Global issues

Grim prospects for global economic growth

The world economy is teetering on the brink of another major downturn. Output growth already slowed considerably to an estimated 2.8 per cent in 2011. Based on relatively optimistic baseline assumptions, the United Nations foresees world gross product (WGP) growth of 2.6 per cent for 2012 and 3.2 per cent for 2013. If the European sovereign debt crisis were to spin out of control and the weaknesses in the United States economy interact to create a downward spiral, the world economy could plunge into a double-dip recession. Alternatively, policy coordination that boosts aggregate demand and more directly attacks unemployment could improve prospects for economic growth (see figure 1).

Premature fiscal austerity in developed countries hampers recovery

The most pressing challenge is the continued jobs crisis and the declining prospects for economic growth. Most developed economies are suffering from remnants of the global financial crisis that erupted in 2008. Subsequent private bank bailouts and higher unemployment weakened public finances and economic activity, plunging some vulnerable countries into sovereign debt crises.

The sovereign debt crises that started in 2010 in a number of European countries worsened in the second half of 2011 and aggravated the weakness 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, in 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.

Fiscal austerity measures curtail aggregate demand in the short run with negative effects on employment and incomes. However, as more and more workers are 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. Failure of


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policy makers, especially in Europe and the United States, to address the jobs crisis and prevent sovereign debt distress and financial sector fragility from escalating, could send the global economy into another recession.

**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 in 2012-2013, but their growth will be well below the pace achieved in 2010 and 2011. Even as economic ties among developing countries have strengthened 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. Low-income countries have also seen a slowdown, but only mildly. 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. Even so, growth is expected to remain below potential in most of these economies.

Should downside risks play out and push the economies of Europe and the United States into recession, other economies would take a significant blow. 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. As a result, average 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.

**Developed economies**

**United States: elevated uncertainty in fiscal policy**

In United States, the “super committee” set up by the Budget Control Act of 2011 failed to reach agreement on deficit reduction before the deadline set on 23 November. As stipulated in the Act, the failure will trigger an automatic across-the-board spending cut of $1.2 trillion to be spread over a ten-year period, starting in 2013. Furthermore, the political negotiations for a possible extension of the social security payroll tax holiday were continuing well into December. Outcomes are still uncertain, but without an agreement the payroll tax cut would expire by the end of 2011 and this would take out an additional $120 billion from household disposable income in 2012, leading to further compression of private consumption.

The unemployment rate declined from 9.0 per cent to 8.6 per cent in November, owing to higher employment as well as a shrinking labour force. Had labour participation remained constant in November, the unemployment rate would still be at 8.9 per cent. Meanwhile, employment in Canada declined for the second month in a row and the unemployment rate increased to 7.4 per cent in November compared with 7.1 per cent in September.

**Developed Asia and Pacific: fall of Japanese exports**

Japan’s export volume index fell by 4.8 per cent in October, for the first time since May 2011, ending a period of recovery from the steep fall caused by the earthquake of March. Meanwhile, industrial production also slowed notably. As the global economy weakens, external demand for Japanese products has softened, but the flood in Thailand has also exacerbated the situation, as Japanese exports to Thailand dropped by 17 per cent in October. Some leading indicators also fell in November: a notable example can be found in the Purchasing Managers’ Index which dropped to 49.1, signalling a contraction in business activity.

**Western Europe: entering a new and very dangerous phase of the business cycle**

Leading indicators and measures of sentiment have been pointing to a sharp slowdown in activity for many months, but high frequency measures of current activity, available through August, showed only a gradual deceleration of activity. GDP data also suggest a gradual slowdown during the year, if account is taken of the disruptions and one-off events in the second quarter of the year are taken into account. In the euro area GDP grew by 0.8 per cent (quarter over quarter) in the first quarter, but decelerated significantly in the second quarter to a rate of 0.2 per cent and maintained that pace in the third quarter. The recent release of high frequency figures for September, however, display a very sharp drop in activity and suggest the entry into a dangerous new phase of activity, industrial production dropped by 2.0 per cent, construction by 1.3 per cent and retail trade by 0.7 per cent. Industrial new orders fell dramatically by 6.4 per cent. This gives a very bad starting point for the final quarter of 2011 and in light of the continuing decline in leading indicators and measures of sentiment, which are now almost uniformly at levels consistent with contractions in activity, it is likely that the euro area has already entered into at least a mild recession.
The new EU members: currencies under pressure

A number of the new EU Member States reported strong economic performance in the third quarter. Poland expanded by 4.2 per cent year on year, driven by private consumption, investment and exports. In Estonia, the economy expanded by 7.9 per cent. Thanks to exceptional harvests, output in Romania increased by 4.4 per cent year on year. However, since income derived from agriculture is tax-exempt, the impact on the whole economy is limited. In Bulgaria, by contrast, the economy grew by a mere 1.3 per cent year on year as industrial growth slowed in response to slackening external demand (Greece and Italy are important export markets) and construction and retail sectors contracted. In Slovenia the economy shrank by 0.5 per cent year on year, with a severe 13 per cent drop in investment.

As investors flee emerging markets, capital is also flowing from Central Europe, putting downward pressure on the currencies of the Czech Republic, Hungary and Poland. The Hungarian forint already depreciated by 18 per cent versus the euro in the second half of 2011. To protect the currency as well as households with foreign-exchange denominated debt, the National Bank of Hungary hiked interest rates by 50 basis points in late November. In November, Hungary also lost its investment grade at Moody’s. The country expressed interest in obtaining a precautionary loan from the IMF, but any unconditional arrangement with the IMF is unlikely.

Economies in Transition

CIS: growth continues to decline

Good harvests were not enough to offset the effects of the challenging external environment faced by the Commonwealth of Independent States (CIS) countries in the second half of 2011. In Kazakhstan, for instance, growth gradually slowed as industry expanded by only 4 per cent in the first 10 months of 2011, while agriculture expanded by almost 23 per cent due to record-breaking harvests. On average, however, the economy grew by 7.0 per cent in the first three quarters of 2011. In Belarus, domestic demand shrinkage resulting from households’ declining real incomes lay behind the significant slowdown in quarterly growth to 1.7 per cent in the third quarter. In the first half of 2011, growth had reached 11.4 per cent. In Azerbaijan, total output grew by only 0.3 per cent in the first 10 months of 2011, despite non-oil growth reaching 8.6 per cent. This was mainly a result of ongoing repair works in the oil sector. In contrast, third quarter growth in the Russian Federation benefited from a buoyant agriculture sector, feeding a GDP expansion of an estimated 4.2 per cent in the first three quarters of 2011, compared to 3.7 per cent in the first half of 2011.

South-eastern Europe: very modest growth in Croatia

According to a flash estimate, in Croatia the third quarter GDP expanded by a mere 0.6 per cent year on year, mainly driven by seasonal tourism. In Serbia, inflation moderated to 8.7 per cent in October in response to low aggregate demand and weak inflationary expectations, enabling the National Bank of Serbia to cut its policy rate further in November by 75 basis points. Last month, Montenegro signed a free-trade agreement with Ukraine, which will enable the country to resume its WTO accession talks. Earlier, Ukraine requested bilateral negotiations with Montenegro within the framework of Montenegro’s WTO accession.

Developing economies

Africa: upside inflation risks in South Africa

The central bank of South Africa highlighted that upside inflation risks stemming from the depreciation of the rand as well as cost-push effects outweigh downside risks due to the possible fallout from the fiscal crisis in Europe. Meanwhile, the ratings agency Moody’s lowered its outlook for South Africa based on concerns regarding the pressure from the interests of various constituencies on public finances. In the same vein, Standard & Poor’s downgraded its credit rating for Egypt in view of a more problematic political and economic outlook after the recent violence in the country.

Drought in Kenya reportedly has led to a shortfall of 60 per cent from the wheat harvest target in the main crop season. As a result, the country will need to step up food imports. Developments in the energy sector again highlighted the often drastic consequences of the lack of diversified generation capacity on the continent. As a concrete example, in Tanzania, the state-run power company requested from regulators an increase in electricity prices by 155 per cent for next year in light of its higher procurement costs for oil-based electricity.

East Asia: weaker exports and industrial production worsen growth outlook

East Asia’s growth outlook has deteriorated in recent months as export demand weakened sharply amid an escalation of the sovereign debt crisis in the euro area and sluggish growth in developed economies. The Philippine economy expanded by 0.3 per cent in the
third quarter of 2011 compared to the previous three months owing, to a big drop in exports and weak agricultural output resulting from unfavourable weather conditions. In the Republic of Korea, exports increased by only 8 per cent in October, compared to an average growth of 21 per cent in the first three quarters. China's exports rose by 15.9 per cent year on year in October, the slowest pace in two years, while the purchasing managers' index signalled a contraction of manufacturing activity in November. In a move to ease liquidity and stimulate lending, the People's Bank of China reduced the reserve requirement ratio for banks by 50 basis points.

In Thailand, the worst flooding in the country's history shut down production in the automotive, hard disk drive and other electronics production sectors. Industrial output declined by 35.8 per cent year on year in October, with auto production falling by 61 per cent. In response, the Bank of Thailand lowered its main policy rate by 25 basis points to 3.25 per cent.

**South Asia: India's economy decelerates; rupee falls to all-time low against dollar**

India's economy grew by 6.9 per cent in the third quarter of 2011, the slowest pace since 2009. Domestic demand weakened markedly following aggressive monetary tightening over the past two years as the Central Bank fought stubbornly high inflation. Investment contracted by 0.6 per cent year on year in the third quarter and private consumption growth slowed to 5.9 per cent, while exports increased significantly by 27.4 per cent. As a result of the more pessimistic outlook for India's economy and increased risk aversion among global investors, capital inflows dried up, sending the Indian rupee to an all-time low against the dollar in November.

After strong political opposition, India's Government did not move forward with a highly controversial bill that would open the country's $450 billion retail sector to foreign companies. The Government had hoped that liberalization would boost infrastructure investment, increase supply-chain efficiency and reduce costs for consumers. However, the bill is vehemently opposed by various political parties and small store owners, who fear massive job losses.

Sri Lanka's Government devalued its currency by 3 per cent in November in an attempt to increase export competitiveness and support growth. Before the devaluation, the Sri Lankan rupee had appreciated by 0.5 per cent against the dollar in 2011, whereas other South Asian currencies had depreciated markedly.

**Western Asia: unconventional monetary tightening in Turkey**

Political unrest continues to affect economies of the region in various ways. The Arab League considers joining Western countries and Turkey in imposing sanctions on the Syrian Arab Republic. Like other countries in the region, the government of the United Arab Emirates also announced measures to counteract social discontent, including a raise of public sector salaries of up to 100 per cent and a bailout fund to help indebted citizens.

In the wake of continued depreciation of the Turkish lira over the past year and higher-than-expected inflation since October, the Turkish central bank left its main policy rate unchanged, but de facto raised interest rates by creating an interest rate corridor. Currently, the central bank keeps the 1-week repo rate set at 5.75 per cent and raised the overnight lending rate to 12.5 per cent. Every day, the central bank considers whether to conduct a 1-week repo auction or not, so as to adjust borrowing cost as market conditions require.

**Latin America: fiscal expansion is back amidst slowing economic activity**

November data point to an overall slowdown of activity following deceleration in advanced economies and cooling off of commodity prices. In Brazil, GDP did not grow in the third quarter. In Chile, industrial output contracted 0.8 per cent year on year. In Mexico, the central bank lowered growth estimates despite year-on-year GDP growth of 4.4 per cent in the third quarter.

A possible slowdown of the Chinese economy is causing concerns. Of Latin America’s commodity exports—which represent more than half the region’s exports and generating 25 per cent of government revenues in Chile and Mexico—China absorbs 20 per cent. However, in Chile, the most exposed of large economies, the share of GDP coming from exports to China is 8 per cent and only 1.5 in Brazil.

Weakening economic prospects have prompted fiscal responses in several countries. In Brazil, fiscal measures in support of food purchases and other goods consumption followed a cut the selic rate from 11.5 to 11 per cent. The Ecuadorian government announced a large investment push for 2012. Colombia, in contrast, tightened monetary policy, raising the policy rate from 4.5 to 4.75 per cent in an effort to contain inflation which reached 4 per cent year on year.

**LDCs: oil sector investments as drivers of business activity in Niger and South-Sudan**

Niger inaugurated its first oil refinery, with 60 per cent being owned by the Chinese state oil company CNPC and the rest by Niger. At the same time, the country, already one of the biggest uranium producers, is expected to see the start of oil production at the end of the year, making it self-sufficient in oil products. In South Sudan, which received most of the oil reserves in the split from Sudan, the government voiced interest in attracting investors for the construction of a refinery.