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World Economic Situation and Prospects

2012

Executive Summary



United Nations

Executive Summary

Global economic prospects for 2012 and 2013

The world economy is on the brink of another major downturn

The world economy is teetering on the brink of another major downturn. Output growth has already slowed considerably during 2011 and anaemic growth is expected during 2012 and 2013.

The problems stalking the global economy are multiple and interconnected. The most pressing challenges lie in addressing the continued jobs crisis and 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 owing to the lack of aggregate demand. But, as more and more workers are out of a job for a long period, especially young workers, medium-term growth prospects will also suffer because of the detrimental effect on workers' skills and experience.

The rapidly cooling economy has been both a cause and an effect of the sovereign debt crisis in the euro area, and of fiscal problems elsewhere. The sovereign debt crises in a number of European countries worsened further in 2011 and aggravated weaknesses in the banking sector. Even bold steps by the Governments of the euro area countries to reach an orderly sovereign debt workout for Greece have been 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 lead to another global recession. Developing countries, which had rebounded strongly from the global recession of 2009, would be hit through trade and financial channels.

Faltering growth with heightened risk for a double-dip recession

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, 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.

However, 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 would send the global economy into another recession. In an alternative downside scenario, growth of WGP would decelerate to 0.5 per cent in 2012, implying a decline in average per capita income for the world. 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. Global output growth could be pushed back up to about 4.0 per cent in 2012 and 2013, but with present policy approaches and stances, such an optimistic scenario will remain a distant reality.

Weakening, but uncertain, outlook for the global economy



Sources: UN/DESA and Project LINK.

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

^a Estimates.

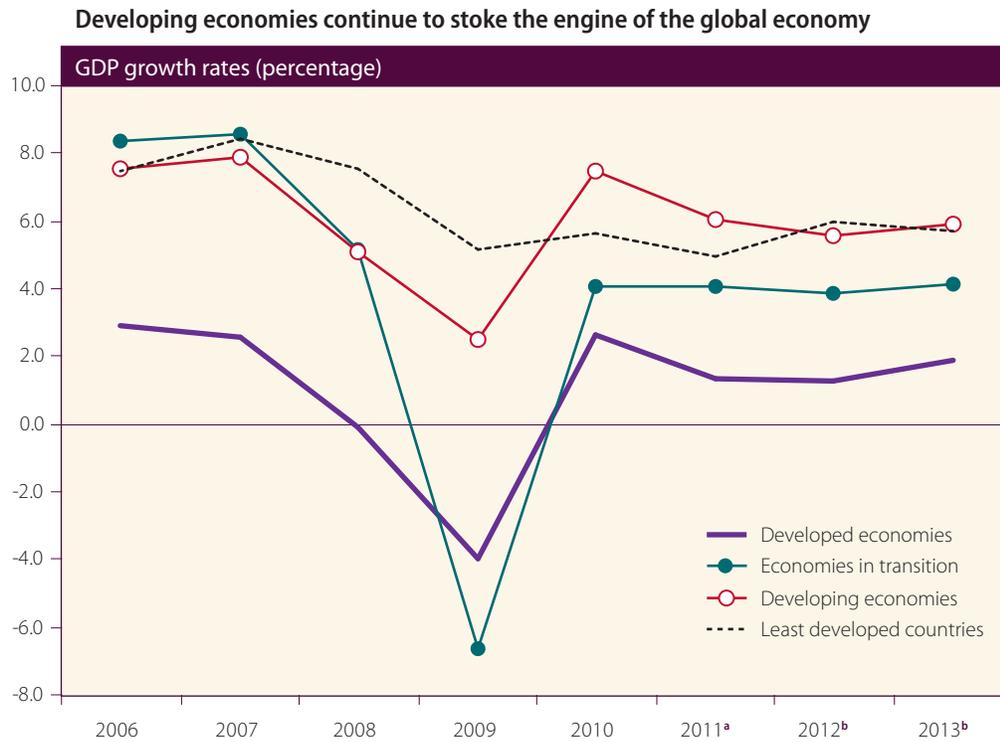
^b United Nations forecasts.

The economic woes in many developed economies are a major drag on the global economy

The economic woes in many developed economies are a major factor in the global slowdown. Most developed economies are suffering from predicaments remnant of the global financial crisis. Growth in the United States slowed notably in 2011. Gross domestic product (GDP) growth is expected to weaken further in 2012 and, even under the baseline assumptions, a mild contraction is possible during part of the year. The country was on the verge of defaulting on its debt obligations in August of 2011 because of political deadlock. The uncertain prospects are exacerbating the fragility of the financial sector, causing lending to businesses and consumers to remain anaemic. 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 suggests a further slowing ahead, perhaps to stagnation by the end of 2011 and into early 2012. Japan fell into 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 above potential, to about 2 per cent per year, in the coming two years, risks remain on the downside.

Developing countries remain vulnerable to downturns in the developed economies

Developing countries and economies in transition are expected to continue to stoke the engine of the world economy, but their growth in 2012-2013 will be well below the pace achieved in 2010 and 2011. Even though economic ties among developing countries have

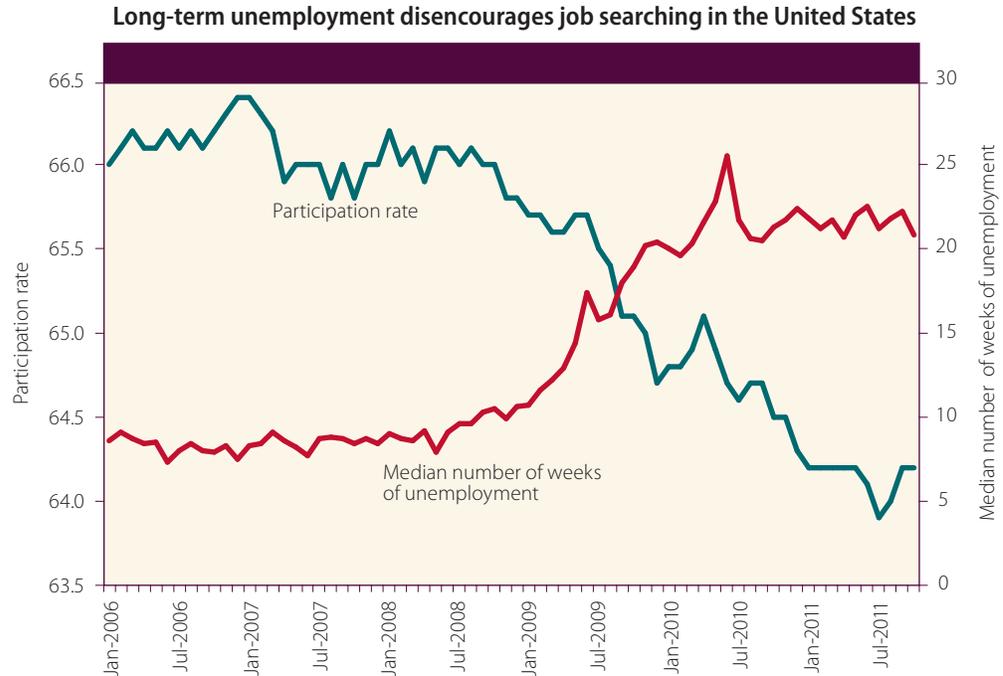


strengthened, these countries remain vulnerable to economic conditions in the developed economies. From the second quarter of 2011, economic growth in most developing countries and economies in transition started to slow notably. Among the major developing countries, growth in China and India is expected to remain robust: growth in China is projected to slow to below 9 per cent in 2012-2013, while India is expected to grow by between 7.7 and 7.9 per cent. Brazil and Mexico are expected to suffer a more visible economic slowdown. 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. The same holds for average growth among the United Nations category of the least developed countries (LDCs). Even so, growth is expected to remain below potential in most of these economies.

The global jobs crisis

High unemployment is a major stumbling block on the path to recovery

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. In many developed economies, the actual situation is worse than reflected in 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



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

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 in general. The skills of unemployed workers deteriorate commensurate with the duration of their unemployment, most likely leading to lower earnings for those individuals who are able to find new jobs in the future. At the aggregate level, the higher the proportion of workers entrapped in protracted unemployment, the greater the adverse impact on the productivity of the economy in the medium to long run.

Employment recovery in developing countries has been much stronger

In developing countries, the 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 and 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.

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 subsequent global recession have increased this gap disproportionately. Barring data limitations, the jobless rate among young workers increased from an estimated 13 per cent in 2007 to about 18 per cent by the first quarter of 2011. The situation remains

particularly acute in some developed economies. 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. In other developing regions, too, youth unemployment has increased more than that of other age groups. Latin America and the Caribbean, in particular, have experienced significant increases in youth unemployment since 2008, although the situation started to improve in the first half of 2011. In South and East Asia and Africa, young workers have a high probability of facing vulnerable employment conditions.

A global employment deficit of 64 million jobs needs to be eliminated

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. With the global economic slowdown projected in the baseline and growth of the workforce worldwide, however, this deficit would increase further, leaving a job shortage of about 71 million, about 17 million of which would be in developed countries. If economic growth stays as anaemic in developed countries as projected in the baseline forecast, employment rates will not return to pre-crisis levels until well beyond 2015.

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

Inflation outlook

Inflation has increased worldwide during 2011, driven by a number of factors, particularly the adverse supply-side shocks that have pushed up food and oil prices and strong demand in large developing economies as a result of rising incomes. Reflationary monetary policies in major developed economies have also contributed to upward pressure.

Inflation should not be a major policy concern in developed economies...

Among developed economies, inflation rates in the United States and Europe 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 to mitigate 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. 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 is a bigger concern in a number of 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.

International trade and commodity prices

The recovery of world trade is decelerating

The recovery of world trade slowed down in 2011 as growth in merchandise trade declined to 6.6 per cent, from 12.6 per cent in 2010. In the baseline outlook, world trade growth will continue at a slower pace of 4.4 and 5.7 per cent in 2012 and 2013, respectively. Feeble global economic growth, especially among developed economies, is the major factor behind the deceleration.

Developing countries were more resilient to the crisis and their importance in world trade continues to increase. Between 1995 and 2010, their share in world trade volume increased from 28.5 to 41.2 per cent. In 2011, they led the recovery of external demand by contributing to half of world import growth, compared with 43 per cent on average in the three years prior to the crisis. The shifting patterns of trade are associated with the rapid industrial growth in major developing countries. Between 1995 and 2011, South-South trade increased at an annual rate of 13.7 per cent—well above the world average of 8.7 per cent.

Commodity prices have increased, but remain highly volatile

For many commodities, the rising trend in prices that started in June 2010 extended into 2011. After peaking during the first half of the year, prices declined slightly. However, in the case of oil, metals, agricultural raw materials and tropical beverages, average price levels for the year 2011 as a whole surpassed the record averages reached in 2008. In the outlook, commodity exporters that have benefited from improved terms of trade over the last two years remain exposed to downward price pressures, which may be significantly amplified by financial speculation in the event of a double-dip recession. Although financial speculation has been on the agenda of several international forums in 2011, including the Group of Twenty (G20), no decisions have thus far been taken at the international level to better regulate commodity futures markets.

Trade in services is mirroring developments in merchandise trade

In 2010, services trade returned to positive growth in all regions and groups of countries, especially developing countries, particularly the least developed among them. As trade in services has shown less sensitivity to the financial crisis compared with trade in merchandise, its rebound was also less pronounced in 2010 and 2011. Developing countries remain net services importers, but their role as service exporters is continuously growing, especially in the transport and tourism sectors.

Trade policy prospects are uncertain

In the context of stalled multilateral trade negotiations in the Doha Round, bilateral trade agreements among (sometimes unequal) partners are proliferating and the notion of a “variable geometry” approach in World Trade Organization (WTO) negotiations

is finding some support among member States. These developments also put at risk the unconditional most favoured nation (MFN) clause, which has been the cornerstone of the multilateral trading system since its inception at the end of the 1940s.

International financing for development

Fragilities in the international financial markets are affecting financing for development

Existing fragilities in the international financial system are affecting the financing available for development. The uneven global recovery, the risk of European sovereign debt crises and a growing liquidity squeeze in the European interbank market have heightened risk aversion and led to increased volatility in private capital flows. At the same time, official development assistance (ODA) and other forms of official flows have been affected by greater fiscal austerity and sovereign debt problems in developed countries. Not unlike private flows, aid delivery has been pro-cyclical and volatile.

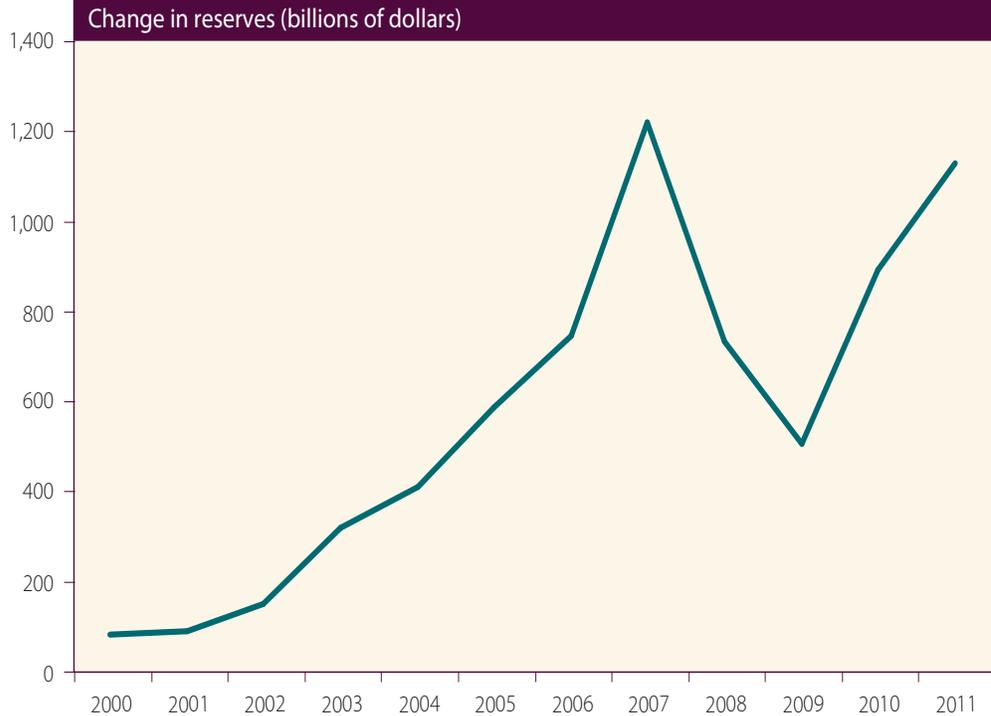
Managing the macroeconomic volatility induced by financial flows presents a challenge for emerging market and developing country policymakers. Waves of capital inflows that are in excess of an economy's absorptive capacity, or highly speculative in nature, may lead to exchange-rate overshooting, inflation, credit booms and asset price bubbles. More importantly, volatile capital flows carry risks for financial and economic stability, with the threat of sudden stops and withdrawals of international capital owing to heightened risk aversion potentially contributing to the spreading financial crises. Policymakers in many countries have responded to these boom and bust cycles by building international reserves as a form of "self-insurance". During 2011, developing countries added another estimated \$1.1 trillion to their reserves, now totalling well over \$7 trillion. However, the vast majority of

Private financial flows to emerging and developing economies: volatile over the Great Recession



Source: International Monetary Fund, *World Economic Outlook*, September 2011.

Emerging and developing economies continue to increase reserves as self-insurance



Source: International Monetary Fund, *World Economic Outlook*, September 2011.

reserves are invested in United States Treasuries and other low-yielding sovereign paper, thus contributing to increasing global imbalances. The building of reserves in developing countries has the effect of transferring financial resources from the developing to the developed world. Developing countries, as a group, are expected to provide a net transfer of financial resources of approximately \$826.6 billion to developed countries in 2011. Furthermore, opportunity costs associated with building reserves exist in the form of forgone domestic investment in development.

Financial reforms are inadequate for containing systemic risks

The international community has also taken steps to reduce global risks and strengthen the international financial system through the introduction of new financial regulations, including the internationally agreed framework known as Basel III. The Dodd-Frank Wall Street Reform and Consumer Protection Act was also signed into law in the United States, among measures taken at the national level. Discussions on regulations for systemically important institutions are still ongoing. However, since most of these measures are being phased in over a long period of time, they have not had an impact on the current economic and financial situation. Furthermore, whether many of these measures suffice to contain risk remains uncertain.

Aid flows fall short of commitments

Important issues also remain regarding the sufficiency and composition of both aid and international liquidity support. Global aid delivery fell short of amounts pledged for 2010 at the Group of Eight (G8) 2005 Gleneagles Summit. On the positive side, grants and the grant element of concessional loans have increased over time, especially in aid directed towards LDCs.

Uncertainties and risks

Developed economies suffer from four weaknesses that mutually reinforce each other

Failure of policymakers, especially 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, with a renewed global recession being a distinct possibility.

The developed economies are on the brink of a downward spiral driven by four weaknesses that mutually reinforce each other: sovereign debt distress, fragile banking sectors, weak aggregate demand (associated with high unemployment) and policy paralysis caused by political gridlock and institutional deficiencies. 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.

Contagion of the sovereign debt crisis could trigger a worldwide credit crunch

It is quite possible that the recent additional measures planned in Europe will not be effective enough to resolve the sovereign debt crisis in the region, thereby leading to a disorderly and contagious default in a number of countries which will wreak havoc in the economies in the region and beyond. The efforts to solve the sovereign debt crisis in Europe failed to quell the unease in financial markets during November 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. A large number of banks in the euro area already stand to suffer significant losses. Contagion of the sovereign debt crisis to large economies would no doubt 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 witnessed in late 2008 and early 2009.

More severe fiscal austerity would push the United States economy into recession

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 among 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 may well fall into another recession. The United States Federal Reserve (Fed) 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.

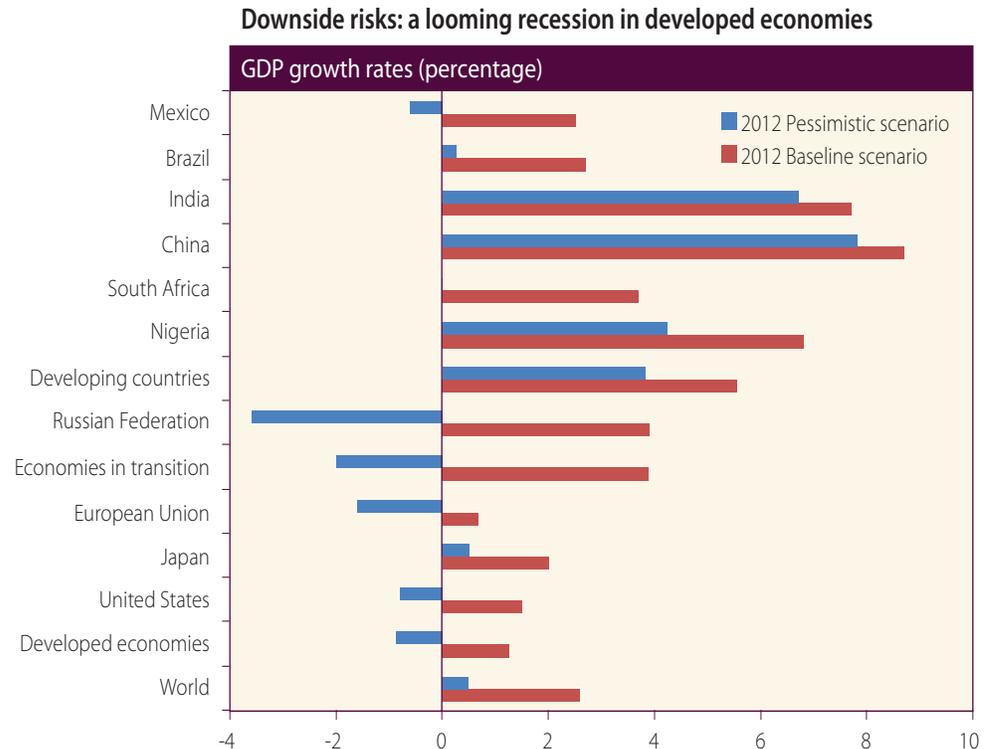
Developing economies would take a significant blow

A recession in either Europe or the United States might not be enough to induce a global recession, but a collapse of both economies most likely would. In the pessimistic scenario of the United Nations forecast for 2012, the economy of the EU would decline by 1.5 per cent and that of the United States by 0.8 per cent. 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 because of the declining values of the holdings of European and United States sovereign bonds, which would affect both official reserve holdings and private sector assets.

Global imbalances remain a policy concern

The large and persistent external imbalances in the global economy that have developed over the past decade remain a point of concern to policymakers. Reducing these imbalances has been a major focus of consultations among G20 Finance Ministers under the Framework for Strong, Sustainable and Balanced Growth and the related Mutual Assessment Process (MAP) during 2011.

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



Source: UN/DESA (see chap. I, tables I.1 and I.2, of the present report).

levels (relative to GDP) during the period 2010-2011. The United States remained the largest deficit economy, although its deficit has fallen substantially from the peak 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. 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.

Global rebalancing is taking place at the expense of growth

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 increase in the household saving rate may be lasting; however, the decline in the business investment rate and surge in the Government deficit in the aftermath of the financial crisis are more likely to be cyclical. In 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. 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. The process of rebalancing can, however, 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.

Unsustainably large imbalances must be addressed, but at their present levels, the global imbalances should not be a primary reason for concern. However, the global rebalancing agenda should not develop at the expense of growth; rather, it should promote growth and employment generation. The commitments made at the G20 Cannes Summit promise to gently move policies in the same direction, but much of the narrowing in the short run will come 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 any significant margin over the next two years. Should the global economy fall into another recession, the imbalances would narrow further in a deflationary manner.

The imbalances are a risk to global exchange-rate stability

The continued build-up of vast net external liability positions of deficit countries are part of a larger topic related to enhanced exchange-rate instability. 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 may easily shift with changes in equity prices in global markets and the credibility of fiscal policy.

In the light of events and problems with policy credibility elsewhere, this 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 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. Global capital flow volatility induced further instability in currency markets.

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 of the 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 help on the import side to reduce inflation, but this advantage could be more than offset by the social cost of higher unemployment rates.

Policy challenges

Developed countries face difficult policy dilemmas

Overcoming the risks outlined above and reinvigorating the global recovery in a balanced and sustainable manner pose enormous policy challenges. 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 takes the form of resistance to emergency measures—for instance, the opposition in some European countries 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 believed to be necessary to return countries to financial stability.

Developing countries find themselves in a different bind

Developing countries face different dilemmas. 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. 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.

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

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. In essence, however, the Cannes Action Plan does not promise to do much more in the short run than that 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. As the baseline projections show, the Cannes Action Plan 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 in this sense, too, the Cannes Action Plan may already have “fallen behind the curve”, as the downside risks have heightened, complicating the effectiveness of the proposed actions.

In order to make the global economic recovery more robust, balanced and sustainable, much more pervasive and better coordinated policy action is needed, especially in terms of short-term stimulus, sovereign debt resolution and orientation towards jobs creation; medium-term plans should focus more strongly on sustainable growth and development and accelerated reforms of financial regulatory systems and the international monetary system.

More short-term fiscal stimulus is needed, not less

First, 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—many developed country Governments still have plenty of fiscal space left for additional stimulus measures. 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, and contrary to political pressures, 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.

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 European Financial Stability Facility (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. However, the continued debt distress and spread of contagion to the larger European economies during the second half of 2011 suggest 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. While finding ways to significantly enhance the firepower of the ESM will be as important as it is difficult to achieve, 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.

Meanwhile, 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.

The stimulus needs to be adequately coordinated internationally

The second (and related) challenge is to ensure that additional short-term stimulus by economies with adequate fiscal space is coordinated and consistent with benign global rebalancing. In Europe, instead of the present asymmetric adjustment through recessionary deflation—where most of the pain is concentrated on the countries in debt distress—it would entail a more symmetrical approach of austerity and structural reforms in the countries in distress combined with euro area-wide reflation. 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, giving time for China and other Asian economies to rebalance towards greater reliance on domestic demand growth.

To achieve such benign global rebalancing with accelerated jobs recovery seems feasible. 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. Global output growth would accelerate to over 4 per cent per year during the period 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 coordination is absent. Most importantly, employment rates, especially among developed countries, would recover to near pre-crisis levels and, by and large, undo the deficit of 64 million jobs left by the global crisis of 2008-2009.

Redesigning macroeconomic policies for job growth and sustainable development

The third challenge will be to redesign fiscal policy—and economic policies more broadly—in order to strengthen its impact on employment and aid in its transition from purely a 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 many developing countries, such as Argentina, China and the Republic of Korea, in contrast, infrastructure investment 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, but in most contexts, direct Government spending tends to generate stronger employment effects.

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

In addition, such cooperative policy solutions should comprise deeper reforms of (international) financial regulation, including those for addressing risks outside the traditional banking system. These would need to be complemented by deeper reforms of the global reserve system that would reduce dependence on the dollar as the major reserve currency, including through better international pooling of reserves. The sovereign debt crisis in Europe has emphasized the need for much stronger internationally coordinated financial safety nets. This could be achieved through reinforcing International Monetary Fund (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), as well as through enhancing the role of Special Drawing Rights (SDRs) as international liquidity.

More development financing is needed to support the achievement of sustainable development goals

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 Millennium Development Goals (MDGs) and for investments in sustainable and resilient growth, especially for 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.

