2015 do not fully support this relationship (figure IV.1), contributing to uncertainty about the anticipated path of interest-rate increases. In the outlook period, the labour force participation ratio is expected to stabilize, and the unemployment rate is expected to remain broadly stable in 2016 and 2017.

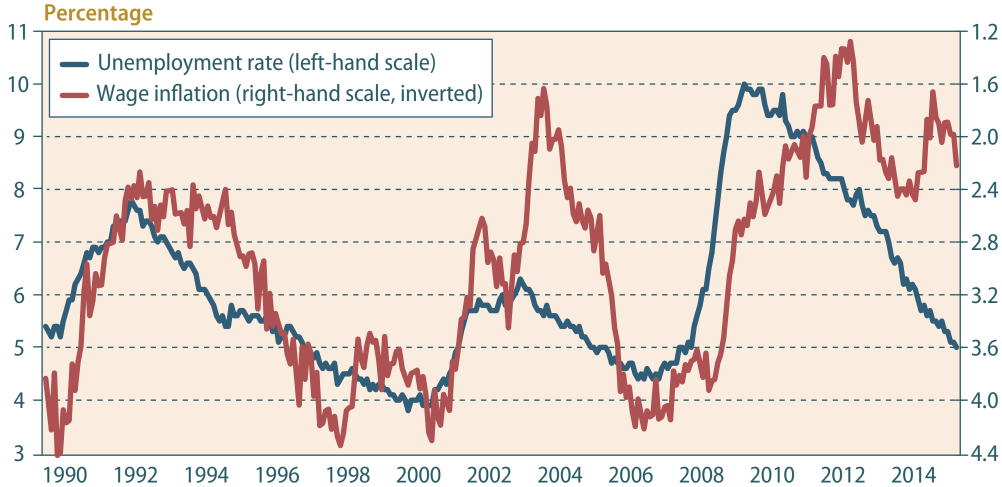
Deflationary risks have receded

Inflation has been weak in 2015 as a result of the decline in the prices for oil and imported goods. However, with the relative stabilization of both the oil price and the dollar exchange rate, year-over-year inflation became slightly positive again in the second quarter of 2015, and risks of deflation had receded. Average consumer price inflation is expected to accelerate to 1.6 per cent and 2.3 per cent in 2016 and 2017, respectively.

Canada: lower oil price hampers GDP growth

The sudden drop in the crude oil price has been associated with a sharp decline in private fixed capital formation in the oil production sector in Canada. As a result, growth in the Canadian economy slowed to an estimated 1.2 per cent in 2015, the lowest growth rate since the Great Recession. This reflects an expected decline in total private fixed investment of 3.5 per cent in 2015, despite the continuous growth in residential investment. As commodity prices stabilize and the economy of the United States strengthens, GDP growth is expected to recover to 2.2 per cent and 2.9 per cent in 2016 and 2017, respectively.

Figure IV.1
United States unemployment rate and wage inflation, January 1990–October 2015



Source: UN/DESA, based on data from the United States Bureau of Labor Statistics.

More accommodative fiscal policy stance lifts the prospects for growth

The recovery in 2016 and 2017 is expected to be broad-based. Private consumption will expand by about 1.9 per cent on average in 2016 and 2017. The drag from non-residential investment on growth is expected to fade out in 2016. Export growth is expected to increase from the estimated 3.0 per cent growth in 2015, supported by the sharp depreciation of the Canadian dollar vis-à-vis the United States dollar and sustained growth in the United States. A new Government was formed in late 2015, which plans to reduce the income tax rate for middle-income bands, financed by increasing the rate for higher income bands. It is expected that growth in government consumption and investment will increase to 1.7 per cent in 2017. Employment growth is predicted to outpace the labour force growth, leading to a slight reduction in the unemployment rate from 6.8 per cent in 2015. The wage rate is expected to increase by close to 3 per cent per year during the outlook period, maintaining upward pressure on inflation.

Developed Asia and the Pacific

Japan: policy-induced downturn anticipated in 2017

The Japanese economy slumped immediately after the introduction of a higher consumption tax rate in April 2014. Recovery since then has been sluggish; GDP declined again in mid-2015 as both private consumption and exports fell sharply. The growth rate for 2015 as a whole is expected to be only 0.5 per cent, increasing to 1.3 per cent in 2016 before dropping again to 0.6 per cent in 2017, reflecting the planned tax hike in April 2017.

Low wage inflation restrains consumption growth

The most important factor impeding growth of the Japanese economy is the feeble private consumption expansion. Growth in household employment income has been slow, although the general situation in the labour market has been relatively solid. Employment has been growing at a slow but persistent pace since 2013, allowing the unemployment rate to recede gradually to 3.4 per cent in 2015. Nevertheless, low wage growth has held back household buying power.

Erosion of production capacity restrains export growth

Japanese merchandise export volumes have yet to recover their pre-crisis levels (figure IV.2). A short-lived expansion in exports started in early 2014, but lost its momentum in early 2015, as a result of a slowdown in many of Japan's export markets, including China. At the annual level, export growth is expected to be only 1.8 per cent in 2015, in contrast to 8.4 per cent in 2014. For the outlook, exports are expected to grow by 3.3 per cent in both 2016 and 2017.

Production facilities expand overseas, limiting domestic investment growth

Private fixed capital formation has been expanding since 2011, although the pace has diminished over time. While corporate profits remain strong, actual investment in the expansion of domestic production capacities has been relatively mild. Instead, large Japanese corporations have been expanding their production facilities overseas since 2011. Domestic fixed capital formation is expected to grow by about 1.5 per cent per annum on average during 2015-2017.

Primary balance improved

Although the 2014 hike in consumption tax caused extreme disruption to economic activity, it also increased government revenue. This has allowed the primary balance to improve, and the government to increase spending, while issuing much less debt. It is assumed that real government consumption will grow slightly faster than GDP in the period of 2015-2017.

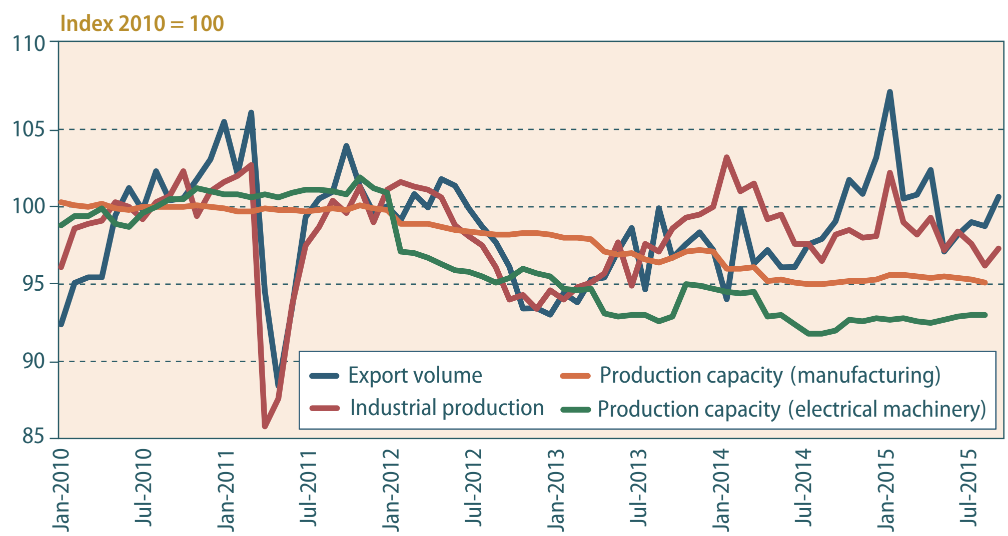
The accommodative monetary policy of the Bank of Japan and the increase in consumption tax helped the headline consumer price index (CPI) reach 2.7 per cent. However, inflation is predicted to be 0.7 per cent in 2015 and will decline marginally to 0.5 per cent for 2016.

Australia: lower commodity prices impede investment and income growth

In Australia, GDP growth decelerated to an estimated 2.3 per cent in 2015, mainly owing to the continuous decline in fixed investment in the natural resource sectors and weaker export growth. Although export growth is expected to recover by 2017, the sustained low prices for major commodities in Australia's export basket will continue to hold back invest-

Figure IV.2

Key monthly indicators for Japan, January 2010–September 2015



Source: UN/DESA, based on data from the Bank of Japan and the Ministry of Economic, Trade and Industry.

ment and will dent the growth of household income and private consumption. Government consumption is expected to increase by less than 2 per cent per annum, owing to efforts to balance the budget. For 2016 and 2017, GDP growth is expected to be 2.5 per cent and 2.2 per cent, respectively. During 2015-2017, employment is expected to remain stable. As the economy will not be in a position to absorb the total expansion of the labour force, the unemployment rate is predicted to remain above 6 per cent in both 2016 and 2017.

Europe

Western Europe: economic prospects improving despite global slowdown

Despite a broad deterioration in global economic activity, economic prospects in Western Europe have generally improved. The European Union (EU) is one of the few major global regions, where the forecast for 2015 GDP growth has not been downgraded from the growth rate projected in 2014. The European policy environment has become more supportive, with expansive monetary stimulus programmes and some easing of the pressure for fiscal consolidation. Meanwhile, the unexpected drop in energy prices has boosted household spending and reduced production costs. This has supported solid retail sales and rising confidence indicators. The EU is now the driving force behind world trade growth, supported by the high level of intraregional trade and also by competitiveness gains relative to the United States. Bank lending conditions have softened and the demand for new loans is rising. While the crisis in Greece overshadowed the broad-based improvement during the first three quarters of 2015, an agreement reached in August on a third bailout programme has dispelled the risk of a Greek withdrawal from the European Monetary Union, removing an important source of uncertainty.

Recovery is fairly broad-based across countries…

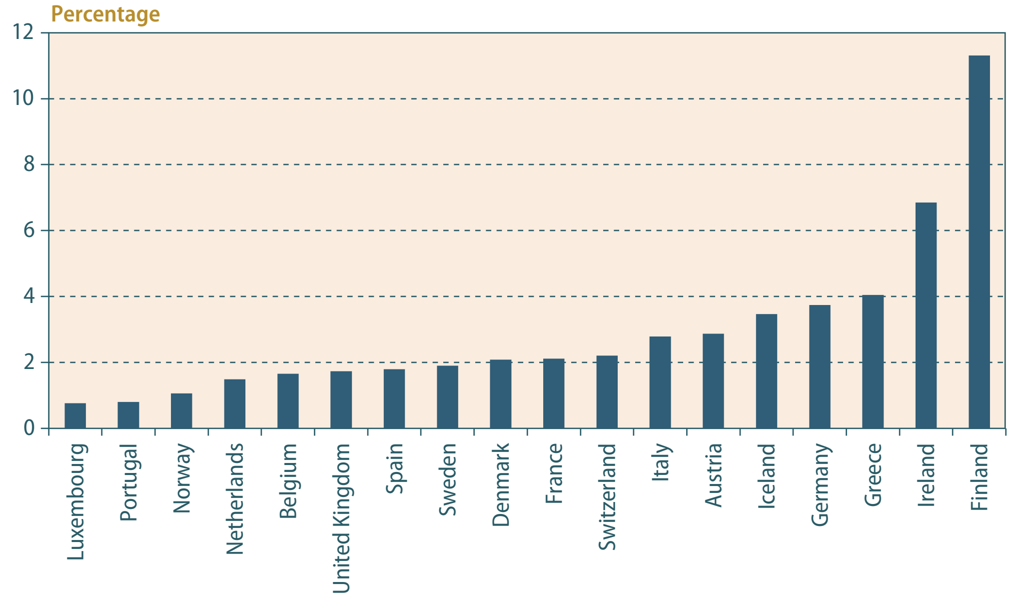
Against this backdrop, GDP growth in the EU-15 is expected to accelerate from 1.8 per cent in 2015 to 2.0 per cent in 2016 and 2.1 per cent in 2017. The growth has been fairly broad-based across countries. While Germany and the United Kingdom of Great Britain and Northern Ireland were at the forefront of the recovery, there has also been a strong rebound in Denmark, Ireland, the Netherlands, Spain and Sweden. Even the beleaguered Greek economy expanded at an annualized rate of 3.2 per cent in the second quarter of 2015. However, given the severe political and economic turmoil that ensued, including a three-week closure of Greek banks and the imposition of stringent capital controls, much of this apparent revival was reversed in the third quarter of the year.

… exposure to the Russian Federation is restraining growth in Austria, Finland, France and Italy

The economic performance of Austria, Finland, France and Italy has lagged behind other EU-15 members, partly reflecting the overhang of bank fragility related to the financial crisis. Existing fragilities have been accentuated by exposure to the Russian Federation. Austrian banks have the highest relative level of exposure, while French and Italian banks are also relatively exposed compared to banks from other developed economies (International Monetary Fund, 2014a); Finland's exposure is instead through the trade channel, with more than 10 per cent of Finnish exports destined for the Russian Federation (figure IV.3).

Outside the EU, Norway and Switzerland have experienced a sharp slowdown in economic activity. In Switzerland, the decision in January 2015 to delink the Swiss franc from the euro led to a shock appreciation of 16 per cent against the United States dollar and 18 per cent against the euro over a two-day period. While much of the sudden adjustment was subsequently corrected, the Swiss franc remains nearly 10 per cent stronger against the euro, which is its biggest trading currency, and net trade impeded growth in 2015. In

Figure IV.3
Share of exports to the Russian Federation in total exports of goods and services, 2012



Source: UN/DESA, based on data from UNCTAD and Eurostat.

Norway, the slowdown reflects the low oil price, which has hit export revenues and stalled investment in the oil sector.

Labour market recovery remains very uneven across countries

While GDP growth is recovering in many European countries, the unemployment rate in the EU-15 stood at 10 per cent in mid-2015, compared to an average of 7.1 per cent in 2007. The aggregate figures mask stark differences across countries, with double-digit unemployment rates in France, Greece, Italy, Portugal and Spain, compared to just 4.5 per cent in Germany. The economic rebound in Spain has allowed the unemployment rate to recede by more than 2 percentage points relative to a year ago, although more than 22 per cent of the labour force still remains unemployed. France, on the other hand, has seen the unemployment rate edge up in recent months. The job vacancy rate in the EU is at its highest level since 2008, pointing to improving labour market opportunities going forward. However, opportunities remain uneven across countries, with job openings concentrated in Belgium, Germany and the United Kingdom. For the EU-15 as a whole, the unemployment rate is expected to fall to 9.2 per cent as GDP growth accelerates in 2016 and 2017, but will remain uncomfortably high in many parts of Europe.

Risks of prolonged deflation have receded

While euro area inflation dipped below zero again in September, core inflation has edged up to 1 per cent, and labour cost inflation has accelerated relative to 2014. If global oil prices do not fall further, the impact of low energy prices on inflation will become more muted by early 2016, and deflation is unlikely to become entrenched in expectations. Nonetheless, inflation of just 0.9 per cent in the euro area is forecast for 2016, well below the European Central Bank (ECB) inflation target.

Monetary stance has eased across Western Europe

Responding to prolonged economic weaknesses and deflation risks, the ECB announced a significant loosening of the monetary stance in January 2015. The latest Bank Lending Survey by the ECB suggests that there has been some pass-through from the quantitative easing programme to easier bank lending conditions and an increasing demand for new loans from both enterprises and households. The central bank of Switzerland has set the lowest interest rates in the world in response to the appreciation of the Swiss franc, at -0.75 per cent. The central banks of Norway and Sweden have cut interest rates three times since December 2014. All of these measures provide a more accommodative policy environment to sustain the recovery, and have put downward pressure on exchange rates.

Germany's trade surplus continues to widen

The euro began depreciating against the United States dollar in June 2014, following the introduction of a negative interest rate target by the ECB. The associated gains in competitiveness, coupled with the drop in commodity-related import values, have allowed the current-account balance to continue to widen, reaching 3 per cent of GDP in mid-2015. This is largely attributable to Germany, which is running the largest current-account surplus in the world. Germany's widening trade surplus outside the euro area may suggest that the euro is undervalued from the perspective of the German economy.

The Excessive Deficit Procedure remains ongoing in France, Greece, Spain and United Kingdom

Government investment remains restrained in many European economies, due to commitments under the Stability and Growth Pact to balance public finances. However, the pressure to consolidate has eased significantly in most countries, and in aggregate the fiscal stance in the EU is expected to be broadly neutral in 2015 and 2016, with additional corrective measures postponed until 2017. However, the Excessive Deficit Procedures (EDP) will remain ongoing in France, Greece, Spain and the United Kingdom next year. These economies remain under pressure to cut spending, which will hold back prospects of revival of the French economy, in particular. In Greece, the net impact of the economic adjustment programme attached to the third bailout, in conjunction with targeted funding mobilized by the European Commission to support investment, is expected to be broadly neutral in 2016.

Box IV.1

A preliminary assessment of the macroeconomic impact of the influx of refugees and migrants in Germany

During the first 10 months of 2015, more than 800,000 refugees and migrants arrived in the European Union (EU), nearly 82 per cent via Greece and nearly 18 per cent via Italy, with the remaining 0.8 per cent via Spain and Malta. At least 3,455 refugees and migrants lost their lives in tragic circumstances in the Mediterranean Sea during their journeys. The main country of origin is the Syrian Arab Republic (35 per cent), with Afghanistan, Eritrea and Iraq accounting for at least another 17 per cent.

During the last quarter of 2015, arrivals accelerated sharply, with the total number of refugees and migrants entering the EU in 2015 estimated to exceed 1 million persons—a dramatic increase over the 5 preceding years, during which the EU-28 countries received a total of 1.8 million asylum applications. Between 2010 and 2014, Germany received nearly a quarter of all asylum applications in the EU-28, with France and Italy together receiving another quarter of these applications. However, in response to decisions taken by the German Government on humanitarian grounds, it is expected that the number of persons seeking asylum in Germany by the end of 2015 will have risen to approximately one million.

In 2014, some 362,850 persons received asylum in Germany with a total public expenditure outlay of €2.4 billion. The increased asylum support will lead to additional public expenditure in Germany to the tune of €20 billion during 2015-17, and possibly even more, taking into account indirect expenditures on education, security and accommodation.

Using the United Nations World Economic Forecasting Model, preliminary simulations indicate that the macroeconomic impact of this sizable additional outlay of €20 billion is relatively modest. The

(*continued*)

Box IV.1 (*continued*)

additional public expenditure is likely to reduce the budget surplus by 0.1 to 0.2 per cent of GDP, while the current-account surplus would decline by 0.2 per cent of GDP. The projected impact on the GDP growth of Germany would be small but positive at close to 0.1 percentage points during 2016 and 2017, reflecting that the increased expenditure primarily stimulates aggregate domestic demand.

The simulations also indicate that real wage growth would slow down in response to the increased labour supply, assuming that about half of the asylum applications will be granted and that a sizeable share of these will meet the challenges of social integration and entering the labour market. These results are similar to those published by the European Commission (2015, box I.1).

According to the baseline forecast, government debt in Germany was due to fall by 8.4 per cent of GDP between 2014 and 2017. But because of the influx of refugees and migrants, it is more likely to fall by 8.0 per cent, as Germany may pay off a smaller share of its debt than it might have done without the influx.

Table IV.1.1

Estimated macroeconomic impact of the influx of refugees and migrants in Germany*

	2015	2016	2017
Extra-government spending (billions of euros)	7.60	7.80	4.60
GDP growth (percentage point)	0.07	0.08	0.10
Government budget balance (percentage of GDP)	-0.12	-0.23	-0.11
Current account (percentage of GDP)	-0.10	-0.22	-0.24

Source: UN/DESA.

* Changes relative to the WESP 2016 Baseline scenario.

The new EU members: recovery is more solid, but still facing challenges

All of the new EU members are expected to register positive GDP growth rates in 2015. The Czech Republic is expected to record an impressive economic upturn at 4 per cent; Poland and Romania may also approach that benchmark. In the outlook, growth in some of the new EU members may ease in 2016 owing to moderation in investment.

Growth is driven by domestic demand

In 2015, growing real wages, bolstered by low or negative inflation and improving labour market conditions, expedited a recovery in private consumption. At the same time, low government bond yields, supported by the quantitative easing by the ECB and the revival of cross-border capital flows, mitigated the pressure on public finances. This has supported fiscal spending. Investment remained robust as the countries absorbed EU funds. In some countries, foreign-currency-denominated debt of households still remains a problem, aggravated by the strengthening of the Swiss franc in 2015. Croatia and Hungary adopted measures to convert most of the loans into domestic currency. A similar action is under consideration in Poland, which would pass the costs to the banks, and spread them over time.

Inflation remains low or negative

The Russian food import ban has led to an oversupply in domestic markets of some new EU members, putting downward pressure on food prices. In conjunction with the lower energy prices, this drove annual inflation into a negative territory in several countries of the region and to near-zero figures in the others. The deflation in parts of the region have so far not had an adverse impact on consumer purchases, thanks to the rising real incomes and the moderation in household deleveraging. However, its long-run risks, including the impact on servicing the debt burden, cannot be discounted.

Monetary conditions among the new EU members remain accommodative, while stable growth, supported by the low oil price, has provided many countries with additional fiscal space. However, several countries in the region still remain subject to the excessive deficit procedure of the EU and have to reduce their budget deficit to a level below 3 per cent of GDP. Even in those countries a serious fiscal drag is unlikely in the near term and public investment programmes should continue.

Monetary conditions remain extremely accommodative, while stable growth expands fiscal space

Despite the positive outlook, the region faces several risks. Although the new EU members' direct exposure to trade with China is limited, the cooling of the Chinese economy may influence them through EU-15 industries. The prospective monetary tightening by the Fed may inflate the dollar-denominated share of public debt, but should not significantly alter capital flows to the region, which predominantly come from Europe. On the other hand, a serious unfolding of the political conflict between the Russian Federation and Ukraine may have negative spillovers for the region. Europe's migrant crisis has created additional challenges. Spending by migrants passing through the new EU members may somewhat strengthen aggregate demand and stimulate output, but increased domestic security-related expenditures may divert funds from social programmes. As the new EU members significantly depend on intra-industry trade, any disruptions in the free flow of goods between them and their European partners can curb growth prospects.

The region is exposed to a number of risks

Economies in transition

Aggregate GDP of the Commonwealth of Independent States (CIS) and South-Eastern Europe contracted by 2.8 per cent in 2015 (see annex table A.2) and is forecast to expand by only 0.8 per cent in 2016 and 1.9 per cent in 2017. The decline in output in 2015 is exclusively attributed to the downturn in the CIS, driven by lower energy prices, geopolitical tensions and precarious access to external finance. South-Eastern Europe, in contrast, saw a pickup in growth in 2015, benefitting from the recovery in the European Union and stronger domestic demand. In 2016, the upturn in South-Eastern Europe is expected to strengthen, while the CIS is projected to see a return to mildly positive growth. Both regions nevertheless face significant downside risks and economic policy challenges.

South-Eastern Europe: growth recovers, but fragilities persist

Economic activity in South-Eastern Europe picked up in 2015 and is expected to accelerate further to 2.6 per cent in 2016 and 3.0 per cent in 2017. The region has benefited from a favourable external environment, including low energy prices and accelerating growth in the EU. Domestic demand has provided a major impulse for the recovery. There are, however, significant differences across countries; Serbia, the largest economy in the region, has seen more subdued growth, constrained by fiscal austerity.

The recovery gathers strength

The economic recovery supported job creation, although unemployment levels remain very high. In Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia, the unemployment rate is over 25 per cent. Unemployment is also above the levels observed before the 2008 crisis, except in Montenegro and the former Yugoslav Republic of Macedonia. The possible repatriation of asylum seekers from the EU may increase domestic labour market tensions, in particular in Albania. Youth employment is a particularly acute problem. High unemployment is accompanied by low activity rates, which limits growth potential.

Labour market improves, but unemployment in some countries remains precariously high

Large external imbalances remain

The EU recovery has facilitated growth in exports, which have expanded faster than imports. The region's import bill has also benefited from low oil prices, while rising inflows of remittances have supported net factor income. However, with the exception of Serbia, these influences have been insufficient to make an impact on the large current-account deficits in the region. Albania and Montenegro, which have the largest deficits, have even seen a further deterioration. While strong foreign direct investment (FDI) inflows helped finance the deficits, foreign debt has also grown in recent years.

Fragilities and downside risks remain

The region will mostly continue to benefit from low oil prices but, given its reliance on external financing, could suffer from a tightening of global financial conditions. The high levels of non-performing loans need to be addressed to reduce financial fragility and facilitate credit growth. Europe's migrant crisis poses additional challenges for the region, by raising fiscal expenditures and threatening to disrupt trade with the EU.

The Commonwealth of Independent States: economic downturn and uncertain prospects

The CIS region moves from sluggish growth to outright contraction

Economic activity in the CIS area contracted sharply in 2015, as the region suffered a deterioration in the terms of trade, precarious access to external finance and high levels of uncertainty. Contracting output in the Russian Federation, the largest economy in the CIS,[1] had a depressing influence throughout the region; declines were also observed in other large economies, including Belarus and Ukraine. The aggregate GDP of the CIS and Georgia is estimated to have contracted by about 3.0 per cent in 2015, following an increase of 0.8 per cent in 2014. A return to growth is expected in 2016, but the recovery will be limited, with GDP increasing by about 0.7 per cent and 1.8 per cent in 2017.

Domestic demand plummets

The region has suffered from a combination of an adverse external environment and powerful domestic contractionary forces. Falling real wages, eroded by inflation, and worsened access to credit depressed household consumption. Investment suffered from poor economic prospects and high financing costs, as well as the diversion of retained earnings to more profitable financial assets. In the Russian Federation, investment contracted sharply, despite growing profits, which were mainly used to reduce corporate debt. Although net private capital outflows from the economy moderated in 2015, they may still surpass $70 billion (equivalent to 6 per cent of GDP). These capital outflows have been associated with a substantial reduction in external debt as the corporate sector repays loans instead of rolling them over. In Ukraine, the destruction of productive capacity due to the conflict in the East of the country and the precarious access to the Russian market led to a sharp fall of exports. However, with imports plummeting, net external demand partly offset the contraction of domestic demand—consumption, in particular. Public investment programmes boosted growth in Azerbaijan, Turkmenistan and Uzbekistan. A decline in remittances, which almost fell by half in dollar terms, and other spillover effects, including reduced exports and investment from the Russian Federation, largely offset the impact of lower energy prices in the region's small energy-importing countries. A number of these countries still managed to register decent growth rates in 2015; this may be explained by one-off factors, such as base-year effects or ample agricultural output, but also increased linkages with China.

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

Labour markets deteriorate

The sharp deterioration in economic performance took its toll on the region's labour markets. The unemployment rate has marginally increased in the Russian Federation, despite the preference of cutting wages, rather than labour. Unemployment in Ukraine, which increased sharply throughout 2014, continued to climb higher. As a lagging indicator of economic activity, unemployment is expected to further increase in the CIS in 2016, before declining in 2017.

Inflation accelerates in many economies

Inflation rose throughout the region, driven by the sharp depreciation of national currencies. In Ukraine, higher gas prices added to headline inflation, which is expected to average about 50 per cent in 2015. Weak domestic demand partly offset the inflationary pressures that resulted from the depreciation, while price controls remained in place in some countries. As exchange rates are expected to stabilize somewhat in 2016, inflationary pressures should moderate; however, in some countries inflation will remain in double digits.

Monetary policy remains tight, despite some rate cuts

Amid a more stable foreign-exchange environment, some CIS countries were able to start reversing the tightening of monetary policy that had been initiated in late 2014 or early 2015 in order to contain depreciation pressures. In the Russian Federation, the authorities started to ease monetary policy, but persistent fragility has mandated a gradual approach, following a series of rapid cuts earlier in the year. The policy rate was also cut in Ukraine. By contrast, the central banks in Georgia, Kazakhstan, and the Republic of Moldova tightened monetary policy in the second half of 2015 to mitigate the pressure on their currencies. Kazakhstan, in turn, switched to a free-floating exchange-rate regime. In many countries, currency interventions to reduce exchange-rate pressures have depleted foreign-exchange reserves.

The poor economic performance and falling oil prices have eroded fiscal revenues and reduced fiscal space. This has been partially offset by weaker exchange rates, since a significant part of fiscal revenues (related to the sale of oil and gas) is in dollars, while fiscal spending is largely in domestic currency. In addition, the unexpectedly strong increase in inflation has supported fiscal balances, as expenditure budgets have been fixed in nominal terms. In Ukraine, a temporary import surcharge was introduced to boost revenues. Energy-exporting countries used their oil funds to offset lost revenue, support the banking sector, and, in the case of Kazakhstan, finance stimulus measures. In the Russian Federation, these domestic resources also provided an alternative to external funding, although the authorities have sought to avoid further depletion. In Azerbaijan, expansionary fiscal policy has supported growth. By contrast, Belarus was forced to consolidate its public finances in the face of growing external constraints.

Prospects are largely unfavourable

The economies of the region face a difficult external environment, which will heighten internal vulnerabilities. A persistent period of low commodity prices makes fiscal consolidation unavoidable. Low investment will constrain future growth and prevent progress towards much-needed economic diversification. In many countries, the persistent fragilities in the banking systems have been exacerbated by the weakening of exchange rates in highly dollarized financial systems. Geopolitical tensions continue to weigh on business sentiment. On the positive side, the Russian Federation is less exposed than other emerging markets to growing financial uncertainty, given the lack of access to international capital markets due to the sanctions. The establishment of the Eurasian Economic Union of Armenia, Belarus, Kazakhstan, Kyrgyzstan and the Russian Federation on the basis of the former Customs Union in January 2015 opens new possibilities for increased trade and investment in the region, although many aspects of the regional integration still have to be negotiated.

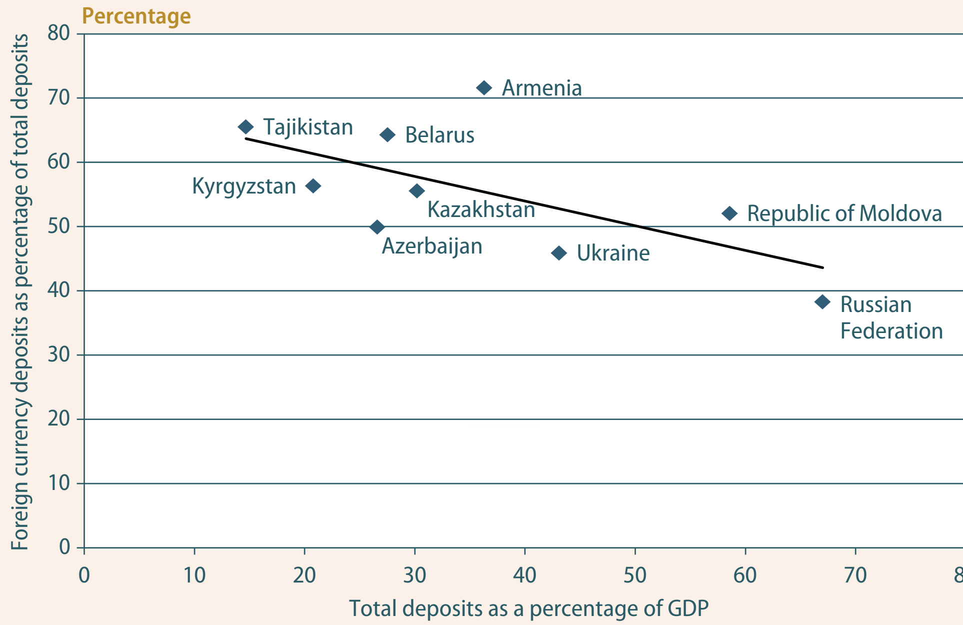
Box IV.2

Financial dollarization in the Commonwealth of Independent States

Financial dollarization is widespread among the Commonwealth of Independent States (CIS) economies, although with significant cross-country differences. The use of foreign currencies as a store of value was a result of very high inflation that followed the introduction of national currencies in the early years of transition. Even though the extreme turbulences that characterized this early period have now disappeared, the memory of past inflation has been reinforced by periodic bouts of macroeconomic instability across the region. This high inflation volatility has contributed to the persistence of financial dollarization, as confidence in national currencies remains fragile. Foreign-currency assets provide an alternative for savers in the absence of other instruments that provide a hedge against inflation. In the CIS, high levels of financial dollarization are often associated with lower financial sector development (figure IV.2.1).

Figure IV.2.1

Foreign-currency deposits and total deposits in the CIS, as of end-2014



Source: National central banks and IMF.

Further drivers of dollarization often include limited exchange-rate flexibility and a policy bias against depreciation, as they introduce asymmetric risks for holders of foreign assets. Expectations of further depreciation of the national currency can also be a factor promoting higher levels of financial dollarization. In Kazakhstan, for example, the currency devaluation in February 2014 was initially followed by a period of exchange-rate stability. However, given the dynamics of oil prices and the depreciation of the currencies of major trading partners in the region, there was a widespread belief that the tenge would weaken further.[a] As a result, the ratio of deposits in foreign currency to total deposits—which had remained roughly stable at about 30 per cent, up to the second half of 2013—started to pick up and increased to 53 per cent in March 2015. Nevertheless, in comparison with other Central Asian economies, Kazakhstan had made rapid progress in reducing financial dollarization since 2001 and, until the 2007-2008 crisis, had registered better macroeconomic performance. This phase of de-dollarization took place in a context of rapid financial development but with limited presence of foreign banks, which often promote the use of foreign currencies in their countries of operation.

Remittances inflows are also seen in the literature as contributing to financial dollarization in the banking sector. In some countries in Central Asia and the Caucasus, remittances are very large relative to

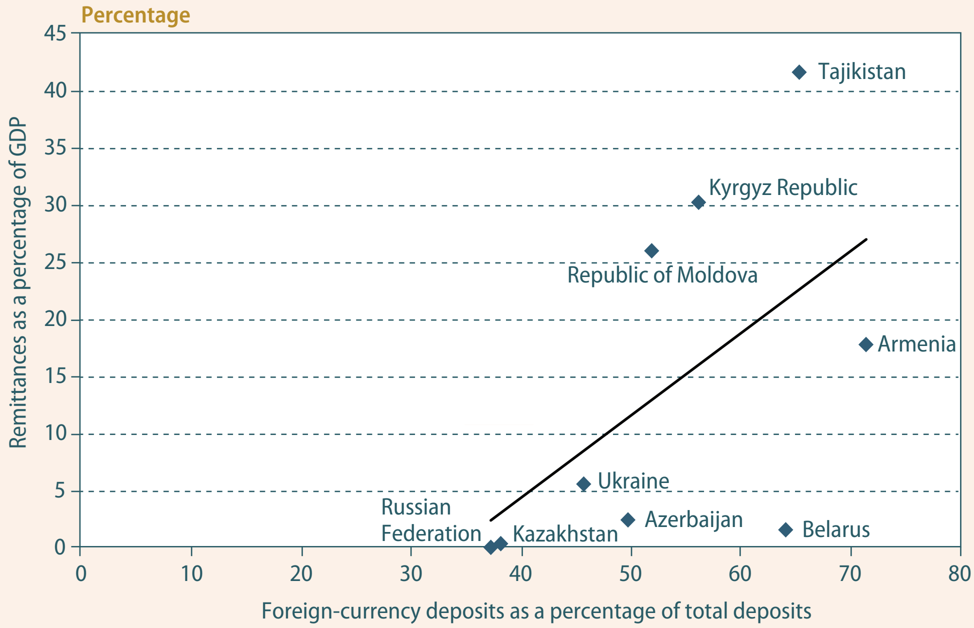
a This expectation was confirmed after the authorities let the exchange rate float freely in August 2015.

(*continued*)

Box IV.2 (*continued*)

GDP and have exhibited a generally increasing trend. In these countries, financial dollarization is particularly significant. In Tajikistan, for example, remittances represent almost half of GDP and the country also has the largest ratio of foreign-currency deposits to total deposits, at about 70 per cent (figure IV.2.2).

Figure IV.2.2
Remittances and foreign-currency deposits in the CIS, as of end-2014



Source: National central banks, IMF and World Bank.
Note: Data for Kazakhstan are from 2013.

The banking sector also plays an important role in driving dollarization. For example, in countries where a significant part of deposits are held in foreign currencies and banks have often limited access to long-term funding in domestic currencies, banks seek to avoid currency mismatching by lending in foreign currencies. Therefore, a close correlation between deposit and loan dollarization can be observed (figure IV.2.3). The fact that banks charge higher rates on loans in local currency in order to offset the risk of depreciation also perpetuates financial dollarization.

National currencies in the CIS have experienced large depreciations since late 2014. The sharp fall of the Russian rouble and the weakening of commodity prices have prompted significant exchange-rate declines. As a result, loans denominated in foreign currencies have become more expensive in national currency terms. These loans are sometimes provided to borrowers who do not have foreign-currency earnings and, therefore, are likely to face increasing difficulties to service their debt, especially in the context of declining or slow growth in real earnings. Thus, currency depreciation might translate into a rise in non-performing loans, putting additional pressure on the banking system in the region. At the moment, such risks appear to be higher in Azerbaijan, Belarus, Kazakhstan and Ukraine.

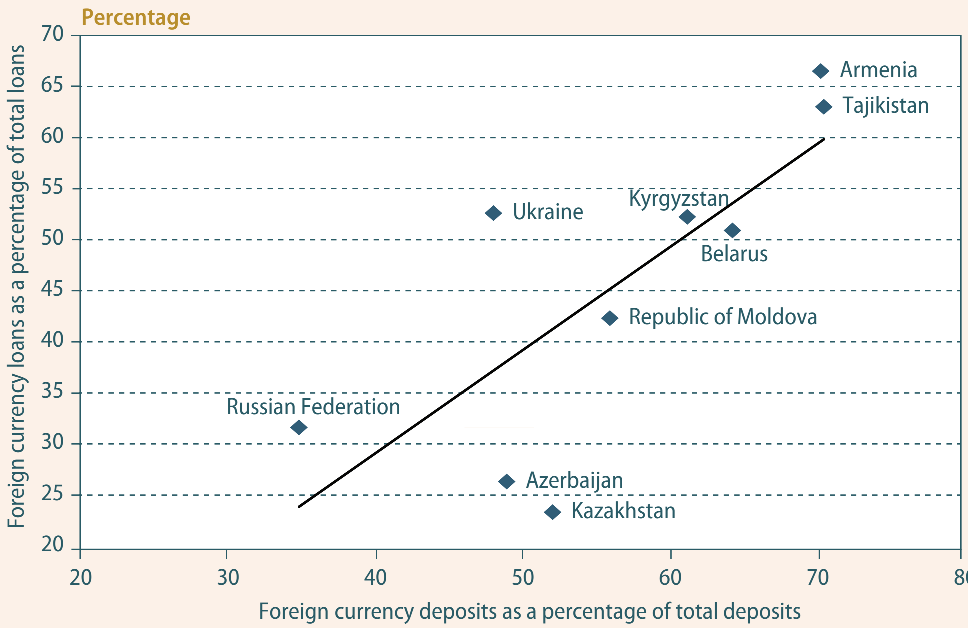
Dollarization is an important policy concern since the use of foreign currency reduces the demand for national currency and, therefore, seigniorage revenue. Moreover, it has major implications for the conduct of monetary policy and financial stability. It restricts the efficiency of the monetary transmission mechanism by weakening the interest-rate pass-through from policy to market rates. In this context, exchange rates acquire more importance for monetary policy than interest rates. At the same time, the presence of large public and private foreign-currency liabilities leads to “fear of floating”, as the impact of currency depreciation on the balance sheet can pose a threat to financial stability. It may also strengthen the effect of exchange-rate variations on inflation.

International experience, including that of the CIS countries, shows that financial dollarization can persist long after sustained declines in inflation. De-dollarization would require a monetary policy that

(*continued*)

Box IV.2 (*continued*)

Figure IV.2.3
Shares of foreign-currency deposits and loans in the CIS, 2015



Source: National central banks.
Note: Most data are from June/July 2015.

ensures price stability, while allowing for some exchange-rate flexibility to discourage taking risks in foreign currencies. The development of deeper financial markets would also contribute to the increased use of national currencies. Prudential banking regulations to reduce the relative attraction of foreign-currency assets, such as differential reserves and provision requirements, can also be useful instruments, provided they are accompanied by supportive macro conditions. By contrast, outright administrative restrictions may have a damaging impact on policy credibility and entrench negative expectations regarding national currencies' values.

Source: UN/ECE.

Developing economies

Aggregate growth of developing economies further slowed in the past year amid lower commodity prices, large capital outflows and increased financial market volatility. On average, GDP in developing countries grew by 3.8 per cent in 2015, down from 4.3 per cent in 2014 and only about half the rate recorded in the period 2004-07. The severe slowdown in developing countries since 2011 reflects both cyclical and structural factors, with potential growth estimated to be significantly lower than before the global financial crisis. In the near term, the external environment for developing countries is expected to remain challenging in the face of subdued import demand in developed economies and elevated global financial risks. In addition, many large developing countries (such as Brazil, China and South Africa) are grappling with structural economic challenges, including a sharp downturn in productivity growth. This implies that any growth recovery in the outlook period will likely be modest. In the baseline forecast, average developing-country growth is projected to strengthen to 4.3 per cent in 2016 and 4.8 per cent in 2017. Even as China's economy will likely continue to slow, East and South Asia will remain the world's most dynamic and fastest-growing regions. The gap with other regions is, however, expected to narrow as growth in Africa, Western Asia and Latin America is set to gradually recover.

Africa: domestic demand drives accelerating growth

Economic growth in Africa has reached 3.7 per cent in 2015, about the same level as in the previous year (excluding Libya), underpinned by private consumption and investment. Government spending, in particular on infrastructure projects, has also been positively contributing to growth over the period. However, the external balance has negatively impacted growth in 2015 because of weak demand and volatile commodity prices, although this impact is expected to soften in 2016. With forecasted growth of 4.4 per cent, the prospects for Africa for 2016 look relatively favourable, despite the uncertainty in the global economy and the weakening of oil and commodity prices. The growth momentum is set to continue, underpinned by increasing domestic demand, coupled with an improving regional business environment, improving macroeconomic management, increasing public investment (especially in infrastructure), a buoyant services sector and increasing trade and investment ties with emerging economies.

East Africa is seeing strong growth thanks to FDI, infrastructure spending and growing domestic markets

East Africa maintained the highest growth rate in the region, at 6.2 per cent in 2015, with a projected increase to 6.8 per cent in 2016. Growth decreased relative to 2014 as a consequence of lower growth in Ethiopia. However, the political uncertainties and instabilities in Burundi and South Sudan and terrorism threats in Kenya and Somalia have weighed on the subregion's growth.

A weaker oil sector pulled down growth in West Africa

Growth in West Africa decreased to 4.4 per cent in 2015, based on a considerably lower growth rate in Nigeria, following a weaker oil sector and the uncertainty caused by the elections of March 2015. The consequences of the Ebola outbreak in the most-affected countries, namely Guinea, Liberia and Sierra Leone, also impacted their growth potential, although Guinea and Liberia returned to positive growth. West Africa's growth is projected to increase to 5.2 per cent and 5.3 per cent in 2016 and 2017, respectively, driven mainly by the improving economic performance of Nigeria, with its emphasis on the growing non-oil sectors.

The overall growth rate decreased slightly from 5.7 per cent in 2014 to 3.4 per cent in 2015 in the Central Africa subregion, despite improved performance in the mining sector. While most countries in the subregion maintained a relatively high growth path, security concerns in the Central African Republic and the decrease in oil production in Equatorial Guinea led to a decline in the subregion's GDP growth. The subregion is expected to experience a rise in its average growth rate to 4.3 per cent in 2016, mainly driven by investment in energy and infrastructure, strong performance of the service sector (notably in Cameroon and Chad), and an increase in oil production, for example, in Chad.

North Africa benefitted from improved political and economic stability

Growth in North Africa accelerated from 2.8 per cent to 3.6 per cent over the 2014-2015 period (excluding Libya), and is projected to increase further to 4.0 per cent in 2016. The positive developments have been helped by some improvements in political and economic stability in the subregion, and the subsequent increase in business confidence, especially in Egypt and Tunisia. The gradual recovery of export markets and improved security should support growth, especially through tourism. Algeria's oil production increased for the first time in eight years and is boosting growth together with the non-oil sectors. Mauritania continues to achieve the highest and steadiest growth in the region, supported by favourable macroeconomic and structural policies. This was mainly boosted by developments in the mining and construction sectors, as well as increased private consumption and investment. Ongoing political challenges in Libya continue to negatively impact both political and economic governance in the subregion.

South Africa's subdued growth pulled down Southern Africa's regional growth performance

Southern Africa's growth has remained flat at 2.5 per cent in 2014 and 2015, with an increase to 3.0 per cent and 3.3 per cent forecast over the next two years. The subregion's low growth performance—relative to previous years and also other subregions—was driven by the relatively poor growth in the biggest economy, South Africa, where weak export demand and low commodity prices for its key raw materials, as well as electricity shortages, contributed to the subdued performance. In Angola, GDP growth remained strong despite low oil prices, as the Government embarks on investing in strategic non-oil sectors such as electricity, construction and technology. Mozambique and Zambia recorded the highest growth in the region, driven by large infrastructure projects and FDI in the mining sector, respectively.

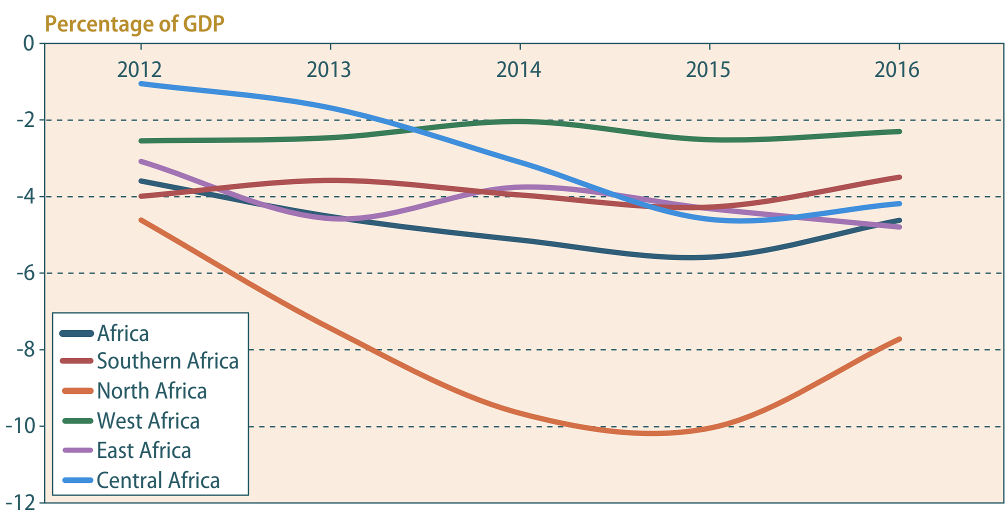
Inflation will moderate

African inflation ticked up to 7.5 per cent in 2015, but is forecast to decrease to 6.7 per cent in 2016 and 6.3 per cent in 2017. Inflationary pressure was reduced by lower global oil prices and the continuing fall of food prices (estimated to be 14 per cent for 2015), while currency depreciations have increased the risk of imported inflation. Public spending in Nigeria in the lead-up to the elections also contributed to inflationary pressure in the subregion, together with the pressure on the naira caused by the lower oil prices. Inflation in West Africa is expected to remain at about 8.4 per cent in 2016 and 2017. In other subregions except North Africa, inflation rates increased in 2015 as well, driven by weather-related shocks, currency depreciations and the removal of subsidies.

Fiscal deficits will improve owing to stabilizing oil prices and public expenditure adjustments

The fiscal deficit of Africa increased from 5.1 per cent of GDP in 2014 to an estimated 5.6 per cent of GDP in 2015 (figure IV.4). The continued decline of oil prices and volatile commodity prices reduced fiscal revenue in most of the African countries, while high spending on infrastructure and higher spending in the lead-up to elections contributed to increased expenditure in some countries.

Figure IV.4
Africa: average budget balance as a share of GDP by subregion, 2012–2016



Source: UN/ECA, based on Economist Intelligence Unit.
Note: Data were retrieved on 16 September 2015; data for 2015 and 2016 are forecast.

Lower oil prices have put fiscal budgets under pressure

The low oil prices have reduced public revenue in oil-exporting countries such as Algeria, Angola, Nigeria and Sudan. At the same time, increased spending for large public investments, continued subsidies for basic goods, in Morocco and Tunisia, for example, and election-related expenditure in Morocco have continued to exert pressure on public expenditure. In West Africa, the widening deficit was driven by the deterioration of fiscal balances mainly in Ghana and Nigeria. In Nigeria, the impact of low oil prices on fiscal balances is limited because of the use of buffers from oil-revenue savings and improved performance of non-oil sectors. In East Africa, the deficit deterioration is mainly a reflection of expansionary fiscal policies in Ethiopia, Kenya, Madagascar, Uganda and the United Republic of Tanzania. The deterioration of the fiscal balance was greatest in Central Africa, where the deficit widened from 3.1 per cent to an estimated 4.6 per cent, driven by expansionary fiscal policies, including infrastructure development in Cameroon, Chad and Equatorial Guinea, as well as election spending in Chad.

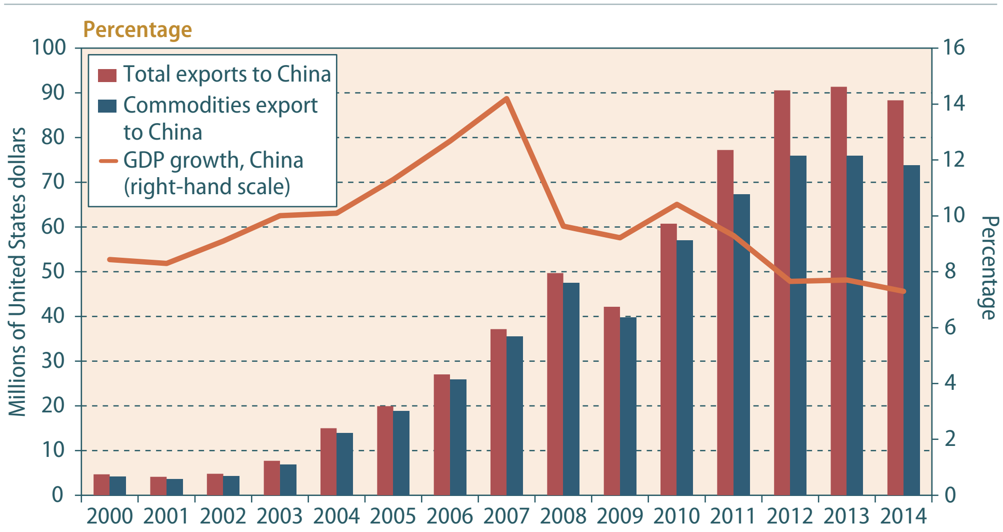
Lower oil prices led to a rise in Africa's current-account deficit

Africa's current-account deficit increased to 5.0 per cent of GDP in 2015, with all economic groupings and subregions reporting a current-account deficit. This was driven to a certain extent by the declining oil prices. Oil-exporting African countries recorded a deficit of 2.1 per cent of GDP in 2014, the first deficit since 2009. In 2015, the deficit increased to 5.1 per cent. For oil importers, the low oil prices led to a narrowing of the deficit. Among the subregions, the current-account deficit was the largest for Central Africa (8.1 per cent), followed by East Africa (7.4 per cent) and Southern Africa (5.7 per cent).

Exports to the euro area and currency depreciation will support Africa's current-account balance

The expected improvement in the economic performance of the euro area will have a positive influence on current-account balances of African countries in 2016 and 2017. The depreciation of major currencies will also assist in promoting exports. However, the reliance of many African countries on imports, particularly capital goods, and the faster rate of growth of imports relative to exports may exacerbate external balances (box IV.3). At the same time, the slowdown in China's growth has also been a concern for African countries, given the increasing importance of the Chinese market. Africa's exports to China are still dominated by commodities, although manufacturing exports have increased in importance in the last five years (figure IV.5).

Figure IV.5
Africa's exports to China, 2000–2014



Source: UNCTADstat and UN/DESA.

Lower oil and commodity prices also impacted international reserves and debt levels

The falling oil and commodity prices drew down the international reserves of African countries to an estimated 15.8 per cent of GDP in 2015, down from 17.1 per cent in 2014. The oil-price decline also impacted the net debt of Africa, which increased from 5.8 per cent in 2014 to an estimated 9.9 per cent of GDP in 2015, compared to 2.9 per cent in 2013. From 2014 to 2015, total gross debt for Africa increased from 22.9 per cent to about 25.7 per cent of GDP.

Box IV.3

Africa's resource exports and product imports: the untapped potential of value-added production

Intermediate products accounted for 60 per cent of Africa's merchandise imports over the last decade and significantly contributed to African countries' growth (United Nations, Economic Commission for Africa, 2015). Over the same decade, intermediate exports have constituted the most dynamic component of Africa's exports, mainly driven by fuel and mineral exports.[a] Africa's exports grew from an average of $84 billion in 2000-2002 to $356 billion 10 years later. However, the region continues to account for only a minimal proportion of global trade (World Trade Organization and IDE-JETRO, 2011).

The lack of global competitiveness of Africa's manufacturing sectors and the extent of untapped potential of domestic value-added production limit the continent's participation in the global supply chain. For example, Africa accounted for $3.9 billion—that is, roughly 16 per cent of global cotton exports in 2012—but only about one tenth of this was cotton fabric. At the same time, the region imported $0.4 billion of cotton and $4 billion of cotton fabrics, suggesting that the continent was effectively trading raw cotton for cotton fabrics. Similarly, Nigeria exported $89.0 billion of crude oil but only $5.6 billion of refined oil products in 2012, while importing $5.5 billion in refined oil (United Nations, Economic Commission for Africa, 2015). Most African countries export the bulk of agricultural intermediates, but with little domestic processing and value addition. For instance, more than 75 per cent of the cocoa exported from West Africa is in the form of cocoa beans, the production of which requires far less value addition than cocoa paste, cocoa butter or chocolate. Overall, African economies import 88 per cent of their intermediates from the rest of the world, with minimal imports from the continent itself. Among intra-Africa imports, the field is dominated by a handful of players—Algeria, Egypt, Morocco, Nigeria, Tunisia and South Africa—which account for nearly 75 per cent of the total.

At the sectoral level, intermediate imports are concentrated in a few sectors such as manufacturing, agriculture, mining and quarrying, with manufacturing being the main driver of imported intermediate demand. Manufacturing intermediates represent more than two thirds of intra-African exports, while mining and quarrying constitute half of Africa's intermediate exports to the rest of the world. With Egypt, Ghana, Kenya, Nigeria, South Africa, the United Republic of Tanzania and Zambia recording gains in their exports of manufacturing inputs within Africa, there is evidence of enhanced forward linkages with manufacturing firms on the continent. However, the small size of Africa's trade in intermediates and the geographical pattern of such trade suggest that there are persistent structural weaknesses in these sectors.

While evidence points to some backward linkages in mining and quarrying (where 25 per cent of imported intermediates are sourced within Africa), the potential to establish regional value chains (RVCs) in the textiles or agriculture sectors is still largely untapped, as less than 10 per cent of intermediates are imported from the region. The extractive industries remain the main channel through which African economies are connected to downstream global value chains, and linkages to the regional market are weak (Organization for Economic Cooperation and Development, 2015g). Most African economies remain mired in the low end of value chains, supplying raw materials and other intermediates that embody very limited domestic value addition (United Nations, Economic Commission for Africa, 2013). This, in turn, fails to foster the establishment of forward linkages with the domestic economies, resulting in minimal contributions to employment generation and growth.

The lack of intermediate exports in the manufacturing sector mirrors the persistently low intra-industry trade in the region, and points to the low levels of African economies' integration into regional and global production networks. Most African countries continue to have poorly diversified structures of production and have experienced premature de-industrialization, which further curtails the scope for intra-industry trade.

African countries should thus develop and strengthen RVCs, as intra-African trade represents a promising avenue to support industrialization. The experiences of selected African countries suggest that an appropriate policy framework focused on enhancing industrialization could go a long way in fostering value-added production in downstream activities, even in extractive industries. For instance, Botswana has managed to foster the emergence of a viable diamond cutting and polishing cluster that employs several thousand workers. Similarly, small and medium-sized Mozambican enterprises have entered the aluminium value chain that is centred on the Mozal smelter.

Source: UN/ECA.

a Such as Algeria, Nigeria, Sudan and Zambia.

Major risks and challenges for Africa include weaker growth in China and the euro area, commodity price levels and currency depreciation

The weak recovery of the global economy continues to pose a challenge for Africa's economic performance through its impact on trade, investment and remittances. At the same time, however, solid performances by the most dynamic export markets for African countries—India and Africa itself—may buffer the impact on trade. Low oil prices continue to pose a challenge, especially for oil-exporting countries, although they have been generally beneficial for oil importers. The depreciation of major African currencies, while possibly beneficial for exports, puts pressure on monetary stability through imported inflation.

Higher interest rates in the United States could divert investment flows from Africa

While FDI flows are expected to remain steady at about 3 per cent of GDP, monetary policy decisions by the Fed present a risk in the medium term. The low interest rates and therefore returns in both the United States and the European countries have increased investors' appetite for emerging markets. The likely rate increase by the Fed may divert investment flows from emerging markets back to developed countries, also negatively affecting the African economies. This presents a risk, particularly for those countries that have introduced sovereign bonds as an alternative source of finance, such as Gabon, Ghana and Zambia.

Weather-related shocks and security issues are further risks for Africa's growth performance

At the regional level, economic performance continues to be hampered by weather-related shocks. Droughts in East Africa in particular remain a challenge to the agricultural sector, which is still the main employer on the continent. As a consequence, poor harvests could also increase the risk of inflation through higher food prices in the drought- or flood-affected countries. Security in some African countries also remains an issue. Security concerns in Egypt and Tunisia have already had a negative impact on income from tourism. The continuing presence of Boko Haram in West Africa and political unrest in countries such as Burkina Faso and Burundi, and more recently Mali, can be a source of domestic disruption and instability, leading to a decrease in investment in these countries.

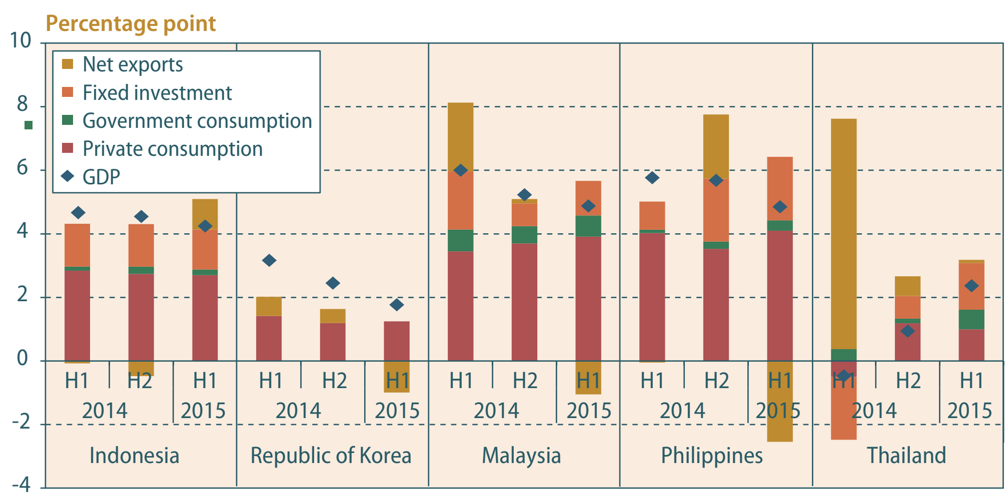
East Asia: despite a weaker-than-expected performance the region drives global growth

Given the subdued growth in most developed countries, domestic demand in East Asian economies continues to play an important role in driving growth. The tepid performance of the export sector is a key factor behind lower-than-expected GDP growth in 2015. With policy support, primarily from the fiscal side, GDP growth is projected to accelerate in 2016 in most of the region's major economies, while China continues on a slower growth path as it seeks to achieve more sustainable growth. In aggregate, East Asian economies are expected to grow by 5.6 per cent in 2016, similar to 2015, but down from an annual average of 6.3 per cent in 2012-2014. Excluding China, however, growth is expected to rebound to 4.1 per cent in 2016, from an estimated 3.4 per cent in 2015. Consumer price inflation is at a multi-year low for major economies in the region, with the most notable exception being Indonesia. As reflected in wider budget deficits, fiscal policy has generally become more expansionary, with scaled-up health and infrastructure spending and stimulus focused on jobs and small and medium-sized enterprises. Further monetary support is expected to remain limited owing to already-low policy rates and anticipated increases in the United States interest rates. Financial market and exchange-rate volatility increased in August 2015, amid concerns about China's outlook as well as the expectation of a United States interest-rate hike. The weakening of the region's currencies against the United States dollar poses risks for external debt (United Nations, Economic and Social Commission for Asia and the Pacific, 2016), and so far has done little to lift the region's exports. Capital outflows could lead to further volatility in asset markets, but bank capital and foreign-currency reserves in most economies seem adequate, based on Basel standards and import cover.[2]

China's growth projected to decelerate moderately, significantly impacting Republic of Korea through trade

China's economy is estimated to have grown by 6.8 per cent in 2015, down from 7.3 per cent in 2014. Growth is likely to have further moderated in the second half of the year owing to weaker exports and restrained investment as the country is working through excess inventories in the property market and overcapacity of heavy industries. Local government spending has also been constrained by fiscal drag resulting from the restrictions on bank lending to local government financing vehicles and reduced land sales revenue (even though revenue has shown signs of recovery in the second half of 2015). Consumer spending continues to expand, despite corrections in real estate and equity markets, but retail sales growth has slowed down compared to previous years. GDP growth is expected to ease further to 6.4 per cent in 2016. The Republic of Korea's economy is estimated to have grown by 2.6 per cent in 2015, down from 3.3 per cent in 2014, as net exports have declined significantly (figure IV.6). The decline in exports is closely linked to the slowdown of the Chinese economy given the Republic of Korea's high trade exposure to China. However, as consumer and business sentiment began to improve in the second half of 2015 and a $20 billion fiscal stimulus was announced in mid-2015, GDP growth is expected to improve to 3.0 per cent in 2016.

Figure IV.6
East Asia: contributions of expenditure components to real GDP growth, January 2014–June 2015



Source: UN/ESCAP, based on data from CEIC database.
Note: Changes in inventories are excluded.

Growth estimates revised downward for a majority of ASEAN economies

Growth estimates for 2015 have been revised downward from the previous forecasts for the majority of Association of Southeast Asian Nations (ASEAN) economies, with the notable exceptions of Myanmar and Viet Nam. Myanmar is projected to have grown by 8.4 per cent in 2015, driven by new investments, rapid credit growth and higher government spending. Viet Nam is expected to grow by 6.4 per cent in 2015 as consumer spending recovered and manufacturing exports remained strong. Similar levels of GDP growth are

2 For further discussion on reserve adequacy, see International Monetary Fund (2011) and Williams (2005).

foreseen for the two economies in 2016, as the aforementioned contributing factors should remain at play.

The Indonesian economy is estimated to have grown by 5.1 per cent in 2015, as commodity exports and investment remained subdued and consumer spending was hit by higher-than-expected inflation. Expected improvement in investment and lower inflation should lift GDP growth to 5.4 per cent in 2016. Thailand's economy is projected to have grown by 2.5 per cent in 2015, up from 0.9 per cent in 2014 when growth stalled amid political unrest. Prolonged weakness in exports held back growth even as government expenditures rebounded. Consumer spending is constrained by household debt and lower farm incomes due to drought. A fiscal stimulus announced in September 2015 and the upcoming large infrastructure projects are expected to improve Thailand's growth prospect.

Malaysia's economy is estimated to have grown by 4.5 per cent in 2015, down from 6 per cent in 2014, as exports fell, largely in the commodity sectors, and private investment growth slowed. Consumer spending held up well, despite softening after April 2015 when a new goods and services tax came into effect. A modest recovery in exports and ongoing investment aimed at upgrading industry and infrastructure should support stronger growth during the outlook period. The Philippines' economy—one of the better performers in ASEAN—is estimated to have grown by 5.8 per cent in 2015, as consumer spending and investment remained robust. Weak exports of goods are partially offset by exports of services, including business process outsourcing. Continued strong domestic demand and public spending that typically precedes elections should lift the Philippines' growth. Singapore is estimated to have grown by 2.3 per cent in 2015 as services and construction growth partly offset manufacturing contraction. Investment will pick up speed in 2016-2017 and play an elevated role in lifting Singapore's growth.

Outside of ASEAN, weak performance of the export sector has significantly slowed down the GDP growth rate of Taiwan Province of China to 1 per cent in 2015—one of the lowest in the region. While projected to grow at a higher rate of 2.3 per cent, output growth of the Hong Kong Special Administrative Region (SAR) of China has also been hit by weak export performance in 2015. A moderate export recovery during the forecast period, coupled with continued steady private consumption growth, is expected to moderately improve the growth outlook of both economies.

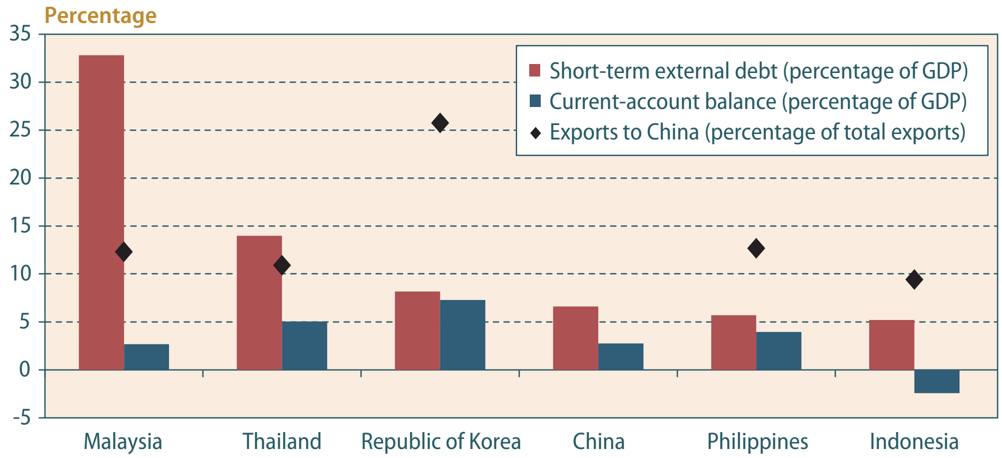
Official unemployment rate is generally low, but other employment-related concerns exist

Among major economies, the official unemployment rate is generally low, in the range of 1 to 4 per cent, except in Indonesia and the Philippines where it stands near or above 6 per cent. The jobless rates for those aged 25 to 29 are much higher, ranging from 4.5 per cent in Thailand to 21.5 per cent in Indonesia. The share of unpaid family workers and own-account workers in total employment remains high, ranging from 21.3 per cent in the Republic of Korea to 61.5 per cent in Viet Nam, based on International Labour Organization estimates. Reflecting low wages and low productivity, two thirds of the employed in Indonesia and the Philippines earn below $4 a day. For East Asian economies to rebalance towards domestic demand (without relying too heavily on debt), it is important to improve labour's share in total income, which has declined or remains low in some economies (United Nations, Economic and Social Commission for Asia and the Pacific, 2016; and International Labour Organization, 2013).

Consumer price inflation is expected to pick up from the subdued levels in 2015

Consumer price inflation is expected to pick up to 2.2 per cent in 2016 from an estimated multi-year low of 1.6 per cent in 2015, in line with stronger economic activity in the majority of the region's economies and a modest rise in global oil prices. In 2015, economies such as Singapore, Taiwan Province of China and Thailand experienced mild headline deflation. Against the backdrop of low oil and commodity prices, inflation was below the

Figure IV.7
East Asia: selected vulnerability indicators



Source: UN/ESCAP, based on data from Trademap and CEIC database.
Note: Exports and current-account balance figures are based on data from 2014 Q3 to 2015 Q2. External debt figures are based on data as of end-2014.

central bank's target band in many major economies, with Indonesia being a notable exception. Core inflation declined in the Philippines, albeit from a high base, and in Thailand, in line with weak domestic demand, but was stable in China and the Republic of Korea. In contrast, inflation remained relatively high in Indonesia and accelerated in Malaysia, owing to the phase-out of fuel subsidies, sharp depreciations against the United States dollar, plus import restrictions in the former and a new consumption tax in the latter.

Monetary policy has been accommodative, but further easing is likely to be limited

Monetary policy has been generally accommodative, although real interest rates have returned to positive territory in all countries, owing to low inflation. In response to weakening domestic demand, the central banks of China, the Republic of Korea and Thailand lowered their policy rates more than once in the first half of 2015; in China and Thailand, policy rates are now at a record low of 1.5 per cent. China reduced reserve requirements and injected liquidity into the banking system through open-market operations and refinancing facilities to support liquidity, which has roughly offset the decline of foreign-exchange deposits, a major source of liquidity. After a hike in response to the fuel subsidy cut announcement, Indonesia's central bank returned its policy rate to 7.5 per cent, while loosening macroprudential measures to support lending for housing and car purchases. Central banks in Malaysia, the Philippines and Viet Nam kept their benchmark rates unchanged in 2015. Further monetary easing is expected to be limited due to anticipated increases in the United States interest rates, low policy rates, and high household debt and asset market speculations in some of the region's economies.

Fiscal policies have generally been expansionary

Fiscal policy stances have become more expansionary amid slowing economic growth. There is room to do even more as public debt levels are relatively low in a majority of the region's economies. Indonesia, the Republic of Korea and Thailand introduced stimulus packages or countercyclical measures in 2015. All major economies except Malaysia had wider budget deficits in 2015 compared to 2014, due to higher social and infrastructure spending, although the deficits also reflected weaker natural resource revenues and, in some cases, general taxation revenues. Both Indonesia and the Philippines increased their deficit targets in 2015 to accommodate higher infrastructure investment and social service spending, although budget disbursements were often delayed. In contrast, the fiscal deficit narrowed in Malaysia, in line with its target to balance the budget and lower debt by 2020.

Regardless of the fiscal stance, countries are reprioritizing expenditures, as seen in recent fuel subsidy reforms in Indonesia and Malaysia. Countries are also strengthening their tax revenues. Malaysia introduced a 6 per cent goods and services tax in April 2015. Thailand will introduce an inheritance tax in early 2016. China is introducing the value added tax (VAT) to more sectors—replacing the existing turnover tax—and plans to introduce a nationwide residential real estate tax.

Exports remained weak in 2015 and weighed on growth in most of the larger economies.

East Asia's trade and current-account surpluses have narrowed since the global financial crisis that began in 2008. In 2015, exports remained weak, given the persistently moderate economic recovery in most developed countries and the continued slowdown in China—a top export destination. Net exports weighed on GDP growth in most of the region's bigger economies. Lower global oil prices have substantially reduced oil and gas revenues in Brunei, Indonesia, Malaysia and Papua New Guinea. Short-term external debt is particularly high in Malaysia, at 33 per cent of GDP as of end-2014 (figure IV.7). This poses risks, especially in the context of much narrower current-account surpluses and tighter global financing conditions. Larger capital outflows could lead to volatility in asset markets, but regional banks are well capitalized and foreign-currency reserves are adequate. In addition to the Chiang Mai multilateral swap arrangement of ASEAN+3 members,[3] East Asia has a number of bilateral swaps, which in the case of Indonesia and Malaysia are equivalent to about a third to nearly half of their own reserves (United Nations, Economic and Social Commission for Asia and the Pacific, 2015a).

Further slowdown of China's economy poses downside risks

Risks to the regional forecast remain largely on the downside. One key risk is the possible acceleration of the slowdown of the Chinese economy. Stabilizing China's growth would require the rebalancing of the economy towards consumption and managing the challenges associated with the rapidly rising private debt. From a longer-term perspective, the ageing population and the fact that China is now crossing the Lewis Turning Point—meaning that room for productivity gains through rural-urban migration is increasingly limited—will also pose considerable challenges. The Government's announcement of ending the one-child policy in October is a welcome step towards addressing the demographic challenge, but its effects will remain limited in the short and medium run. The direct impact of a sharper-than-expected slowdown in China on East Asia would be mainly felt through the trade and investment channels, given the close trade linkages and rising Chinese investment in the region. Another key risk is the possibility of excessive market reactions to the pending rate hike in the United States, which could result in further depreciations of East Asia's currencies, significant capital outflows, and tightening of the liquidity conditions in the region. However, since the market has already internalized some of the anticipated interest-rate differentials in 2016 and the rate rise is expected to be modest, the short-term impact of the rate hike is likely to be limited.

South Asia: growth expected to strengthen, driven by private consumption and investment

Economic growth in South Asia is projected to accelerate in 2016-2017, contingent upon steady progress on domestic policy reforms. South Asia's GDP is expected to grow by 6.7

3 The +3 members of the Association of Southeast Asian Nations (ASEAN) are China, Japan and the Republic of Korea.

Box IV. 4

The potential impact of monetary policy normalization in the United States on Asia and the Pacific

As the economy of the United States of America regains growth momentum and labour market indicators improve, market expectations of imminent yet gradual increases in the federal funds rate are almost universal; the only difference of opinion is related to their timing. In September 2015, the United States Federal Reserve estimated that the federal funds rate could rise from the current rate of near zero to 3.4 per cent by end-2018. This will put pressure on other economies to follow suit, although the magnitude of the rate increase in each economy will be determined by country-specific factors, such as macroeconomic fundamentals and economic growth prospects.

This box examines the potential impact of these likely changes in the monetary policy stance of the United States on developing Asia-Pacific economies. In the short term, the United States rate hike could lead to financial market volatility, including further downward pressure on currencies; in the longer term, it will result in higher borrowing costs, which could be particularly detrimental for small economies that rely heavily on foreign borrowings.

In recent years, a mismatch between actual and anticipated announcements regarding the direction of United States monetary policy has already affected global risk appetite and led to episodes of financial turmoil, resulting in large capital outflows, sharp corrections in equity prices and steep currency depreciations in many Asia-Pacific economies. In mid-2013, amid fears that the United States quantitative easing programme would be tapered earlier than expected, the Indian rupiah quickly lost 15 per cent against the dollar, and the currencies of Indonesia, Malaysia, the Philippines and Thailand weakened by 7-9 per cent. While increases in United States interest rates are widely anticipated, the pace remains uncertain and the actual announcement could still lead to financial market volatility in some of the region's economies. The global stock market sell-off in August 2015, driven largely by concerns over slower economic growth in China, illustrates how strongly investors sometimes react to developments that have been generally expected.

A more fundamental, longer-term effect of the United States monetary policy normalization is higher financing costs for developing economies. It is estimated that a one percentage point increase in domestic short-term interest rates over 2016, in response to United States interest-rate increases, could lower annual output growth in eight major Asia-Pacific economies by 0.3-0.7 percentage points.[a] As expected, there is a positive association between the size of the estimated impact and the domestic credit-to-GDP ratio. Economies that are more sensitive to higher borrowing costs, namely China, Hong Kong Special Administrative Region (SAR) of China, the Republic of Korea and Singapore all have credit-to-GDP ratios of at least 110 per cent.

While the estimated economic growth impact of higher financing costs in these major economies is notable, a more worrying case is the impact on smaller developing economies that are particularly vulnerable to higher interest rates. This includes economies where growth and financial stability could be negatively impacted by higher borrowing costs, while room for macroeconomic policy responses is limited.

Lao People's Democratic Republic, Mongolia and Papua New Guinea are the three Asia-Pacific countries that rely most heavily on foreign capital to finance their investment needs. During 2012-2014, these countries had large current-account deficits, ranging, on average, from 16-30 per cent of GDP.[b] In these economies, external debt stood at about 80-180 per cent of gross national income in 2013 and debt service payments were substantial. In Mongolia, debt service amounted to almost 30 per cent of goods and services exports and primary income in 2013. Since these economies exhibit low foreign-currency sovereign ratings, borrowing on a non-concessional basis would also incur higher costs amid tighter global financial liquidity. As credit default risks tend to rise with higher interest rates, a healthy banking sector is needed to maintain financial stability. However, in Lao People's Democratic Republic, direct exposure of banks to foreign-currency loans remains high (International Monetary Fund, 2015h). In Mongolia, a stress test has revealed that some banks have inadequate capital positions in the case of an economic shock (International Monetary Fund, 2015i). In both countries, banks' balance sheets have deteriorated recently after years of rapid credit growth.

a This simulation is based on the Oxford Global Economic Model. The eight economies are China, Hong Kong SAR, India, Indonesia, the Philippines, the Republic of Korea, Singapore and Thailand. For more details, see ESCAP (2015b, box 2).

b Another country with a large current-account deficit during the same period is Bhutan (21 per cent of GDP), but this was largely due to funds from India to finance large-scale hydropower projects.

(*continued*)

Box IV.4 (*continued*)

In terms of fiscal policy space, the three countries face different situations. According to a joint IMF-World Bank debt sustainability analysis, the risk of public debt distress in Mongolia is considered high, with key debt indicators staying above the relevant thresholds for the coming years. In Lao People's Democratic Republic, the risk of distress is still moderate, but has risen in recent years and the public debt profile is highly sensitive to currency depreciation. In contrast, Papua New Guinea appears to have a more comfortable fiscal position (International Monetary Fund, 2014b; 2015j). In the case of an adverse shock, such fiscal space can be used to implement countercyclical measures, such as temporary tax reductions for households and small businesses that face higher debt burdens.

Taken together, rising international interest rates in the coming years tend to affect economies such as Lao People's Democratic Republic and Mongolia more than others because of the high degree of exposure and the limited room for fiscal policy response. As both economies are commodity exporters, their near-term growth outlook is further constrained by lower global prices of primary commodities and sluggish import demand from China.

Source: UN/ESCAP.

per cent in 2016, up from an estimated growth of 6.0 per cent in 2015.[4] The improved outlook is likely to be broad-based. In most economies, including Bangladesh, India, Pakistan and Sri Lanka, strong private consumption will continue to be the main driver of growth, offsetting relatively tight fiscal policies and subdued exports. Consumer spending will be supported by low commodity prices, moderate inflation, steady employment growth (especially in the service sector), and rising workers' remittances. Some country-specific factors, such as the lifting of international sanctions against the Islamic Republic of Iran and reconstruction spending in Nepal, are also expected to help growth during the outlook period. A significant downside risk for the region is deteriorating market confidence, should progress on policy reforms fall short of expectations. Given the limited room for expansionary fiscal policy responses, any adverse shock, such as lower-than-average monsoon rainfalls, could have a sizable negative impact on output growth.

India's outlook is largely favourable, but reform challenges remain

South Asia's estimated growth of 6.0 per cent in 2015 is marginally lower than the 2014 growth of 6.4 per cent, but well above the average growth rate of 5.0 per cent recorded in 2011-2013. As in recent years, growth in 2015 was largely driven by domestic demand. Private consumption and investment were supported by relatively stable macroeconomic conditions and easier monetary policy in several countries, including India and Pakistan. Real exports, which account for a relatively small proportion of GDP in most countries, performed poorly amid subdued demand in major trading partners. India's economy, which accounts for over 70 per cent of the regional GDP, is projected to grow by 7.3 per cent in 2016 and 7.5 per cent in 2017, slightly up from an estimated 7.2 per cent in 2015. The macroeconomic environment in India has improved notably over the past two years, helped by the sharp decline in the prices of oil, metals and food. Consumer and investor confidence has risen even as the Government faces difficulties in implementing its wide-ranging reform agenda. In other economies such as Bangladesh, Pakistan and Sri Lanka, robust consumer spending, supported by lower energy prices and strong remittance inflows, continues to drive the expansion of service sectors, in particular domestic trade activities. In the Islamic Republic of Iran, the removal of international sanctions is expected to provide a boost to economic activity, with oil production and exports forecast to recover gradually. In Nepal, growth is projected to be supported by reconstruction efforts, following the devastating

4 The regional averages for GDP growth and consumer price inflation are based on data for the following countries: Bangladesh, India, the Islamic Republic of Iran, Nepal, Pakistan and Sri Lanka.

earthquake in April 2015; however, the damage caused to critical infrastructure will continue to negatively impact economic activity in 2016. In Bhutan, economic growth is expected to strengthen following the construction of large-scale hydropower projects. Given the highly cyclical and volatile investment patterns in the hydropower sector, the authorities in Bhutan face the challenge of stimulating investment in the productive non-hydropower and non-construction sectors, while also improving the overall capital efficiency.

Despite some recent improvements, massive labour market challenges remain

Available data point to generally stable labour markets in South Asia although high-frequency data is limited. Moreover, official data does not fully reflect labour market developments across the region. In India, official labour market surveys indicate significant employment gains in the industrial sector in late 2014 and early 2015, driven by strong performances in the textile and information technology sectors. In Sri Lanka, total employment expanded by 1.7 per cent in the first half of 2015 (year on year), while the unemployment rate remained relatively low at 4.5 per cent. During this period, average real wages rose by about 4 per cent, with even faster gains for agricultural workers. By contrast, in Bangladesh and Nepal, nominal wages are estimated to have increased at about the same rate as consumer prices, resulting in a stagnation of real wages. In the Islamic Republic of Iran, the unemployment rate has been in double digits for the past several years, standing at 10.8 per cent in mid-2015. For all countries with available data, unemployment rates were significantly higher among women than men. This is a concern given that the labour force participation rate is much lower among women. Given the high number of new labour market entrants each year, employment pressures will remain significant even as economic growth in South Asia gains further strength in the forecast period.

Consumer price inflation has declined to its lowest level in a decade

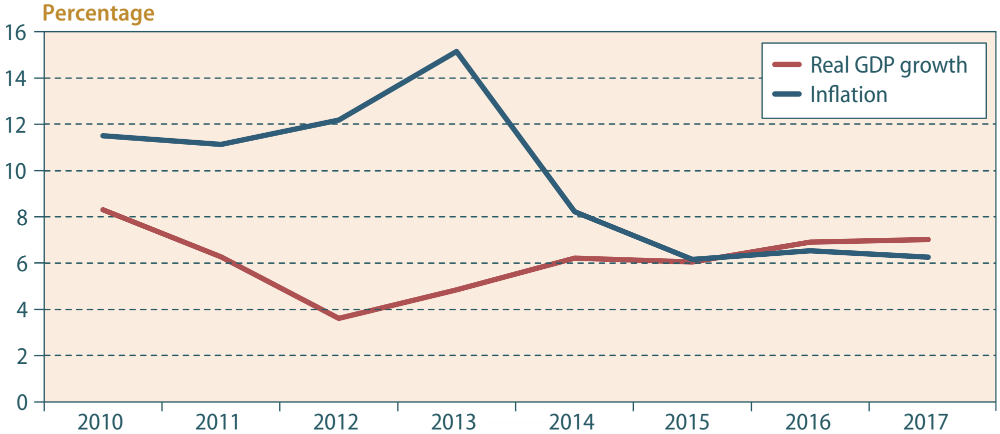
As a net oil-importing region, South Asia has seen reduced inflationary pressures owing to the sharp decline in international oil prices. Average consumer price inflation slowed from 8.2 per cent in 2014 to 6.2 per cent in 2015, the lowest level in more than a decade. All of the region's economies recorded a decline in inflation. Besides the sharp drop in international oil prices, the reduction in inflationary pressures can also be attributed to domestic factors such as robust harvests, some easing of supply-side bottlenecks, and decelerations in rural wage growth. The relative importance of these factors varies from country to country, as does the extent of the decline in inflation. In India, Pakistan and Sri Lanka, inflation rates have fallen significantly and upward price pressures are expected to remain limited in the short run. According to the forecasts, South Asia's average inflation rate in 2016 will be below the average GDP growth rate for the first time since 2006 (figure IV.8).

Monetary policy has been loosened amid lower inflation

Lower inflation has allowed for monetary policy easing in several economies. The policy interest rates have been cut by 50 to 300 basis points in India, Nepal, Pakistan and Sri Lanka in the first three quarters of 2015 as central banks aim to support credit growth and boost economic activity. However, interest rate cuts by the central banks have so far had limited impact on credit growth, as there has been little pass-through to either bank lending rates or lending conditions. For example, the Reserve Bank of India reduced the policy rate by 125 basis points between January and September 2015, but this translated into much smaller decreases in the base interest rate of the country's major banks, and commercial loan growth has not increased during the same period. Available data suggests stable bank asset quality, even as the level of non-performing loans has remained elevated in some countries, notably Pakistan. Going forward, monetary policy is projected to remain accommodative in most countries. The room for further easing is, however, constrained by an expected pickup in inflation and concerns that rate cuts could further weaken the domestic currencies and push up the external debt burden.

Figure IV.8

South Asia: annual GDP growth and consumer price inflation rates, 2010–2017



Source: UN/DESA.
Note: Figures for 2015 are partially estimated; figures for 2016 and 2017 are forecast.

Fiscal deficits are declining owing to lower oil prices, robust growth and subsidy cuts

Fiscal deficits narrowed to about 3-5 per cent of GDP in most economies in 2015. This improvement reflects lower oil prices, stronger economic activity and rationalization of fuel subsidies in some economies. India abolished diesel subsidies, while Bangladesh, India, the Islamic Republic of Iran and Nepal reduced subsidies on fuel and/or electricity. These policy reforms should help to enhance the fiscal space in the region. Nonetheless, fiscal positions in most economies remain fundamentally weak owing to the small tax base, poor tax administration, and the large expenditures required for closing the infrastructure and energy gaps and maintaining internal security. Afghanistan and Bhutan continue to rely heavily on foreign aid inflows, which account for 70 and 30 per cent of total government spending, respectively. Looking ahead, fiscal deficits are expected to moderate gradually in most economies as a result of still low energy prices and stronger economic growth. Fiscal reforms to boost government revenues would support fiscal consolidation efforts, but such reforms have experienced delays in most economies amid strong public and political opposition.

Weakness in merchandise trade persists

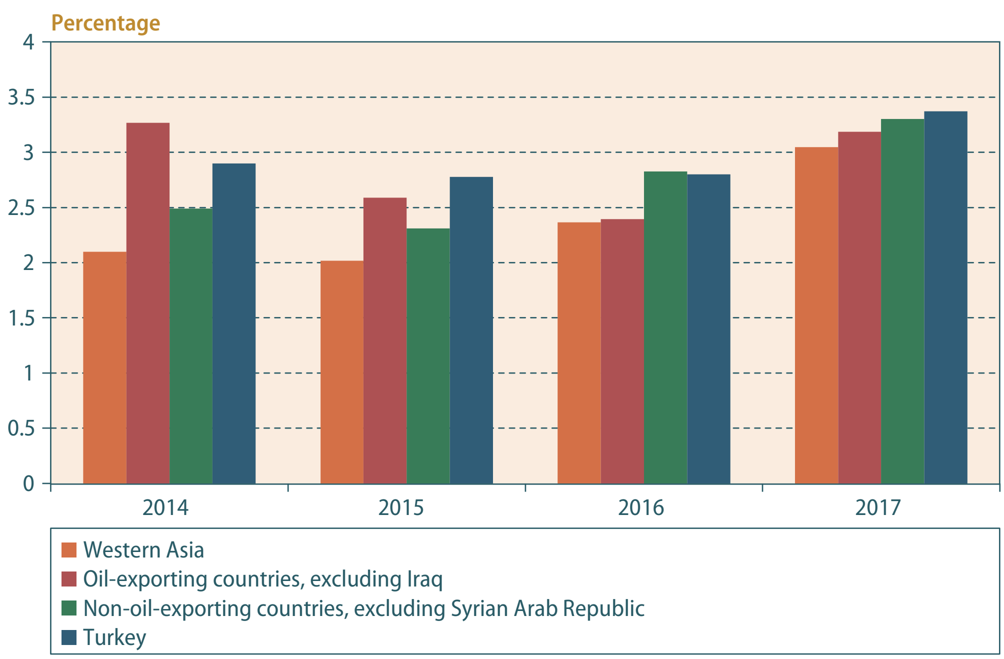
Merchandise exports were generally weak owing to subdued demand in the major trading partners. Intraregional trade is relatively small. Most economies in the region saw their export revenues decline in 2015. In India, the dollar value of exports in the first three quarters of 2015 fell by 15 per cent from a year ago and was at the lowest level since 2010. In addition to sluggish external demand, this decline also reflects the sharp drop in the prices of fuel and other commodities and the strong appreciation of the dollar. Despite the weakness in exports, the trade deficits narrowed in most economies as import bills fell even more sharply. The performance of service exports, particularly tourism, was mixed. Growth in overseas visitors to India and Sri Lanka decelerated, while arrivals in Bhutan were more buoyant. Meanwhile, workers' remittances continued to increase in all countries where remittances account for a sizeable proportion of GDP, namely Bangladesh, Nepal, Pakistan and Sri Lanka. While remittance growth generally slowed, the weaker exchange rates in these economies (except Bangladesh) have supported household incomes in local currencies. In the wake of improved trade balances and steady remittance growth, the current-account balances in South Asia generally improved in 2015. For 2016-2017, a mild recovery in merchandise export growth is projected relative to the low base in 2015 as economic activity in some major destination markets, particularly the United States and Europe, picks up. Some country-specific factors, such as the expected removal of international sanctions against the Islamic Republic of Iran, are also expected to support export growth.

Western Asia: along with military conflicts, low oil prices weigh on regional GDP growth

In addition to the ongoing military conflicts, the main factor influencing the region's economies during the past year has been the slump in oil prices. This has created very different prospects for countries, depending on whether they are net oil exporters or importers. But for the region as a whole, given the weight of oil exporters in regional output, the overall effect of lower oil prices is negative. Average GDP growth in the region is thus expected to be weak, estimated at 2.0 per cent in 2015. A partial recovery in countries experiencing conflicts is expected to help GDP growth to accelerate to 2.4 per cent in 2016, even though this remains very weak when compared with GDP growth figures of the past 15 years. In 2017, oil-exporting economies are expected to benefit from a recovery in oil prices, leading to a regional GDP growth figure of 3.0 per cent (figure IV.9).

Given the expectations of low oil prices in the near future, growth prospects in oil-exporting countries will largely depend on non-oil economic activities. Despite low oil prices, a moderate domestic demand expansion is projected in some economies of the Cooperation Council for the Arab States of the Gulf (GCC), sustained by substantial fiscal spending on infrastructure. Particularly in Qatar and Saudi Arabia, where financial reserves are sufficiently large, fiscal spending continued to support GDP growth in 2015 and will, to some extent, do so in 2016. However, fiscal consolidation is expected in most countries, especial-

Figure IV.9
GDP growth by economy groups in Western Asia, 2014–2017



Source: UN/DESA.
Note: Growth rates for 2015 are partially estimated; rates for 2016 and 2017 are forecast.

Box IV.5

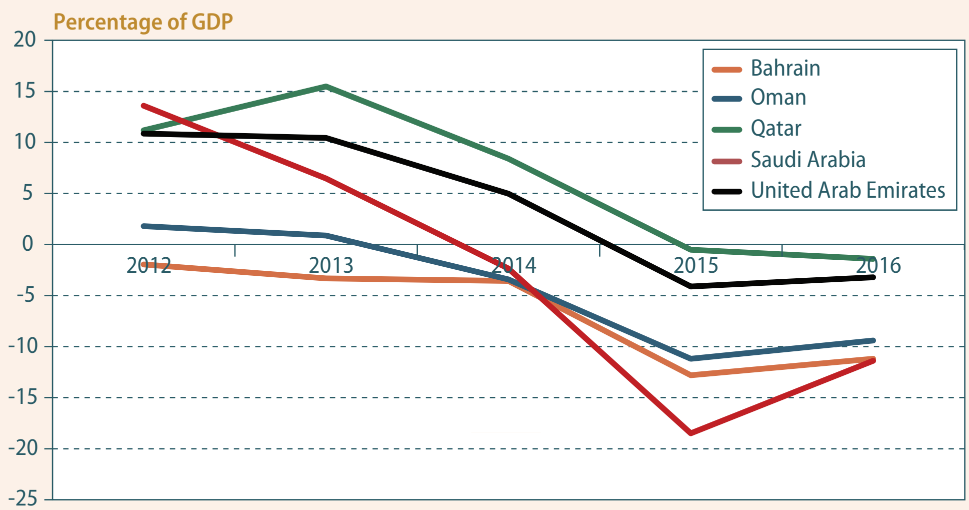
The impact of the current oil-price shock on public finances for oil-exporting countries in Western Asia

Oil prices are of central importance to many Western Asian economies, as oil-exporting countries rely heavily on oil revenues to fund their budgets. The share of oil revenues in national budget revenues ranges from 31.9 per cent in Qatar to 91.5 per cent in Iraq.[a] As a share of gross domestic product (GDP), oil revenues range from 14.6 per cent in Qatar to 59 per cent in Kuwait.

Given the strong dependence on oil-export revenues, the current oil-price slump has severe implications. The consequent strain on Arab oil exporters' public finances can be assessed by comparing the Brent oil price of $43 per barrel (pb) (as of 16 November 2015) to the International Monetary Fund (IMF) 2015 projections of countries' fiscal break-even oil price: Kuwait, $49.1 pb; Qatar, $55.5 pb; United Arab Emirates, $72.6 pb; Oman, $94.7 pb; Saudi Arabia, $105.6 pb; and Bahrain, $107.0 pb (International Monetary Fund, 2015m). As a result of subdued oil prices, all these oil-exporting economies are expected to register fiscal deficits in 2015 (figure IV.5.1).

Figure IV.5.1

Western Asia: budget balance for selected oil-exporting countries, 2012–2016



Source: Economist Intelligence Unit. Data for 2015 and 2016 are forecast.
Note: Budget balance is defined here as central government receipts minus central government outlays.

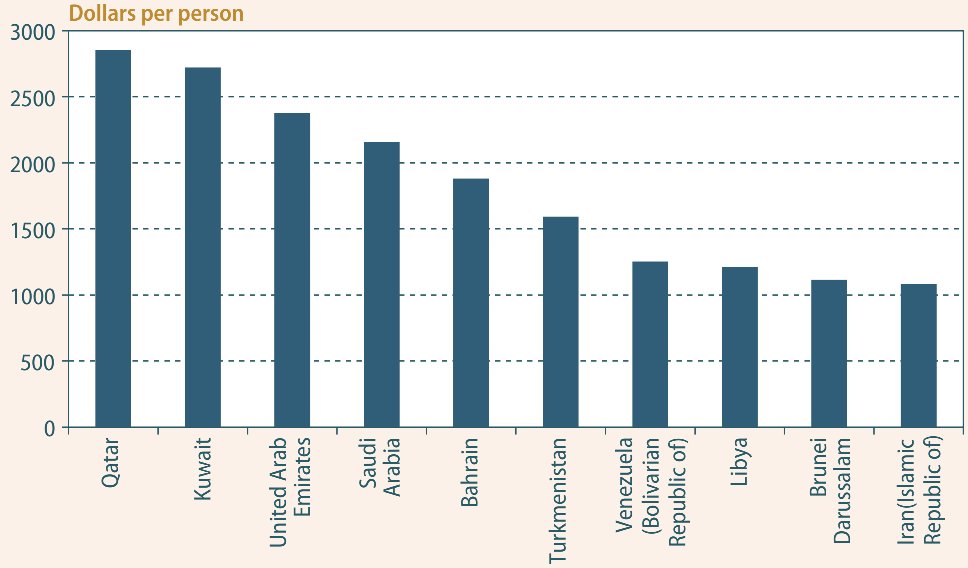
At the same time, oil subsidies are also relatively high in the region, amounting to approximately 8.6 per cent of the regional GDP (Sdralevich and others, 2014), compared with only 2 per cent at the global level. Although the phenomenon prevails in oil-importing countries as well, the GDP share of subsidies tends to be higher in oil-exporting countries. In terms of actual subsidy per capita, the five highest levels in 2013 were observed in countries of the Cooperation Council for the Arab States of the Gulf (GCC): Qatar $2,853; Kuwait, $2,721; United Arab Emirates, $2,378; Saudi Arabia, $2,155; and Bahrain, $1,888 (figure IV.5.2). The specific combination of subsidized products differs across countries, but they generally focus on food and oil products. The region's average fossil-fuel subsidization rates are also among the highest in the world, ranging from 53.3 per cent in Iraq to 78.5 per cent in Qatar.[b]

Against this backdrop, oil-exporting economies in Western Asia have different options, depending on their specific macroeconomic conditions. First, they may tap into their sovereign wealth funds (SWF). However, even though all oil-exporters have SWFs,[c] only Saudi Arabia has sufficient buffers ($660 billion) that would allow it to cover approximately 5.3 years of the projected 2015 fiscal deficit (International Monetary Fund, 2015n). Indeed, the country is exercising this option, as Saudi Arabia's SWF is projected to shrink by $94.4 billion in 2015.

(*continued*)

Box IV.5 (*continued*)

Figure IV.5.2
Top 10 countries in the world with the highest fossil-fuel subsidy per capita, 2013



Source: International Energy Agency (2014b).

The second option is to issue debt, which is particularly appealing in the current context of ultra-low interest rates (and this applies to all countries, given that their currencies are pegged to the United States dollar). Furthermore, the current levels of debt in the region are generally low: with the exception of Iraq, which has a total debt-to-GDP ratio of 70 per cent, total debt in oil-exporting countries ranges from 1.2 per cent of GDP in Oman to 44 per cent in Bahrain. The debt option has been considered by Saudi Arabia, for instance, which has announced that it will issue $27 billion in bonds. Other countries such as Kuwait and the United Arab Emirates are also considering this option.

The third option is to reduce spending, which raises a number of vital questions. Countries can postpone large capital projects, similar to what Saudi Arabia is doing with Riyadh's metro system, or even delay payments to contractors. However, this option may not suffice and cuts might have to include current spending on some existing subsidies. For instance, Bahrain has reduced subsidies on common food products such as beef and chicken, while Oman is lowering subsidies on rice, flour, and sugar. Cutting subsidies is arguably the most viable option in the long term, but in the short term it can be politically challenging, as it may provoke adverse public reactions. For instance, in 2014, Yemen undertook reforms to cut fuel subsidies, only to be reversed months later owing to a spike in social unrests.

The traditional approach in oil-exporting countries has often been to direct their natural wealth towards their citizens in the form of granting benefits and privileges (e.g., facilitating job creation for their nationals, heavily subsidizing oil and food products, or massively investing public funds towards public goods). These privileges are now at risk, at least partly, adding to pressures on the socioeconomic models in the region. Therefore, countries will have to strike a delicate balance between the sustainability of public finances and sociopolitical stability.

Source: UN/ESCWA.
a Latest IMF Article IV Consultations (International Monetary Fund, 2015k; 2015l).
b Average fossil-fuel subsidisation rate is defined as the average fossil-fuel subsidy as a share of the full cost of supply (International Energy Agency, 2014b).
c See Sovereign Wealth Funds Asset Map, available from http://www.swfinstitute.org/sovereignwealthmap.html.

ly in 2016 (box IV.5), as revenues plummet along with lower oil prices, leading to a slower economic expansion during the forecast period.

In the more diversified economies of the region, macroeconomic prospects are mixed, despite the positive effect of lower oil prices. In Turkey, GDP growth is estimated to have slowed down to 2.8 per cent in 2015 and the same rate is projected for 2016. The slowdown reflects a number of factors, including efforts to consolidate fiscal spending, limited monetary policy space, weaker domestic demand, currency volatility and capital outflows. In Israel, the economic growth estimate for 2015 has also been revised down, to 2.3 per cent, as exports declined in volume, while private demand has been held back by the recent surge in violence.

Conversely, economic prospects are expected to improve in Jordan and Lebanon during the forecast period, even though these economies will continue to be constrained by the conflict in the Syrian Arab Republic. In Jordan, large infrastructure projects already under way and expansionary monetary policies will stimulate domestic demand. In Lebanon, the tourism sector will continue to be an important economic driver, as long as the security situation does not deteriorate. These economies are also benefiting from positive spillover effects related to the dynamic non-oil sectors in GCC countries, where many national emigrants are employed and continue to send remittances and transfer capital, helping to sustain domestic demand.

Geopolitical turmoil, armed conflict and humanitarian crises remain a heavy burden for the economies of Iraq, the Syrian Arab Republic and Yemen. In particular, Iraq and the Syrian Arab Republic are engulfed in conflicts that have led to substantial destruction of their economic structures. The consequences on public finances (through increased spending), foreign direct investments and tourism are being felt across the region. In terms of social capital, the high cost of the conflicts has translated into large amounts of refugees fleeing to Europe.

The region will continue to register high unemployment rates, especially among youth

The region will continue to register some of the highest unemployment rates among developing countries. Unemployment figures are not expected to improve during the forecast period, as extremely high structural unemployment, particularly among youth, and several armed conflicts will require longer-term solutions. In Turkey, for instance, the unemployment rate reached 10.2 per cent in the second quarter of 2015, almost a full percentage point higher than one year earlier. Considering current macroeconomic developments, including tighter monetary policy and the expected growth in the working-age population, unemployment is expected to increase in Turkey during the forecast period.

Inflationary pressures have eased in most countries

Besides oil, the continued decline in commodity prices—particularly of food items—has eased inflationary pressures in the region, especially in Jordan and Lebanon. The main driver of inflation in GCC countries remains real estate assets. Inflation has also been contained in Iraq despite the armed conflict. Conversely, hyperinflation continued in the Syrian Arab Republic in 2015 as a direct consequence of the current foreign-exchange constraints. Yemen also saw high inflationary pressures as the armed conflict intensified. The inflation rate is now expected to reach about 22 per cent in 2015. In 2016, the upward shift in real estate prices in GCC countries is expected to taper off, moderately lowering consumer price inflation. Inflation in the Syrian Arab Republic and Yemen is expected to remain high, owing to foreign-exchange constraints and ongoing sociopolitical instability, which negatively affects supply chains.

Monetary policies in GCC countries have remained unchanged, as most countries have their currencies pegged to the United States dollar and their monetary policies thus mirror that of the Fed. The funding cost in terms of three-month interbank money market rates in GCC countries stayed at about 1.0 percent, although it started to rise slowly in the first half of 2015. Given that United States interest rates are projected to rise during the forecast period, the monetary stance in GCC countries is expected to change accordingly. Falling international commodity prices have created sizeable policy space for monetary easing in Jordan and Lebanon: the Central Bank of Jordan took monetary easing measures in February and July 2015, while Banque du Liban, the Lebanese central bank, has also used monetary stimulus measures to boost domestic demand. In Turkey, monetary policy is expected to tighten further during the forecast period, given relatively high inflation and the persistent depreciation of the Turkish lira (TRY). Between January and September 2015, the TRY lost more than 25 per cent against the dollar.

Limited fiscal space for countercyclical measures

In oil-exporting countries, fiscal revenues have plummeted as oil prices have dropped, leading to a process of fiscal readjustment, spending cuts and even reforms of subsidy policies. In parallel, fiscal consolidation in some countries has also entailed issuance of debt securities. For instance, Saudi Arabia issued in July 2015 its first sovereign bonds since 2007. Conversely, low oil prices have alleviated balance-of-payment and fiscal constraints in non-oil-exporting countries, notably Jordan, Lebanon and Turkey. Similarly, Israel has also reduced its fiscal deficit, helped both by higher public revenues and fiscal consolidation in 2015. However, revenue prospects remain generally weak for both oil-exporting and more diversified economies. For some countries, such as Jordan and Yemen, direct and indirect external assistance has become essential to maintaining their capital spending levels.

Many oil-exporting economies record current-account deficits

With the exception of Kuwait and Qatar, countries are estimated to register current-account deficits in 2015. Import levels in GCC countries are sustained by the growing non-oil sector, while exports from GCC countries have weakened, owing to lower oil prices. The current-account deficits of Iraq and Yemen are estimated to deteriorate significantly, owing to the continuing armed conflicts. The Syrian Arab Republic remains under severe foreign-exchange constraints, as the Syrian pound continued to depreciate sharply against the dollar. At the same time, the current-account deficits are estimated to edge down in Jordan and Lebanon, as their trade balances are improving and remittances continue to support the current account.

Downside risks include lower external demand for oil and higher capital outflows

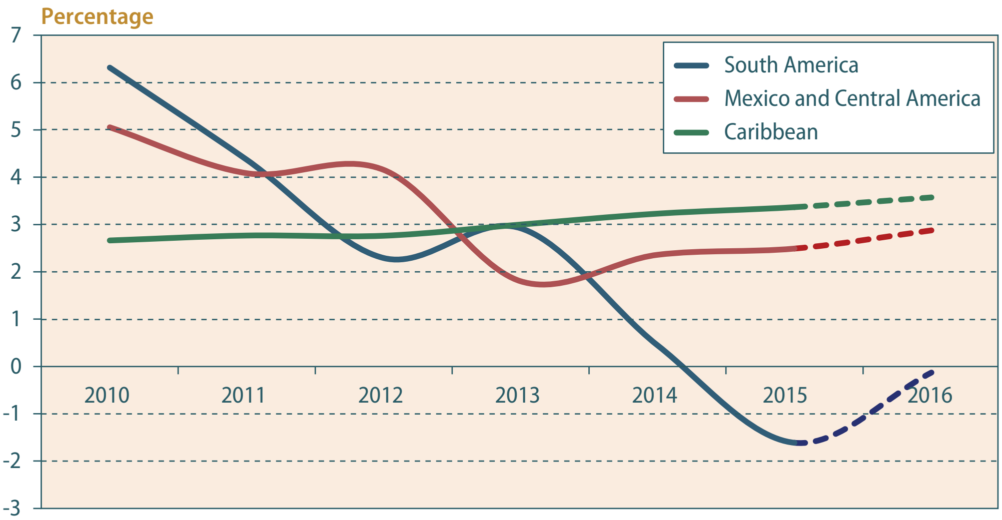
There are downside risk factors to this outlook. The first is the expansion of conflicts beyond Iraq, the Syrian Arab Republic and Yemen. The breakdown of social capital due to the increasing displaced population, as well as the destruction of economic capital, are fundamental concerns regarding the long-term economic prospects. The second factor is an abrupt decline in demand for crude oil. Despite the low level of oil prices, global demand for oil has been increasing only slightly. Concerns are growing about China's economic slowdown, which could inhibit oil demand further. This would impact GCC countries' already weak fiscal positions, as well as business confidence in the region. The third factor is the effect of United States monetary tightening, which can take two interrelated forms: first, countries may suffer capital outflows as investors leave riskier markets in search of rising returns in the United States; second, as many countries have their currency pegged to the United States dollar, higher interest rates may hinder growth via lower investment.

Latin America and the Caribbean: on a "two-track" growth path

After a decade of robust growth, economic activity has sharply decelerated

Latin America and the Caribbean entered into a period of economic difficulties amid domestic weaknesses and less supportive external conditions. After experiencing robust growth during the commodity boom period, with average regional growth above 4.0 per cent per annum between 2004 and 2013, the region has seen growth fall sharply to 1.0 per cent in 2014 and then a contraction of 0.5 per cent in 2015 (figure IV. 10). The challenging global context—including lower commodity prices and subdued global trade, the slowdown in China and the expected normalization of United States monetary policy—is affecting the region through different channels. As a result, several economies have experienced a deterioration of their terms of trade, with negative effects on their fiscal accounts, investment prospects and capital inflows. In the outlook period, economic activity in Latin America

Figure IV.10
Latin America and the Caribbean: GDP growth rates, 2010–2016



Source: UN/DESA.
Note: Growth rates for 2015 are partially estimated; rates for 2016 are forecast.

and the Caribbean is projected to expand by only 0.7 per cent in 2016; growth is forecast to accelerate to 2.7 per cent in 2017, but this recovery is subject to significant downside risks.

This aggregate picture encompasses divergent subregional situations. The economies of Mexico and Central America are projected to expand by 2.9 per cent in 2016, up from 2.5 per cent in 2015, benefiting from stronger domestic demand and the recovery in the United States. By contrast, after an estimated contraction of 1.6 per cent in 2015, South American economies are expected to contract more moderately—by 0.1 per cent in 2016—with some large economies facing considerable difficulties in narrowing the output gap. Meanwhile, the Caribbean economies are expected to expand by 3.6 per cent in 2016, slightly above 2015, benefiting from a strengthening of tourism activity.

Among the largest countries, GDP growth in Mexico is expected to accelerate from 2.3 per cent in 2015 to 2.7 per cent in 2016, owing to a recovery in investment demand and the strengthening of the United States. In South America, the Brazilian economy is expected to remain in recession, contracting by 0.8 per cent in 2016 amid continuing weakness in investment and challenging fiscal and monetary conditions. Argentina is expected to grow by 1.6 per cent in 2016, while facing strong pressures to implement a fiscal adjustment. Meanwhile, the economy of the Bolivarian Republic of Venezuela is expected to contract by 6.0 per cent in 2016, amid serious domestic imbalances and very high inflation. Smaller economies such as Costa Rica, the Dominican Republic, Guyana, Honduras, Nicaragua Panama and the Plurinational State of Bolivia are projected to continue to register relatively robust growth rates in 2016, above 4.0 per cent.

Investment demand continues to decline, especially in South American economies

At the regional level, the weakening aggregate demand has been driven by the continuing fall in investment and, to a lesser degree, by the slowdown in private consumption. The contribution of gross capital formation to growth, which had been declining for several years, fell more sharply by the end of 2013. Regional gross fixed capital formation contracted by 1.9 per cent in 2014 and continued to decline in the first half of 2015. Efforts to stimulate public investment and private-public partnerships across the region in recent years have not succeeded in boosting private investment. The ongoing weak performance of investment is a serious concern because of its adverse impacts on the dynamics of the business cycle and on the medium- and long-term growth prospects in the region.

Labour markets gradually worsen across the region

The economic slowdown is gradually affecting labour markets across the region, particularly in South America. Since the second quarter of 2015, unemployment rates have started to increase visibly, amid lower job creation and decreasing employment rates. Hence, the regional unemployment rate is expected to increase from 6.0 per cent in 2014 to 6.6 per cent in 2015, and even further in 2016. This upward trend in unemployment will be driven by South American economies. For instance, in Brazil the rise in unemployment started to become visible by early 2015 and it has strengthened since then. In addition, real wages continue to rise modestly in most countries, which together with the expected increase in unemployment will constrain households' consumption in the near term. Preliminary data also point to a gradual deterioration in the quality of employment in the region, illustrated by an incipient shift from salaried work towards self-employment.

Fiscal policy space is increasingly constrained

The capacity of Latin American and Caribbean countries to stimulate aggregate domestic demand is contingent on the space available for countercyclical policies. In this regard, both fiscal and monetary authorities still seem to have some room for maneuvering, but external shocks have reduced the space. In particular, the fiscal accounts have deteriorated in 2015, owing to a sharp fall in revenues in several economies resulting from lower commodity prices. For instance, countries such as Brazil, Colombia, Ecuador and Mexico have implemented important adjustments in public budgets for 2015 and 2016. Meanwhile, tax revenues have shown signs of recovery in the wake of the reforms implemented by some countries in the last few years.

Importantly, the higher deficits have not led to an increase in the central government debt in Latin American economies—estimated at about 34 per cent of GDP—as financing conditions remain favourable. However, the public debt levels continue to differ greatly across countries. For instance, the public debt in Brazil is the highest in Latin America, close to 65 per cent of GDP, and it has continued to rise owing to the economic recession. At the other extreme, debt levels in Chile, Paraguay and Peru are only about 20 per cent of GDP. It is important to note, however, that debt in the non-financial public sector has increased strongly in some countries recently, especially among public sector firms.

The region is facing increasing monetary policy dilemmas

In terms of monetary policy, most economies in the region have adopted a countercyclical approach since 2014. For instance, countries such as Chile, Mexico and Peru significantly cut interest rates in order to stimulate economic activity. The most notable exception was Brazil, which continued to raise interest rates in an attempt to contain inflation pressures and capital outflows. Countries that use monetary aggregates as their main policy instrument in Central and South America experienced faster growth in their monetary base since the second half of 2014. In this context, domestic lending in the region continued to grow in 2015, albeit at lower rates than in previous years. However, in the near term, the region—particularly South American economies—will face increasingly complex dilemmas regarding their monetary stances. In particular, growth remains subdued, while inflation has visibly accelerated. In addition, expectations over the normalization of the monetary policy in the United States could increase financial volatility and further reduce capital inflows. For example, authorities in Chile, Colombia and Peru have already raised interest rates moderately in recent months.

Overall, the countercyclical monetary policy stance was facilitated by relatively low regional inflation. In Mexico and Central American countries, inflation remains stable and low. By contrast, inflation in South American economies has visibly accelerated, mainly because of the significant depreciation of domestic currencies in several economies. In Brazil, inflation remains relatively high and above the central bank's target, but is expected to slow down gradually in 2016. The extreme case is the Bolivarian Republic of Venezuela, where consumer price inflation is expected to rise above 150 per cent in 2016, aggravated by severe macroeconomic imbalances.

Several economies have seen a sharp depreciation of domestic currencies…

The regional economic slowdown, together with the expectation of an interest-rate hike in the United States, lower commodity prices and the sharp contraction of capital inflows, have led to a significant depreciation of domestic currencies in Brazil, Chile, Colombia and Mexico. Mirroring the reduction in capital inflows—including not only portfolio flows but also foreign direct investments, international reserves have started to decline. So far, the sharpest declines in international reserves have been observed in the Bolivarian Republic of Venezuela, Uruguay and Trinidad and Tobago.

…but the value of exports continues to decline

In 2015, the value of exports fell for the third consecutive year, dropping by almost 14.0 per cent, owing to the lower commodity prices. In Mexico and Central American countries exports edged up, benefiting from the recovery in the United States. By contrast, South American commodity exporters have been seriously affected by the slowdown in China and the lower prices for minerals and metals. In the first six months of 2015, Colombian and Brazilian exports to China declined by more than 70 and 20 per cent, respectively. The region's trade balance has deteriorated further in 2015. Overall, the regional current-account deficit, which stood at 2.7 per cent of GDP in 2014, is expected to have increased to 3.0 per cent in 2015.

The region is encountering significant difficulties in its attempts to continue improving socio-economic indicators

The downside risks to the baseline scenario for the region are a sharper-than-expected slowdown in China and additional declines in commodity prices. An escalation of global financial turbulences involving a sharp increase in external financing costs could also affect the growth outlook for the region. Besides the short-term fluctuations, it seems that the region will face serious difficulties in the medium-term to return to the economic growth rates of the previous decade, particularly if commodity prices continue to be subdued. In this context, recent progress in some socioeconomic indicators, such as the significant reduction in poverty, will be difficult to sustain.

Box IV.6

Commodity price volatility and its impacts on Latin American and Caribbean economies

Since the 2000s, commodity prices have exhibited significant swings. After registering one of the most intense, long-lasting and broad-based booms in history in the first decade of the 2000s, commodity markets have subsequently declined sharply. The slump in prices is visible across all commodities (figure IV.6.1), but it has been felt with greater intensity in energy and metals and minerals, with accumulated declines of 52.6 and 46.5 per cent, respectively, between 2011 Q2 and 2015 Q3.

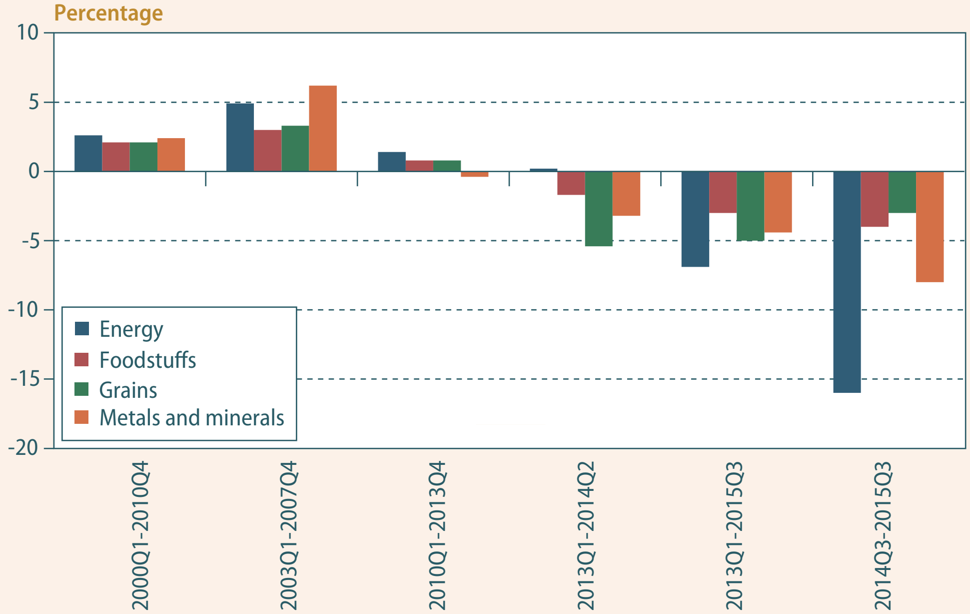
The sharp price declines are explained in part by economic fundamentals. The decline of growth in China has been a key factor. China's consumption accounts for roughly 11 per cent of global oil consumption, with one third for coal, two thirds for iron ore, and more than half for copper. Large changes in prices are required to adapt to changes in demand and supply in order to clear the market, due to the relatively small short-run supply and demand price elasticities of commodities, in particular for energy and metals.

Speculation is also an important factor behind commodity price movements. Commodities are playing an increasing role as financial assets, with prices responding to changes in expectations about future demand conditions, rather than to the actual supply and demand. The growing role of commodities as financial assets is reflected in the growth in activity on commodity future markets, including commodity derivatives. Between 1995 and 2012, the number of outstanding contracts on commodi-

(*continued*)

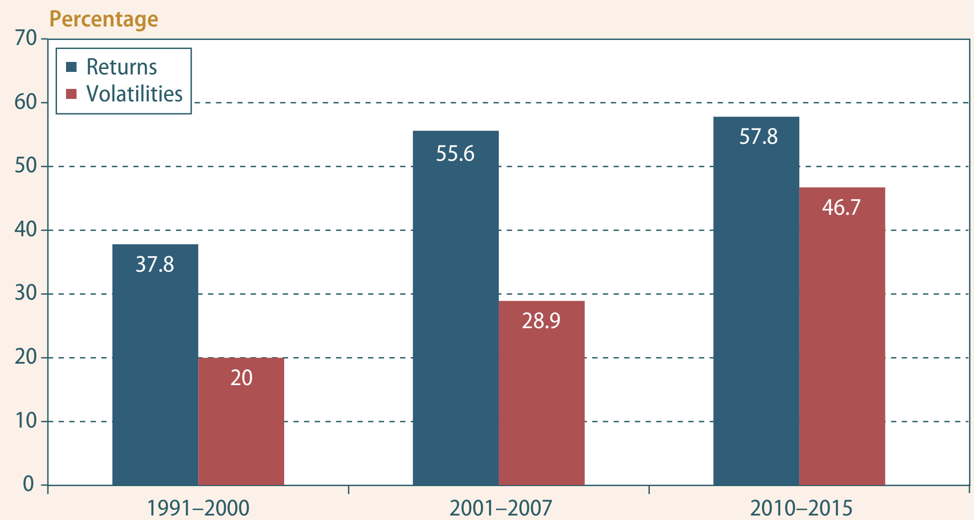
Box IV.6 (*continued*)

Figure IV.6.1
Average quarterly growth of commodity indices, selected periods between 2000 Q1 and 2015 Q3



Source: UN/ECLAC, based on Pink Sheet Commodity Data, World Bank, 2015, available from http://www.worldbank.org/en/research/commodity-markets. Growth rates were computed using geometric averaging procedure.
Note: Data from 2015 Q3 refers to August 2015.

Figure IV.6.2
Share of statistically significant correlations between commodity indices and equity indices (returns and volatilities), 1991–2000, 2001–2007 and 2010–2015



Source: UN/ECLAC.
Note: The chart depicts the share of statistically significant monthly pairwise correlations between commodity indices and equity indices (returns and volatilities of these indices). The indices examined include different commodity indices (agriculture, energy, industrial metals, livestock, precious metals and non-energy), the Dow Jones AIG and Standard and Poor Commodity Indices (DJAIG, GSCI), and equity indices including the Dow Jones Industrial Average (DJIA) and Standard and Poor's 500 (S&P500).

ty exchanges increased from $36.6 million to $182 million for futures, and from $373.6 million to $2.1 billion for derivatives. Similarly, between 1998 and 2014, the volume of over-the-counter commodity derivative contracts expanded from $4.3 billion to $2.2 trillion (notional amounts outstanding). Currently commodity derivatives represent less than 0.5 per cent of the total across all asset classes (Financial Conduct Authority, 2014). Commodities have also become more closely correlated with traditional financial

(*continued*)

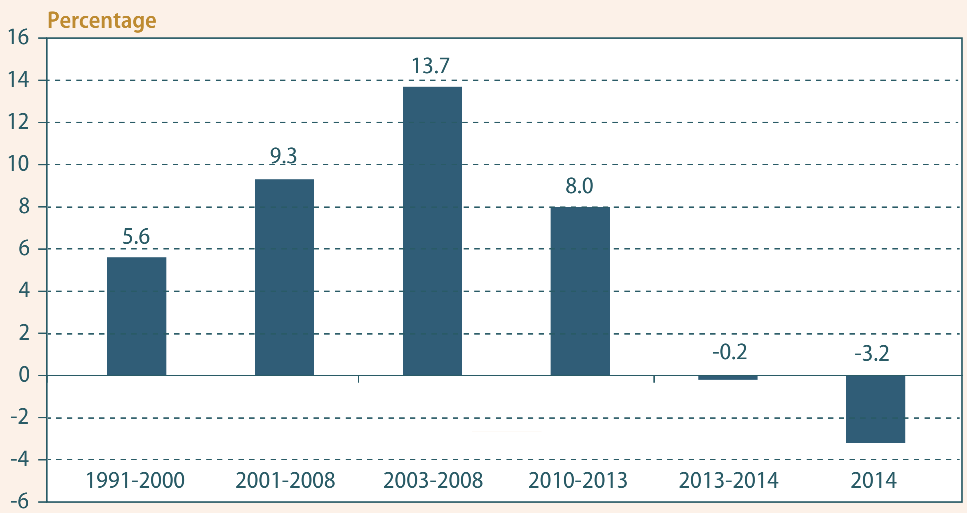
Box IV.6 (*continued*)

assets such as equities. Available evidence indicates that the share of statistically significant monthly correlations between the returns and volatilities for different commodity indices and equity indices has increased since the 1990s (figure IV.6.2).[a]

The changes in commodity prices have important real and financial effects on Latin America and the Caribbean. Higher volatility in commodity prices can lead to greater uncertainty regarding world demand and supply conditions (both of commodities and of economic activity), a postponement of investment decisions, difficulties for firms in strategic planning, and disruptions and uncertainties in the implementation of fiscal budgets.

The recent commodity-price declines clearly benefit net-energy-importing countries such as those of Central America. At the same time, falling commodity prices are detrimental to commodity-exporting countries such as those of South America. In fact, commodities represent, on average, 71.4 per cent of total exports in South America. In addition, commodities are also a main source of government revenues. For mineral producing countries (e.g., Chile, Peru and the Plurinational State of Bolivia), the fiscal income generated by the production of minerals is equivalent on average to 2.0 per cent of gross domestic product (GDP) and 8.6 per cent of total revenues for the period 2010-2013. The contribution from hydrocarbon production is even greater, accounting during the same period for more than 10 per cent of GDP and 40 per cent of total revenues on average for Ecuador, Trinidad and Tobago, the Plurinational State of Bolivia and Venezuela (Bolivarian Republic of). In addition, the economic sectors that depend on commodities explain a large share of the output, foreign direct investment inflows, and also domestic investment.

Figure IV.6.3
Latin America (seven countries): average annual rate of investment growth in real terms, 1991–2014



Source: UN/ECLAC, based on official quarterly data.
Note: The countries included are Argentina, Brazil, Chile, Colombia, Peru, Plurinational State of Bolivia and Venezuela (Bolivarian Republic of).

The decline and volatility of commodity prices have had a significant effect on the behaviour of investment, which shows a marked decline for most economies since 2011, and in some cases contractions since 2014. The data available for seven Latin American countries (Argentina, Brazil, Chile, Colombia, Peru, the Plurinational State of Bolivia and Venezuela (Bolivarian Republic of)) show that the unweighted average investment growth rate for this group of countries peaked at 13.7 per cent in the period 2003-2008. Since then, the investment growth rate has continuously declined with averages of 8.0 per cent, -0.2 per cent and -3.2 per cent for 2010-2013, 2013-2014, and 2014, respectively (figure IV.6.3).

The investment cycle is highly linked and synchronized with the GDP cycle. In fact, investment volatility reflects specific characteristics of the region's business cycle. The available empirical evidence suggests that the dynamic of the investment cycle has been unfavourable to sustained, inclusive medium- and long-term growth. Investment behaviour not only affects the speed and rate of capital accumulation but also has a direct bearing on productivity, which is an important determinant of long-term growth.

Source: UN/ECLAC.

a See Büyüksahin, Haigh and Robe (2010). The rate of return on the j^{th} investable index in period t is equal to $r^j_t = 100\text{Log}(P^j_t / P^j_{t-1})$, where P^j_t is the value of the index at time t. The volatility of an index in period t is $(r^j_t - X)^2$, where X is the mean value of r^j_t over the sample period.