Development Policy and Analysis Division ◆ Department of Economic and Social Affairs

World Economic Situation and Prospects

Monthly Briefing

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Summary

- Policy space in many developing countries constrained by El Niño
- Further improvement in labour market conditions in Europe and the United States
- Monetary stance eases in the CIS but tightens in Africa

Global issues

The world economy continues to face major headwinds. A tumultuous start in global commodity and financial markets early in the year suggests that these headwinds are unlikely to ease in the near term, although markets have largely stabilized in the past month and some recent indicators for developed economies suggest more solid labour market developments. The continued depressed commodity prices have important ramifications for both exporters and importers of commodities. The 20 per cent drop in oil prices since October 2015 has increased the risks of deflation in many developed economies this year. This has prompted additional monetary easing measures in the euro area and Japan, while the United States Federal Reserve (Fed) is now expected to postpone further interest-rate rises until the latter part of 2016. At the same time, many commodity exporters have found their policy space severely constrained, as low commodity prices have pushed up fiscal and current-account deficits and put downward pressure on exchange rates. Posing further challenges to many developing countries, the severe drought related to El Niño effects has driven up food prices in a number of countries in Africa, Asia and Latin America and the Caribbean, pushing up inflation. The links between the environmental and macroeconomic impacts of El Niño are examined in more detail below.

Widespread economic impact of the 2015/2016 El Niño[1]

According to the Food and Agricultural Organization of the United Nations, 60 million people are affected by droughts, floods and extreme weather related to the current El Niño phenomenon, threatening livelihoods, food security and health. This section examines the spillover effects from the environmental impacts of El Niño on the macroeconomy. El Niño is a periodic climate phenomenon, characterized by prolonged warming of sea surface temperature in the central and eastern Pacific Ocean. On average, it occurs every 2 to 7 years and can last up to 18 months. The current El Niño cycle, which started in early 2015, has been one of the strongest on record, possibly reflecting the impact of climate change on the intensity of the phenomenon. While the climatic event is expected to calm by mid-2016, the damage wrought by El Niño may have effects that are far more prolonged. In addition, there is a tendency for strong El Niño events to be followed by its cold counterpart, La Niña, suggesting that harsh weather conditions may continue to weigh on the global economy into 2017/2018.

While severe drought and its impact on food production are generally the greatest threat from El Niño, damage is also wrought through fires, flooding, water shortages, tropical storms, damage to fisheries, and disease outbreaks such as cholera, dengue and malaria, as well as animal disease outbreaks and plant pests. The regions most severely affected by the current cycle include the Horn of Africa, Southern Africa, the Dry Corridor of Central America, Southeast Asia and several small island developing States in the Caribbean and the Pacific.

Since early 2015, many countries in Southern Africa have recorded their lowest rainfall in decades, with drought emergencies declared in Lesotho, Malawi, Swaziland, Zimbabwe and more than 75 per cent of South African provinces. Severe drought has also swept across Ethiopia and several parts of Somalia. Other regions of Africa, including southern Kenya and northern Tanzania, may be at risk due to excessive rainfall, which puts the regions at risk of outbreaks of diseases such as cholera and Rift Valley fever.[2]

The current El Niño has also been associated with severe drought in Central America, notably in El Salvador, Guatemala, Honduras, Nicaragua and Panama, decimating maize and bean harvest. At the same time, El Niño has contributed to heavy rains and flooding in Argentina, southern Chile, Paraguay, northern Peru and Uruguay, with Paraguay the worst hit by massive flooding in late December 2015. Fish stocks have also been seriously affected, notably the stocks of Peruvian anchovies and farmed salmon off the coast of Chile.

In India, El Niño contributed to reduced monsoon rainfall in 2015, leading to the second consecutive year of drought following the mild El Niño of 2014/2015. In the Philippines, 40 per cent of the country is affected by drought, while parts of the country have

1 This section draws on information reported by the Food and Agricultural Organization of the United Nations (http://www.fao.org/el-nino/en/) and United Nations Economic and Social Commission for Asia and the Pacific, “El Niño 2015/2016: Impact outlook and policy implications”, Advisory Note, December 2015.

2 See http://www.vmerge.eu/publications/rvf-newsletters/climate-update-for-rvf-in-east-africa-4-march-2016. Major outbreaks of Rift Valley fever occurred in Kenya, Somalia and Tanzania following similar rainfall levels during the strong El Niño events of 1997/1998 and 2006/2007.

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Contact email: rashid12@un.org, http://www.un.org/en/development/desa/policy/wesp/wesp_mb.shtml

also been struck by tropical cyclones and severe flooding. In eastern Indonesia, drought has been accentuated by wildfires, which have destroyed millions of hectares of forest and agricultural land. Mongolia has suffered from a particularly harsh winter preceded by drought, with damaging repercussions for livestock.

Many small island developing States are particularly vulnerable to climatic events, such as El Niño. States of emergency over drought have been declared in Palau, the Marshall Islands, and the Federal States of Micronesia, with drought conditions also prevailing in Fiji, Samoa, Solomon Islands, Tonga, Timor-Leste and Vanuatu. Haiti is suffering from a third consecutive year of drought, and the severely food-insecure population in the country has doubled. Papua New Guinea is also facing its worst drought in decades, coupled with frosts in the highlands.

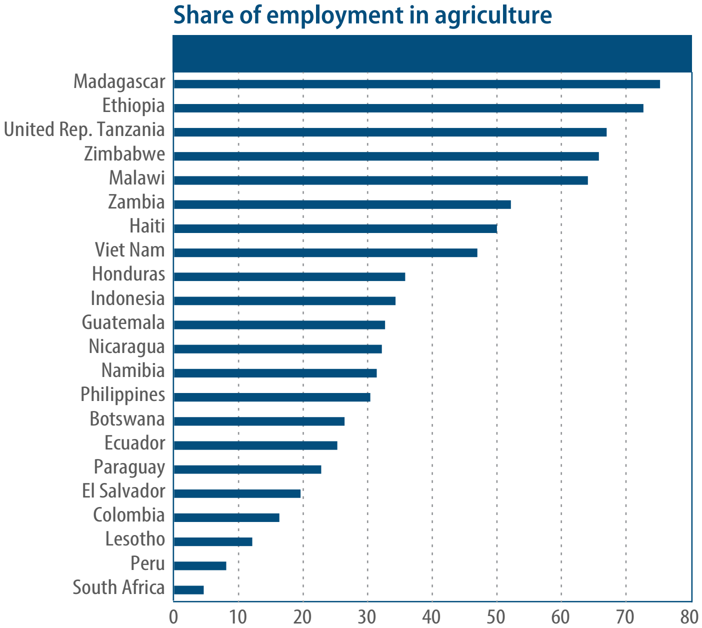
The damages wrought by El Niño feed into the economy through several channels. The agricultural sector is the most sensitive to weather conditions, with crops and livestock vulnerable to drought, flooding, extreme temperatures, disease, fires and severe storms. Freshwater resources, reef ecosystems, fisheries, public health systems, tourism and infrastructure are also at risk. Figure 1 illustrates the share of employment in agriculture in a selection of countries that have suffered severe El Niño-related effects. In countries such as Madagascar, Ethiopia, Tanzania, Zimbabwe, Malawi, Zambia and Haiti, at least 50 per cent of employment is in agriculture, leaving the economies particularly exposed to the agricultural output losses wreaked by El Niño effects.

The damage to the agricultural sector reduces farming income, while pushing up prices for food and leading to a heightened risk of food insecurity. Drought can also put pressure on energy supply, particularly in countries that rely on hydropower. For example, Zambia has recently asked South Africa to supply significant amounts of electricity, due to a sharp drop in capacity of the hydropower plant in Lake Kariba. The impact on food supply and health risks also affects government fiscal positions in affected countries as they face additional costs and also need to provide relief against the backdrop of falling or stagnant fiscal revenue.

Severe damage to agricultural production in affected regions has caused food-price spikes in many countries, despite the global deflationary impact of low commodity prices. Countries with a heavy reliance on hydro energy have also seen a sharp rise in prices for local carbon-based energy. Figure 2 illustrates headline inflation and food-price inflation in a selection of economies that have suffered agricultural losses attributable to El Niño. While the effects are not uniform across countries, high food-price inflation is prevailing across a wide range of countries in Africa, Latin America and Asia as well as small island developing States in the Caribbean and Pacific. This is clearly exerting upward pressure on headline inflation in many countries, and the combination of slowing growth, strong depreciation pressures and rising inflation continues to pose a dilemma for monetary policymakers in many developing countries.

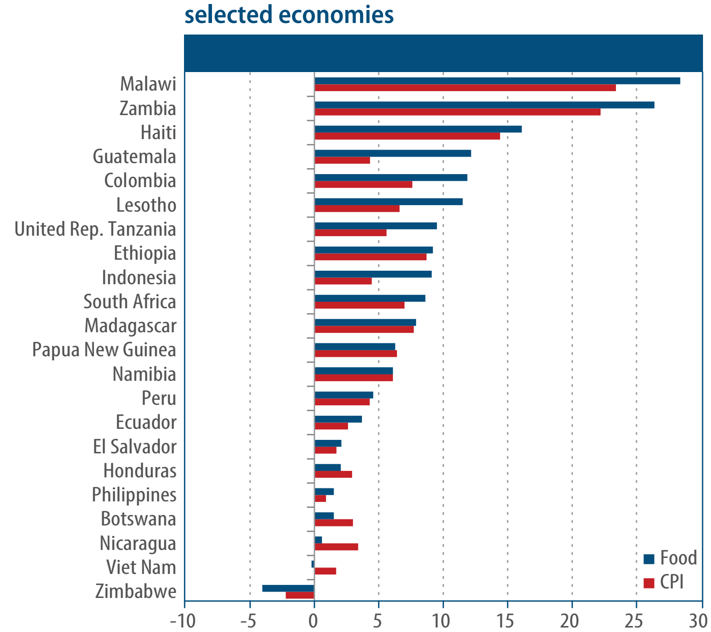
The economic losses associated with El Niño tend to have a disproportionately large impact on the poor, given that food constitutes a large share of their consumption basket. Those who rely on subsistence farming are particularly at risk. Following the strong 1997/1998 El Niño, poverty rates increased by 15 per cent in many countries, and there is a risk that the current cycle will set back progress in poverty reduction in the affected countries. The climatic impact of El Niño may also exacerbate economic inequalities across countries; economies such as the United States of America and Canada often tend to benefit from such a shift in weather patterns, which brings wet weather to the dry areas on the west coast and

Figure 1
Share of employment in agriculture



Source: International Labour Organization, World Bank.
Note: Sample periods differ across countries and refer to the most recent available data between 2008 and 2014.

Figure 2
Headline and food price inflation in selected economies



Source: tradingeconomics.com
Note: Sample periods differ across countries and refer to the most recent available year-on-year inflation data between September 2015 and March 2016.

warmer winters in the north-east.[3] The ongoing havoc wreaked by El Niño merits concerted policy efforts at both the national and global levels to ensure that it does not undermine or derail national efforts for achieving the 2030 Agenda for Sustainable Development.

United States: a strengthening labour market

Labour market indicators in the United States continue to improve, with total non-farm payroll employment up by 215,000 in March, following a rise of 245,000 in February. The unemployment rate has hovered at around 5 per cent since October 2015, a level that is broadly in line with the longer-term equilibrium assumptions of the Bureau of Labor Statistics. While labour force participation remains depressed relative to rates prevailing in 2008, participation has been on an upward trajectory since November 2015. Recent job gains have been primarily located in service sectors and construction, while manufacturing and mining industries have suffered job losses. These setbacks reflect the impact of low oil prices on the mining sector, while manufacturing sectors struggle to cope with the strong dollar, which appreciated by 13 per cent in effective terms in 2015. While inflation has picked up in recent months, with core inflation reaching 1.7 per cent in February, the Fed is expected to remain cautious regarding interest-rate rises, as global economic and financial developments continue to pose risks.

Japan: planned tax hike for 2017 unlikely to bring inflation back to target

The Japanese economy has been facing the risk of deflation and high public debt for many years. Policies adopted to address these challenges have had only limited effects. The consumption tax hike in April 2014 kicked the headline inflation rate to a level above 3 per cent for a few months. However, inflation subsequently dropped to less than 0.5 per cent, as the base effect faded out and energy prices declined. The tax hike was also associated with a sharp contraction in private consumption, on a magnitude comparable to that observed during the Great Recession. Successive monetary easing measures since 2013 have also tried to raise inflation expectations. Nevertheless, surveys show that corporations have adjusted their expectations downward since mid-2015. Even the introduction of a negative interest rate in January 2016 has not improved inflation expectations.

Currently, the critical question facing the Japanese economy is whether consumption tax will increase from 8 per cent to 10 per cent in April 2017 as planned. Given the weak consumer confidence and extremely low growth in wages, this would have a significant negative impact on household consumption and the economy, and may have a temporary impact on headline inflation, as it did in 2014. Against this backdrop, the Government has stated that it may introduce additional fiscal measures to support the economy before the coming Group of 7 meeting being held on May 26 and 27 this year.

Europe: further improvement in labour markets

Europe has shown further signs of improving labour markets. In Spain, employment generation, as measured by the number of contributors to the social security system, registered its twenty-eighth consecutive month of expansion. In the Netherlands, annual employment growth has been steady at 1.4 per cent for three consecutive months, while the number of vacancies increased by 20 per cent in the fourth quarter of 2015 over the same period in the previous year.

Recent inflation data lent additional urgency to the European Central Bank's efforts to lift inflation towards its policy target of less than but close to 2.0 per cent, as France registered deflation in February. The main driving force of the deflation trend was a decline in energy prices by 6.8 per cent, linked to the low price of oil. Core inflation, which excludes volatile energy and food prices, stood at 0.7 per cent, down slightly from 0.9 per cent in the previous two months. Recent monetary policy moves in Europe include a 25-basis-point cut by Norway's central bank in view of weakening growth dynamics, bringing its main policy interest rate to 0.5 per cent, while the Hungarian National Bank has become the first in Eastern Europe to introduce a negative interest rate when it cut its overnight deposit rate to -0.05 per cent.

Economies in transition: time for monetary loosening

In the Russian Federation, forward-looking indicators worsened in March, with the purchasing managers' index contracting to 48.3 from 49.3 in February and new orders from the manufacturing sector declining despite the weak currency. Lower energy revenues and fragile business and consumer confidence have led to negative spillovers to non-energy sectors in some of the Commonwealth of Independent States (CIS) energy exporters. In particular, gross domestic product (GDP) declined by 3.2 per cent in January-February in Azerbaijan with the non-oil economy contracting by 5.5 per cent. In Belarus, where the economy is strongly exposed to the Russian market, GDP dropped by 4.0 per cent in January-February; in Kyrgyzstan, the sharply reduced gold output (which accounts for the significant share of the country's industrial production) has led to a 7.8 per cent contraction in the same period.

Against the background of slowing inflation, several countries in the CIS relaxed monetary policy in March and early April, aiming to stimulate lending to the real sector. This follows significant rate hikes—in some cases by over 1000 basis points—in 2015. Policy rates were cut by the Central Bank of the Republic of Armenia by 25 basis points, by the National Bank of Belarus by 100 basis points, and by the National Bank of the Kyrgyz Republic and the National Bank of Moldova by 200 basis points. Despite lower nominal rates, slowing inflation will render real interest rates still too high and private investment in many CIS economies will remain held back by cautious lending and uneasy business sentiment.

Africa: diminishing policy space

As the impact of El Niño persists and international oil prices remain low, many countries in Africa are facing limited space for macroeconomic policy. Deteriorating balance of payments have triggered currency devaluations in many countries, while severely depressed government revenues have driven significant cutbacks in public expenditure plans. For example, Angola plans to cut its public expenditure by 20 per cent in the 2016 budget year.

Drought has severely affected grain production in many countries, pushing up the price of staples, which in turn has fed into headline inflation. Inflation for South Africa reached 7 per cent in February, the highest level since 2009. Inflation in excess of 20 per

3 Cashin, P., Mohaddes, K., and Raissi, M., "El Niño, Good Boy or Bad", Finance & Development, IMF, March 2016.

cent has been recorded in Angola, Malawi and Zambia, while rates in excess of 10 per cent have been recorded in Ghana, Mozambique, Nigeria and Sudan. The spike in inflation has prompted monetary authorities in Angola, Mozambique, Namibia, and South Africa to raise their policy rates. Egypt and Nigeria also raised interest rates in March.

Developing East Asia: exports show no signs of rebound in early 2016

After accounting for over 30 per cent of global trade growth during 2010-2014, it is estimated that developing East Asia's contribution dropped to around 20 per cent in 2015. A majority of the region's large exporters experienced double-digit declines in the value of merchandise exports in 2015. The downward trend has continued into early 2016, with further deep declines recorded in recent months in the Hong Kong Special Administrative Region of China, Indonesia, Malaysia, Republic of Korea, Singapore, Taiwan Province of China and Thailand. The exception among the region's major exporters is Viet Nam, which enjoyed positive export growth throughout 2015 and the first quarter of 2016.

Subdued global demand is a key factor behind the weak export performance. The modest recovery in the developed economies has not been sufficient to offset the fall of demand from emerging markets, especially those from the region itself. Weak commodity prices have also played a central role for commodity exporters in the region. As these factors are expected to persist, weak export growth will continue to remain a drag on growth in 2016 for many economies in the region.

South Asia: Sri Lanka entering into economic difficulties

The economic outlook for Sri Lanka has weakened significantly in recent months, amid balance-of-payments problems and growing concerns over a debt crisis. International reserves have declined substantially—by a third over the sixteen months to February 2016—while the rupee has tumbled, reaching record lows in recent weeks. In addition, the fiscal deficit ballooned to more than 7.0 per cent of GDP in 2015, as economic activity slowed down visibly during the second half of the year. In the fourth quarter of 2015, year-on-year GDP growth fell to a meagre 2.5 per cent, leading to an annual growth of only 4.8 per cent, significantly lower than the figures above 7.0 per cent in previous years.

Sri Lankan authorities are undertaking several policy responses. In January, the central bank lifted policy interest rates by 50 basis points, and additional hikes are expected during 2016. Meanwhile, the Government decided to raise the value added tax from 11.0 to 15.0 per cent and to reintroduce a capital gains tax. Also, the Government will issue new sovereign bonds up to $3 billion in 2016 and is currently negotiating with the International Monetary Fund (IMF) to receive a $1.5 billion loan. Negotiations could suffer significant delays if the IMF requires a tighter fiscal consolidation. In the short term, these recent developments will continue to restrain the economy. In the medium term, Sri Lanka needs to implement further reforms to increase tax revenues and productive policies to strengthen its sources of foreign-exchange earnings.

Western Asia: GCC member countries increasingly rely on external debt to stabilize fiscal accounts

Amid persistent low oil prices, countries of the Cooperation Council for the Arab States of the Gulf (GCC) face worsening fiscal and economic conditions. Despite the fact that some economies benefit from large international reserves and sovereign wealth funds, all GCC countries are undertaking major reforms in order to maintain fiscal sustainability, cutting expenditures and public subsidies (in fuel and electricity, for instance) and lifting specific taxes, such as corporate taxes in Oman and tobacco and soft drinks taxes in Saudi Arabia. GCC countries preliminarily agreed on the introduction of a value added tax in 2018, while privatization plans might gain traction in the near future in countries such as Kuwait, Oman and Saudi Arabia.

Against this backdrop, several countries are increasingly relying on syndicated loans and bond issuances to finance the fiscal deficits. For instance, Oman signed a $1 billion syndicated loan with various international banks, while Saudi Arabia is negotiating a $10 billion loan and is expecting to tap the bond markets by September for the first time. Meanwhile, Qatar is also financing a large proportion of the fiscal deficit through a combination of international loans and bond sales, and Bahrain launched a $600 million bond sale in February. In United Arab Emirates, a new law is expected to allow the issuance of federal bonds in 2016. This trend is expected to expand in the near term, but some GCC countries might encounter refinancing difficulties as growth continues to slow and financial liquidity tightens. In the outlook, GCC countries need to strike an appropriate balance between subsidy reforms, spending cuts and debt levels in order to secure fiscal sustainability, growth prospects and social cohesion.

Latin America and the Caribbean: weak public and private investment weighs on economic growth

While Brazil and Venezuela (Bolivarian Republic of) remain mired in deep recessions, most other South American economies are also experiencing growth well below potential amid considerable global and domestic headwinds. Argentina, Chile and Uruguay registered full-year growth of only 1.8 per cent, 2.1 per cent and 1.0 per cent, respectively, in 2015. The pace of expansion also slowed notably in some of the region's fastest-growing economies in recent years, including the Plurinational State of Bolivia, Colombia and Paraguay. A key factor in the broad-based regional slowdown has been weak investment as Governments and private corporations adjust to sharply lower commodity prices. In Chile, gross fixed capital formation has declined for two consecutive years. After a 6.1 per cent drop in 2014, it fell by a further 1.5 per cent in 2015, owing to sluggish investment in machinery and equipment. Gross fixed capital formation also contracted last year in Brazil, Ecuador, Uruguay, Venezuela (Bolivarian Republic of) and even in Peru, which ranked among the region's best performers in 2015 with GDP growth of 3.3 per cent. The weakness is also reflected in significantly lower foreign direct investment (FDI) inflows. According to UNCTAD estimates, total FDI inflows to Latin America decreased by 14 per cent in 2014 and 11 per cent in 2015. Given the generally subdued outlook for commodity prices, potentially tighter financial conditions and considerable policy uncertainty in several countries, the prospects of a robust investment recovery in South America are relatively bleak.

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