Monthly Briefing
World Economic Situation and Prospects

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Summary

- The global economy started 2010 on a positive note, with continuing recovery in industrial production and international trade, led by Asian developing countries. However, economic policymakers may face even tougher challenges in 2010
- The significant increase in government indebtedness in Greece and other EU countries may threaten global financial stability
- Rain shortfalls in large parts of Africa will form a major threat to food security during 2010
- The devastating earthquake in Haiti presents serious economic challenges, including those of a long-term nature; addressing them will require a sustained international effort and debt forgiveness

Global issues

The world economy started 2010 on a positive note, with further signs of continued recovery. Both international trade and industrial production stayed on their upward trends. Most economies showed positive gross domestic product (GDP) growth in the last quarter of 2009. The recovery remains uneven and fragile, however. Financial stability remains tentative and credit supplies are still very tight in many economies. In addition, in countries such as Greece, Spain and Ireland, worsening public finances have led to lower ratings for sovereign debt. This situation has triggered concerns over renewed financial turmoil with possible global implications, as fears for sovereign default in the euro zone could put the European currency under pressure and shock financial markets. In recent weeks, the euro depreciated from about $1.45 to $1.39 per dollar.

Not all countries are recovering at the same pace. Developing Asia continues to lead the recovery, but growth remains feeble, especially in many European countries and in the economies in transition. A continued rebound in the prices of primary commodities is supporting a recovery in many developing countries in Africa and Latin America, Although this has proven to be a boon for some countries, it has been a bane for energy and food importers, as detailed in the recent World Economic Vulnerability Monitor No. 3 (February 2010).

Persistent high unemployment rates (the global unemployment rate is projected by the ILO to be 6.5 per cent in 2010) are an indication that the recovery is still slow and tentative. This has been further confirmed by recent data which show that positive fourth-quarter GDP growth in the United States and Europe was largely based on decelerating inventory change, while private investment and consumer demand remain weak.

Note to the Secretary-General prepared by the Global Economic Monitoring Unit
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Developed economies

United States: strong GDP growth in fourth quarter, but no job growth

According to the United States Bureau of Economic Analysis, GDP expanded at an annualized rate of 5.7 per cent during the fourth quarter of 2009 (the final figure for the third quarter was 2.2 per cent). This picture is not as rosy as it may seem, because about 60 per cent of output growth is explained by a slower pace of inventory reduction by businesses (which contributes to growth because of the way national accounts are estimated). Absent this effect, GDP growth would only have been 2.4 per cent. Net exports and private consumption and investment all showed increases in the fourth quarter, but not so government expenditures, which had been a driving force of the recovery in previous quarters. In fact, state-level spending contracted and the expansion of federal-level spending slowed significantly in comparison with the third-quarter level.

The United States economy lost another 20,000 jobs in January, according to the latest employment data, deepening concerns that relief from the recession will be slow in coming. Nonetheless, the unemployment rate fell to 9.7 per cent, from 10 per cent in December, though more a reflection of slower job shedding than of labour force growth. A more positive sign was the increase of employment in the manufacturing industry in January. Construction workers, however, continue to suffer as the real estate sector remains grim.

Western Europe and the European Union: the economic climate is improving, but worries about public indebtedness are mounting and could threaten financial stability

Western Europe is also showing continued, albeit weak, recovery, underpinned by rebounding exports, a turnaround in the inventory cycle and continued support from government spending. Private investment and consumption demand remain weak. Industrial production continued to rebound in November 2009 after a brief fall in October, but remains 17 per cent below its previous peak in early 2008. Positive signals for industry include a resumed rise in industrial new orders and a rise in capacity utilization in the fourth quarter of 2009 from its record low in the third quarter, the first increase since the onset of the crisis. The economy of the United Kingdom showed positive growth in the fourth quarter, according to preliminary figures, showing that it has finally exited recession after six consecutive quarters of decline.

Rising unemployment rates remain a major concern. They reached 10 per cent on average for the euro area in November. The jobless rate increased to 19.4 per cent in Spain and 12.9 per cent in Ireland.

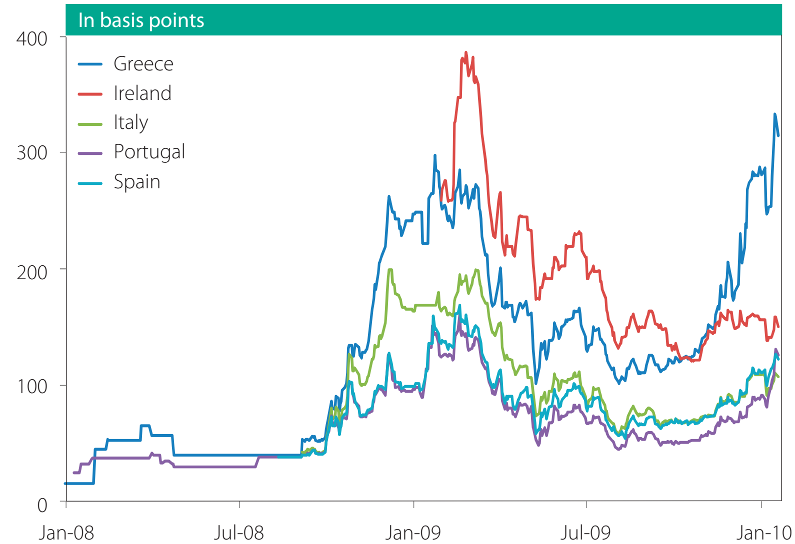
Sharp increases in the public debt of a number of European countries have become a source of major concern as they could lead to renewed financial turmoil, with possible global repercussions. Greece's situation is at the forefront of these concerns, but there are also worries about Ireland, Spain, Portugal, Italy and even the United Kingdom.

The Greek Government caused widespread shock when it revealed that its current estimate of the fiscal deficit was 12.7 per cent of GDP in 2009 (as opposed to its earlier estimate of 6.7 per cent) and the situation is all the more serious when coupled with a public debt ratio of 125 per cent. The Government has proposed a 3-year austerity plan to bring this deficit to below 3 per cent by 2012. The plan has been greeted with widespread scepticism, in part because no one trusts the figures, but also because the proposed measures rely too heavily on revenue enhancement as opposed to spending cuts. Increasing fears over a possible default have led all three major credit rating agencies to downgrade Greek sovereign debt to the point where the eligibility of Greek government bonds as collateral for European Central Bank (ECB) operations has been placed in jeopardy. For the year as a whole, Greece needs to raise €55 billion (or 21.3 per cent of the country's GDP in 2009) to fund its debt requirements. In the first offering, investors demanded the highest premium for government debt since beginning of the European Monetary Union (EMU), with yields for

10-year Greek bonds 380 basis points above those of German bonds. Greek bonds now have a higher spread over United States bonds than do those of the average emerging market. The situation is worrying as this risk reassessment has spread to other highly indebted regional economies (see figure 1). These concerns have also led to a decline in the value of the euro in currency markets, as indicated.

As Greece represents between only 2 and 3 per cent of euro area GDP, the danger from a default lies more in its impact on the reputation and financial stability of the euro area. The possibility that Greece may seek a bailout from the International Monetary Fund (IMF), as Iceland did, could be considered a blow to the euro area's reputation. If European policymakers cannot soon find a way to solve the crisis internally, they risk a new round of financial turmoil.

Figure 1: Credit Default Swap Spreads



Source: Bloomberg L.P.

The new European Union member States: Poland remains resilient to global recession

The economy of Poland, which did not enter recession at all, continued to grow in the third quarter of 2009, expanding by 1.7 per cent year on year. According to preliminary indicators, growth continued in the fourth quarter and may reach 1.6 per cent for the year as a whole on the back of resilient domestic demand and satisfactory export performance. Elsewhere among the new European Union (EU) members, the economic picture is mixed, and double-digit declines in output year on year continued in the fourth quarter in Latvia and Lithuania.

The central banks continued monetary easing in the Czech Republic, Hungary and Romania, countries with flexible exchange rates, so as to avert speculative capital inflows, and to restart business lending. However, corporate access to credit still remains limited.

The IMF and the EU delayed the release of about $3 billion in assistance to Romania in the last quarter of 2009, insisting that it first pass its budget for 2010 (which was approved in early January).

Developed Asia and Pacific: continued deflation in Japan

Deflation remains a challenge in Japan. The core consumer price index (CPI) has been declining every month for more than a year, despite various monetary easing measures. There has been some recovery of GDP, however, but it has been driven mainly by exports, while domestic demand remains weak. The new budget for fiscal year 2010, which starts in April, includes some reduction in public investment but an increase in direct support to households.

Economies in transition

Commonwealth of Independent States: economic fragility continues

Developments in the Russian Federation, Kazakhstan and Ukraine were positive in the third and fourth quarters of 2009. In November 2009, industrial production increased (year on year) by 1.4 per cent in the Russian Federation; by 10.2 per cent in Kazakhstan and by 8.6 per cent in Ukraine.

Nevertheless, the overall economic situation remains fragile. By late December, business lending in the Russian Federation had not expanded despite the tenth consecutive cut in interest rates since April. The rate of unemployment increased further to 8.1 per cent in November, up from 7.6 per cent in September.

In Kazakhstan, bank credit expanded and in November the authorities announced the first dollar-denominated bond issuance in a decade. Nonetheless, several banks defaulted on their debts in November, highlighting the continued financial fragility.

The IMF delayed disbursement of the last tranche of its $16.4 billion standby arrangement agreed upon with Ukraine in late 2008. The Fund reached an agreement with the Government to lower the performance criterion on net international reserves for December, freeing up $2 billion for use by Ukraine's monetary authority.

South-Eastern Europe: trying to reduce deficits while retaining some stimulus

In Serbia, the recession continued as GDP fell by 2.7 per cent year on year in the third quarter of 2009, but the decline was less than in the previous two quarters when output had contracted by more than 4 per cent. The Central Bank is expecting annual GDP to contract by 2.9 per cent in 2009, which is much less severe than had been feared earlier. The economic decline has moderated, in part thanks to rebounds in energy production and manufacturing output.

The EU decided in December to unfreeze trade-related provisions of its Stabilisation and Association Agreement with Serbia and thereby to prolong the provision of exemptions for custom tariffs on imports from Serbia. The exemptions were to expire in 2010.

Governments in the region are taking belt-tightening measures in 2010, which include significant spending freezes and tax increases. The Serbian Government intends to continue with more targeted fiscal stimulus, however, through subsidies on loans to households in order to boost domestic credit growth and local currency lending. In the former Yugoslav Republic of Macedonia, the Government will proceed with its planned infrastructure spending and will offer tax breaks for private infrastructure projects.

Developing economies

Africa: economic recovery is under way, although bad harvests threaten millions of lives across the continent

Recent data from the South African Reserve Bank for November 2009 show a continued strong increase in the composite leading business cycle indicator in Africa's largest economy. Nonetheless, the recovery is expected to remain subdued and it will take some time before the economy returns to pre-recession levels of output.

The Egyptian economy has shown resilience during the global crisis. Even so, in January, the Government presented its third economic stimulus package to Parliament, worth about $2 billion; this was 10 per cent more than planned in October 2009. The additional stimulus is to be spent mainly on infrastructure.

These developments are in stark contrast with heightened risks of hunger and destitution elsewhere in the region. Millions of people are facing food shortages after erratic rains hit farming in the central Sahel region. The Niger is hardest hit, with 2.7 million people likely to experience severe food insecurity and another 5 million being at "moderate risk". The populations of northern Burkina Faso, northern Nigeria and Chad are also affected.

In Southern Africa, prospects for the harvesting of main crops starting in April are also bleak, or at least very poor. Severe rainfall deficits since mid-December have seriously affected maize and other cereal crops in Madagascar, Malawi, Mozambique and Zimbabwe. Such problems had already been present in the Horn of Africa, and the situation continues to be harsh with vast populations facing severe food shortages caused by prolonged droughts.

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East Asia: East Asian economies prepare to gradually unwind stimulus measures

Economic recovery in East Asia remains strong compared to other regions, and inflationary pressures are beginning to pick up. In most countries, Governments are responding with plans to gradually unwind some of the stimulus measures.

In China, year-on-year growth accelerated to 10.7 per cent in the last quarter of 2009, lifting full-year growth to 8.7 per cent. The expansion was driven by the exceptionally large monetary and fiscal stimulus policies and a rebound in trade. The Republic of Korea and Singapore, by contrast, experienced a slowdown of quarterly growth as manufacturing output weakened compared to the strong third quarter. Yet, on a year-on-year basis, economic activity expanded.

In several East Asian economies, most notably the Philippines and Thailand, inflationary pressures have emerged in recent months on the back of higher food and commodity prices and ample domestic liquidity. Property prices in China rose at their fastest pace in 18 months in December 2009, adding to fears of a housing market bubble. In an attempt to curb bank lending and tighten liquidity, the Central Bank of China increased the commercial lenders' reserve requirement ratio by 50 basis points. Similarly, the Central Bank of the Philippines took an initial step to unwind the monetary stimulus by increasing its rediscount rate. However, with the exception of Viet Nam, monetary authorities have so far refrained from raising their key policy rates as they continue to see significant risks to the global recovery.

South Asia: inflationary pressures mount as economic activity gains momentum

Economic activity in South Asia is gaining momentum, most notably in India and Sri Lanka, but public expenditures continue to play a key role for the recovery. In Bangladesh, the Government reacted to a decline in merchandise exports—which were 6.7 per cent lower during the period July to October 2009 compared to the previous year—by announcing a second fiscal stimulus package. The package mainly aims to support export-oriented industries, including textile and garment manufacturers. Meanwhile, India's export sector has started to recover: earnings in November 2009 were 18.2 per cent higher than a year ago.

In most economies of the subregion, inflation is moving up as food and fuel prices increase rapidly. In India, year-on-year wholesale price inflation rose from 4.8 per cent in November 2009 to 7.3 per cent in December, while consumer price inflation also accelerated considerably. The Central Bank of India responded to increased inflationary pressures as well as higher-than-expected growth in the third quarter of 2009 by tightening monetary policy. At the end of January 2010, it increased the cash-reserve ratio for banks by 75 basis points in order to absorb excess liquidity. At the same time, it left the main policy rates unchanged in reaction to concerns about the robustness of the global recovery and the strength of the domestic economy.

Western Asia: economic stabilization continues

The economic downturn continues in parts of Western Asia, albeit at a slower pace. In Turkey, GDP fell by 3.3 per cent year on year in the third quarter of 2009, after having fallen by 7.9 per cent in the previous quarter. Private consumption was one of the "brighter" spots, showing the smallest contraction (0.9 per cent) as a result of government stimulus measures. Government spending increased by 5.2 per cent. The slower decline in output was accompanied by a slight drop in the unemployment rate to 13 per cent on average during September-November 2009, down from 13.4 per cent in the previous three months.

Israel registered a modest economic contraction of 0.2 per cent year on year in the third quarter of 2009. Compared with the previous quarter, however, the economy expanded by 3.0 per cent on an annualized basis. External demand, gross fixed capital formation and consumption solidly contributed to growth.

Latin America and the Caribbean: mixed economic trends

In Brazil, consumer and industrial producer confidence indices continued their upward trends in December and January. The rate of unemployment declined further from 7.4 per cent in November to 6.8 per cent in December 2009, showing evidence of recovery in the region's major economy. The economy of the Bolivarian Republic of Venezuela, in contrast, continued to slide in the last quarter of 2009, leading the Government to devalue the national currency by 50 per cent against the United States dollar in January. The Government hopes this measure will double State oil revenues in local currency and create breathing space for fiscal stimulus. The devaluation may push up the country's inflation (which was already the highest in Latin America in 2009) even farther, however.

In Colombia, industrial production grew by 2 per cent year on year in December, after having contracted for seven consecutive months. In Chile, in contrast, manufacturing output dropped unexpectedly by 0.3 per cent from a year earlier, despite the fact that the economy at large expanded by 3.1 per cent year on year in November 2009. In January 2010, Chile officially became the first South American member of the Organization for Economic Cooperation and Development (OECD).

Also in January, the Central Bank of Mexico announced a plan to boost currency reserves by buying dollars in currency markets and using its $47 billion dollar Flexible Credit Line facility with the IMF, which expires in April. Argentina will be facing renewed external debt-payment problems and difficulties in financing the government deficit in 2010. The President's intention to use international reserves to solve these payment problems led to the ouster of the Central Bank Governor.

Least developed countries: Haiti's economy also devastated by the earthquake

The January earthquake in Haiti caused untold human tragedy. It also devastated the economy of the region's poorest country where, even before the quake, an estimated 80 per cent of the population was already living in poverty. At present, the economy is paralyzed since the banking system is partially shut down for security measures and there is a lack of cash. Transport systems and routes are dysfunctional, affecting trade in general and limiting the distribution of water, food and medicines. Prices of essential goods are rising rapidly, by between 50 and 100 per cent, according to some estimates. A large share of the population is exposed to hunger and the risk of disease. In Port-au-Prince alone, about 700,000 people are homeless.

Donors have already sent $783 million in aid to Haiti and have pledged another $1.13 billion. On 27 January, the IMF approved an emergency augmentation of $102 million for Haiti's credit facility. This will help the country finance urgently needed essential imports and will make cash available to banks.

The long-term challenges for the reconstruction and economic recovery of Haiti are enormous. Impact assessments still need to be made, but some estimate that the earthquake could have caused a loss of more than 50 per cent of the country's GDP. Sustainable reconstruction efforts will require prolonged international support. The recent donor meeting on Haiti held in Montreal concluded that perhaps as much as $1 billion to $2 billion per year in foreign assistance would be needed over the coming decade. Further proposals have been made to provide substantial debt relief to Haiti, which had already suffered from severe debt distress before the earthquake. The World Bank has announced that Haiti's debt payments will be waived for the next five years, and the Paris Club of creditors has called on all of its members to cancel their claims on Haiti. A promise to this effect was confirmed at the G7 ministerial meeting in early February.■