Chapter I
Global economic outlook

Prospects for the world economy in 2012-2013

The world economy is on the brink of another recession

Following two years of anaemic and uneven recovery from the global financial crisis, the world economy is teetering on the brink of another major downturn. Output growth has already slowed considerably during 2011, especially in the developed countries. The baseline forecast foresees continued anaemic growth during 2012 and 2013. Such growth is far from sufficient to deal with the continued jobs crises in most developed economies and will drag down income growth in developing countries.

Even this sombre outlook may be too optimistic. A serious, renewed global downturn is looming because of persistent weaknesses in the major developed economies related to problems left unresolved in the aftermath of the Great Recession of 2008-2009.

The problems are multiple and interconnected

The problems stalking the global economy are multiple and interconnected. The most pressing challenges are the continued jobs crisis and the declining prospects for economic growth, especially in the developed countries. As unemployment remains high, at nearly 9 per cent, and incomes stagnate, the recovery is stalling in the short run because of the lack of aggregate demand. But, as more and more workers remain out of a job for a long period, especially young workers, medium-term growth prospects also suffer because of the detrimental effect on workers' skills and experience.

The rapidly cooling economy is both a cause and an effect of the sovereign debt crises in the euro area, and of fiscal problems elsewhere. The sovereign debt crises in a number of European countries worsened in the second half of 2011 and aggravated the weaknesses in the balance sheets of banks sitting on related assets. Even bold steps by the Governments of the euro area countries to reach an orderly sovereign debt workout for Greece were met with continued financial market turbulence and heightened concerns of debt default in some of the larger economies in the euro zone, Italy in particular. The fiscal austerity measures taken in response are further weakening growth and employment prospects, making fiscal adjustment and the repair of financial sector balance sheets all the more challenging. The United States economy is also facing persistent high unemployment, shaken consumer and business confidence, and financial sector fragility. The European Union (EU) and the United States of America form the two largest economies in the world, and they are deeply intertwined. Their problems could easily feed into each other and spread to another global recession. Developing countries, which had rebounded strongly from the global recession of 2009, would be hit through trade and financial channels. The financial turmoil following the August 2011 political wrangling in the United States regarding the debt ceiling and the deepening of the euro zone debt crisis also caused a contagious sell-off in equity markets in several major developing countries, leading to sudden withdrawals of capital and pressure on their currencies.

Policy paralysis has become a major stumbling block

Political divides over how to tackle these problems are impeding needed, much stronger policy action, further eroding the already shattered confidence of business and consumers. Such divides have also complicated international policy coordination. Nonetheless, as the problems are deeply intertwined, the only way for policymakers to save the global economy from falling into a dangerous downward spiral is to take concerted action, giving greater priority to revitalizing the recovery in output and employment in the short run in order to pave more solid ground for enacting the structural reforms required for sustainable and balanced growth over the medium and long run.

Faltering growth

Surrounded by great uncertainties, the United Nations baseline forecast is premised on a set of relatively optimistic conditions, including the assumptions that the sovereign debt crisis in Europe will, in effect, be contained within one or just a few small economies, and that those debt problems can be worked out in more or less orderly fashion. As indicated in box I.1, it further assumes that monetary policies among major developed countries will remain accommodative, while the shift to fiscal austerity in most of them will continue as planned but not move to deeper cuts. The baseline also assumes that key commodity prices will fall somewhat from current levels, while exchange rates among major currencies will fluctuate around present levels without becoming disruptive.

Global output growth is slowing and risks for a double-dip recession have heightened

In this scenario, which could be deemed one of "muddling through", growth of world gross product (WGP) is forecast to reach 2.6 per cent in the baseline outlook for 2012 and 3.2 per cent for 2013. This entails a significant downgrade (by one percentage point) from the United Nations baseline forecast of mid-2011[1] but is in line with the pessimistic scenario laid out at the end of 2010.[2] The deceleration was already visible in 2011 when the global economy expanded by an estimated 2.8 per cent, down from 4.0 per cent in 2010 (table I.1 and figure I.1). The risks for a double-dip recession have heightened. As discussed in the section on the downside risks below, in accordance with a more pessimistic scenario—including a disorderly sovereign debt default in Europe and more fiscal austerity—developed countries would enter into a renewed recession and the global economy would come to a near standstill (see table I.2 below). More benign outcomes for employment and sustainable growth worldwide would require much more forceful and internationally concerted action than that embodied in current policy stances. The feasibility of such an optimistic scenario, which would push up global output growth to about 4.0 per cent, is discussed in box I.4 and in the section on policy challenges.

Developing country growth remains strong, but is decelerating…

Developing countries and economies in transition are expected to continue to stoke the engine of the world economy, growing on average by 5.6 per cent in 2012 and 5.9 per cent in 2013 in the baseline outlook. This is well below the pace of 7.5 per cent achieved in 2010, when output growth among the larger emerging economies in Asia and Latin America, such as Brazil, China and India, had been particularly robust. Even as economic ties among developing countries strengthen, they remain vulnerable to economic conditions in the developed economies. From the second quarter of 2011, economic growth in most developing countries and economies in transition started to slow notably to a pace of 5.9 per cent for the year. Initially, this was the result, in part, of macroeconomic policy tightening in attempts to curb emerging asset price bubbles and accelerating inflation, which in turn were fanned by high capital inflows and rising global commodity prices. From mid-2011 onwards, growth moderated further with weaker external demand from developed countries, declining primary commodity prices and some capital flow reversals. While the latter two conditions might seem to have eased some of the macroeconomic policy challenges earlier in the year, amidst increased uncertainty and volatility, they have in fact complicated matters and have been detrimental to investment and growth.

…because of the economic problems in developed countries

The economic woes in many developed economies are a major factor behind the slowdown in developing countries. Economic growth in developed countries has already

1 See United Nations, *World economic situation and prospects as of mid-2011* (E/2011/113), available from http://www.un.org/en/development/desa/policy/wesp/wesp_current/2011wespupdate.pdf.

2 See *World Economic Situation and Prospects 2011* (United Nations publication, Sales No. E.11.II.C.2), pp. 34-35, available from http://www.un.org/en/development/desa/policy/wesp/wesp_current/2011wesp.pdf.

Box I.1

Key assumptions for the United Nations baseline forecast for 2012 and 2013

The forecast presented in the text is based on estimates calculated using the United Nations World Economic Forecasting Model (WEFM) and is informed by country-specific economic outlooks provided by participants in Project LINK, a network of institutions and researchers supported by the Department of Economic and Social Affairs of the United Nations. The provisional individual country forecasts submitted by country experts are adjusted based on harmonized global assumptions and the imposition of global consistency rules (especially for trade flows, measured in both volume and value) set by the WEFM. The main global assumptions are discussed below and form the core of the baseline forecast—the scenario that is assigned the highest probability of occurrence. Alternative scenarios are presented in the sections on "risks and uncertainties" and "policy challenges". Those scenarios are normally assigned lower probability than the baseline forecast, but in the present volatile and uncertain economic context, the pessimistic scenario presented in the "risks and uncertainties" section should be assigned a probability at least as high as that of the baseline.

Background to the baseline assumptions

It is assumed that within the span of the forecasting period, the sovereign debt crisis in Europe will be contained and that adequate measures will be taken to avert a liquidity crisis that could lead to major bank insolvencies and a renewed credit crunch. These measures include an orderly restructuring of Greek debt, some degree of bank recapitalization and a strengthening of the European Financial Stability Facility (EFSF) so that markets perceive that there is sufficient firepower to handle a possible default by one of the larger member countries. The recently announced package agreed on at the summit meeting of euro area leaders in October, if fully implemented, covers, albeit imperfectly, most of these issues. In addition, it is assumed that the plans announced for fiscal consolidation and restructuring will be implemented in the crisis-affected countries. In the United States, it is assumed that either the Joint Select Committee on Deficit Reduction would come to an agreement on a package to cut $1.2 trillion in Government spending over the next 10 years or, in case of no agreement, that the contingency plan for a similar sized annual budget reduction of $120 billion would come into effect (see also note 3). More broadly, the planned macroeconomic policies of major economies for the short run (2012-2013), as also reflected in the Cannes Action Plan for Growth and Jobs adopted on 4 November 2011 by the leaders of the Group of Twenty (G20), are all assumed to be followed through in the baseline scenario.

Monetary and fiscal policy assumptions for major economies

The Federal Reserve Bank of the United States (Fed) is assumed to keep the federal funds interest rate at its current low level of between 0.0 and 0.25 per cent until the end of 2013. The Fed will implement the planned swap of its holdings of $400 billion in short-term Treasury Bills for long-term Government bonds, and will also reinvest the receipts of maturing assets, so as to maintain the size of its current asset holdings. The European Central Bank (ECB) is assumed to make another 25 basis-point cut in its main policy rate by the end of the year, bringing the minimum bid rate back down to 1.0 per cent. The ECB is expected to continue to provide liquidity to banks through a number of facilities, such as refinancing operations of various term-lengths and purchasing sovereign bonds under the Securities Markets Programme (SMP). The Bank of Japan (BoJ) is assumed to keep its main policy interest rate at 0.05 per cent and to continue to use its balance sheet to manage liquidity—through the Asset Purchase Program (APP)—to buy risk assets, such as commercial paper and corporate bonds, in addition to Government bonds and bills. The BoJ is also assumed to continue to intervene in foreign exchange markets to stabilize the value of the yen. In major emerging economies, the People's Bank of China (PBC) is expected to keep its monetary tightening on hold, based on a contingent assumption that inflation in the economy will start to moderate.

In terms of fiscal policy, it is assumed that in the United States only the items for the payroll tax cut and emergency unemployment compensation of the proposed American Jobs Act will be enacted and that long-term deficit-reduction actions will come into effect from January 2013.

Box I.1 (cont'd)

In the euro area, as well as in most economies in Western Europe, it is assumed that the plans announced for fiscal consolidation will be fully implemented. In Japan, the total size of the five-year post-earthquake reconstruction plan is estimated to cost ¥19 trillion, or 4 per cent of GDP, to be financed mostly by increases in taxes. In China, the fiscal stance is expected to remain "proactive", with increased spending on education, health care and social programmes.

Exchange rates among major currencies

It is assumed that the euro will fluctuate around a yearly average of $1.36 in 2012 and 2013, implying a depreciation of 2.5 per cent from its 2011 level. The Japanese yen is assumed to average about ¥78 to the dollar for the rest of the forecast period, representing an appreciation of 2.4 per cent in 2012 compared with the average exchange rate in 2011; during 2011, the yen had already appreciated by 8.9 per cent. The Chinese renminbi is assumed to average CN¥ 6.20 per United States dollar in 2012 and CN¥ 6.02 in 2013, appreciating by 3.9 and 2.9 per cent, respectively.

Oil prices

Brent oil prices are assumed to average about $100 per barrel (pb) during both 2012 and 2013, down from $107 pb in 2011.

Table I.1
Growth of world output, 2005-2013

Annual percentage change

	2005-2008[a]	2009	2010[b]	2011[c]	2012[c]	2013[c]	*Change from June 2011 forecast*[d]	
							2011	*2012*
World	**3.3**	**-2.4**	**4.0**	**2.8**	**2.6**	**3.2**	**-0.5**	**-1.0**
Developed economies	1.9	-4.0	2.7	1.3	1.3	1.9	-0.7	-1.1
United States of America	1.8	-3.5	3.0	1.7	1.5	2.0	-0.9	-1.3
Japan	1.3	-6.3	4.0	-0.5	2.0	2.0	-1.2	-0.8
European Union	2.2	-4.3	2.0	1.6	0.7	1.7	-0.1	-1.2
EU-15	2.0	-4.3	1.9	1.5	0.5	1.6	-0.2	-1.2
New EU members	5.4	-3.7	2.3	2.9	2.6	3.1	-0.2	-1.4
Euro area	2.0	-4.3	1.9	1.5	0.4	1.3	-0.1	-1.2
Other European countries	2.6	-1.9	1.5	1.0	1.1	1.6	-1.0	-0.9
Other developed countries	2.6	-1.0	2.9	1.4	2.2	2.5	-1.4	-0.5
Economies in transition	7.1	-6.6	4.1	4.1	3.9	4.1	-0.3	-0.7
South-Eastern Europe	5.0	-3.7	0.6	1.7	2.3	3.2	-0.5	-0.8
Commonwealth of Independent States and Georgia	7.3	-6.9	4.5	4.3	4.0	4.2	-0.3	-0.8
Russian Federation	7.1	-7.8	4.0	4.0	3.9	4.0	-0.4	-0.7
Developing economies	6.9	2.4	7.5	6.0	5.6	5.9	-0.2	-0.6
Africa	5.4	0.8	3.9	2.7	5.0	5.1	-0.9	-0.4
North Africa	5.0	3.2	4.0	-0.5	4.7	5.5	-1.2	-0.3
Sub-Saharan Africa	5.9	1.7	4.8	4.4	5.3	5.0	-0.5	-0.2
Nigeria	4.6	-8.3	2.8	6.3	6.8	7.0	0.6	0.5
South Africa	5.0	-1.7	2.8	3.1	3.7	3.5	-0.6	-1.1
Others	6.7	3.6	5.1	4.8	5.8	5.3	-1.1	0.1
East and South Asia	8.3	5.2	8.8	7.1	6.8	6.9	-0.1	-0.4
East Asia	8.5	5.1	9.2	7.2	6.9	6.9	-0.1	-0.3
China	11.9	9.2	10.4	9.3	8.7	8.5	0.2	-0.2
South Asia	7.8	5.5	7.2	6.5	6.7	6.9	-0.4	-0.3
India	9.0	7.0	9.0	7.6	7.7	7.9	-0.5	-0.5

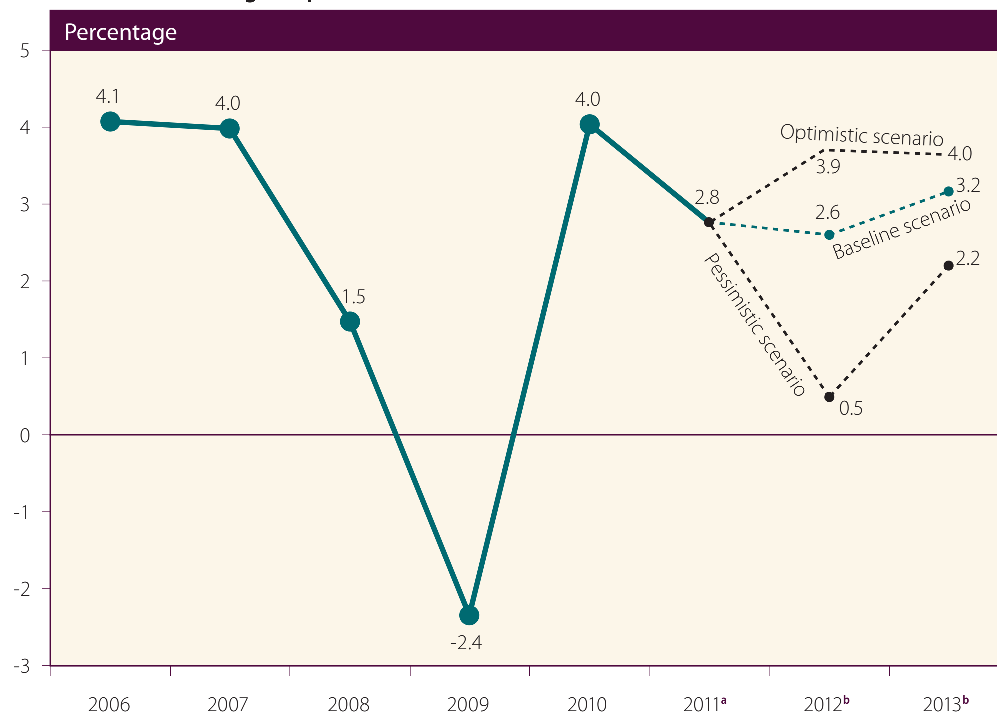
Table I.1 (cont'd)

	2005-2008[a]	2009	2010[b]	2011[c]	2012[c]	2013[c]	Change from June 2011 forecast[d] 2011	2012
Western Asia	5.4	-0.9	6.3	6.6	3.7	4.3	0.8	-0.5
Latin America and the Caribbean	5.0	-2.1	6.0	4.3	3.3	4.2	-0.2	-1.6
South America	5.6	-0.4	6.4	4.6	3.6	4.5	-0.4	-1.6
Brazil	4.6	-0.6	7.5	3.7	2.7	3.8	-1.4	-2.6
Mexico and Central America	3.5	-5.7	5.6	3.8	2.7	3.6	0.0	-1.6
Mexico	3.2	-6.3	5.8	3.8	2.5	3.6	0.1	-1.8
Caribbean	7.1	0.9	3.5	3.4	3.6	4.3	-0.6	-1.1
By level of development								
High-income countries	2.1	-3.7	3.0	1.6	1.5	2.0		
Upper middle income countries	7.5	1.2	7.3	6.1	5.5	6.0		
Lower middle income countries	7.0	4.3	6.8	5.9	6.4	6.6		
Low-income countries	6.2	4.8	6.1	5.7	6.0	5.9		
Least developed countries	7.8	5.2	5.6	4.9	6.0	5.7	-0.7	0.2
Memorandum items								
World trade[e]	6.8	-9.9	12.8	6.6	4.4	5.7	-0.5	-2.4
World output growth with PPP-based weights	4.4	-0.9	4.9	3.7	3.6	4.1	-0.4	-0.8

Source: UN/DESA.

a Average percentage change.
b Actual or most recent estimates.
c Forecasts, based in part on Project LINK and baseline projections of the UN/DESA World Economic Forecasting Model.
d See United Nations, *World economic situation and prospects as of mid-2011* (E/2011/113).
e Includes goods and services.

Figure I.1
Growth of world gross product, 2006-2013



Sources: UN/DESA and Project LINK.

Note: See box I.1 for assumptions underlying the baseline forecasts, section on "Risks and uncertainties" for assumptions for the pessimistic scenario and box I.4 for the optimistic scenario.

a Estimates.
b United Nations forecasts.

slowed to 1.3 per cent in 2011, down from 2.7 per cent in 2010, and is expected to remain anaemic in the baseline outlook, at 1.3 per cent in 2012 and 1.9 per cent in 2013. At this pace, output gaps are expected to remain significant and unemployment rates will stay high.

Developed countries suffer from predicaments lingering from the global financial crisis

Most developed economies are suffering from predicaments lingering from the global financial crisis. Banks and households are still in the process of a deleveraging which is holding back credit supplies. Budget deficits have widened and public debt has mounted, foremost because of the deep downturn and, to a much lesser extent, because of the fiscal stimulus. Monetary policies remain accommodative with the use of various unconventional measures, but have lost their effectiveness owing to continued financial sector fragility and persistent high unemployment which is holding back consumer and investment demand. Concerns over high levels of public debt have led Governments to shift to fiscal austerity, which is further depressing aggregate demand.

Growth in the United States slowed notably in the first half of 2011. Despite a mild rebound in the third quarter of the year, gross domestic product (GDP) is expected to weaken further in 2012 and even a mild contraction is possible during part of the year under the baseline assumptions. While, if enacted in full, the American Jobs Act proposed by the Government could have provided some stimulus to job creation, it would not have been sufficient to prevent further economic slowdown, as fiscal stimulus has already faded overall with many job losses caused by cuts in state-level budgets. Even as the total public debt of the United States has risen to over 100 per cent of GDP, yields on long-term Government bonds remain at record lows. This would make stronger fiscal stimulus affordable, but politically difficult to enact in a context where fiscal prudence is favoured and where the country has already been on the verge of defaulting on its debt obligations in August of 2011 because of political deadlock over raising the ceiling on the level of federal public debt. Failure by the congressional Joint Select Committee on Deficit Reduction to reach agreement in November of 2011 on fiscal consolidation plans for the medium term has added further uncertainty.[3] The uncertain prospects are exacerbating the fragility of the financial sector, causing lending to businesses and consumers to remain anaemic. Persistent high unemployment, at a rate of 8.6 per cent, and low wage growth are further holding back aggregate demand and, together with the prospect of prolonged depressed housing prices, have heightened risks of a new wave of home foreclosures.

Growth in the euro area has slowed considerably since the beginning of 2011, and the collapse in confidence evidenced by a wide variety of leading indicators and measures of economic sentiment suggest a further slowing ahead, perhaps to stagnation by the end of 2011 and into early 2012. Even under the optimistic assumption that the debt crises can be contained within a few countries, growth is expected to be only marginally positive in the euro area in 2012, with the largest regional economies dangerously close to renewed downturns and the debt-ridden economies in the periphery either in or very close to a protracted recession.

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3 When the debt ceiling was lifted in August 2011, it was agreed that a bipartisan "supercommittee" try to reach agreement, before the end of November, on reducing the Federal budget deficit by $1.2 trillion over the medium run. The committee failed to do so, triggering an agreed back-up plan according to which the United States Government would enact spending cuts to the tune of $110 billion in each fiscal year from 2013 to 2021. This failure to reach an agreement in Congress does not alter the baseline scenario for this report. However, it has heightened the downside risks, in particular with regard to what will happen with regard to two stimulus measures expiring on 1 January 2012, namely, the 2 per cent payroll tax cut and emergency unemployment insurance benefits. At the time of writing, it is still possible for Congress to extend these measures. Should that not occur, it would affect the 2012 baseline projection for GDP growth in the United States, lowering it by an estimated 0.6 percentage points. It would further erode consumer and investor confidence and increase the risk of the downside scenario's materializing.

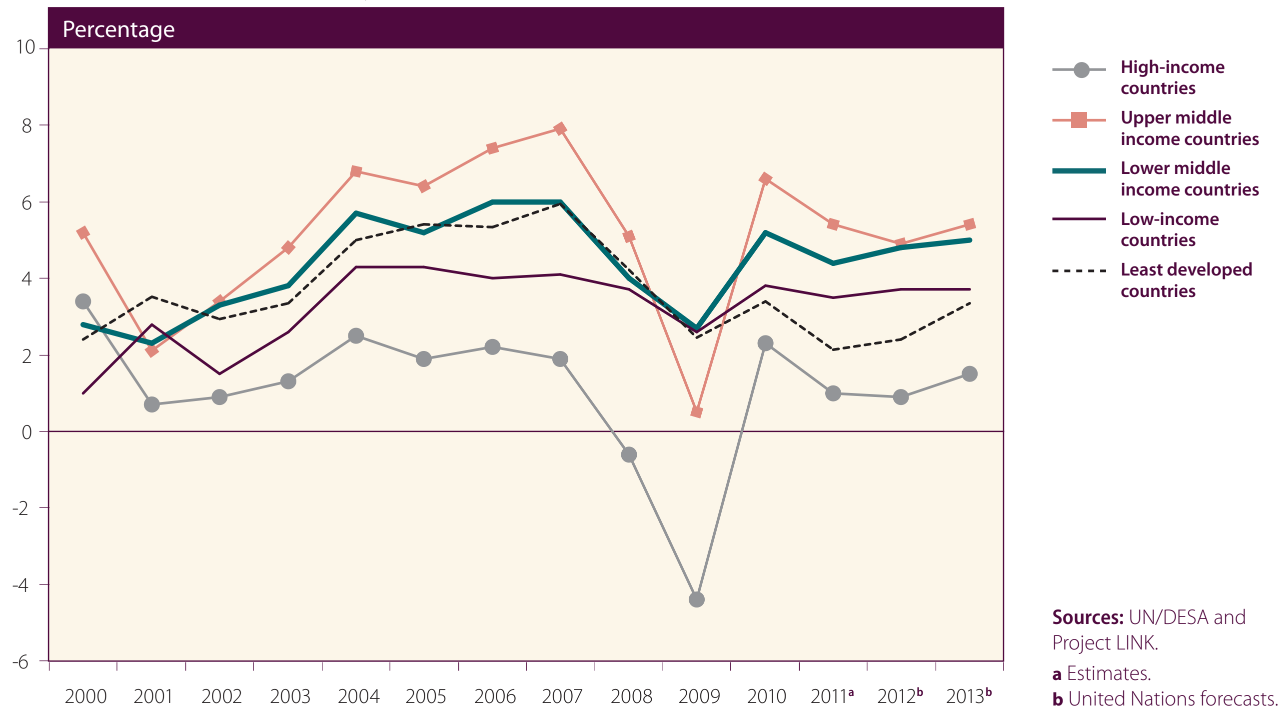
Japan was in another recession in the first half of 2011, resulting largely, but not exclusively, from the disasters caused by the March earthquake. While post-quake reconstruction is expected to lift GDP growth in Japan to about 2 per cent per year, which is above its long-term trend, in the coming two years, risks remain on the downside, emanating from the challenges of financing the reconstruction and coping with a possible, more pronounced and synchronized downturn along with other major developed economies.

As indicated above, developing countries are expected to be further affected by the economic woes in developed countries through trade and financial channels. Among the major developing countries, China's and India's GDP growth is expected to remain robust, but to decelerate. In China, growth slowed from 10.4 per cent in 2010 to 9.3 per cent in 2011 and is projected to slow further to below 9 per cent in 2012-2013. India's economy is expected to expand by between 7.7 and 7.9 per cent in 2012-2013, down from 9.0 per cent in 2010. Brazil and Mexico are expected to suffer more visible economic slowdowns. Output growth in Brazil was already halved, to 3.7 per cent, in 2011, after a strong recovery of 7.5 per cent in 2010, and is expected to cool further to a 2.7 per cent growth in 2012. Growth of the Mexican economy slowed to 3.8 per cent in 2011 (down from 5.8 per cent in 2010), and is anticipated to decelerate further, to 2.5 per cent, in the baseline scenario for 2012.

Growth in LDCs is below potential, but strengthening mildly

Low-income countries have also seen a slowdown, albeit a mild one. In per capita terms, income growth slowed from 3.8 per cent in 2010 to 3.5 per cent in 2011, but despite the global slowdown, the poorer countries may see average income growth at or slightly above this rate in 2012 and 2013 (see figure I.2). The same holds for average growth among the United Nations category of the least developed countries (LDCs). Nonetheless, growth is expected to remain below potential in most of these economies. In 2011 and 2012, per capita income growth is expected to reach between 2.0 and 2.5 per cent, well below the annual average of 5.0 per cent reached in 2004-2007. Despite

Figure I.2
Growth of GDP per capita, by level of development, 2000-2013



Sources: UN/DESA and Project LINK.
a Estimates.
b United Nations forecasts.

the high vulnerability of most LDCs to commodity price shocks, they tend to be less exposed to financial shocks, and mild growth in official development assistance (ODA) has provided them with a cushion against the global slowdown. Conditions vary greatly across these economies, however; as discussed in box I.2, Bangladesh and several of the LDCs in East Africa are showing strong growth, while adverse weather conditions and/or fragile political and security situations continue to plague economies in the Horn of Africa and in parts of South and Western Asia.

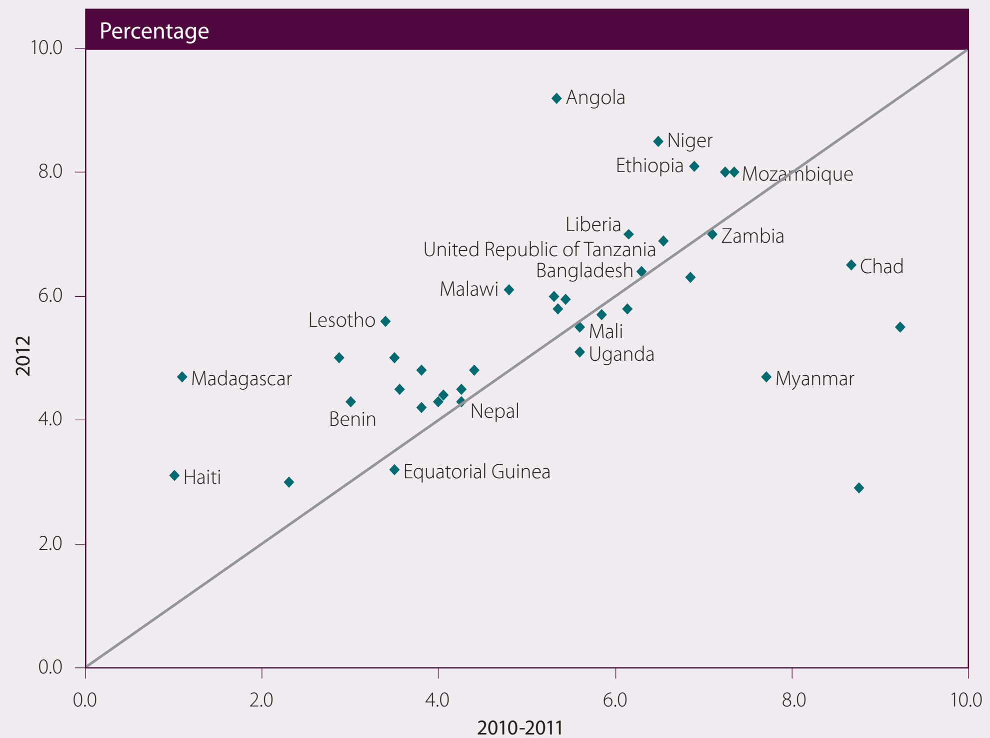
Box I.2

Prospects for the least developed countries

The least developed countries (LDCs) will continue to see a growth performance that stands apart from the global pattern. While world economic growth decelerated markedly in 2011, LDCs experienced only a mild slowdown from 5.6 per cent in 2010 to 4.9 per cent in 2011. In the outlook for 2012, LDCs are expected to escape the global trend, with gross domestic product (GDP) growth ticking up again to 5.9 per cent. Even so, growth is expected to remain below potential in most of these economies. In 2011 and 2012, per capita income growth is expected to reach between 2.0 and 2.5 per cent, well below the annual average of 5.0 per cent reached in 2004-2007. Despite the high vulnerability of most LDCs to commodity price shocks, they tend to be less exposed to financial shocks, and mild growth in official development assistance (ODA) has provided them with a cushion against the global slowdown.

Conditions vary greatly across these economies, however (see figure). As a positive example, Bangladesh's economy grew by 6.5 per cent in 2011, continuing the upward trend of the previous year. Growth was underpinned by a robust expansion in private consumption and investment and a recovery in exports. Export revenues were boosted by strong apparel sales as the European Union enhanced duty-free market access for LDCs and international retailers shifted production to Bangladesh because of the country's low labour costs. Despite a slowdown in exports, growth is forecast to remain robust in 2012.

GDP growth in the least developed countries, 2010-2011 and 2012



Source: UN/DESA.

Note: Data for 2012 refer to the United Nations baseline forecast. Data for 2010-2011 refer to the two-year average growth rate, with that for 2011 being partly estimated.

Box I.2 (cont'd)

Angola is also witnessing robust growth, which is forecast to accelerate from 4.1 per cent in 2011 to 9.2 per cent in 2012 on the back of rising production in the hydrocarbon sector. However, despite the positive headline growth figures, the country continues to suffer from a lack of economic diversification and higher value added activities in the private sector, as well as from institutional deficits.

In Nepal, economic activity continued to be hindered by political uncertainty and a fragile security situation, in addition to other factors, such as power shortages. Real GDP growth declined from 4.6 per cent in 2010 to 3.9 per cent in 2011 as solid growth in private consumption was largely offset by a contraction in investment and exports. Tourism earnings and remittance inflows registered moderate gains, a trend that is likely to continue in 2012. The manufacturing, construction and banking sectors are expected to perform slightly better in 2012, lifting growth to a still meagre and below-potential 4.3 per cent. Similarly, in Uganda, solid growth due to strong investment in the natural resources sector and vibrant construction, transport and communication sectors has become subject to increasing downside risks in the light of lingering political unrest.

By contrast, a number of other LDCs find themselves in outright dire situations. In the Horn of Africa, severe drought conditions have led to a famine that is taking a heavy humanitarian toll, especially among children, and forcing many people to flee their homes. Somalia has been hit especially hard, as drought has compounded an already disastrous situation stemming from poverty and military conflict.

Across the group of LDCs, continued and growing (albeit slowly) ODA has provided a buffer to weather the crosscurrents of the unstable and volatile global economic environment.

The overall positive economic outlook for LDCs remains subject to considerable risks. A pronounced fall in oil prices would hit oil exporters such as Angola especially hard, compounding a situation that is problematic even in a time of solid oil prices, in view of high income inequality and a shortfall in private sector business activity owing to the dominant role of the State. A further risk lies in the continued dependence of public budgets in many LDCs on ODA flows. If the pressure for fiscal consolidation in developed economies feeds through into pronounced cuts in ODA, policymakers in LDCs would see their room to manoeuvre limited further. Another risk lies in the weather pattern and, in this context, also in the possibility of more lasting changes in climate conditions. Compounding the negative fallout from adverse weather conditions is the fact that agriculture is the dominant economic sector in many LDCs.

Unemployment—a key policy concern

Three years after the onset of the Great Recession, persistent high unemployment remains the Achilles heel of economic recovery in most developed countries. The unemployment rate averaged 8.6 per cent in developed countries in 2011, still well above the pre-crisis level of 5.8 per cent registered in 2007. At more than 20 per cent, the rate remains the highest in Spain, while Norway's jobless rate is the lowest, at 3.5 per cent. Notably, the unemployment rate in the United States has remained at about 9 per cent since 2009, with virtually no improvement in the labour market during 2011 as layoffs in the public sector have partly offset job creation in the private sector and labour force growth has kept pace with overall employment growth.

The protracted jobs crisis in developed countries is harming long-term prospects

In many developed economies, the actual situation is worse than reflected in the official unemployment rates. In the United States, for instance, labour participation rates have been on a steady decline since the start of the crisis. Increasing numbers of workers without a job for a prolonged period have stopped looking for one and are no longer counted as part of the labour force. About 29 per cent of the unemployed in the United States have been without a job for more than one year, up from 10 per cent in 2007. Such a prolonged duration of unemployment tends to have significant long-lasting detrimental

impacts on both the individuals who have lost their jobs and on the economy as a whole. The skills of unemployed workers deteriorate commensurate with the duration of their unemployment, most likely leading to lower earnings for those individuals who are eventually able to find new jobs. At the aggregate level, the higher the proportion of workers trapped in protracted unemployment, the greater the adverse impact on the productivity of the economy in the medium to long run. The International Labour Organization (ILO) estimated that by the first quarter of 2011, almost one third of the unemployed in developed countries had been without a job for more than one year, a situation affecting about 15 million workers (figure I.3).[4]

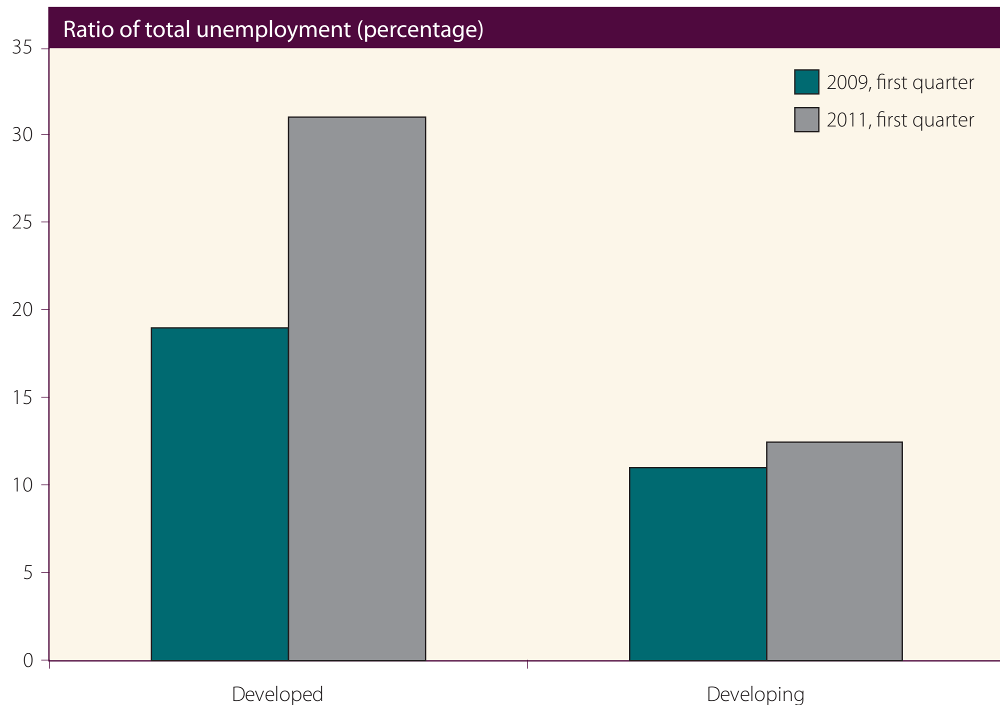
Despite employment recovery, long-term unemployment is also a concern in developing countries

In developing countries, employment recovery has been much stronger than in developed economies. For instance, unemployment rates are back to or below pre-crisis levels in most Asian developing countries, while employment has recovered in most countries in Latin America also. However, developing countries continue to face major challenges owing to the high shares of workers that are underemployed, poorly paid, have vulnerable job conditions or lack access to any form of social security. At the same time, open unemployment rates remain high, at well over 10 per cent in urban areas, with the situation being particularly acute in a number of African and Western Asian countries. Long-term unemployment has also increased in developing countries (figure I.3).

Youth unemployment is a major concern worldwide

High youth unemployment is a concern worldwide. Unemployment rates among youth (persons 15-24 years of age) tend to be higher than other cohorts of the labour force in normal times in most economies, but the global financial crisis and its consequent global recession have increased this gap in most parts of the world. Barring

Figure I.3
Long-term unemployment in developed and developing countries, 2009 and 2011



Source: International Labour Organization (ILO), *World of Work Report 2011* (Geneva).

4 Estimate of total long-term unemployment in developed economies, based on International Labour Organization (ILO) labour statistics database (LABORSTA), accessed 22 November 2011.

data limitations, the jobless rate among young workers in developed countries increased from an estimated 13 per cent in 2008 to about 18 per cent by the beginning of 2011. In Spain, an astonishing 40 per cent of young workers are without a job. A quarter or more of the youth in Western Asia and North Africa and one fifth of those in the economies in transition are unemployed. Also, in other developing regions, youth unemployment has increased more than that of other age groups. Latin America and the Caribbean, in particular, experienced significant increases in youth unemployment since 2008, although the situation started to improve in the first half of 2011. In East Asia, South Asia and Africa, young workers have a high probability of facing vulnerable employment conditions.

Skilled and unskilled young workers are affected by unemployment in different ways. Skilled youth that lose their jobs tend to have greater difficulty in getting a new job than more experienced workers and, hence, tend to face longer periods of unemployment than other workers; when they do find new jobs, they mostly have to settle for salaries lower than they earned before. Since entry salaries affect future salaries, youth who have lost jobs during the current financial crisis will face the risk of getting lower salaries for a prolonged period, even after the economy recovers. This group of unemployed, educated youth has recently received attention in the political debate as the "lost generation". Unskilled young workers who have recently lost jobs have been found to be at greater risk of becoming "discouraged workers", leading them to exit the labour force and end up dependent upon families and social programmes in the long term, especially in developed economies where such programmes exist. In developing economies, unskilled youth in unemployment face the additional risk of a permanent loss of access to decent work, causing them to stay outside the formal economy and have much lower lifetime earnings.

To make up for the employment deficit left by the crisis, 64 million jobs need to be created worldwide

Meanwhile, more young people continue to enter labour markets worldwide. In order to restore pre-crisis employment and absorb the new labour entrants, an employment deficit, estimated at 64 million jobs in 2011, would need to be eliminated.[5] With the global economic slowdown projected in the baseline and growth of the workforce worldwide, however, the deficit would increase further, leaving a job shortage of about 71 million, of which about 17 million would be in developed countries.[6] If economic growth stays as anaemic in developed countries as is projected in the baseline forecast, employment rates will not return to pre-crisis levels until far beyond 2015 (figure I.4).

Persistent high unemployment is holding back wage growth and consumer demand and, especially in the United States, pushing up delinquency on mortgage payments. Combined with continued financial fragility in the developed economies, it is also depressing investment demand and business confidence and further holding back economic recovery.

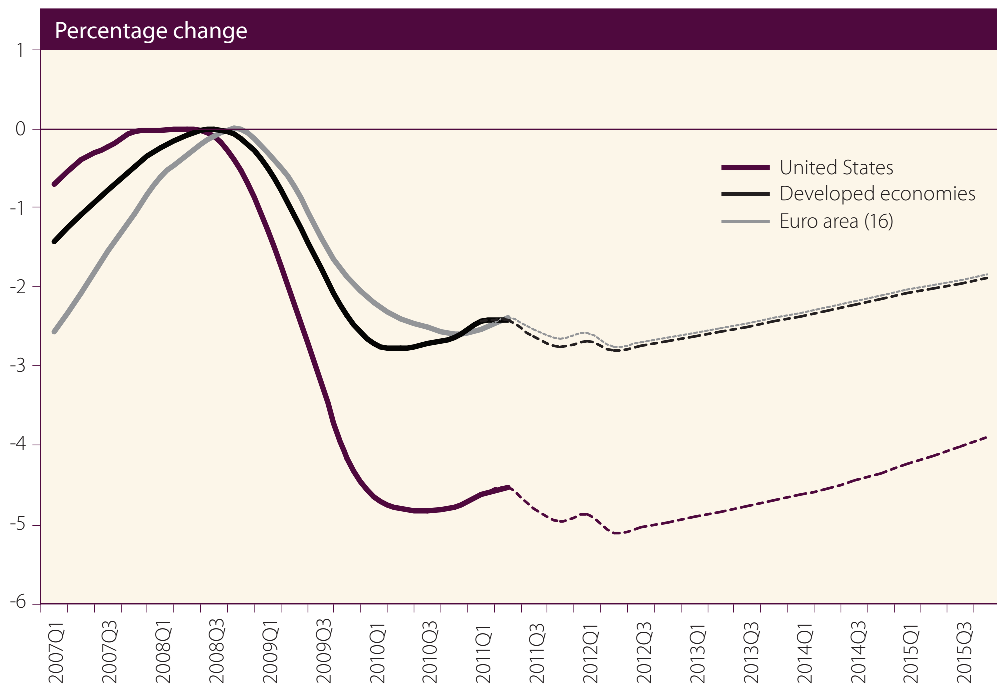
Benign inflation outlook

Inflation has increased worldwide in 2011, driven by a number of factors, particularly the supply-side shocks that have pushed up food and oil prices and strong demand in large

5 Using ILO data, the employment deficit is estimated here as the difference between the global employment rate as observed in 2007 and 2011 multiplied by the working-age population.

6 Estimate based on the UN/DESA Global Policy Model. See box I.4 and the appendix table to the present chapter for baseline trends in employment rates in major economies and an assessment of an alternative policy scenario to eliminate the deficit.

Figure I.4
Post-recession employment recovery in the United States, euro area and developed economies, 2007 (Q1)-2011 (Q2) and projections for 2011 (Q3)-2015 (Q4)



Source: UN/DESA, based on data from ILO and IMF.

Note: The chart shows percentage changes of total employment (as a moving average) with respect to pre-recession peaks. Projections (dashed lines) are based on estimates of the output elasticity of employment (Okun's law), following a similar methodology to that of ILO, *World of Work Report 2011* (Geneva).

developing economies as a result of rising incomes and wages. Reflationary monetary policies in major developed economies have also contributed to upward pressure by, among other things, increasing liquidity in financial markets, which has kept interest rates down but has also increased financial investment in commodity futures markets, inducing an upward bias in commodity prices and enhancing volatility (see chap. II).

Inflation does not pose a present danger in developed countries…

Among the developed economies, inflation rates in the United States and Europe have edged up during 2011, moving from the lower to the upper bound of the inflation target bands set by central banks. This increase was in line with the policy objective in these economies, aimed at mitigating the risk of deflation in the aftermath of the financial crisis, as their central banks continued to inject more liquidity into the economy through various unconventional policy measures. In Japan, the disruption caused by the earthquake in March 2011, along with other factors, pushed up the general price level, ending a protracted period of deflation. Nonetheless, inflation should not be a major policy concern for most developed economies. Inflation is expected to be moderate in the outlook for 2012-2013 with the weakening of aggregate demand, subdued wage pressures in the face of continued high unemployment and—barring major supply shocks—the moderating of international commodity prices.

…but remains a concern among developing countries

Inflation rates surpassed policy targets by a wide margin in a good number of developing economies. The monetary authorities of these economies have responded with a variety of measures, including by tightening monetary policy, increasing subsidies on food and oil, and providing incentives to domestic production. In the outlook, along with an anticipated moderation in global commodity prices and lower global growth, inflation in most developing countries is also expected to decelerate in 2012-2013.

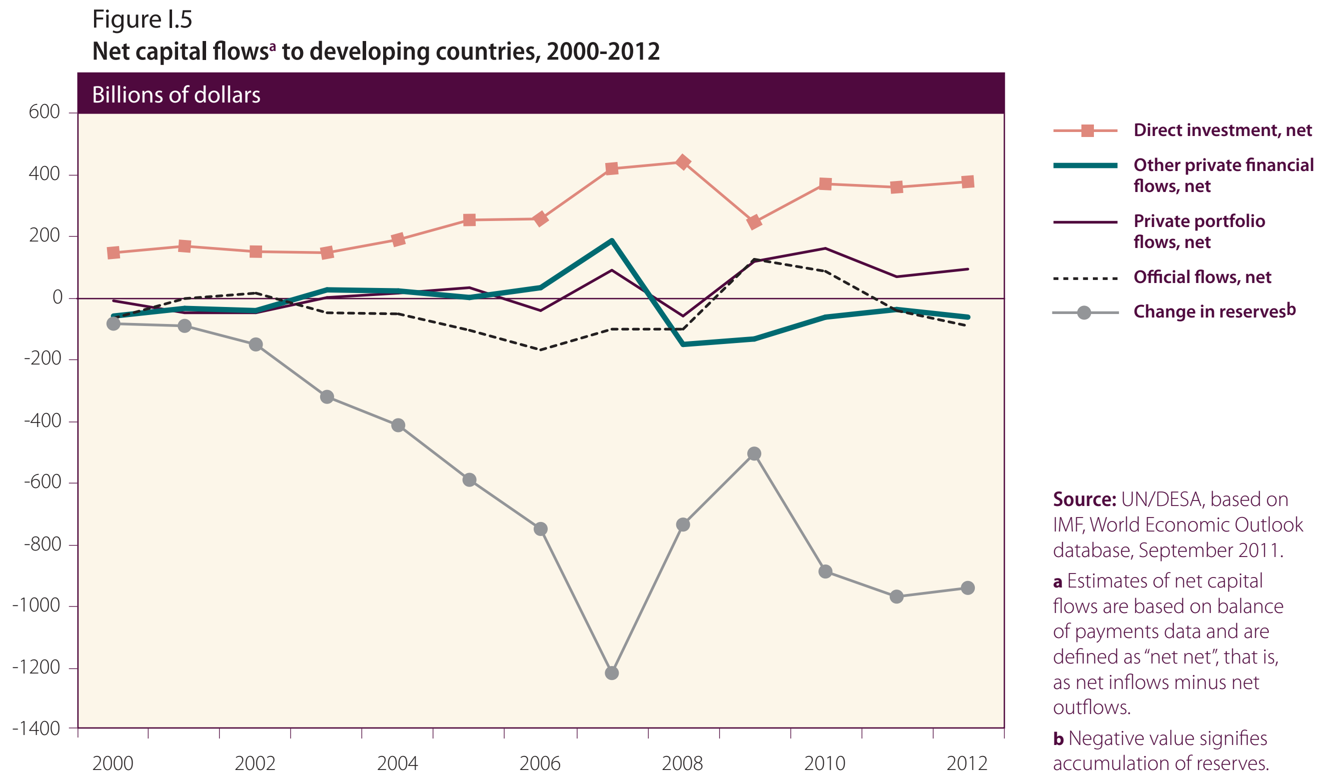
The international economic environment for developing countries and the economies in transition

Increased volatility in private capital flows

Private capital flows increased further in 2011…

Net private capital inflows[7] to emerging and developing economies increased to about $575 billion in 2011, up by about $90 billion from 2010 levels (figure I.5). The recovery in capital inflows from their precipitous decline during the global financial crisis continued until the middle of 2011 but suffered a strong setback with the sharp deterioration in global financial markets in the third quarter of the year. The current level of inflows remains well below the pre-crisis peak registered in 2007. As a share of GDP of developing countries, net capital inflows are at about half of their peak levels. The outlook for external financing will be subject to uncertainty owing to counteracting forces during 2012 and 2013. On the one hand, continued sovereign debt distress in developed economies will sustain the present uncertainty and volatility in global financial markets, and this will likely deter portfolio capital flows to emerging economies. Deepening of the sovereign debt crisis may lead to more capital being pulled back for deleveraging of financial institutions in developed countries or in a search for safe havens (such as dollar- or Swiss franc-denominated assets), as was the case during the financial turmoil of the third quarter of 2011. On the other hand, higher growth prospects for most emerging economies (despite the downgraded forecast) will likely attract more foreign direct investment (FDI), while interest rate differentials will continue to favour lending to emerging economies even if

Figure I.5
Net capital flows[a] to developing countries, 2000-2012



Source: UN/DESA, based on IMF, World Economic Outlook database, September 2011.

a Estimates of net capital flows are based on balance of payments data and are defined as "net net", that is, as net inflows minus net outflows.

b Negative value signifies accumulation of reserves.

7 The measure used here refers to net inflows minus net outflows.

the risk premiums for some of these economies rise further, a trend already visible in the second half of 2011 (figure I.6).

...although portfolio flows have shown great volatility

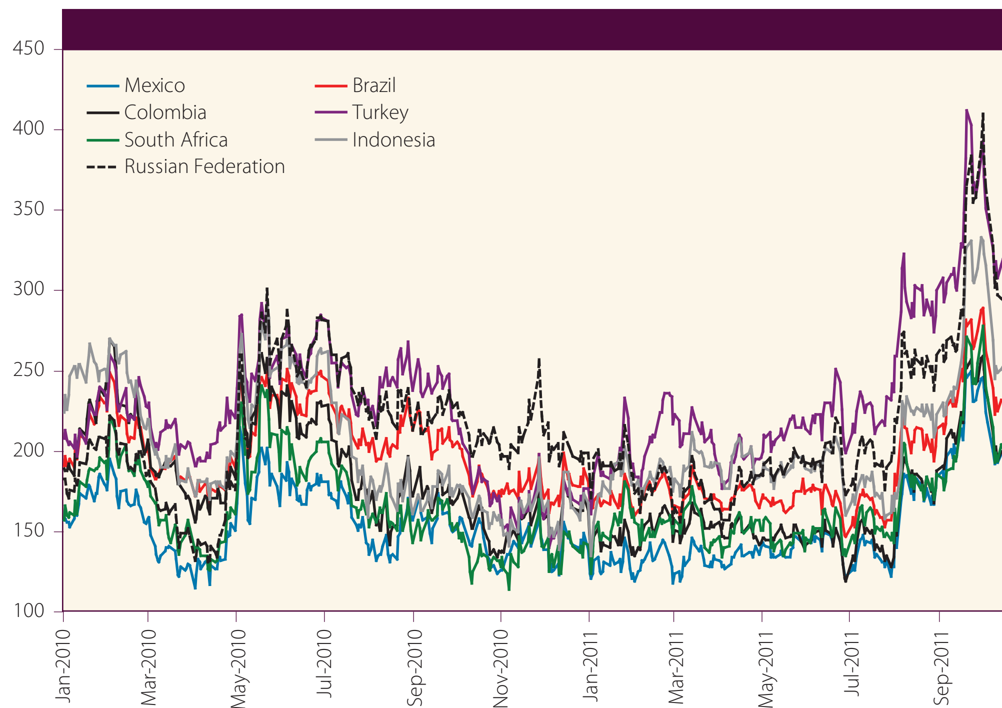
Short-term portfolio equity flows to developing countries went into a tailspin in the second half of 2011. As a result, net inflows of portfolio equity to emerging economies in 2011 are estimated to register a decline of about 35 per cent from 2010 levels, exhibiting vivid proof of the high volatility these flows tend to be subject to.

International bank lending to emerging and developing economies continued to recover slowly from its sharp decline in 2009. In 2011, bank lending had recovered to only about 20 per cent of its pre-crisis peak level, as international banks headquartered in developed countries continued to struggle in the aftermath of the financial crisis. Non-bank lending has been more vigorous, as both private and public sectors in emerging economies managed to increase bond issuance, taking advantage of low interest rates in global capital markets.

Net FDI remained the largest single component of private capital flows in 2011, reaching $429 billion, up by more than $100 billion from its 2010 level. Asian emerging economies received most (about 45 per cent) of the FDI inflows, followed by Latin America. These estimates are net of FDI from emerging market economies, which continued to increase. China and a few other Asian developing countries further increased investments in Latin America and Africa, primarily destined towards sectors producing oil, gas and other primary commodities.

Net disbursements of ODA reached a record high of $128.7 billion in 2010. Despite this record level, the amount of aid fell well short (by more than $20 billion) of the commitments made at the Gleneagles Summit of the Group of Eight (G8) on 6 July 2005 and those of other members of the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) to increase aid

Figure I.6
Daily yield spreads on emerging market bonds, January 2010-October 2011



Source: JPMorgan Chase.

to developing countries. Total ODA increased by 6.5 per cent in real terms in 2010, but OECD donor surveys suggest that bilateral aid from DAC members to core development programmes in developing countries will grow at a mere 1.3 per cent per year during 2011-2013 owing to the fiscal constraints of donors. At the current rate of progress, donors will not fully deliver on their commitments in the near future and will remain far removed from the long-standing United Nations target of providing 0.7 per cent of their gross national income (GNI) by 2015.

Developing countries added more than $1 trillion to their reserve holdings

On balance, however, financial resources continue to flow out of the emerging and developing economies in large quantities as their accumulation of foreign exchange reserves have increased further. In 2011, emerging economies and other developing countries are estimated to have accumulated an additional $1.1 trillion in foreign exchange reserves, totalling about $7 trillion.

Continued volatility in commodity prices

Commodity prices have dropped after a strong increase in early 2011

International prices of oil and other primary commodities continued to rise in early 2011, but declined in the third quarter. The pattern resembles that of 2008, although the reversal has not been as drastic. Nonetheless, average price levels of most commodities for 2011 remained well above those in 2010, by between 20 and 30 per cent. The reversals since mid-2011 have been driven by four key factors: a weaker global demand for commodities resulting from bleaker prospects for the world economy, positive supply shocks in a number of markets, a sell-off in markets for financial commodity derivatives that occurred in concert with the downturn in global equity markets, and an appreciation of the United States dollar. In the outlook, the prices of most primary commodities are expected to moderate by about 10 per cent in both 2012 and 2013, consistent with the forecast of weaker global economic growth. It is to be expected, however, that commodity price volatility will continue to remain high.

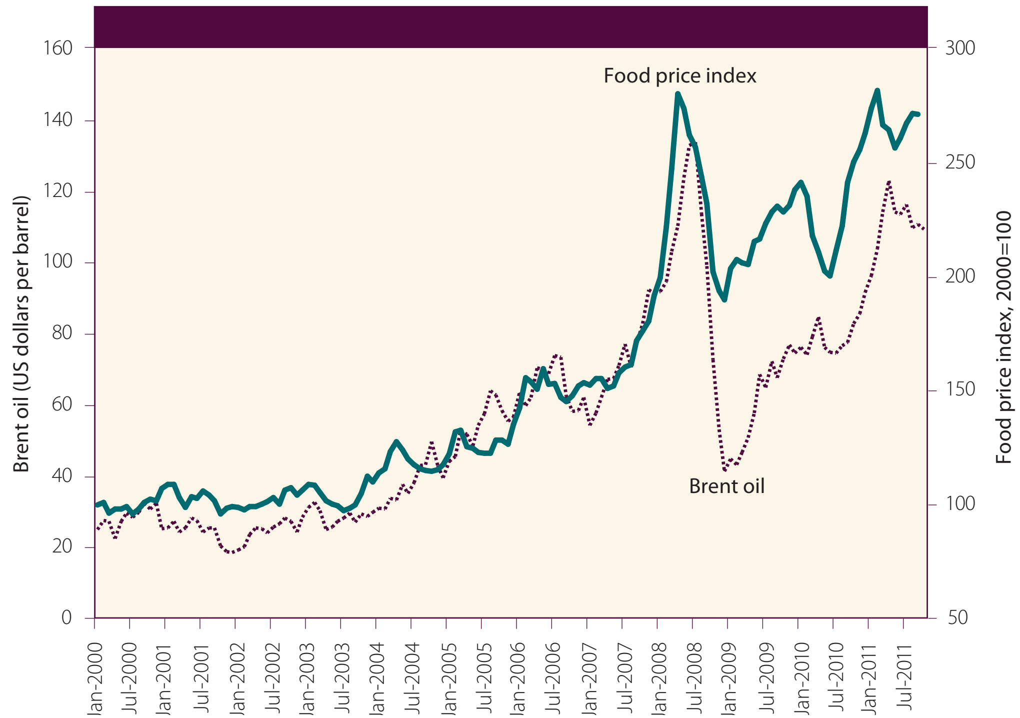
Brent oil prices averaged $111 per barrel (pb) in the first half of 2011, compared with an average of $79 for 2010 as a whole (figure I.7). The surge was mainly driven by the political unrest in North Africa and Western Asia, which caused disruptions in oil production, especially in Libya. However, oil prices dropped sharply in the third quarter of 2011 amidst weakening global demand, the anticipated resumption of oil production in Libya as well as a rebound of the exchange rate of the United States dollar.

In the outlook for 2012, demand for oil is expected to weaken because of slower economic growth in developed countries. Yet, total demand is expected to remain sustained because of the increased energy needs of developing countries, as well as the restocking of oil inventories. Oil production is expected to resume progressively in Libya, while Saudi Arabia may keep its production at the current level. However, the continued geopolitical instability in North Africa and Western Asia is likely to keep the risk premium on oil prices elevated. All things considered, the Brent oil price is expected to decline by 6 per cent, to $100 pb, in the baseline forecast for 2012 and to continue to fluctuate around that level in 2013. Nonetheless, price uncertainty and volatility will remain high because of, among other things, the influence of financial factors. These include, in particular, fluctuations in the value of the United States dollar and unpredictable trends in financial derivatives' trading in commodity markets.

Food prices have been volatile but remain high

After sliding considerably in the first half of 2010, world food prices have risen sharply, peaking around February 2011 (figure I.7). Despite subsequent falls, prices remain comparatively high. The average price of cereals during the first nine months of 2011 was

Figure I.7
International oil and food prices, January 2000-October 2011



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

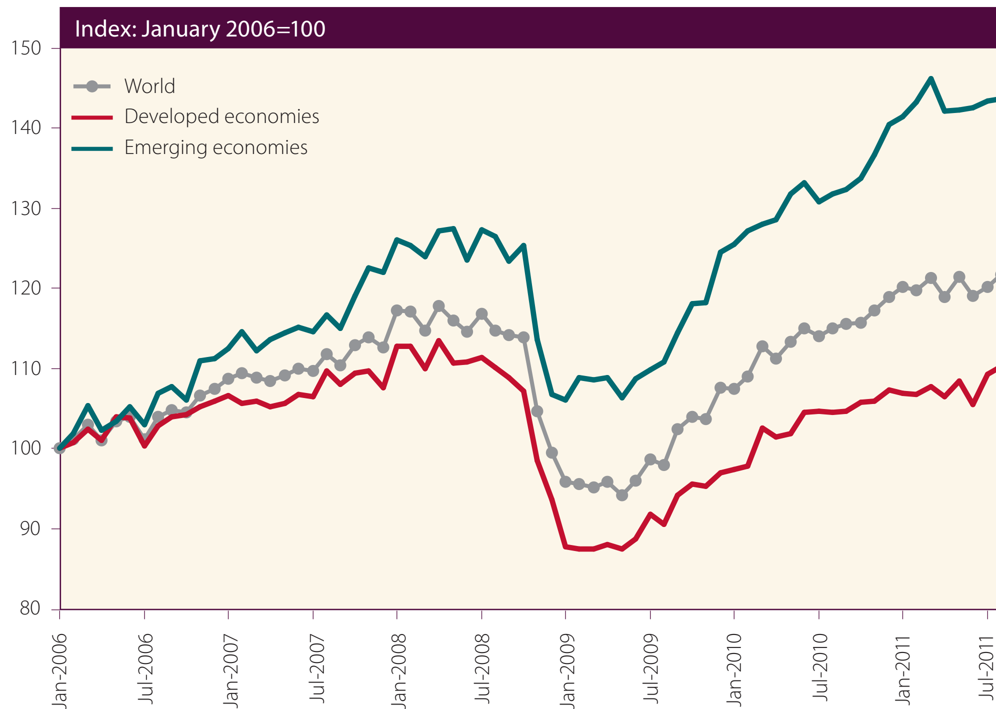
about 40 per cent higher than that recorded over the same period of 2010. Despite similar swings, meat, vegetable oils and sugar prices have also been on the rise. The impact on food-dependent developing countries has been considerable, but variable. A famine caused by prolonged droughts was declared in the Horn of Africa, but other countries in Africa enjoyed good harvests of maize and sorghum. Generally speaking, however, higher food prices have been an important factor in the high inflation of many developing countries, or a cause of additional fiscal burdens where the impact was mitigated by food subsidies.

In the outlook, food prices may moderate somewhat with the global downturn and expected good harvests for a number of key crops (including wheat). Yet, prices are likely to remain volatile, as food markets remain tight and any adverse supply shock could induce strong price effects. Continued uncertainty in financial markets can also be expected to exacerbate commodity price volatility.

Moderating world trade growth

World trade continued to recover in 2011, albeit at a much slower pace than in 2010. After a strong rebound of more than 14 per cent in 2010, the volume of world exports in goods decelerated visibly, to 7 per cent, in 2011 (figure I.8). The level of total world exports had fully recovered to its pre-crisis peak by the end of 2010, but it is estimated to be still below the long-term trend level by the end of 2011. As has been the case with the recovery of WGP, developing countries, particularly Asian economies with large shares in the trade of manufactured goods, led the recovery. While the level of trade in volume terms has already far surpassed the pre-crisis peak for developing countries as a group, the trade volume for

Figure I.8
World merchandise exports, by volume, January 2006-August 2011



Source: CPB Netherlands Bureau for Economic Policy Analysis, rebased by UN/DESA.

developed economies has yet to recover fully from the global crisis. Commodity-exporting developing countries experienced a strong recovery in the value of their exports in the first half of 2011, owing to the upturn in commodity prices, but saw little growth of export volumes. Some of the value gains were lost again in the second half of the year with the downturn in key commodity prices.

In the outlook, the volume growth of world trade is expected to moderate to about 5.0 per cent in 2012-2013. The dichotomy between a robust growth in trade in emerging economies and a weak one in developed economies will continue.

Uncertainties and risks

Risks of another global recession

Policy failure poses the most acute risk for the global economy

Failure of policymakers, especially those in Europe and the United States, to address the jobs crisis and prevent sovereign debt distress and financial sector fragility from escalating, poses the most acute risk for the global economy in the outlook for 2012-2013. A renewed global recession is just around the corner. The developed economies are on the brink of a downward spiral enacted by four weaknesses that mutually reinforce each other: sovereign debt distress, fragile banking sectors, weak aggregate demand (associated with high unemployment and fiscal austerity measures) and policy paralysis caused by political gridlock and institutional deficiencies. All of these weaknesses are already present, but a further worsening of one of them could set off a vicious circle leading to severe financial turmoil and an economic downturn. This would also seriously affect emerging markets and other developing countries through trade and financial channels.

The baseline forecast assumes that the set of additional measures agreed upon by the EU in late 2011 will suffice to contain Greece's debt crisis. The measures include a 50 per cent reduction of Greece's sovereign debt, steps to recapitalize European banks and deeper fiscal cuts in Greece. The baseline assumes this would help engender an orderly workout of the sovereign debt crisis in the euro area and prevent the Greek default from spreading to other economies and leading to a major collapse of banks. For the United States, the baseline assumes that the Government will put in place a policy package that would provide some minor stimulus in the short run, while cutting Government spending and increasing taxes over the medium run. The baseline further subsumes the policy commitments made by other Group of Twenty (G20) members at the Cannes Summit in France, held on 3 and 4 November 2011. These reaffirm—by and large—existing Government plans, with the main emphasis on moving towards further fiscal austerity while sustaining accommodative monetary policies in most developed countries; and with continued focus on price stability through monetary tightening in major developing economies and those countries who are running large current-account surpluses enacting fiscal policies that promote more domestic-led growth.

Inability to address sovereign debt problems in the euro area and the United States could trigger another global recession

The presumption of the baseline scenario is that the combination of these policies will allow developed economies to "muddle through" during 2012, but will be insufficient to catapult a robust economic recovery. The risk is high, however, that these relatively benign baseline assumptions will prove to be overly optimistic. It is quite possible that the additional measures planned in Europe will not be effective enough to resolve the sovereign debt crisis in the region, leading to a disorderly and contagious default in a number of countries which will wreak havoc in the economies of the region and beyond. The efforts to solve the sovereign debt crisis in Europe failed to quell the unease in financial markets during November of 2011, and fresh warning signs of further problems emerged as Italy's cost of borrowing jumped to its highest rate since the country adopted the euro. Another sign of increasing financial distress was a jump in the Euribor-OIS, Europe's interbank lending rate, from 20 to 100 basis points—not as high as at the onset of the 2008 global financial crisis, but high enough to cause concern. A large number of banks in the euro area already stand to suffer significant losses, but contagion of the sovereign debt crisis to economies as large as Italy would no doubt overstretch the funds available in the European Financial Stability Facility (EFSF), put many banks on the verge of bankruptcy and trigger a worldwide credit crunch and financial market crash in a scenario reminiscent of the September 2008 collapse of Lehman Brothers Holdings Inc. Such a financial meltdown would no doubt lead to a deep recession, not only in those economies under sovereign debt distress, but also in all other major economies in the euro area, possibly with the intensity of the downturn seen in late 2008 and early 2009.

The political wrangling over the budget in the United States may also worsen and could harm economic growth if it leads to severe fiscal austerity with immediate effect. This would push up unemployment to new highs, further depress the already much-shaken confidence of households and businesses, and exacerbate the beleaguered housing sector, leading to more foreclosures which, in turn, would put the United States banking sector at risk again. Consequently, the United States economy could well fall into another recession. The United States Federal Reserve might respond by adopting more aggressive monetary measures, for example, through another round of quantitative easing; but in a depressed economy with highly risk averse agents, this would likely be even less effective in terms of boosting economic growth than the measures taken in previous years.

A recession in either Europe or the United States alone may not be enough to induce a global recession, but a collapse of both economies most likely would. Table I.2 shows the possible implications of a more pessimistic scenario of this kind. GDP of the EU would decline by 1.6 per cent and that of the United States by 0.8 per cent in 2012. This would constitute about one third of the downturn experienced during 2009. The scenario assumes that financial conditions would not escalate into a full-blown banking crisis with worldwide repercussions, but it also assumes some overshooting of the impact into the real economy—as was the case in 2009—allowing for a mild recovery in 2013, albeit with GDP growth remaining well below the baseline forecast.

Developing countries would be hit hard

Developing economies and the economies in transition would likely take a significant blow. The impact would vary as their economic and financial linkages to major developed economies differ across countries. Asian developing countries, particularly those in East Asia, would suffer mainly through a drop in their exports to major developed economies, while those in Africa, Latin America and Western Asia, along with the major economies in transition, would be affected by declining primary commodity prices. In addition, all emerging economies would have to cope with large financial shocks, including a contagious sell-off in their equity markets, reversal of capital inflows and direct financial losses due to the declining values of the holdings of European and United States sovereign bonds, which would affect both official reserve holdings and private sector assets.

As a result, GDP growth in developing countries would decelerate from 6.0 per cent in 2011 to 3.8 per cent in 2012, that is, to almost half the pace of growth (about 7 per cent per year) achieved during 2003-2007 and about 3 percentage points below the long-term growth trend. This growth deceleration is not quite as big as in 2009 (when the pace of developing country growth dropped by almost 4.5 percentage points), yet various regions would suffer negative per capita income growth, likely causing renewed setbacks in poverty reduction and in achieving the other Millennium Development Goals (MDGs).[8] Growth of WGP would decelerate to 0.5 per cent in 2012, implying a downturn in average per capita income for the world.

Uncertainties associated with the global imbalances and heightened exchange-rate volatility

The large and persistent external imbalances in the global economy that have developed over the past decade remain a point of concern for policymakers. Reducing these imbalances has been the major focus of consultations among G20 Finance Ministers under the G20 Framework for Strong, Sustainable and Balanced Growth and the related Mutual Assessment Process (MAP) during 2011. The imbalances have declined during the current economic downturn, but there is concern that in the absence of corrective actions, they will rise again as the world economy recovers. The Cannes Action Plan for Growth and Jobs,[9] adopted by the G20 leaders at the Cannes Summit on 4 November 2011 includes some concrete policy commitments towards such corrective action.

The global imbalances have stabilized at reduced levels…

In practice, after a substantial narrowing during the Great Recession, the external imbalances of the major economies stabilized at about half of their pre-crisis peak levels

8 For an assessment of the impact of economic downturns suffered during the global crisis of 2008 and 2009 on MDG achievement, see *World Economic Situation and Prospects 2011*, op. cit., box I.3, pp. 14-15.

9 Available from http://www.g20.org/Documents2011/11/Cannes20Action20plan20420November202011.pdf.

Table I.2
A downside scenario for the world economy[a]

GDP growth rate (percentage)					
				Deviation from baseline forecast	
	2011	*2012*	*2013*	*2012*	*2013*
World	**2.8**	**0.5**	**2.2**	**-2.1**	**-1.0**
Developed economies	1.3	-0.9	1.1	-2.1	-0.8
United States of America	1.7	-0.8	1.1	-2.3	-0.9
Japan	-0.5	0.5	1.2	-1.5	-0.8
European Union	1.6	-1.6	1.0	-2.3	-0.6
EU-15	1.5	-1.8	0.9	-2.3	-0.6
New EU members	2.9	1.1	2.6	-1.5	-0.5
Euro area	1.5	-2.0	0.6	-2.4	-0.7
Other European countries	1.0	-0.1	1.1	-1.2	-0.5
Other developed countries	1.4	0.2	1.7	-2.0	-0.7
Economies in transition	4.1	-2.0	3.3	-5.9	-0.9
South-Eastern Europe	1.7	-2.8	2.7	-5.1	-0.5
Commonwealth of Independent States and Georgia	4.3	-2.0	3.3	-6.0	-0.9
Russian Federation	4.0	-3.6	3.0	-7.5	-1.0
Developing economies	6.0	3.8	4.5	-1.7	-1.4
Africa	2.7	3.3	3.7	-1.7	-1.5
North Africa	-0.5	4.7	4.6	0.0	-0.9
Sub-Saharan Africa	4.4	2.6	3.2	-2.6	-1.8
Nigeria	6.3	4.2	5.2	-2.6	-1.8
South Africa	3.1	0.0	1.7	-3.7	-1.8
Others	4.8	4.0	3.5	-1.8	-1.8
East and South Asia	7.1	5.6	5.7	-1.2	-1.2
East Asia	7.2	5.6	5.7	-1.3	-1.2
China	9.3	7.8	7.6	-0.9	-0.9
South Asia	6.5	5.7	5.8	-1.0	-1.1
India	7.6	6.7	6.9	-1.0	-1.0
Western Asia	6.6	1.1	2.5	-2.7	-1.8
Latin America and the Caribbean	4.3	0.8	2.4	-2.5	-1.8
South America	4.6	1.2	2.7	-2.4	-1.8
Brazil	3.7	0.3	2.0	-2.4	-1.8
Mexico and Central America	3.8	-0.4	1.8	-3.1	-1.8
Mexico	3.8	-0.6	1.8	-3.1	-1.8
Caribbean	3.4	3.8	2.6	0.3	-1.7
By level of development					
High-income countries	1.6	-0.7	1.2	-2.1	-0.8
Upper middle income countries	6.1	3.2	4.7	-2.3	-1.2
Lower middle income countries	5.9	5.2	5.3	-1.2	-1.3
Low-income countries	5.7	6.0	4.2	0.0	-1.7
Least developed countries	4.9	5.4	4.0	-0.6	-1.8

Source: UN/DESA.

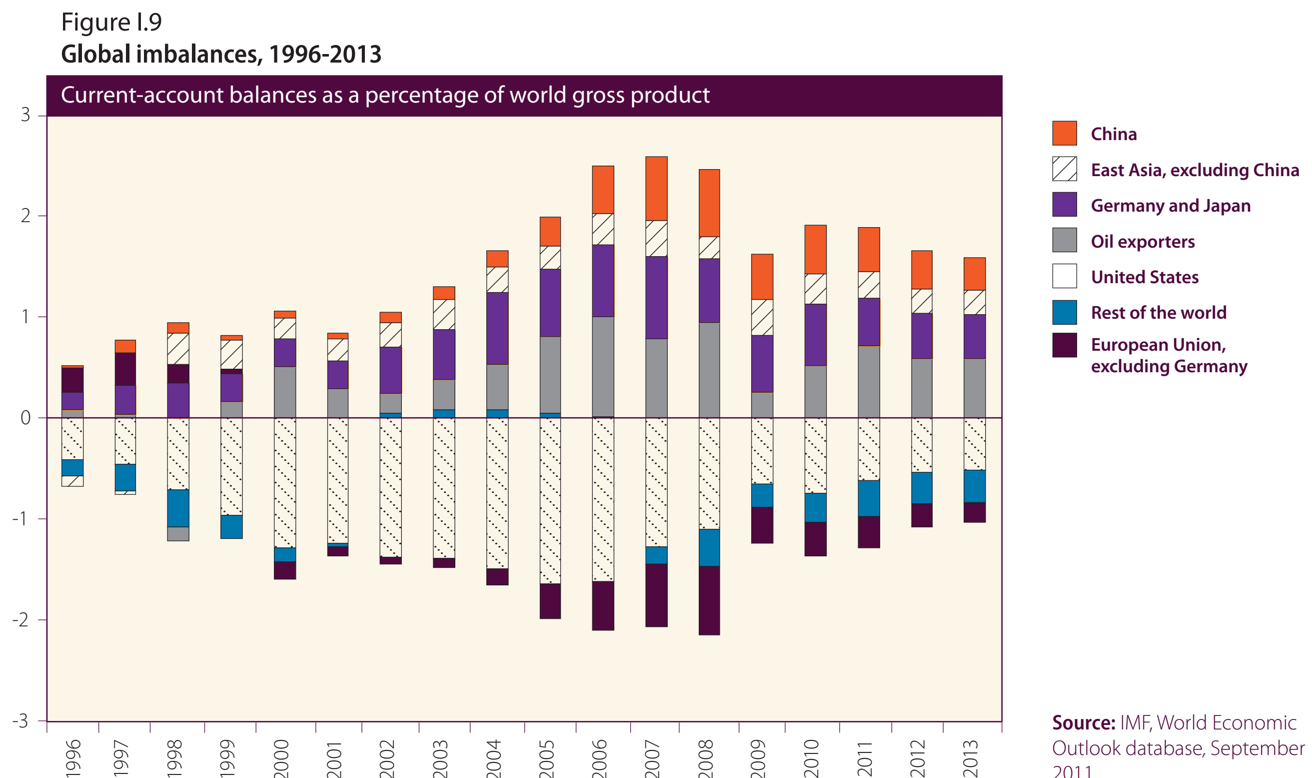
a See section on “Risks and uncertainties” for assumptions for this scenario.

(relative to GDP) during 2010-2011 (figure I.9). The United States remained the largest deficit economy, with an estimated external deficit of about $450 billion (3 per cent of GDP) in 2011, but the deficit has come down substantially from the peak of $800 billion (6 per cent of GDP) registered in 2006. The external surpluses in China, Germany, Japan and a group of fuel-exporting countries, which form the counterpart to the United States deficit, have narrowed, albeit to varying degrees. China, for instance, registered a surplus of about $250 billion (less than 4 per cent of GDP) in 2011, dropping from a high of 10 per cent of GDP in 2007. Japan is estimated to have registered a surplus of 2.5 per cent of GDP in 2011, a reduction of one percentage point of GDP compared with the level in 2010 and about half the size of the peak level reached in 2007. While Germany's surplus remained at about 5 per cent of GDP in 2011, the current account for the euro area as a whole was virtually in balance. Large surpluses, relative to GDP, were still found in oil-exporting countries, reaching 20 per cent of GDP or more in some of the oil-exporting countries in Western Asia.

…yet, no benign rebalancing has taken place

At issue is whether the adjustment of the imbalances in major economies has been mainly cyclical or structural. In the United States, some of the corresponding adjustment in the domestic saving-investment gap seems to be structural. For example, the household saving rate has increased from about 2 per cent of disposable household income before the financial crisis to about 5 per cent in the past few years. Despite a decline in recent months, it is likely that the average saving rate will stay at this level in the coming years, given the changes that have taken place in house financing and the banking sector after the financial crisis. On the other hand, the significant decline in the business investment rate and the surge in the Government deficit in the aftermath of the financial crisis are more likely to be cyclical. Business investment has been recovering slowly, while the budget deficit is expected to decrease somewhat. As a result, in the baseline scenario, the external deficit of the United States may stabilize at about 3 per cent of GDP in the medium run.

Figure I.9
Global imbalances, 1996-2013



Source: IMF, World Economic Outlook database, September 2011.

With regard to the surplus countries, the decline in the external surplus of China has also been driven in part by structural change. China's exchange-rate policy has become more flexible, with the renminbi appreciating gradually but steadily vis-à-vis the United States dollar over the past year.[10] Meanwhile, the Government has scaled up measures to boost household consumption, aligning the goal of reducing China's external surplus with that of rebalancing the structure of the economy towards greater reliance on domestic demand. However, the process of rebalancing can be only gradual over the medium to long run so as to prevent it from being disruptive. In Japan, a continued appreciation of the yen has contained its external surplus. In Germany, room remains for policies to stimulate more domestic demand so as to further narrow its external surplus. The surpluses in oil-exporting countries are of a quite different nature from those in other economies, as these countries need to share the wealth generated by the endowment of oil with future generations via a continued accumulation of the surplus into the foreseeable future.

The policy commitments made at the Cannes G20 Summit promise to gently move things in the same direction, but with much of the narrowing in the short run coming from cyclical factors, including slower aggregate demand growth and moderating commodity prices. Hence, at projected baseline trends, the global imbalances are not expected to widen by a significant margin in the next two years. Should the global economy fall into another recession, the imbalances would narrow further in a deflationary manner.

There are concerns that the present process of global rebalancing will be addressed at the expense of job growth and will not help stabilize exchange rates

Unsustainably large imbalances must be addressed, but at their present level, the global imbalances should not be a primary reason for concern. There are two other related concerns, however. The first is that the global rebalancing agenda should not develop at the expense of growth; rather, it should promote growth and employment generation as this will also be key to overcoming public debt woes. While the rebalancing as proposed in the Cannes Action Plan is said to be aligned with a strategy for "growth and jobs", most of the concrete policy actions are already contained in existing Government plans, which—as shown in the outcome of the baseline scenario—add up to only anaemic growth at best, and thus to a further cyclical, rather than structural, adjustment of the global imbalances.

The second related problem is the continued build-up of vast external liability positions of deficit countries which have similarly large external asset positions of the surplus countries as a counterpart. In a context of enhanced uncertainty in financial markets, these accumulated net investment positions are part of a larger topic related to enhanced exchange-rate instability. The net external liability position of the major reserve currency country, the United States, stands at about $2.5 trillion (17 per cent of GDP), but is down from its peak of $3.3 trillion (23 per cent of GDP) in 2008. Foreign holdings of United States Government debt dominate the composition of external liabilities, estimated at over $22 trillion, while United States foreign asset holdings mainly consist of private equities. Mounting external liabilities by the United States, associated in part with increasing fiscal deficits, have in fact been a major factor in the downward pressure on the United States dollar against other major currencies since 2002, although there have been large fluctuations around the trend. Confidence in the dollar is subject to volatility as perceptions of the sustainability of the United States liability position can easily shift along with changes in equity prices in global markets and the credibility of fiscal policy, both of which have been under varying (but heavy) pressure during 2011. The political wrangling over the debt ceiling in the United States has damaged market confidence and triggered a sell-off in equity markets worldwide.

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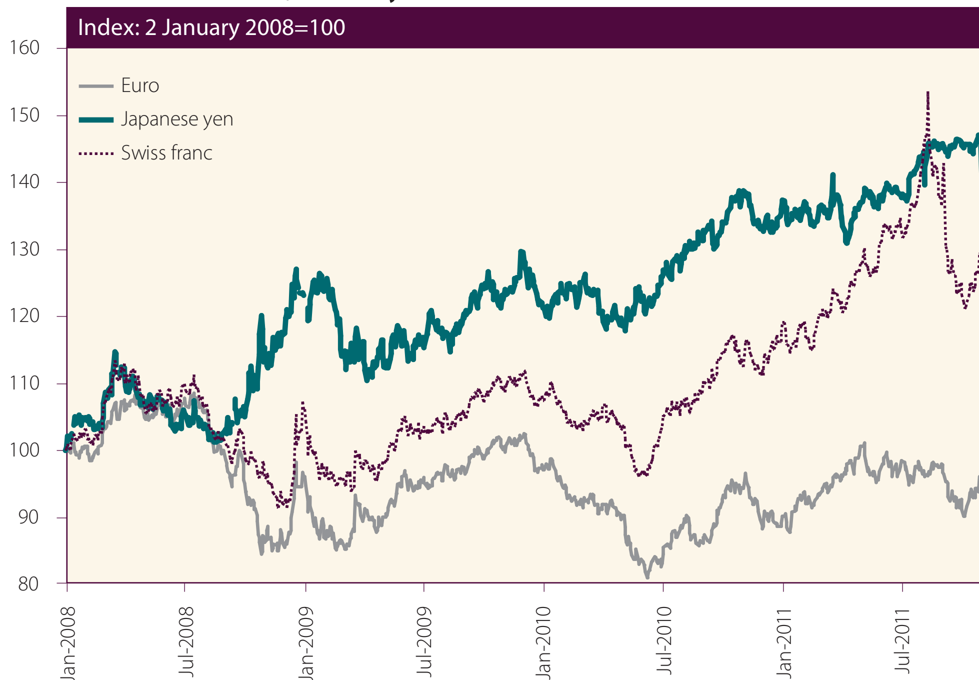
10 The renminbi has appreciated by about 30 per cent against the dollar since China abandoned the dollar peg in 2005.

In the light of events and problems with policy credibility elsewhere, this situation did not lead to univocal dollar depreciation. In the euro area, the lack of policy direction and coherence in dealing with sovereign debt problems put downward pressure on the euro. On a slightly different tack, but essentially in the same vein, the United Kingdom of Great Britain and Northern Ireland suffered its own version of a credibility crisis with the continued failure of its central bank to achieve its inflation target. Japan's earthquake, in turn, triggered a repatriation of private asset holdings for investment in reconstruction works, putting upward pressure on the yen. The volatility in global capital flows (discussed above) induced further instability into currency markets.

Indeed, exchange rates among major international reserve currencies, namely, the United States dollar, euro and Japanese yen, continued to display large fluctuations during 2011 (figure I.10). Developing countries also witnessed greater exchange-rate volatility. The dollar continued its downward trend against other major currencies in the first half of the year, but rebounded notably against the euro in the third quarter when concerns about the sovereign debt crisis in the euro area intensified, and devalued again later in the year after some agreements were reached in Europe on scaling up measures to deal with the debt crisis. Over the year as a whole, the Japanese yen appreciated against both the dollar and the euro, despite interventions by the Bank of Japan to curb the appreciation. Among other currencies in developed economies, the Swiss franc appreciated the most in the first half of the year, as a result of flight-to-safety effects, leading to the decision of the Swiss authorities not to tolerate any strengthening of the exchange rate below SwF 1.20 per euro.

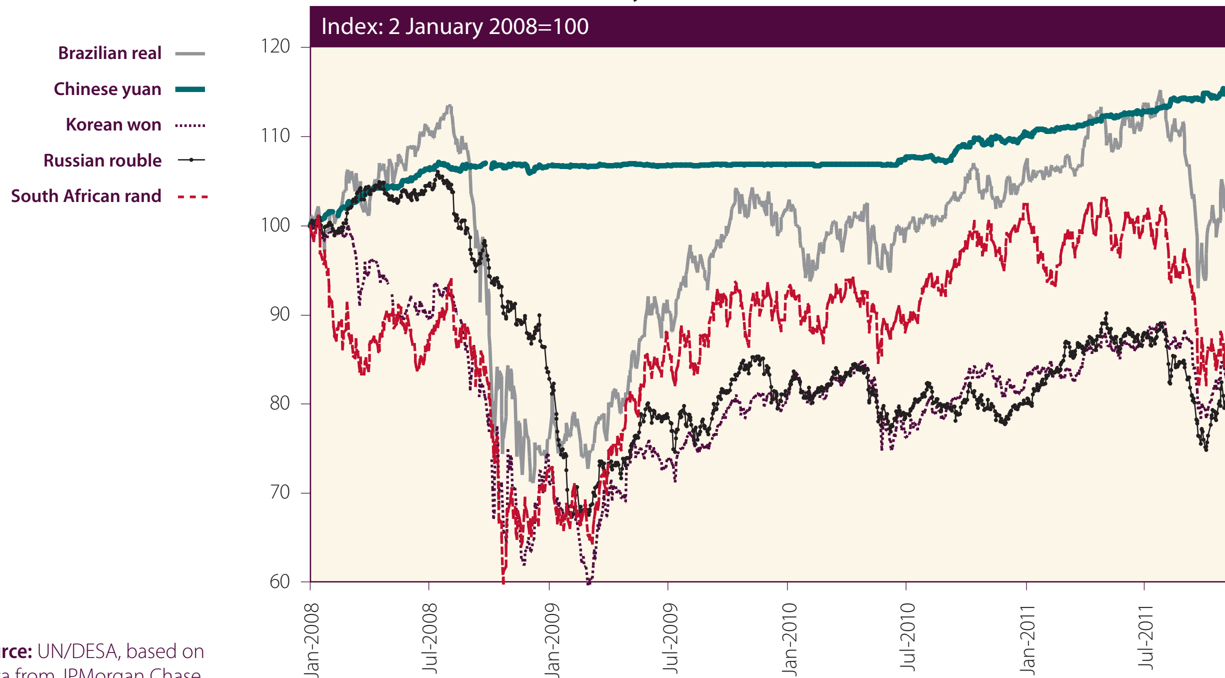
Strong capital inflows attracted by robust economic performance put upward pressure on the currencies of most emerging economies over the past two years. This trend went into a tailspin with the heightened turbulence in global financial markets starting in mid-2011 (figure I.11). For instance, Brazil's real fell 16 per cent against the United States

Figure I.10
Exchange rates of major reserve currencies vis-à-vis the United States dollar, 2 January 2008-10 November 2011



Source: UN/DESA, based on data from JPMorgan Chase.

Figure I.11
Exchange rates of selected currencies vis-à-vis the United States dollar, 2 January 2008-10 November 2011



Source: UN/DESA, based on data from JPMorgan Chase.

dollar in the third quarter, while the Russian rouble and the South African rand depreciated by 15 and 19 per cent, respectively.

However, since early 2009, the underlying trend has been for the currencies of most emerging economies to appreciate against the dollar. In the cases of Brazil, Indonesia, the Republic of Korea, South Africa and Thailand, for instance, this trend reflects in part a recovery from the depreciation that occurred at the apex of the global financial crisis in 2008. The Chinese renminbi, in contrast, has slowly but gradually appreciated against the dollar ever since 2005, as part of a deliberate exchange-rate policy.

Exchange-rate volatility is posing policy challenges to developing countries

Currency appreciation poses a challenge for many developing countries and some European countries by reducing the competitiveness of their respective export sectors. While domestic demand has been taking on a more significant role as a driver of growth on the back of rising incomes in many emerging economies, a forced and premature shift away from an export-led growth model owing to pronounced and sustained currency appreciation might create significant dislocations, especially in labour markets in the form of a spike in unemployment. Stronger currencies can help on the import side to reduce inflation, but this advantage could be more than offset by the social cost of higher unemployment rates.

An additional problem tied to sustained exchange-rate trends lies in an increased probability of sudden trend reversals, as occurred in the third quarter of 2011. Contrary to many fundamental factors, virtual panic about the debt problems in Europe and the possibility of a global recession set off a flight to the dollar, which has again confirmed its role as the safe-haven currency of last resort in situations of extreme market stress. Emerging market currencies that had experienced sustained appreciation pressure suffered a precipitous fall in their values in a very short time span, illustrating the unpredictable nature of developments in currency markets.

The increased currency volatility has injected an additional element of uncertainty into currency markets and created significant feed-through effects into the real economy. As companies face greater difficulties in pricing their products and anticipating their costs, business planning becomes more uncertain, underpinning a generally more cautious approach that also includes an even greater reluctance to hire new employees. Such increased volatility would also be likely to spill over into more price instability in commodity markets given the high degree of financialization of those markets and the impact of exchange rates (especially the value of the dollar) on commodity prices (see chap. II). Uncertainty and volatility in currency markets can be expected to remain high during 2012-2013.

Policy challenges

Developed countries are in a no-growth trap

Overcoming the risks outlined above and reinvigorating the global recovery in a balanced and sustainable manner poses enormous policy challenges. Most developed economies—Europe and the United States, as well as Japan—find themselves in a difficult economic bind. There are no simple solutions that would quickly win political support. Their economies have been growing too slowly for too long, making it more and more difficult to pay for the increasing costs of health care and pensions for ageing populations. The United States and Europe face the risk of their problems feeding into each other. Recent economic stagnation may make voters and policymakers unwilling to opt for hard choices, and the political paralysis might, in turn, worsen the economy by creating new financial turmoil. In the short term, this so-called no growth or low growth trap[11] takes the form of resistance to emergency measures—for instance, the opposition in some European countries that are perceived to be more fiscally prudent, to bail out what are seen to be more profligate countries; this may force the latter towards more fiscal austerity and induce lower growth and social opposition. Over the longer term, the trap is created by resistance to the higher taxes and reduced benefits deemed necessary to return countries to financial stability. The resistance is understandable given the weakness of income growth over the past decade, but is unlikely to hold up against the pressures for adjustment.

Developing countries face different policy dilemmas

Developing countries find themselves in a different bind. On the one hand, they need to protect themselves against volatile commodity prices and external financing conditions, in some cases through more restrictive macroeconomic policies and reserve accumulation, thereby contributing to the lack of global aggregate demand. On the other hand, they need to step up investment to sustain higher growth and reorient their economies towards faster poverty reduction and more sustainable production. In particular, they need to be mindful that the quality of growth should not be such that it deprives important groups of workers of decent jobs—not just the working poor but also the youth and, in some cases, the better educated amongst them. Feelings of the lack of a meaningful future have become a source of social tensions, most visibly in the Arab world.

G20 leaders recognized these concerns to some extent in the Cannes Action Plan and announced a global strategy for growth and jobs. The plan is to address short-term vulnerabilities, while strengthening the medium-term foundations for growth. The mix of concrete measures and policy commitments for the short run are by and large

11 The trap was so named in a recent article by Benjamin F. Friedman, "The no-growth trap", *National Interest*, No. 116 (November-December 2011), available from http://nationalinterest.org/article/the-no-growth-trap-6050.

consistent with what is already subsumed in the baseline forecast for 2012 and 2013. It refers, if only in vague terms, to the possible implementation of some elements of the American Jobs Act proposed by the Government of the United States as well as its commitment to medium-term fiscal consolidation. It further includes Japan's reconstruction efforts (although these are assumed to be largely tax-financed) and the coming into effect of the "comprehensive" package agreed to by the Governments of the euro area for an orderly workout of the sovereign debt crises in the area.[12] It also includes the commitment of ensuring monetary policies that support economic recovery but maintain price stability in the medium run, and commitments of countries with relatively strong public finances (such as Australia, Brazil, Canada, China, Germany, Indonesia and the Republic of Korea) to let automatic stabilizers work and, in the face of worsening world economic conditions, take discretionary measures to support domestic demand.

Current policy intentions of the G20 at best provide for a scenario of "muddling through"

In essence, however, the Cannes Action Plan does not promise to add much more to what was already contained in Government plans enacted during 2011, when macroeconomic policies in most developed economies were already characterized by a combination of an extremely loose monetary policy stance and shifts towards fiscal austerity. The central banks of the euro area, Japan and the United States all maintained their policy interest rates at low levels and expanded the size of their balance sheets to inject more liquidity into the economy through various unconventional monetary measures. The fiscal policy stance in most developed economies was tightened through austerity measures, inducing a drain on GDP growth. In contrast, macroeconomic policy varied greatly across developing countries. Monetary tightening in efforts to stem inflation was perhaps the more common feature among major emerging economies. The Cannes Action Plan does not promise to do much more in the short run (apart for the elements highlighted above), and as the baseline projections show, would fall short of reinvigorating the world economy and bringing down unemployment. Most hopes seem to be set on strengthening the medium-term foundations for growth, but the related six-point plan[13] could quickly "fall behind the curve" if the downside risks to the outlook materialize. In fact, during November of 2011 it became clear that markets have been little impressed by either the G20 Action Plan or the euro area's package for handling the sovereign debt crisis and containing contagion to large economies. Financial turmoil continued amidst increased political uncertainty with the Government leaders of both Greece and Italy being forced to step down over the sovereign debt crisis. Italy's borrowing costs were pushed to record highs and the world's seventh-largest economy edged closer towards the brink of default.

12 This includes the agreement to (i) flexibilize and enhance the EFSF instruments to a firepower of up to €1 trillion; (ii) significantly strengthen economic and fiscal surveillance and governance of the euro area; (iii) ensure that euro area member States experiencing tensions in sovereign debt markets make stronger efforts in terms of fiscal consolidation and structural reforms; (iv) ensure the sustainability of the Greek public debt through a rigorous adjustment programme and a voluntary nominal discount of 50 per cent on Greek debt held by private investors; and (v) raise confidence in the banking sector, including by facilitating access to term funding, where appropriate, and temporarily increasing the capital position of large banks to 9 per cent of Core Tier 1 capital after accounting for sovereign exposures by the end of June 2012, while maintaining the credit flow to the real economy and ensuring that these plans do not lead to excessive deleveraging.

13 The six-point plan to strengthen the medium-term foundations for growth agreed to by the G20 leaders in Cannes would consist of (1) commitments to fiscal consolidation; (2) commitments to boost private demand in countries with current-account surpluses, and, where appropriate, to rotate demand from the public to the private sector in countries with current-account deficits; (3) structural reforms to raise growth and enhance job creation across G20 member countries; (4) reforms to strengthen national/global financial systems; (5) measures to promote open trade and investment, rejecting protectionism in all its forms; and (6) actions to promote development.

This has increased the likelihood of the pessimistic scenario's materializing, with the consequences outlined in the section above.

The only way to overcome present economic woes is through much more pervasive policy coordination

In order to make the global economic recovery more robust, balanced and sustainable, the policy directions discussed in *World Economic Situation and Prospects 2011* still apply, but they have taken on greater urgency. There are important commonalities with the Cannes Action Plan, but actions will need to be much more pervasive and better coordinated, especially in terms of short-term stimulus, sovereign debt resolution and orientation towards job creation, while medium-term plans should focus more strongly on sustainable growth and development and accelerated reforms of financial regulatory systems and the international monetary system.

Stronger macroeconomic stimulus…

More short-term fiscal stimulus is needed, not less

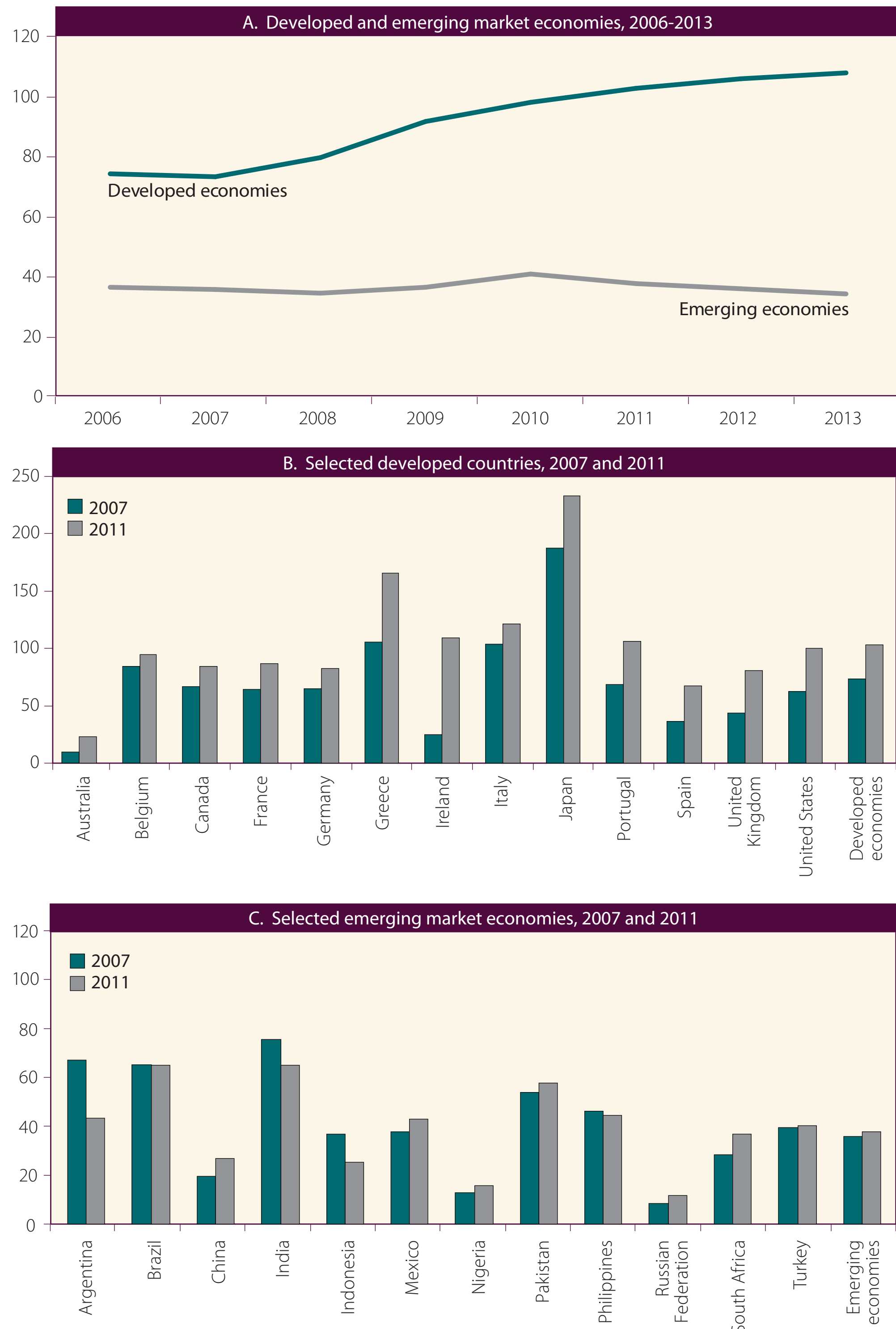
As a first step, developed countries, in particular, should be cautious not to embark prematurely on fiscal austerity policies given the still fragile state of the recovery and prevailing high levels of unemployment. While high public indebtedness is a concern and has continued to increase in most developed economies, in a number of cases (including the United States) to over 100 per cent of GDP (figure I.12), many developed country Governments still have plenty of fiscal space left for additional stimulus measures. A high debt-to-GDP ratio does not necessarily render public indebtedness unsustainable. Risk premiums on sovereign debt constitute one indication. The spreads on interest rates on public borrowing have increased significantly for Greece and a few other European economies, but they remain low (and have even decreased further) for Germany, Japan, the United States and other developed countries (figure I.13).

Contrary to prevailing political pressures, the countries with fiscal space should pursue a "J-curve" approach towards fiscal adjustment (see box I.3). With high unemployment and weak private demand, a premature fiscal tightening may derail the fragile recovery and lead to further worsening, rather than improvement, of fiscal balances. Instead, the Governments of economies with low financing costs in capital markets should allow automatic stabilizers to operate and sustain or enhance deficit-financed fiscal stimulus in the short run. The additional stimulus should continue up to the point where sufficient GDP and job growth have taken effect and unemployment rates have fallen to levels at which more sustained private demand growth may be expected. In this approach, Governments would allow the fiscal deficit to widen further initially, perhaps for another two or three years, until more robust GDP and employment growth boosts Government revenues, thus facilitating swifter and less harmful budget deficit reduction.

A J-curve process of fiscal consolidation is feasible

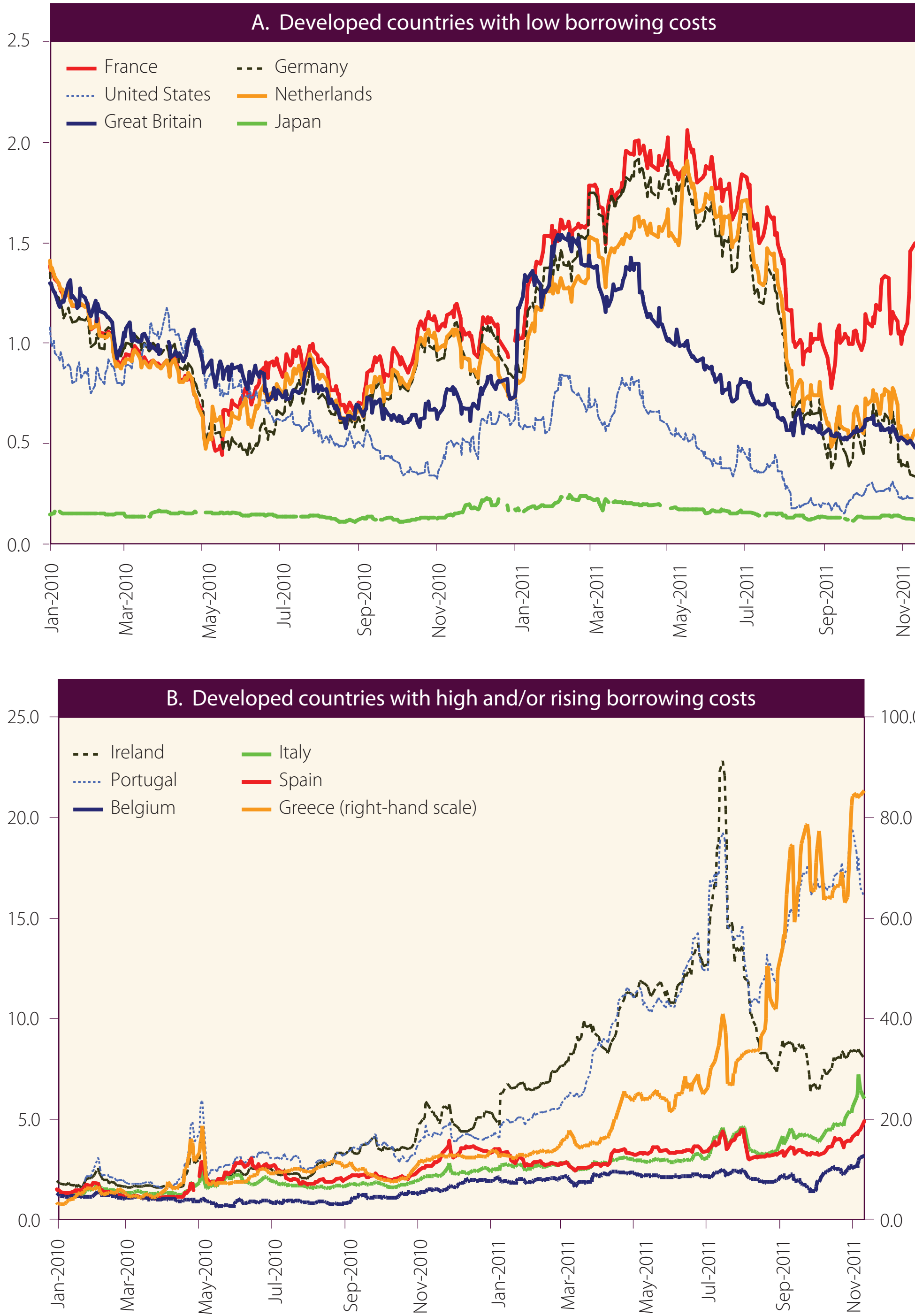
As explained further in box I.3, a J-curve process of fiscal consolidation is quite feasible provided one dollar of additional short-term stimulus translates into more than one dollar of additional aggregate demand, which is typically the case when the economy is in a downturn and even more so if the stimulus is oriented towards infrastructure and direct job creation (as argued in more detail below). A second necessary condition is that the cost of Government borrowing in capital markets (the nominal interest rate on long-term bonds) be less than the rate of potential nominal GDP growth so as to ensure a benign debt-GDP growth dynamic. This condition is currently satisfied in Germany, Japan and the United States, and several other developed countries not mired in sovereign debt distress. Given the current high degree of uncertainty in capital markets, the additional

Figure I.12
Growing public debt burdens
(percentage of GDP)



Source: Data from IMF, *Fiscal Monitor: Addressing Fiscal Challenges to Reduce Economic Risks* (Washington, D.C., September 2011).

Figure I.13
Yields on two-year sovereign bonds in developed countries, January 2010-November 2011



Source: JPMorgan Chase.

Box I.3

A "J-curved" fiscal adjustment?

Three years after the onset of the Great Recession, fiscal policy in most developed economies is facing a dual challenge: the need for preventing a double-dip recession as the economic recovery falters and the need for safeguarding the fiscal sustainability in the long run. In a few European economies, the debt situation has gone beyond the limits of affordable access to refinancing in capital markets. They seem to have little option left but to frontload austerity measures with or without a deal for an orderly debt restructuring. Other developed economies, however, for which the cost of public borrowing remains low, have more space to implement a fiscal framework that allows for more stimulus in the short run to bolster the economic recovery and bring public debt to more sustainable levels over the long run. The present box postulates a possible "J-curved" trajectory for the fiscal balances of those developed economies without severe debt distress, and discusses the conditions under which such a policy approach would constitute a workable option.

In the present-day context of a large fiscal deficit, below-potential growth, elevated unemployment, and continued financial deleveraging, substantial cuts in Government spending and increases in taxes may be ineffective in reducing the budget deficit. Worse still, along the lines of Keynes's paradox of thrift, when both consumers and Governments simultaneously spend less to save more, the resulting recession and contraction of gross domestic product (GDP) would again render public debt unsustainable. Even if a double-dip recession is avoided, fiscal austerity may keep economic growth below potential for a prolonged period, thus keeping up unemployment. In this case, Government revenue will not recover sufficiently; the large budget deficit will linger and public debt will continue to rise. The view held by some analysts and policymakers in major economies that lower public deficits and debts would enhance the confidence of private sector agents, and hence could help restore growth, tends to hold little ground when unemployment is high and deleveraging firms and banks are highly risk averse.

The J-curve approach brings an alternative perspective. In economies with low financing costs in capital markets, Governments have policy space to let automatic stabilizers operate and sustain or enhance deficit-financed fiscal stimulus. It would make sense to use this space up to the point where sufficient GDP and job growth have taken effect and unemployment rates have fallen to levels at which more sustained private demand growth may be expected. In this approach, Governments would allow the fiscal deficit to widen further initially, perhaps for another two or three years, until more robust GDP and employment growth boosts Government revenues, facilitating swifter and less harmful budget deficit reduction. At that point, if needed, more structural fiscal reforms may be put in place to accelerate gradual reduction of the public debt-to-GDP ratio. As a result, the fiscal balance would evolve in the shape of a J-curve: worsening initially, to improve strongly thereafter.

The feasibility of achieving such a J-curve depends on a number of economic conditions. One important condition that would need to be satisfied is that the fiscal multiplier in the economy be greater than 1, meaning that an increase of one dollar in Government spending or tax cuts generates an increase of more than one dollar in GDP. If the multiplier is smaller than 1, it implies that an increase in Government spending or a tax cut will be partially offset by reductions in private consumption or investment. Consequently, as a second-round effect, Government revenue would not increase sufficiently to cause the budget deficit to fall over time.

Do major developed economies meet this condition? A review of various studies shows that the estimated value of the fiscal multiplier in the United States over the past three decades has been in the range of 0.8-1.5, thus leaving some uncertainty as to whether this condition is satisfied or not.[a] Estimates of fiscal multipliers for European economies tend to fall into a similar range.[b] However, the estimate of the multiplier in most of these studies is the average value over a time span that includes both economic booms and recessions.[c] Indeed, the multiplier is likely to be much larger during recessions, when there is slack in capacity utilization and when households and businesses are too risk averse to spend, as is the case at present.[d] Moreover, the composition of fiscal stimulus will influence the size of the multiplier. Increases in Government spending on infrastructure investment, for instance, tend to have larger multipliers than tax credits or direct income transfers, especially when comparing the cumulative multiplier effects over a number of years.

a Valerie Ramey, "Can government purchases stimulate the economy?" *Journal of Economic Literature*, vol. 49, No. 3, pp. 673-685.

b See, for example, Pablo Burriel and others, "Fiscal multipliers in the euro area", session 3, No. 19 in *Fiscal policy: lessons from the crisis*, papers presented at the Banca d'Italia workshop held in Perugia, 25-27 March 2010 (Rome: Banca d'Italia), available from http://www.bancaditalia.it/pubblicazioni/seminari_convegni/Fiscal_Policy/6_Fiscal_Policy.pdf.

c Jonathan Parker, "On measuring the effects of fiscal policy in recessions", *Journal of Economic Literature*, vol. 49, No. 3, pp. 703-718.

d For example, Alan Auerbach and Yuriy Gordnichenko, in "Measuring the output responses to fiscal policy", *American Economic Journal: Economic Policy* (forthcoming), estimate that the multipliers for the United States range between 0.0 and 0.5 during economic expansions, but are much higher, in the range of between 1.0 and 1.5, during economic recessions. Jonas D. Fisher and Ryan Peters provide similar estimates in "Using stock returns to identify government spending shocks", *Economic Journal*, vol. 120, No. 544, pp. 414-436.

Box I.3 (cont'd)

The second necessary condition is that the cost of Government borrowing in capital markets (the nominal interest rate on long-term bonds) be less than the rate of potential nominal GDP growth. This will ensure a benign debt-GDP growth dynamic. Currently, in Germany, Japan and the United States, long-term interest rates on Government bonds are clearly lower than their respective potential nominal GDP growth rates. It is uncertain, however, whether additional Government spending and larger budget deficits would push up interest rates significantly, as has occurred in the European economies that are now facing severe debt distress. A number of complementary actions could help reduce the uncertainty in capital markets. In the present context, these would include (a) a continued commitment to accommodative monetary policies and to low interest rates; (b) support of bank recapitalization and tightening of financial regulation so as to reduce financial fragility and bank exposure to sovereign debt risk; and (c) the advancement of credible and concrete plans aimed at a more structural resolution of fiscal problems over the medium to long run.

Last, but not least, the feasibility of a J-curved fiscal adjustment will be highly dependent upon political factors. It will require a broad-based trust of society in support of the Government's taking the calculated risk of allowing a further worsening of the fiscal deficit to provide more fiscal stimulus in the short run while committing to solving the structural debt problems over the medium to long run.

short-term stimulus could cause interest rates to go up, but Governments can contain this by (a) continued commitment to accommodative monetary policies, (b) more forceful bank recapitalization measures and tighter financial regulation to address financial sector fragility and (c) credible and concrete plans aimed at a more structural resolution of fiscal problems over the medium to long run.

Further strengthening of financial safety nets will also be needed to stem market uncertainty and the risk of further debt distress. The establishment of Europe's temporary funding facilities (the EFSF and the European Financial Stabilisation Mechanism (EFSM)), the more permanent European Stability Mechanism (ESM) and related measures have brought some resolve to dealing with Europe's sovereign debt crisis.[14] However, the continued debt distress and spread of contagion to the larger European economies during the second half of 2011 suggests these measures have not been bold enough. The firepower of the financial safety nets is too limited to cope with the sovereign debt problems of countries like Italy and Spain. Finding ways to significantly enhance the firepower of the ESM will be as important as it is difficult to achieve. It may prove difficult for economic reasons, since leveraging resources for the EFSF (and ESM, for that matter) would be akin to seeking collateralized debt obligations to sub-triple A bonds, and thus may not attract large voluntary contributions. It will not be easy for institutional and political reasons either, because it requires changing the euro area treaty and overcoming opposition from countries not facing debt distress. It is clear that the euro area needs the help and involvement of other major economies, the surplus countries amongst them in particular. This would require reaching a swifter international agreement to enhance International Monetary Fund (IMF) resources

14 In response to the crisis in Greece, the European Council set up a European Financial Stabilisation Mechanism (EFSM) and a European Financial Stability Facility (EFSF) in 2010. Later, these facilities were also used to assist Ireland and Portugal. In early 2011, a permanent crisis management mechanism—the European Stability Mechanism (ESM)—with an effective lending capacity of up to €440 billion was agreed upon. The ESM is to replace the EFSM and EFSF by mid-2013. In July 2011, euro area Government leaders agreed to broaden the mandate of the ESM with a provision for precautionary lending, the provision of loans to sovereigns that are not part of a programme for restoring capital buffers, and the use of the mechanism to purchase sovereign bonds in secondary markets.

to supplement the EFSF, and accepting a more accelerated voice and quota reform of the IMF (see below). The European Central Bank (ECB) could contribute further if it were willing to assign itself a greater role as lender of last resort.

Debt workout mechanisms are needed in both Europe and the United States

Debt workout mechanisms should not be restricted to sovereign debts in Europe. Many developed countries, the United States in particular, may face a second round of mortgage crises as so many mortgages are "under water" and problems are likely to increase with persistent high unemployment and the general weakness in housing markets. Countries facing these conditions may need to consider facilitating household bridge loan assistance and mortgage restructuring and "rent-to-start-over" plans in order to ease the process of household deleveraging and avoid large-scale foreclosures. Without such measures, the road to recovery may be much harder.

The short-term policy concern for many developing countries will be to prevent rising and volatile food and commodity prices and exchange-rate instability from undermining growth and leading their economies into another boom-bust cycle. These countries would need to ensure that macroeconomic policies are part of a transparent counter-cyclical framework that would include the use of fiscal stabilization funds and strengthened macroprudential financial and capital-account regulation to mitigate the impact of volatile commodity prices and capital inflows. Strengthened social policies would need to offer sufficient income protection for the poor and vulnerable against higher food and energy prices.

…that is adequately coordinated internationally

The second (and related) challenge is to ensure that additional short-term stimulus by economies with fiscal space is coordinated and consistent with benign global rebalancing. In Europe, instead of the present asymmetric adjustment through recessionary deflation—which concentrates most of the pain on the countries in debt distress—this would entail a more symmetrical approach of austerity and structural reforms in the countries in distress combined with euro area-wide reflation. The subsequent economic recovery would ease medium-term fiscal consolidation and debt reduction, as mentioned earlier. The United States would equally need to consider such a sequenced approach. The first priority should be to boost demand in order to reduce unemployment, especially through public investment and more direct job creation. This would help households delever and boost consumption demand through income growth. Infrastructure investment and other structural measures would underpin strengthened export competitiveness over the medium run. This would give time for China and other Asian economies to rebalance towards greater reliance on domestic demand growth, in line with existing Government plans and the intentions of the Cannes Action Plan for medium-term global rebalancing.

Global rebalancing with accelerated job recovery is feasible if concerted action is taken

To achieve such benign global rebalancing with accelerated job recovery seems feasible. It would be growth enhancing and would also bring public debt ratios down to sustainable proportions over the medium run. Simulations with the United Nations Global Policy Model—reflecting the key policy directions suggested above and those below regarding coordinated short-term global stimulus, orderly sovereign debt workouts and structural policies aimed at stronger job creation and sustainable development—show that this would be a win-win scenario for all economies, as it would significantly enhance GDP and employment growth compared with the baseline, while reducing public debt-to-GDP ratios and requiring limited exchange-rate realignment (see box I.4). WGP would accelerate to over 4 per cent per year during 2012-2015, especially since developed

economies would be lifted from their anaemic growth, while developing countries would also reach a higher growth path compared with the baseline situation, where policy co-ordination is absent. Most importantly, employment rates, especially among developed countries, would recover to near pre-crisis levels, a situation which would remain elusive in the baseline forecast. Also, in developing countries, employment growth would be significantly higher. By and large, the 64 million jobs' deficit resulting from the global crisis of 2008-2009 would have dissipated by 2016 in this scenario. Even given such a perhaps slow employment recovery, the scenario underscores that providing more fiscal stimulus in the short run and avoiding premature fiscal austerity is a feasible way of dealing effectively with the global jobs crisis while at the same time inducing a benign and more sustainable rebalancing of the global economy.

Box I.4

A coordinated strategy for jobs and growth

A scenario of strengthened international policy coordination aimed at dealing with the jobs crisis and averting a double-dip recession was simulated using the United Nations Global Policy Model.[a] The Model takes on board the key policy directions suggested in the report, including a stronger role for fiscal policy in the short-term outlook—one that gives priority to employment generation and greener growth through better-targeted Government spending, private investment incentives and structural policies. In the policy simulation, there is no premature fiscal austerity overall, and growth of Government spending is kept positive across major economies and regions. Public spending increases at a rate below gross domestic product (GDP) growth, in such a way that budget deficits and public debt-to-GDP ratios are gradually reduced over time. At the same time, policies are assumed to be coordinated to a certain degree with stronger fiscal impulses provided in countries with more fiscal space, as well as in the surplus economies, so as to help bring about a global rebalancing. The scenario further assumes that fiscal and monetary policies in developed economies are redesigned in ways suggested in the text, aimed at putting GDP growth on a path towards reaching levels of (non-inflationary) potential output, with an initial post-recession acceleration and with employment rates approaching pre-crisis levels. Furthermore, it is assumed that effective debt workout mechanisms and financial safety nets are put in place to contain the abnormal rise in interest rates on sovereign debt, and that the impulses to enhance short-term employment and output growth will restore consumer and investor confidence and normalization of the credit supply.

Emerging and developing countries are also assumed to engage in additional fiscal stimulus in this policy scenario, but the degree of stimulus has been tailored to the available fiscal space in each country grouping using the initial level of public indebtedness as a benchmark. Since greater fiscal space in most cases appears to be closely associated with larger external surpluses accumulated in the recent past, the simulated pattern of stimulus measures across countries is thus helping the global rebalancing. Furthermore, it is assumed that developing countries use most of the stimulus to strengthen investment in infrastructure and sustainable productive capacity in agriculture and energy, and that they gain greater access to developed country markets along with efforts to diversify their export base. This implicitly assumes that multilateral trade rules and a strengthened aid-for-trade programme are supportive of these developments. In low-income countries in particular, the increased public and private investment would lead to larger external deficits in the early years of the simulation period. The simulation assumes these countries have adequate access to official development assistance and other external financing to cover those deficits.

Under these assumptions, growth of world gross product would move up to about 4.0 per cent per annum, with both developed and developing economies seeing growth accelerate by between 1 and 2 percentage points in comparison with the baseline (see figure A). Most importantly, employment rates, especially among developed countries, would return to near pre-crisis levels, unlike those in the baseline scenario (figure B). Also, in developing countries, employment growth would be

a Available from http://www.un.org/en/development/desa/policy/un_gpm.shtml.

Box I.4 (cont'd)

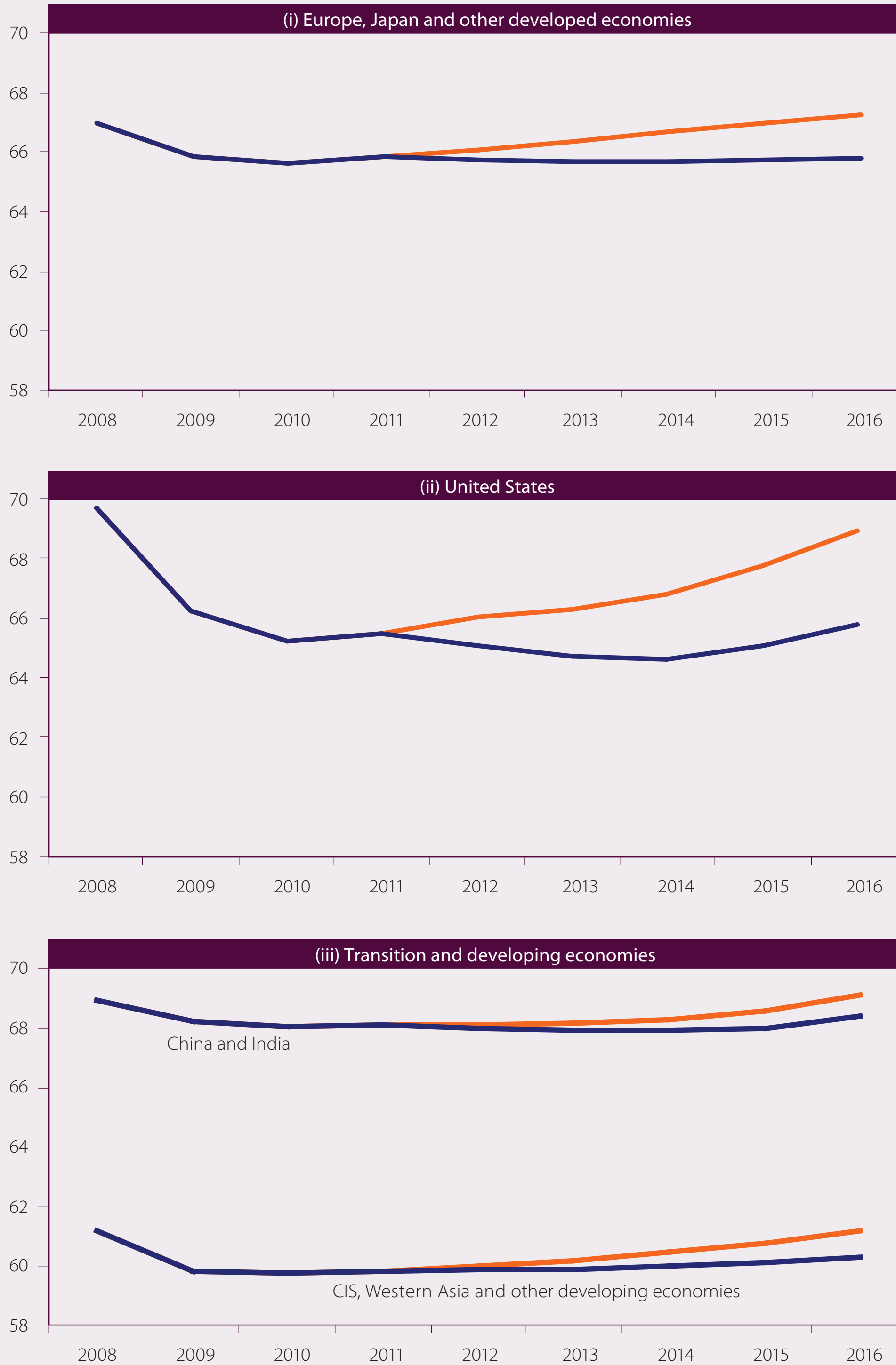
Figure A
GDP growth of selected major economies and country groupings, 2009-2016
(percentage)

Baseline

Coordinated strategy for jobs and growth

Box I.4 (cont'd)

Figure B
Employment rates of selected major economies and country groupings, 2008-2016
(percentage of working-age population)



Source: UN/DESA Global Policy Model (http://www.un.org/en/development/desa/policy/un_gpm.shtml).

Box I.4 (cont'd)

significantly higher. The employment deficit caused by the global crisis of 2008-2009, estimated at 64 million jobs worldwide in 2011, would by and large dissipate by 2016, although, in the present scenario, would still fall slightly short of the global employment rate seen in 2007. The simulation results show further that these outcomes are achievable alongside improving fiscal balances and stabilizing public debt ratios over the medium run (as shown in the appendix table to this chapter), with a gradual decline thereafter. Government budget balances would quickly shift towards the upward slope of the J-curve (see box I.3), given the relatively mild, but well-targeted, fiscal impulses assumed in the scenario.

Current-account imbalances would be reduced gradually, in part because surplus countries are providing greater fiscal stimuli that would trigger stronger domestic private investment and consumption growth in those countries. With investments in energy efficiency and more sustainable (and greener) energy supplies, world energy prices would stabilize to lower levels over the medium run. Food prices would also stabilize as stronger demand is met with more rapidly increasing supply underpinned by increased investment in sustainable food production. Thus, external surpluses of major commodity exporting economies would also adjust gradually.

Even with such a perhaps slow employment recovery, this scenario underscores that providing more fiscal stimulus in the short run and avoiding premature fiscal austerity is a feasible way to effectively deal with the global jobs crisis while at the same time inducing a benign and more sustainable rebalancing of the global economy. However, it would require much more forceful international policy coordination and a shift in the orientation of the Cannes Action Plan of the Group of Twenty (G20).

Redesigning macroeconomic policies for jobs growth and sustainable development

Fiscal policies, in tandem with income and structural policies, will need to be reoriented to foster job creation and green growth

The third related challenge will be to redesign fiscal policy—and economic policies more generally—in order to strengthen its impact on employment and aid in its transition from a pure demand stimulus to one that promotes structural change for more sustainable economic growth. Thus far, stimulus packages in developed countries have mostly focused on income support measures, with tax-related measures accounting for more than half of the stimulus provided. In contrast, in many developing countries, such as Argentina, China and the Republic of Korea, infrastructure investment has tended to make up the larger share of the stimulus and strengthened supply-side conditions. The optimal mix of supporting demand directly through taxes or income subsidies or indirectly through strengthening supply-side conditions, including by investing in infrastructure and new technologies, may vary across countries. In most contexts, however, direct Government spending tends to generate stronger employment effects. A prudent policy would be to target public investments towards alleviating infrastructure bottlenecks that mitigate growth prospects, and to supplement this policy with fiscal efforts to broaden the tax base. One priority area would be to expand public investment in renewable clean energy as part of commitments to reduce greenhouse gas (GHG) emissions and in infrastructure that provides greater resilience to the effects of climate change.[15] Such a reorientation of stimulus measures has the potential to provide significantly greater employment effects, as the renewable energy sector tends to be more labour-intensive than existing, non-renewable energy generation.

The redesigned fiscal strategy would also need to monitor closely the way in which income growth and productivity gains are shared in society. Recent studies

15 As shown in annex table A.22, GHG emissions in the Annex I countries to the Kyoto Protocol are projected to decline by about 1 per cent per year during 2011-2013 given the slow recovery in GDP growth and existing plans for improving energy efficiency and emissions reductions. However, the pace of the reduction is too slow to meet the agreed targets under the Kyoto Protocol.

by the IMF, the ILO and the United Nations Conference on Trade and Development (UNCTAD) suggest that rising inequality has implications for the effectiveness of macroeconomic policies and global rebalancing.[16] Declining wage shares (resulting from higher unemployment and underemployment or lagging real wage growth) may undermine consumption growth and thereby contribute to national and international imbalances. Labour market and income policies may thus need to supplement fiscal and monetary policies for a more balanced outcome. In particular, allowing labour incomes to grow at the pace of productivity growth can help underpin a steady expansion of domestic demand and prevent income inequality from rising.

The supplementary policies could target the unemployed by, for example, providing job-search training, short-term vocational training or general and remedial training. These policies have worked in a number of countries to compensate for sharp declines in vacancies. Social protection policies are another crucial element in cushioning the impact of economic shocks and helping people avoid falling into poverty. They are also important tools for boosting aggregate demand and contributing to the sustainability of economic growth. Just as social transfers, such as family benefits, unemployment benefits and other cash transfers, help protect household consumption against shocks or crises, they also prevent asset depletion that may have adverse long-term consequences and further undermine a sustainable recovery.

Addressing international financial market, commodity price and exchange-rate volatility

Better coordinated monetary policies and deeper financial reforms are needed to curtail capital flow, exchange-rate and commodity price volatility

The fourth challenge is to find greater synergy between fiscal and monetary stimulus, while counteracting damaging international spillover effects in the form of increased exchange-rate tensions and volatile short-term capital flows. This will require reaching agreement at the international level on the magnitude, speed and timing of quantitative easing policies within a broader framework of targets to redress the global imbalances. This, in turn, will require stronger bilateral and multilateral surveillance, including through more thorough assessment of spillover effects and systemic risks. While this need has been recognized by the G20 and the International Monetary and Financial Committee of the IMF, accelerated progress needs to be made in order to establish an operational framework that will enable timely and concerted action to be taken to (a) address the present major risks in global currency and financial markets and (b) signal when, for example, monetary policies in major developed countries are likely to influence the size and composition of flows to emerging and other developing countries. Cooperative policy solutions should, therefore, take precedence as they can achieve better outcomes for the global economy and offload pressures on developing countries to take strong measures to mitigate the impact of volatile capital flows. Such cooperative policy solutions should also comprise deeper reforms of (international) financial regulation, including those aimed at addressing risks outside the traditional banking system (investment banks, hedge funds, derivatives markets, and so forth). Requiring higher reserve requirements and/or collateral on cross-border portfolio

16 See Andrew Berg and Jonathan D. Ostry, "Inequality and unsustainable growth: two sides of the same coin?", IMF Staff Discussion Note, SDN/11/08 (Washington, D.C.: International Monetary Fund, 8 April 2011); International Labour Organization (ILO), *World of Work Report 2011* (Geneva), chap. 3; and United Nations Conference on Trade and Development, *Trade and Development Report 2011: Post-crisis policy challenges in the world economy* (United Nations publication, Sales No. E.11.II.D.3), pp. 16-22.

investments by non-banking institutions and setting limits on positions that financial investors can take in commodity futures and derivatives markets may also help stem some of the volatility in capital flows and mitigate commodity price volatility.

Such measures will, by no means, provide sufficient safeguards against continued volatility in food, energy and other commodity prices. To achieve that, much more will need to be done to ensure a more sustainable supply of these commodities.

These sets of financial reforms will need to be complemented by deeper reforms of the global reserve system, reducing dependence on the dollar as the major reserve currency through, for example, a better pooling of reserves internationally. The sovereign debt crisis in Europe has emphasized the need for much stronger internationally coordinated financial safety nets. This could be achieved through enhancing IMF resources and closer cooperation between the IMF and regional mechanisms of financial cooperation (not just in Europe, but also those in Asia, Africa and Latin America) and through enhancing the role of Special Drawing Rights (SDRs) as international liquidity, while expanding the basket of SDR currencies to include currencies from major developing countries. Such reforms are in the G20 pipeline, but have been sliding down the agenda. Global stability will require that these be moved up the priority list.

Adequate development financing

Ensuring more predictable access to development finance for developing countries will require further reforms to the international financial architecture

The fifth challenge is to ensure that sufficient resources are made available to developing countries, especially those possessing limited fiscal space and facing large development needs. These resources will be needed to accelerate progress towards the achievement of the MDGs and for investments in sustainable and resilient growth, especially in the LDCs. Apart from delivering on existing aid commitments, donor countries should consider mechanisms to delink aid flows from their business cycles so as to prevent delivery shortfalls in times of crisis, when the need for development aid is at its most urgent.

More broadly, the global crisis and the recent financial turmoil have highlighted the need for very large liquidity buffers to deal with sudden, large capital market shocks. Many developing countries have continued to accumulate vast amounts of reserves ($1.1 trillion in 2011) as a form of self-protection. But doing so comes with high opportunity costs and is contributing to the problem of the global imbalances. A better pooling of reserves, regionally and internationally, could reduce such costs to individual countries and could also form a basis for more reliable emergency financing and the establishment of an international lender-of-last-resort mechanism. Broadening existing SDR arrangements could form part of such new arrangements.

Appendix

A coordinated policy scenario for job creation and stronger global growth, 2011-2016

	2011	*2012*	*2013*	*2014*	*2015*	*2016*
GDP growth (percentage)						
United States	1.6	2.7	3.2	3.2	3.2	3.2
Europe	1.7	2.4	2.4	2.3	2.3	2.3
Japan and other developed countries	0.2	2.3	2.3	2.5	2.5	2.5
China and India	9.0	9.0	8.8	8.7	8.6	8.5
CIS and Western Asia (major oil exporters)	5.8	6.0	6.3	6.5	6.4	6.4
Other developing countries	4.1	5.5	5.5	5.6	5.6	5.6
Additional employment with respect to the baseline (millions)						
United States	0.0	2.2	3.6	5.0	6.4	7.8
Europe	0.0	1.4	2.8	3.9	4.8	5.7
Japan and other developed countries	0.0	0.1	0.6	1.2	1.5	1.8
China and India	0.0	2.8	4.8	6.9	10.0	13.6
CIS and Western Asia (major oil exporters)	0.0	0.6	1.2	1.7	2.4	3.1
Other developing countries	0.0	2.7	5.2	8.1	12.1	16.7
Growth of government spending (constant prices, percentage)						
United States	1.1	1.0	1.3	1.7	1.8	1.9
Europe	0.0	0.0	0.3	0.5	0.5	0.5
Japan and other developed countries	1.6	1.6	1.4	1.2	1.1	1.1
China and India	6.4	6.5	6.8	7.5	7.4	7.2
CIS and Western Asia (major oil exporters)	4.3	5.6	4.5	4.2	4.9	5.1
Other developing countries	4.9	5.8	5.2	5.1	5.2	5.2
Growth of private investment (constant prices, percentage)						
United States	-1.1	-2.2	5.2	7.0	7.3	6.9
Europe	2.4	-0.5	3.9	4.6	4.4	3.9
Japan and other developed countries	3.7	2.8	4.9	4.2	3.6	3.1
China and India	8.9	8.1	8.1	8.0	7.6	7.4
CIS and Western Asia (major oil exporters)	13.9	11.3	8.4	7.2	7.9	7.9
Other developing countries	7.0	6.6	7.7	7.6	7.8	7.9
Fiscal balance (net government financial surplus, percentage of GDP)						
United States	-10.0	-8.6	-7.3	-6.5	-5.9	-5.4
Europe	-6.0	-4.8	-4.1	-3.5	-3.0	-2.5
Japan and other developed countries	-1.7	-1.9	-1.7	-1.5	-1.1	-0.8
China and India	-3.6	-2.8	-2.2	-1.8	-1.5	-1.2
CIS and Western Asia (major oil exporters)	-3.1	-2.7	-2.0	-1.5	-1.0	-0.7
Other developing countries	-3.2	-3.3	-3.1	-3.0	-2.8	-2.7
Net private sector financial surplus (percentage of GDP)						
United States	6.5	5.7	4.9	4.2	3.5	3.0
Europe	4.7	3.6	3.1	2.6	2.1	1.7
Japan and other developed countries	2.2	1.6	1.3	1.1	0.9	0.7
China and India	7.1	5.8	4.8	4.2	3.6	3.1
CIS and Western Asia (major oil exporters)	9.0	7.1	6.2	5.6	5.4	5.2
Other developing countries	4.3	4.1	3.8	3.7	3.5	3.4

Appendix (continued)						
	2011	*2012*	*2013*	*2014*	*2015*	*2016*
Current-account balance (percentage of GDP)						
United States	-3.1	-2.9	-2.5	-2.3	-2.4	-2.4
Europe	-1.3	-1.2	-1.0	-0.9	-0.8	-0.8
Japan and other developed countries	0.5	-0.2	-0.4	-0.4	-0.3	-0.2
China and India	3.4	3.0	2.7	2.4	2.1	1.9
CIS and Western Asia (major oil exporters)	5.9	4.4	4.1	4.2	4.4	4.5
Other developing countries	1.1	0.8	0.7	0.7	0.7	0.7
Government debt [a] (percentage of GDP)						
United States	84	87	89	90	90	89
Europe	81	82	83	85	86	87
Japan and other developed countries	146	141	142	144	145	146
China and India	18	19	17	17	18	18
CIS and Western Asia (major oil exporters)	35	38	38	36	35	34
Other developing countries	44	47	49	50	51	51
Memorandum items						
Growth of gross world product at market rate (percentage)	2.8	3.9	4.0	4.1	4.1	4.1
Growth of gross world product at PPP rate (percentage)	3.8	4.8	4.9	5.0	5.0	5.1
Global creation of employment above baseline (millions)	0.0	9.7	18.2	26.8	37.3	48.8
Employment gap compared with 2007 employment rate (millions)	-63.8	-58.9	-53.1	-44.3	-29.1	-6.4
Growth of exports of goods and services (percentage)	8.4	11.3	9.3	8.2	7.6	6.8
Real world price of energy (index)	1.5	1.6	1.5	1.4	1.4	1.4
Real world price of food and primary commodities (index)	1.0	1.0	1.0	1.0	1.0	1.0
Real world price of manufactures (index)	1.0	1.1	1.1	1.1	1.1	1.1

Source: UN/DESA Global Policy Model, available from http://www.un.org/en/development/desa/policy/un_gpm.shtml.

a Public debt is measured on a cash basis and, data permitting, nets out intragovernment debt.