

Chapter 4

Regional developments and outlook

Developed market economies

The economies of the developed countries still face strong headwinds in their struggle to return to sustained growth. The Great Recession left a host of troublesome legacies: continued deleveraging by households and firms, which is holding back consumption and investment demand; still fragile banking sectors whose lending to the private sector is not yet normalized; depressed housing markets that put additional strains on the banking system and hold back consumer spending and construction investment; and substantially deteriorated fiscal balances and rising public indebtedness that Governments are trying to redress through fiscal austerity, but which, in already depressed economic situations, is further pushing up unemployment rates and slowing economic recovery. Unemployment rates remain high in most developed economies and in some cases have reached disturbing levels, affecting a quarter or more of the work force. A large share of workers remains without having had a job for a year or longer, a major social concern that threatens to lower long-run economic growth. Slower growth in emerging market economies, which had proved a strong support to global growth since the end of the Great Recession, started to compound these difficulties in the course of 2012. Many of these factors have also led to a tremendous drop in confidence by both firms and consumers, leading to postponed investment and consumption decisions.

Most developed countries are responding to these problems by combining a mix of highly accommodative monetary policy (keeping policy interest rates near zero coupled with a wide variety of unconventional policies) with very tight fiscal policy in an attempt to bring down budget deficits. Thus far, however, this policy mix has proven insufficient to reinvigorate the recovery and bring down unemployment. Gross domestic product (GDP) of developed economies as a group is expected to grow by a meagre 1.1 per cent in 2012 and 2013 and 2.0 per cent in 2014, well below the pace needed to recover the jobs lost during the Great Recession.

North America

United States: protracted and anaemic growth

The economy of the United States continues to struggle to overcome the deep-rooted problems that surfaced with the sub-prime mortgage crisis of six years ago. Per capita income and employment levels are still below those reached before the crisis. In early 2012, there were signs of a more robust recovery. Business investment and exports were on the rise and job creation was stronger than expected. However, those promising signs faded later in the year with the further deepening of the sovereign debt crisis in the euro area and the

worldwide slowdown of economic activity. At home, increasing concerns over the looming fiscal cliff cast a darkening shadow over the domestic economy (see chapter I). As these factors continue to linger, growth prospects for the United States economy remain sluggish for 2013. Nascent signs of recovery of the beleaguered housing sector form a bright spot between the darkening clouds. Also, additional policy support is expected to come in the form of the new round of quantitative easing launched by the United States Federal Reserve (Fed), which committed to continue purchasing mortgage-backed securities until the employment situation improves substantially. In the United Nations baseline outlook, GDP growth is forecast to be 1.7 per cent in 2013, lower than the already anaemic pace of 2.1 per cent estimated for 2012 (see table I.1 and annex table A.1). Risks remain for an even worse scenario in the short run, emanating from the possibilities of a fiscal cliff, further eruption in the euro area debt crisis and a hard landing in large developing economies.

Assuming these downside risks can be averted, the economy of the United States is expected to gain some strength in the medium term. The process of deleveraging seen in the household and financial sectors over the past four years is expected to ease in 2014. This would help improved lending conditions and could underpin stronger investment and consumption spending.

Business investment is hindered by heightened risk factors

Business investment was a key driver of the moderate recovery of the past two years, growing at about 8.6 per cent for 2011 and 7.5 per cent for the first quarter of 2012. However, as firms have become more risk averse amid the heightened economic uncertainties at home and abroad, investment demand has weakened notably. Growth of investments in business equipment and software is expected to slow from 11 per cent in 2011 to 7 per cent in 2012 and further to 6 per cent in 2013, while investment in business structures is expected to slow to below 4 per cent in 2013.

The housing sector is recovering slowly and residential investment is picking up

After five years of slump, the housing sector is showing signs of recovery. According to the Federal Housing Finance Agency (FHFA) price index, house prices are estimated to increase by more than 4 per cent in 2012. Inventories of unsold homes are falling and housing permits and starts are on an upward trend. Residential investment has been on the rise in 2012 and is expected to continue growing in the following years, driven by population growth and very low interest rates.

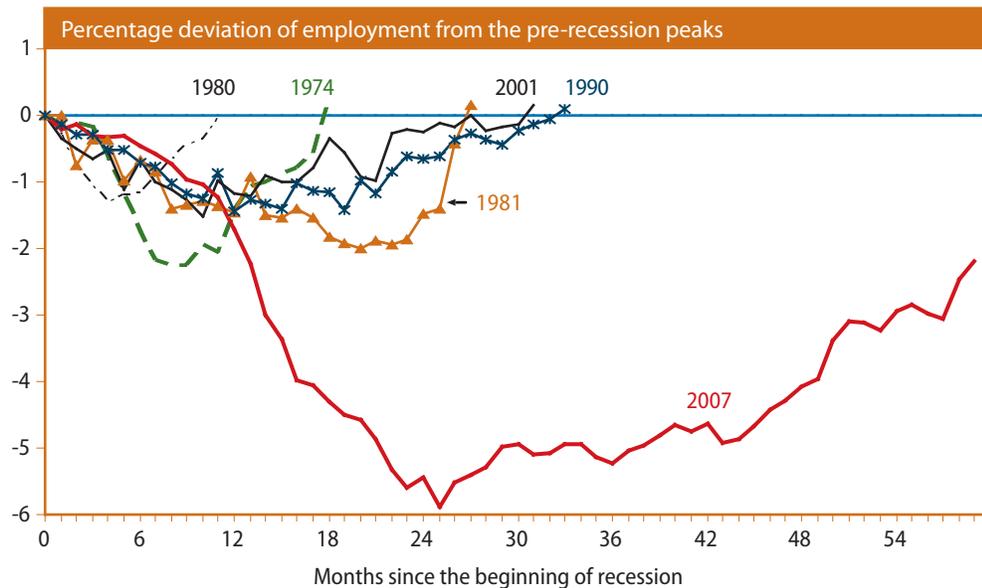
Poor job market restrains consumption

Nonetheless, consumer demand is expected to remain subdued in the short run as households continue to face constraints, including the lingering need to reduce debt burdens, persistent high unemployment, and uncertainties about possible shifts in tax policy in the coming years. Payroll employment increased by slightly more than 1 per cent in 2012, exceeding labour force growth, but not enough to make up much of the job loss from the Great Recession (figure IV.1). The unemployment rate stayed above 8 per cent for most of 2012, but dropped below 8 per cent in the final months of the year. The participation rate remains at a low of about 63 per cent, while the share of long-term unemployed (those unemployed for more than six months) is at a historic high of about 40 per cent, well above the peak of 25 per cent observed in previous post-war recessions. In the outlook, employment is expected to continue growing at a moderate pace, keeping the unemployment rate above 7 per cent by the end of 2013 (see annex table A.7).

Inflation, as measured by the headline consumer price index (CPI), moderated in 2012 to about 2.0 per cent from 3.1 per cent in 2011 and is expected to retreat further in 2013 to 1.3 per cent (see annex table A.4).

Exports were another driver of output growth over the past two years, reaching about 11.0 per cent in 2010 and 6.7 per cent in 2011. However, it has moderated

Figure IV.1
United States: Post-recession recovery of employment^a over five decades



Source: UN/DESA, based on data from the United States Bureau of Labor Statistics.
^a Monthly seasonally adjusted level of civilian employment.

significantly in 2012, slowing to 3.6 per cent for the year as a whole. Demand for United States exports declined in Europe and slowed markedly in large developing countries. Import growth has also decelerated at a similar pace. In the outlook for 2013, exports and imports are both expected to grow by around 3.5 per cent. The current-account deficit in the balance of payments fell to about 3 per cent of GDP in 2012 and is forecast to narrow slightly in 2013.

The monetary policy stance remains very accommodative in the United States. In September 2012, the Fed announced that it would keep the target range for the federal funds rate between 0.0 and 0.25 per cent through mid-2015, providing an anchor for the expectations of businesses and households. The Fed also decided to extend the average maturity of its holdings of securities through 2012 and to maintain its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities. In addition, the Fed launched a new round of quantitative easing to purchase agency mortgage-backed securities at a pace of \$40 billion per month until the labour market has improved substantially—meaning, technically, that such purchases will most likely continue through mid-2014.

Fiscal policy, in contrast, is expected to tighten further in the outlook. Real federal government spending on goods and services is expected to fall by about 3 per cent in 2013 and 2014. Spending had already been curtailed by 2.5 per cent in the previous two years. More importantly, significant uncertainty remains about how Congress will decide on the key components of the stimulus measures of the past years, including the expiration of the payroll tax cut and emergency unemployment insurance benefits. There is equal uncertainty about the fate of the Bush tax cuts and the automatic spending cuts that would come into effect in the absence of Congressional agreement (see the “Uncertainties and risks” section in chapter I). In the baseline, it is assumed that the 2 per cent payroll tax cut and emergency unemployment insurance benefits are extended for 2013, and then phased out gradually in subsequent years. It is also assumed that the automatic spending

Monetary policy continues to aggressively support growth

The risk of a fiscal cliff was a major cause of enhanced uncertainty during 2012

cuts now scheduled to begin in January 2013 will be delayed, giving more time for the new Congress and re-elected president to produce a package of spending cuts and tax increases, including a combination of cuts in Medicare, Medicaid and Social Security and increases in income taxes, effective in 2014. The Bush tax cuts are assumed to be extended during 2013-2014.

Canada: economy losing momentum

The Canadian economy started 2012 on a positive note, but lost momentum during the year, as its two drivers of growth, business investment and exports, weakened visibly. In the outlook, declining government spending and residential construction investment will continue to be a drag on economic activity in the short run. Weaker global economic prospects will lower demand for Canadian exports. GDP is forecast to grow by 1.5 per cent in 2013, down from an estimate of 1.8 per cent in 2012. Some strengthening is expected in 2014, as GDP is forecast to increase by 2.8 per cent. The rate of unemployment is expected to stagnate at 7.4 per cent in 2013, the same level as in 2012. Inflation is forecast to stay below 2 per cent.

The Bank of Canada is expected to maintain its interest-rate target at the current level and only allow for a gradual increase from mid-2014. Government spending is expected to be retrenched further as part of fiscal consolidation efforts that aim to yield a budget surplus by 2015. Budget plans implemented in 2012 also include incentives for investments in research and development and capital equipment, in efforts to buttress productivity growth over the medium and long run.

Developed Asia and the Pacific

Japan: economy back in recession

In 2012, Japan's economy made a rugged recovery from the 0.7 per cent decline in the previous year. Growth was strong in the first quarter of 2012, but the momentum was lost shortly thereafter and the economy fell back into recession, in the second half of the year. GDP growth for 2012 as a whole is estimated at a meagre 1.5 per cent. In the outlook, Japan's economy is expected to climb out of the recession, but GDP growth will remain very weak at 0.6 per cent in 2013 and 0.8 per cent in 2014 (see table I.1 and annex table A.1). At this pace, it will likely be 2015 before Japan's economy returns to its size preceding the Great Recession in 2007.

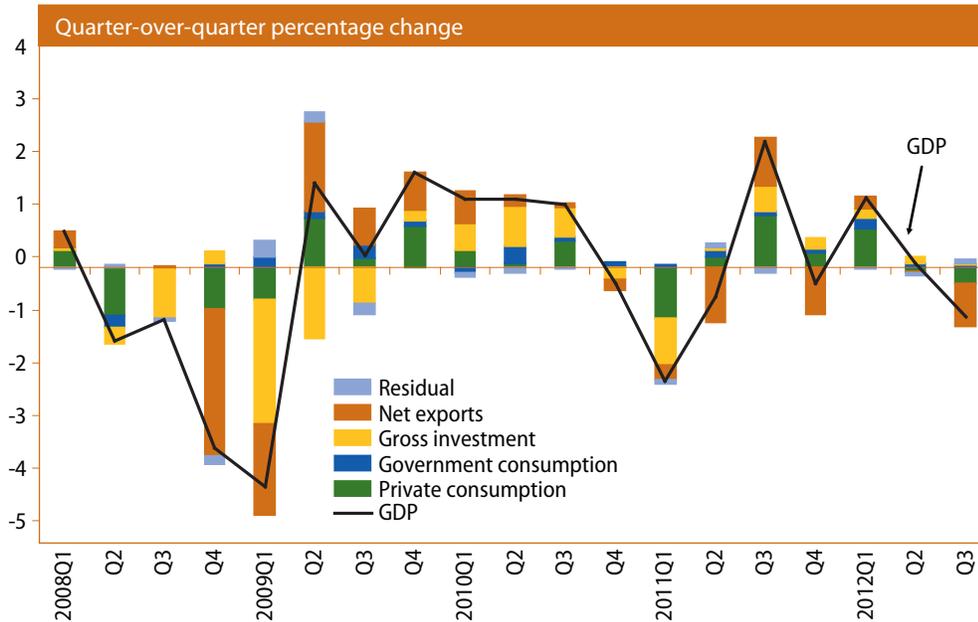
A much weaker trade performance has had a strong, economy-wide impact. Since 2011, GDP shrank during all four quarters against the backdrop of steep declines in net exports (figure IV.2). The interruptions to industrial production caused by the earthquake and tsunami in March 2011 and the flooding in Thailand during the fourth quarter critically influenced these trends. These adverse factors were compounded by weaker external demand, the appreciation of the Japanese yen, and increased fuel imports for electricity generation after the stoppage of nuclear power plants. In 2011, Japan's trade balance showed a deficit for the first time in 20 years. It is expected to remain in deficit in 2012 and the outlook period. The current account of the balance of payments continued recording a surplus, however, as a result of positive investment income earned on the country's large

Deteriorating trade seriously impacts the entire economy

stock of foreign assets. The external surplus stood at 1.5 per cent of GDP in 2012 and is expected to remain at this level during 2013 and 2014, much smaller than the surpluses recorded before the global economic crisis.

Figure IV.2

Japan: Contribution of major expenditure categories to the growth of GDP



Source: UN/DESA, based on data from Japan Economic and Social Research Institute, available from <http://www.esri.go.jp/index-e.html> (accessed on 13 November 2012).

Private consumption grew by 1.9 per cent in 2012, helped by the post-disaster reconstruction and boosted by government incentives to encourage the purchase of energy-efficient automobiles. Consumer demand is expected to slow considerably, however, with the broader economic slowdown, the end of the automobile subsidy programme, scheduled cuts in pension benefits,¹ and the planned increase in the consumption tax rate. Private consumption is expected to grow at a meagre 0.1 per cent in 2013 and 0.2 per cent in 2014.

During 2012, reconstruction in the disaster-affected areas generated the strongest investment growth in 15 years. In 2013 and 2014, however, fixed investment is expected to decelerate sharply to 1.7 per cent and 1.5 per cent, respectively. After growing by 1.3 per cent in 2012, government consumption is expected to decelerate to 0.4 per cent in 2013 and 0.1 per cent in 2014. The fiscal tightening is the result of policymakers' concerns over the budget deficit and the phasing out of post-disaster reconstruction spending.

Although Japan was in recession in 2011, the open unemployment actually declined to 4.6 per cent, down from 5.1 per cent in the previous year. A shrinking labour force—now a long-term trend—is the main factor explaining the decline. Employment is expected to grow only slowly over the forecast period and the unemployment rate is expected to stay around 5.0 per cent over the outlook horizon (see annex table IV.7).

Nominal wages increased in 2010, but declined by 0.2 per cent in 2011 and still further in 2012. After two years of continuous increase, real wages declined in 2012 as a result of the lower nominal wage and weakened deflation. Deflationary conditions still prevail, although the decline in consumer prices moderated in both 2011 and 2012 as energy prices rose. Given the projections of tepid growth in the outlook, deflationary pressure on core consumer price is expected to persist in 2013 and 2014, although it will be

Despite the weak growth outlook, unemployment rates are expected to remain stable

Deflation continues

¹ Beginning in April 2013, the pension age in Japan will increase gradually from 60 to 65.

less pronounced than during the 2000s as the output gap has narrowed with post-disaster reconstruction. In 2014, headline consumer price inflation is expected to accelerate to 1.8 per cent, owing to the planned increase in the consumption tax rate (see annex table A.4).

Fiscal policy is targeted to reduce deficit

In 2012, the Japanese parliament ratified a package of reforms of the social security and tax systems. The tax reforms include a change in the tax code that will enhance the tax base, and the consumption tax rate will be increased from the current level of 5 per cent to 8 per cent in April 2014, and further to 10 per cent in October 2015. The social security reforms involve extension of the retirement age, requirements for firms to hire workers older than 60, and cuts in pension benefits. According to Government estimates, the tax increase and the other elements of the package would reduce the budget deficit by more than 4 per cent of GDP over the medium run.

Bank of Japan adopts inflation targeting and continues monetary easing

The Bank of Japan (BoJ) has kept its policy interest rate near zero for several years already and is expected to continue to do so throughout the forecast period. It also adopted the practice of inflation targeting on 14 February 2012, with the target currently set at an annual change of 1 per cent in the CPI. In the baseline outlook, it is assumed that the predicted acceleration in inflation resulting from the consumption tax increase during 2014 will not induce the BoJ to raise its policy rate. During the first ten months of 2012, the BoJ further expanded its Asset Purchase Programme to ¥91 trillion and extended the time frame for implementation from mid- to end-2013. The quantitative easing is expected to lower long-term interest rates further. The BoJ also introduced a new element of monetary easing. Under the new framework, depository institutions can ask the BoJ to provide the full amount of the net increase in lending to the private sector. The cost of this funding is initially set to the level of the overnight call rate, which is assumed to remain between of 0.0-0.1 per cent for a few years.

Australia: recovering from the worst flooding in history

Australia suffered from devastating floods in 2010 and early 2011, which led to a sharp decline in exports in 2011. Nevertheless, the gradual recovery of coal production and investment for reconstruction and new production capacity more than compensated for these losses, such that GDP increased by 2.3 per cent. Driven by a solid expansion in exports and robust private consumption spending, and given the trend of continuing population growth, GDP growth rebounded further to 3.0 per cent in 2012 and is forecast to sustain this pace at 2.6 per cent and 3.3 per cent for 2013 and 2014, respectively. In 2012, exports grew by 5.4 per cent, facilitated by new production capacity in the mining sector. However, with the global economic slowdown, export growth is expected to decelerate to 3.4 per cent and 3.6 per cent in the coming two years. Investment in the mining sector is likely to expand at a robust pace, but will most likely remain tepid in other sectors.

In July 2012, a carbon tax was introduced in Australia, which temporarily lifted inflation to an annualized rate of 2 per cent, the lower bound of the inflation target zone set by the Reserve Bank of Australia. In November 2011, the central bank eased monetary policies by lowering policy interest rates after two years of policy tightening. Low inflation, the weak external environment and declining housing prices motivated the policy shift.

New Zealand: earthquake reconstruction boosts growth

In 2011, New Zealand suffered from a severe earthquake in the Canterbury region for the second time in recent years. The delayed reconstruction activity is expected to push the average investment growth rate to around 7 per cent during 2012-2014. In mid-2012, the Government was aiming to balance the budget by mid-2015, but was also expected to allocate more funds for reconstruction in the short run. Exports from New Zealand to developing Asia and Australia (mainly food and live animals) are expected to see moderate growth in 2013 and 2014. Overall, GDP is expected to grow by 2.1 per cent in 2012 and by 2.1 per cent and 2.7 per cent for 2013 and 2014, respectively.

Europe

Western Europe: the debt crisis and its reverberations continue to depress the region

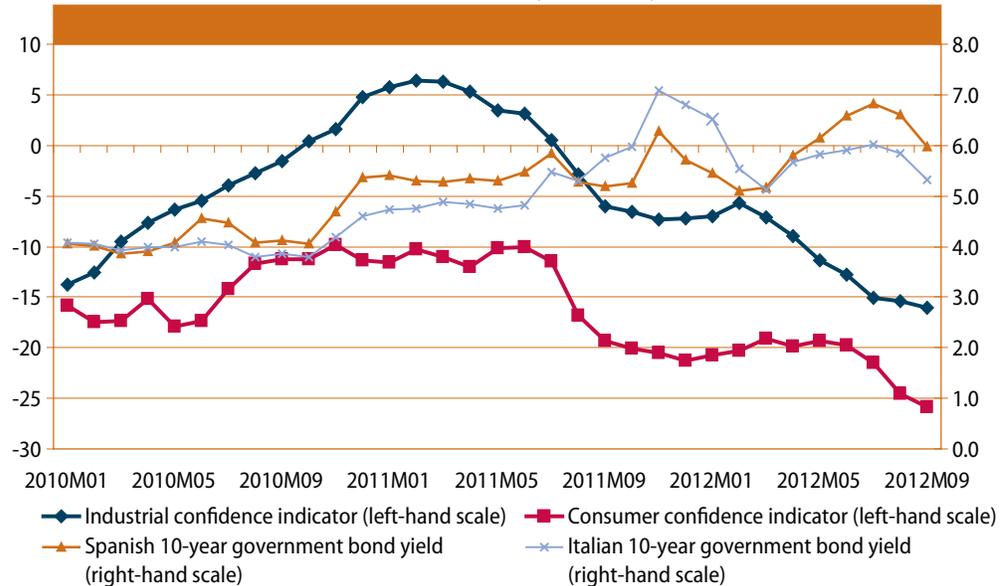
The euro area sovereign debt crisis and attendant fiscal austerity programmes remain the dominant forces depressing growth in the region. Coupled with slowing external demand and high oil prices, this portends bleak prospects in the outlook. The first quarter of 2012 saw a stabilization of economic activity in the euro area as a whole after the sharp drop in activity experienced at the end of the previous year. In the remainder of 2012, however, the euro area economy witnessed continuous deterioration, with negative quarterly rates of growth in the second and third quarters—a technical recession—and an expected sharp drop in GDP in the fourth quarter. For the year as a whole, GDP is expected to decline by 0.5 per cent in 2012 and, given the weak starting point and continuing negative pressures, growth is expected to reach only 0.3 per cent in 2013 and strengthen marginally to 1.4 per cent in 2014 (annex table A.1).

Business, consumer and financial market confidence has closely followed the perceived policy successes and failures in moving the euro area sovereign debt crisis towards resolution (figure IV.3). At the end of 2011 and in February 2012, the European Central Bank (ECB) conducted two large-scale long-term refinancing operations (LTRO). These operations were successful in halting the liquidity crisis in the banking system and, for a few months, tensions abated and confidence improved. But tensions returned not long after, with bond yields for the crisis countries surging upwards, and confidence resumed its downward trend. Two policy initiatives were announced later in the year: the Outright Monetary Transactions (OMT) of the ECB, under which it would make unlimited purchases of the sovereign bonds of countries under stress, but with the stipulation that the country formally request assistance; and an agreement by Heads of State that would allow the use of the new rescue facility, the European Stability Mechanism (ESM), to directly recapitalize banks, thus breaking the link between bank recapitalization and government debt—again, with the condition that a new banking supervision entity be created first. These initiatives were successful at cooling tensions as bond yields for Italy and Spain dropped significantly. The efforts have been undermined, however: in the case of OMT, by reluctance to request formal assistance; and with the use of ESM for bank recapitalizations, by subsequent clarifications that legacy bank problems would not be covered, which then meant that the link between banking problems and sovereign debt was not broken.

Confidence is severely hit by the continuing sovereign debt crisis

These issues, coupled with the increasing realization that an agreement on a banking union may take a considerable period of time (exacerbated by a dismal economic situation with many countries in recession and unemployment rates in some cases at record highs), have been further reasons for continued concerns.

Figure IV.3
Confidence in the euro area and selected 10-year bond yields



Source: European Commission and JPMorgan Chase.

Other measures taken during the year include agreement on a new Fiscal Compact—essentially a beefed-up version of the Stability and Growth Pact—and the final approval by all member states of the new rescue fund, the ESM, which is now operational. Taken together, these policies address many of the defects in the original design of the EMU by adding a lender of last resort, a banking union and a more credible Fiscal Compact. But they do not address the key short-term issues of restoring growth in the region or how to put the crisis countries on a more probable path to fiscal sustainability.

Depressed confidence provides another route for crisis contagion across Western Europe

The confidence crisis has affected all countries in Western Europe and together with trade effects and financial market contagion, it has reduced the growth divergence previously in evidence. At least five economies are now in technical recession. Italy's GDP is expected to decline by 2.4 per cent in 2012 and 0.3 per cent in 2013 and Spain's by 1.6 per cent and 1.4 per cent, respectively. The other countries in recession are Cyprus, Greece and Portugal. Not all economies are equally affected. Germany's economy has slowed substantially and is expected to grow by only 0.8 per cent in 2012 after 3.0 per cent in 2011, with only a marginal rise to 1.0 per cent in 2013. France narrowly averted recession with a slight up-tick in GDP growth in the third quarter. Output growth is expected to reach only 0.1 per cent for 2012 as a whole and 0.3 per cent in 2013. Outside of the euro area, the economy of the United Kingdom of Great Britain and Northern Ireland exited recession in the third quarter, boosted by the Olympic games, but nonetheless GDP is expected to contract by 0.3 per cent for 2012. In the baseline forecast, only a slight rebound to 1.2 per cent is expected for 2013, as exports pick up (aided by a depreciation of the currency) and domestic demand solidifies.

Consumption is expected to remain weak in the outlook, but with significant differences across the region. Austerity programmes depress consumption but vary in intensity across countries. The strength of labour markets is another key factor, in terms of both employment and wages, and also varies significantly. The level of uncertainty stemming from the ebbs and flows of the euro area crisis is having a more uniform impact across the region, as consumer confidence, which had been improving earlier in the year, has since declined sharply. For the euro area, consumption is expected to decline in both 2012 and 2013, but this is dominated by the large declines in only some countries, particularly those in crisis, while other countries are expected to see some support from consumer spending.

Consumption is held back by low confidence and harsh fiscal austerity

Investment spending also remains weak in the region with little prospect for a sustained upturn given weak demand, elevated uncertainty from the sovereign debt crisis, and funding difficulties, particularly in the crisis countries. Fixed investment declined sharply in the euro area in 2012, with only a slight rebound expected in 2013 and 2014. Both domestic and foreign demand remains anaemic. Industrial confidence has been hit badly by the sovereign debt crisis. Although rising in the early part of 2012, renewed tensions from the crisis led to further sharp declines throughout the year. Capacity utilization picked up slightly in the first quarter of 2012, but then dropped in the subsequent quarters and remains low by historical standards. Bank lending to non-financial corporations continued to decline in the third quarter, owing both to declining demand, as firms cut back on investment spending, and to supply conditions. Despite better access to retail and wholesale funding, banks tightened credit standards further in the third quarter and are expected to do so again in the final quarter of the year, owing to a perceived increase in risk.² Funding conditions do vary across the region, however. In the crisis countries, conditions are extremely tight as their banking systems remain under tremendous pressure, but conditions are much easier in other countries. Housing investment remains a major drag on activity in some countries, particularly those that experienced a housing bubble and subsequent collapse, such as Spain and the United Kingdom.

Investment spending stymied by a lack of demand and heightened uncertainty

Exports slowed noticeably during the year, given the extremely weak intraregional import demand, compounded by weaker extraregional demand, particularly from East Asia. The latter had been an important source of export growth for countries specializing in capital goods. In the euro area, some support to export performance (and muting of imports) is coming from the depreciation of the euro, but lackluster demand is currently the dominant force.

Meagre growth in some countries and recession in others has wreaked havoc on labour markets. In the euro area the rate of unemployment climbed to 11.6 per cent in September, up 1.3 percentage points from one year ago and another record for the EMU era. Significant regional differences remain. In Greece and Spain, unemployment is above 25 per cent and in Portugal above 15.7 per cent—countries which have all been subject to harsh austerity programmes. At the other extreme are Austria, Germany, Luxembourg and the Netherlands where rates of unemployment are nearer to 5 per cent. Yet, given the only marginal pick up in activity expected from mid-2013 and into 2014, all countries are expected to see at least some increase in unemployment in 2013 before gradually coming down, with an estimated average of 11.3 per cent in the euro area in 2012, 11.8 per cent in 2013 and 11.6 in 2014 (see annex table A.7).

Unemployment continues to rise, in some cases to EMU record levels

Headline inflation, as measured by the Harmonized Index of Consumer Prices (HICP), has been above 2 per cent since December 2010 (the upper bound of the targeted

² European Central Bank, "The Euro area bank lending survey: 3rd Quarter of 2012" (October).

inflation rate set by ECB). It reached 2.5 per cent in October 2012, boosted in part by high energy and other commodity prices as well as by administered prices (including rises in VAT rates). Core inflation, which abstracts from energy, food, alcohol and tobacco to measure underlying inflationary pressures, has been much lower, at about 1.5 per cent, with no evidence of upward creep. In the outlook, headline inflation is expected to drift down slowly, averaging 2.2 per cent in 2012, 2.0 per cent in 2013 and 1.9 per cent in 2014 (see annex table A.4). Given the poor outlook for growth, the output gap will remain large, wage growth, while picking up modestly, will remain contained, and the assumptions on oil and other commodity prices will yield little impact from these sources.

Fiscal austerity dominates the macroeconomic policy stance

Fiscal policy in the region continues to be focused on reducing fiscal imbalances. Government budget deficits of euro area members declined on average from 6.0 per cent of GDP in 2010 to 4.1 per cent of GDP in 2011, and further in 2012 to near 3.0 per cent. Most countries have been subject to Excessive Deficit Procedures (EDP) since the end of the Great Recession, which typically requires a minimum of 0.5 per cent correction in the deficit-to-GDP ratio per annum with a specified time frame for return to balance. The situation in the crisis-affected countries is far more severe, with significantly higher targeted annual consolidations and longer time periods of austerity necessary. Given that these targets are established in terms of ratios to GDP, growth shortfalls have required additional austerity measures, thereby adding pressure to the continued downward spiral, especially in the debt-ridden crisis countries. In the outlook, it is assumed that existing fiscal plans are implemented so that growth shortfalls will not be made up; rather, the time periods for consolidation are lengthened.

The ECB continues to be active in attempts to combat the sovereign debt crisis

Since the crisis erupted, the ECB has relied on unconventional policies, leaving its main policy interest rate at 1 per cent. These policies included: refinancing operations conducted at fixed rates with unlimited supplies of liquidity, at increasingly long maturities and with reduced collateral requirements; provision of foreign currency liquidity; purchases of covered bonds; and, more controversially, purchases of sovereign debt in secondary markets under the Securities Markets Programme (SMP). At the end of 2011 and in February 2012, the ECB introduced a bold new policy, two large-scale LTROs. In July, it returned to conventional policy, lowering all three of its policy rates by 25 basis points, bringing its main refinancing rate to 0.75 per cent and the deposit rate to 0 per cent. In September, the ECB announced a new policy initiative dubbed “Outright Monetary Transactions” (OMT), whereby it would make potentially unlimited purchases of selected country bonds and hold them for a potentially unlimited duration in order to reduce the yields, but with the stipulation that the country must first formally request assistance and accept conditionality (this now supersedes the SMP, which has ended).

In the outlook, given the backdrop of recessionary conditions throughout the rest of 2012 and only very minor pick-up expected in 2013 and 2014, policy is expected to remain highly accommodative. For conventional policy, it is assumed that the ECB will cut the minimum bid rate by another 25 basis points, but hold the deposit rate at 0 per cent. It is also assumed that the new OMT will remain in place throughout the forecast period, and will be activated if necessary to maintain appropriate bounds to selected country bond yields.

Key risks to the forecast continue to be weighted to the downside. The sovereign debt crisis could flare up significantly, impacting on bank solvency and depressing confidence. Governments may be forced to make up for growth shortfalls by introducing new austerity measures. Oil prices could surge again. On the positive side, external demand,

particularly from East Asia and perhaps the United States, may pick up earlier and with more vigour than anticipated, giving a boost to exports and investment. Tensions may subside in the region following more convincing implementation of already announced packages of policy measures, which would boost confidence.

The new EU members: “muddling through” continues

The tenuous economic recovery that emerged in the new European Union (EU) member States in 2010 has continued to weaken throughout 2012. Although some countries of the region, such as the Baltic States and Poland, started the year with solid first quarter economic results, the ongoing troubles in the euro area, which still remains the major export market for the region and the biggest source of foreign direct investment (FDI), has led to a visible deterioration of the region’s current economic prospects. Some of the new EU members, such as the Czech Republic, Hungary and Slovenia, saw negative annual economic growth.

The impact of the unfavourable trade environment in 2012 has been further aggravated by the ongoing fiscal austerity measures and, consequently, by suppressed domestic demand and weak labour markets. Most of the fiscal space the new EU members possessed has been exhausted and some countries, such as Poland, face constitutional limits on the size of public debt. The search for alternative markets by portfolio investors has led to more favourable borrowing terms for the new EU members in 2012. However, the commitment to fiscal discipline remains one of the prerequisites for the low sovereign debt yields of those countries and further squeezes fiscal policy space.

New EU banking regulations compelled the parent EU-15 banks operating in the region to improve their capital adequacy ratios. This led to continued deleveraging in the new EU member States in 2012, partially mitigated by the actions of the ECB. A serious distress in those parent banks could still lead to a severe credit crunch in Eastern Europe. The new Vienna Initiative, agreed in early 2012 to prevent such a development, does not contain the same commitments as the earlier initiative by the same name adopted in 2009.

The persistent weakness in external and domestic demand led to a slowdown in GDP growth in 2012. Aggregate GDP of the new EU members expanded by 1.2 per cent in 2012 and growth will accelerate to a still moderate rate of 2.0 per cent in 2013 amid numerous uncertainties and risks.

Economic performance varied in the region in 2012. The biggest economy, Poland, is relatively sheltered from the euro area troubles, having a smaller export-to-GDP ratio compared with its regional peers and exhibiting extensive trade ties with the Russian Federation. In 2012, the country benefited from the massive infrastructure spending related to the Euro 2012 Football Championship. However, cooling domestic demand and the need for fiscal consolidation slowed the economy in the second half of the year, with annual growth expected to be below 3 per cent in 2012 and in 2013. For other countries in Central Europe, industrial output in 2012 was held back by faltering external demand. The automotive industry slowed in the second half of 2012. Economic growth prospects for those exporters in 2013 will largely depend on the developments in the euro area. The economies of the Baltic States may grow at about 3 per cent in 2013. Bulgaria and Romania may face additional risks as they have stronger trade, finance and investment links with Greece and Italy.

Price pressures in the region that resurfaced in mid-2012, triggered by higher oil and food prices, subsided later in the year. Although headline inflation rates in a number

Both external and internal demand remain weak

The region exhibits divergent trends in 2012

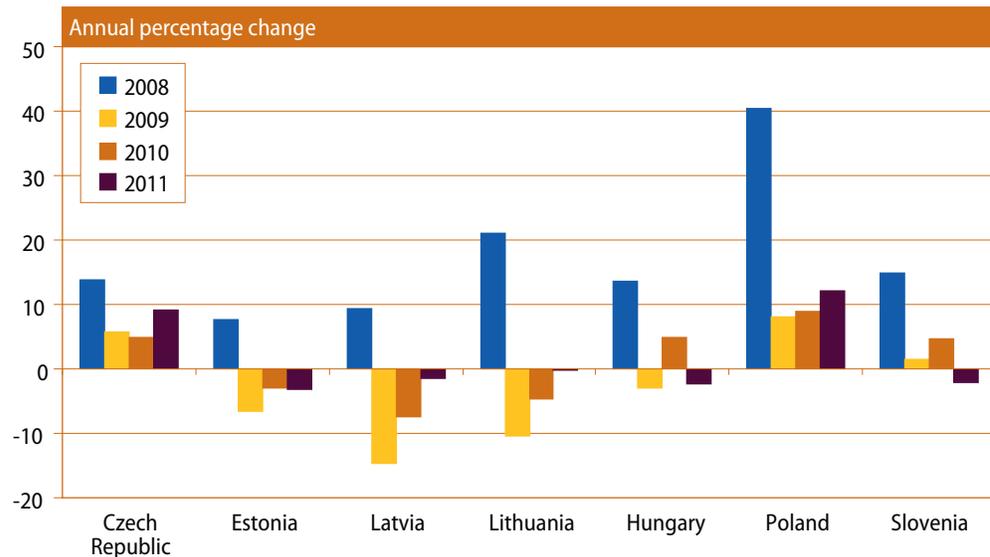
of cases overshoot the respective central banks' targets, this was mostly driven by external shocks and increases in indirect taxes to meet fiscal revenue targets. Core inflation remained weak, with the exception of the Baltic States and Poland. Provided that economic activity picks up in 2013, inflationary pressures may strengthen, but headline inflation in 2013 is likely to be lower because of the base effect of one-off price increases in 2012.

Fiscal policies have been following a consolidation path to reduce the budget deficits in the medium term to the required benchmark of 3 per cent of GDP, as stipulated by the EU Stability and Growth Pact. Lower than projected economic growth forced fiscal authorities to revise their budgets in mid-2012, resorting to new revenue-enhancing measures, such as additional increases in indirect and other taxes. Those policies improved sentiment in international capital markets but are contractionary, at least in the short term.

By contrast, monetary policies remained expansionary during 2012. Benchmark interest rates were cut in the Czech Republic, Hungary (where the central bank prioritized growth over inflation), Latvia and Poland. Nevertheless, credit markets remain stagnant, although banking sectors in some of the new EU members recorded profits in 2012 (figure IV.4). Both demand for credit and credit supply remain weak, as households continue to repay their debt, businesses are cautious, and banks, facing reduced access to cross-border funding, clearly refrain from risky lending. Accommodative monetary policy may, however, support the region's exports through weaker exchange rates.

The impact of fiscal policy is contractionary

Figure IV.4
Net domestic credit in selected new EU member States, 2008-2011



Source: World Bank.

Labour markets require policy action

Labour markets, which recovered in 2011 most notably in the Baltic States, suffered some setbacks in 2012 as the unemployment rates slightly increased, partly reflecting reductions in the size of the public sector. The ongoing fiscal consolidation is complicating Governments' efforts to address labour market issues, although public works programmes in some countries, such as Hungary, created some employment for low-skilled workers. Much of the unemployment in the region is long term, requiring much stronger policy action.

In line with the deceleration in global trade growth, the expansion in exports and imports of the new EU members weakened in 2012. External demand for manufactured goods softened most notably, which in turn weakened demand for imported inputs by export industries. Import demand slowed further as a result of weaker domestic demand. Nonetheless, volume growth rates of both exports and imports remained mostly positive. Most export gains came from trade with non-EU partners such as the Russian Federation and Ukraine. In 2012, the current account was in surplus in Hungary and Slovakia and in deficit in other countries in the region, with a similar situation being expected in 2013.

A protracted recession in the EU-15, which would delay the recovery of FDI, remains the biggest risk faced by new EU members. Other downside risks include the inability to prevent a sharp cut in cross-border lending and an excessively contractionary impact of fiscal tightening.

Trade of new EU members weakened in 2012

Economies in transition

In the difficult global environment of 2012, the economies of the Commonwealth of Independent States (CIS) and South-Eastern Europe exhibited divergent trends. The aggregate GDP of both regions expanded by 3.5 per cent in 2012, but this figure masks significant variations. While the economies of the CIS continued to grow, although at a lower rate as compared with 2011, South-Eastern Europe saw another year of economic stagnation with declining output in Croatia and Serbia. Commodity exports and robust domestic demand supported growth in the key economies of the CIS, while worker remittances, mainly from the Russian Federation, played an important role for the smaller economies of that area. For the countries of South-Eastern Europe, both external demand, hit by the crisis in the euro area, and internal demand, undermined by fiscal austerity policies and stagnant labour markets, remained weak. Both country groups continue to face serious economic challenges, such as diversification of output in the CIS and reindustrialization of South-Eastern Europe. In line with the expected mild recovery in the global economy, growth in the aggregate GDP of transition economies is projected to accelerate to 3.6 per cent in 2013, as economic activity in South-Eastern Europe improves.

South-Eastern Europe: countries face another year of economic stagnation

Real economic activity in South-Eastern Europe in 2012 remained below that achieved in 2008 before the onset of the global financial crisis. After a very weak recovery in 2010 and 2011, the region's growth turned negative in 2012 and is forecast to remain below trend in 2013 owing to weakness in both external and internal demand. As a result, exceedingly high rates of unemployment that plagued the region even before the global crisis are expected to continue for at least several more years, if not longer. In 2012, spring floods, summer droughts and forest fires destroyed crops, especially corn and potatoes, and physical infrastructure throughout the region. The major risks to the forecast are to the downside as the region's strong financial, trade and remittance linkages with some of the most troubled countries of the EU, such as Greece and Italy, make it quite vulnerable should there be a further deterioration in the euro area. FDI inflows into these economies remain depressed at about half their levels prior to the crisis. This decline in investment is

an important factor in explaining not only the currently low growth and high unemployment rates, but also the fairly weak medium- to long-run growth prospects. The aggregate GDP of South-Eastern Europe declined by 0.6 per cent in 2012 and is forecast to recover only modestly to 1.2 per cent in 2013. In 2013, Croatia is set to join the EU. The country's admission to the Union should bring certain economic benefits, through the removal of the last trade barriers and stronger FDI inflows, as well as larger financial assistance.

There has been considerable variation in the economic performance of the South-Eastern European economies. Albania and the former Yugoslav Republic of Macedonia have both experienced solid growth since 2010, although it moderated significantly in 2012 as growth in the EU declined. Among the other four economies, Bosnia and Herzegovina and Montenegro recorded growth near 0 per cent in 2012, while Croatia and Serbia experienced a recession.

Unemployment is expected to remain elevated

Although the economies of South-Eastern Europe were quite negatively impacted by the global crisis of 2008-2009, their unemployment rates did not increase initially as much as might have been expected. Likewise, their unemployment rates have not declined appreciably with the recovery and are expected to stay elevated for many years. In Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia, unemployment is above 30 per cent, while in Serbia, it is above 25 per cent.³ The unemployment in South-Eastern Europe is mostly structural; active labour market policies, improved education and training facilities, and more incentives for investment would be required—in addition to aggregate demand policies—to reduce it.

Inflation has been moderate in the region, with rates in the 2 to 4 per cent range, although in mid-2012, inflationary pressures intensified following a spike in food and energy prices, or some one-off effects such as rises in VAT rates or increases in administratively controlled utility prices. As the impact of one-off factors tapers off, inflation in the region in 2013 should be one half of a percentage point weaker.

Fiscal stimulus is unlikely

Fiscal policies in 2013 will hardly be able to support growth, as most Governments aim to consolidate public finances. Faced with lower-than-projected economic growth in the first half of 2012 and lower-than-anticipated revenue intake, some Governments in the region had to revise their annual budgets and introduce additional measures to meet fiscal targets. For Bosnia and Herzegovina, which obtained a new stand-by loan from the International Monetary Fund (IMF), fiscal policy should also meet the conditions set by the Fund.

The conduct of monetary policy in South-Eastern Europe is constrained by unilateral “euroization”, which is the case in Montenegro, or by formal or informal currency pegs. In the countries with flexible currencies, monetary easing continued in 2012 in Albania, but interest rates in Serbia, where inflation moved beyond the central bank's tolerance band, were raised several times. Monetary conditions in the region should remain mostly accommodative in 2013, however, as private credit growth remains slow to pick up.

Current-account deficits remain a risk for the region

All South-Eastern European countries have run trade deficits in goods in 2012 and this is expected to continue in 2013. The tourism sector, on the other hand, performed well in Croatia and in Montenegro. The current-account deficits in the region, despite the inflows of workers remittances, again started to expand in 2010, as recovering domestic demand spurred imports. Albania, Bosnia and Herzegovina, Montenegro and Serbia have relatively large current-account deficits, approaching or exceeding 10 per cent of GDP.

³ In some countries, there are substantial differences between monthly registered unemployment rates and labour force surveys, which are only conducted on a yearly basis.

The Commonwealth of Independent States: growth slows down

Economic growth slowed down across the region in 2012.⁴ A tepid global recovery dampened economic activity and constrained access to external financing. Economic performance has weakened in most countries, including in the largest economy, the Russian Federation, which remains a major influence on the others. Aggregate GDP in the region rose by around 3.8 per cent in 2012. Growth is expected to remain at a similar level next year, well below potential, as the world economy continues to provide a difficult background for the economies of the region. The recent accession of the Russian Federation to the World Trade Organization (WTO) may generate some additional positive growth impulses in the long term (box IV.1).

Box IV.1

The economic effects of the Russian Federation's accession to the World Trade Organization

In August 2012, after 18 years of protracted negotiations, the Russian Federation eventually joined the World Trade Organization (WTO). Following the accession of China in 2001, the Russian Federation was the largest economy outside of the WTO framework. By joining the organization, the country undertook a number of serious commitments: to gradually reduce its average tariff bound to about 8 per cent; to bring its national regulation of market access for services in line with the General Agreement on Trade in Services (GATS); to soften its barriers on foreign direct investment; and to reduce state interference into the economy. The country's negotiating team, however, refused to accept the commitment to allow foreign banks to establish their presence in the economy, except as subsidiaries or representative offices.

On the global scale, the economic implications of the country's WTO membership will be very modest, compared with China's accession in 2001. The admission of China to the WTO has eventually led to a significant decline in the prices of manufactured goods, but in the case of the Russian Federation, most of the exports currently consist of primary commodities, which are generally not subject to tariff barriers. For the Russian Federation itself, however, the membership and its potential impact on economic diversification will have significant macroeconomic implications.

The Russian economy remains in dire need of diversification. Most of its exports (about 69 per cent in 2010) consist of oil, fuels and natural gas, and the economy is dependent on imports of manufactured goods. The high volatility of global energy prices and the country's dependence on this sector has resulted in considerable macroeconomic volatility. As productivity growth in commodity sectors is generally below those in manufactures, this production structure has contributed to slower long-term economic growth. Given population ageing and projected shortfalls in the pension system in the coming decades, this has significant implications for fiscal sustainability.

Despite limited manufactured exports, the Russian economy is currently running a comfortable trade surplus and is diverting part of its hydrocarbon revenues to a national wealth fund. However, in the longer run, the country may face serious challenges when it is eventually confronted with significant declines in oil production and a tighter market for natural gas. Still, the Russian economy contains certain industrial sectors, such as aviation and engine production, which may find a niche in global markets, if managed efficiently, and has a well-educated and professional labour force. The Russian automotive sector, which attracted a significant amount of FDI and is benefiting from booming car sales, is an example of a successfully upgraded industry, although it may need further modernization to withstand the post-transition competitive environment.

⁴ Georgia's performance is also discussed in the context of this region for reasons of geographic proximity and similarities in economic structure.

Box IV.1 (cont'd)

Prior to the WTO accession, Russian policies aimed at industrial diversification were not always friendly to the concept of free trade. To achieve import substitution, the Government resorted to introducing export taxes, increasing import tariffs and requiring local content for manufactured products. Direct state intervention was quite common and the country routinely resorted to protectionist policies. FDI into the Russian Federation was at least partially restricted in 42 sectors designated to be “strategic”. Consequently, FDI flows into the Russian economy were more modest compared with other emerging markets (see figure). Since domestic businesses, on the other hand, often did not have adequate access to financing, investment rates remained low.

The immediate economic impact of the country’s WTO membership is expected to be limited. Only about one third of tariff reductions will be applied immediately; for most other product groups, a transition period of several years has been agreed upon. Some sectors, such as pig farming, dairy production and pharmaceuticals, as well as production of trucks and buses, will come under stiffer competition. The federal budget may lose about \$6 billion in 2013 alone through reduced import duties.

The long-run impact matters more though. Assessments of potential longer-term gains or losses for the Russian economy vary, with both optimistic and pessimistic views. According to the optimistic views,^a which are contingent on much higher investment rates, significant inflows of FDI (including into the services sector) and further financial deepening, the Russian economy will gain about 10 per cent of GDP in the long term. Private consumption in the medium run will gain several percentage points, improving the livelihoods of many households. As the Russian Federation already enjoys a most favoured nation status with virtually all of its trading partners, most of those advantages will not come from market access terms; rather, benefits will derive from the drastic increase in productivity in the most competitive exporting sectors, a higher variety of imported inputs, a serious technological upgrade, and the ability to use the WTO dispute settlement framework for resolving anti-dumping cases. The Russian services sector (including finance, telecommunication and transportation) is expected to gain in size and efficiency following strong FDI inflows.

The more pessimistic view, however, assumes low FDI inflows and little progress in domestic modernization that will lead to negative effects on the economy at large, as many weak industries would lose market shares and the Russian Federation could lose out in any trade dispute because of inexperience in using WTO’s dispute settlement framework. Significantly reduced support for the agricultural sector will make it uncompetitive, while lower customs revenues will affect the budget. The closing of unprofitable enterprises and loss of corporate income tax payments will impact regional budgets. Some economists fear that agriculture and manufacturing sectors for construction materials, consumer goods, food industries and machine building could lose as many as 2 million jobs or more in less than ten years, and that the accession will induce output losses, affect household consumption and worsen income inequality.

Which one of those scenarios will materialize? Following China’s accession to the WTO, which led to a more predictable business and dispute resolution environment, FDI inflows into China’s manufacturing sector, with its abundant labour resources, surged, and export growth accelerated further, to about 20 per cent a year. Such a scenario is unlikely in the case of the Russian Federation. Therefore, the proponents of both views agree that the transition period should be used efficiently. Since currently protected manufacturing sectors, oriented towards the domestic market, are likely to shrink, the key to success would be to expand export-intensive industries and services. It will be important, to the extent allowed by the WTO framework, to create incentives for exporters and to attract FDI into those industries and services. Attracting FDI into high value-added sectors where the entire vertical integration chain can be developed domestically will improve the access to know-how and technology, and increase employment and the quality of human capital. Potential investors into the Russian economy would benefit not only from exporting opportunities, but also from the sheer size of the Russian domestic market and the free trade agreements in the CIS area.

According to the World Bank’s *Doing Business 2013* report, the Russian Federation ranked 112 out of 185 economies on ease of doing business. The Government aims to achieve a much better ranking within several years, and drafted several road maps outlining ways to improve the investment

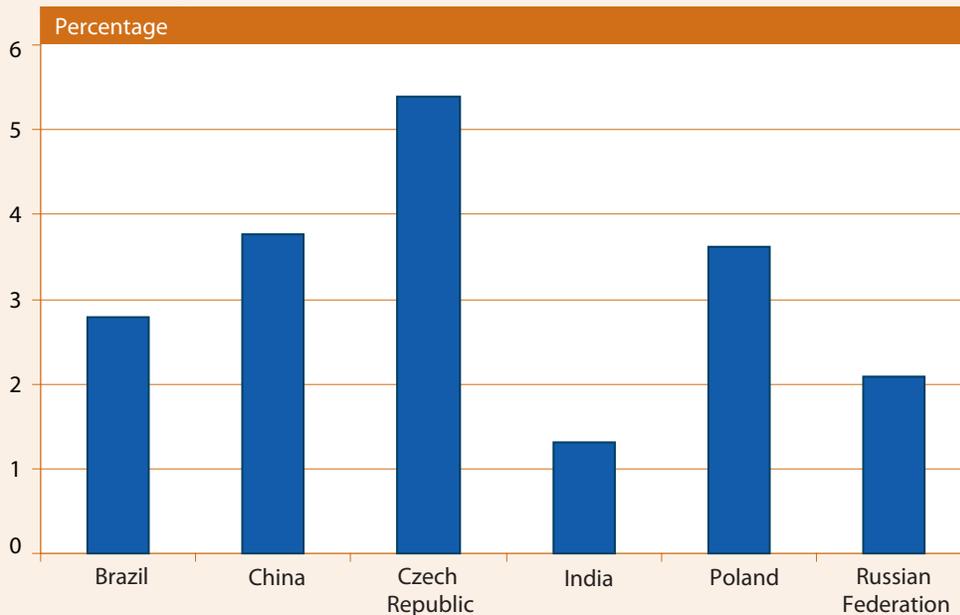
^a See, for example, Thomas Rutherford and David Tarr, “Russia’s WTO accession: What are the macroeconomic, sector, labor market and household effects?” available from http://siteresources.worldbank.org/INTRANETTRADE/Resources/Topics/Accession/Rutherford-Tarr_russia-macro-effects.pdf, accessed on 4 December 2012.

Box IV.1 (cont'd)

climate both for domestic and foreign businesses, including reducing bureaucracy, achieving serious progress in investor protection and fighting corruption. The quality of the business environment will be an important factor influencing the eventual impact of WTO membership. The Government has also to improve the institutional capacity to utilize the WTO dispute settlement mechanism.

The proponents of both views also agree that an efficient government-sponsored policy of mitigating the social costs of WTO membership, especially for unskilled workers, will be needed for the transition period. Therefore, strengthening the social safety net and investing in retraining should remain the focus of economic policymakers.

Annual average FDI flows as a share of GDP, 1996–2010

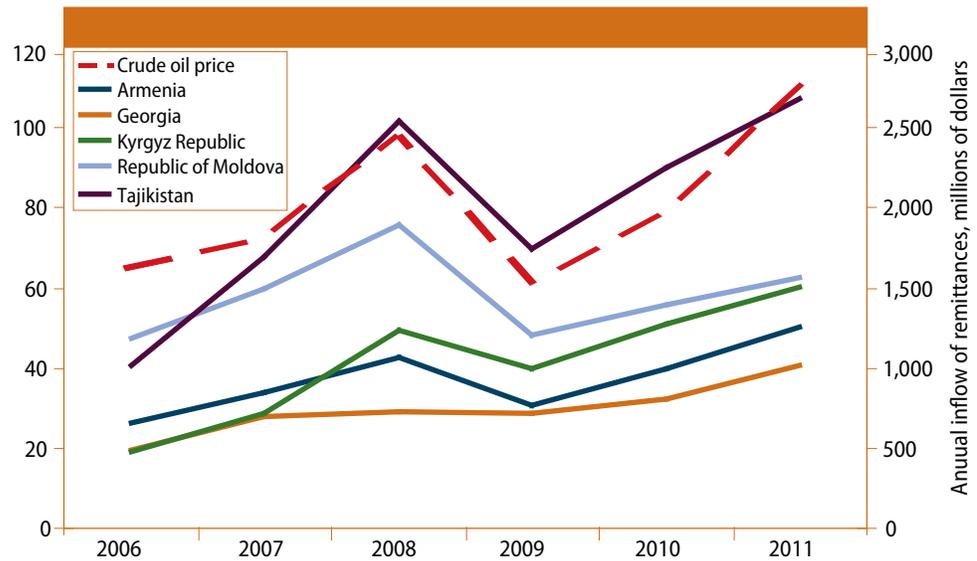


Source: World Bank.

Continued income growth, favourable labour market dynamics and declining inflation have provided impetus to domestic demand through the region. However, persistent uncertainty regarding economic prospects and difficult international financing conditions contributed to a slowdown in investment. While growth of retail lending supported private consumption in the Russian Federation, high shares of non-performing loans in the banking system constrained new lending and thereby the expansion of domestic demand in Kazakhstan. In Azerbaijan, the oil sector stabilized after last year's large fall in output, although the non-hydrocarbons economy remained the main source of economic dynamism. In Ukraine, the poor performance of export-oriented industrial branches was compounded by the problems of the agricultural sector. For the smaller, low-income countries, the Russian economy provides an important source of revenue through the remittances sent back home by workers from these countries (figure IV.5). Problems in the gold sector, including a drastic fall in output caused by social protests and strikes, resulted in a sharp economy-wide slowdown in the Kyrgyz Republic.

Domestic demand offsets external weakness

Figure IV.5
Crude oil price and the inflow of remittances into small economies of the CIS



Source: World Bank.

Sustained economic expansion has brought a reduction in unemployment in the region, although there are some marked differences in the performance of labour markets across countries. The unemployment rate reached historic lows in the Russian Federation, as jobs growth was accompanied by a shrinking active population. By contrast, the economy of Kazakhstan continued to generate employment at a rapid pace, but this was in line with the growth of the labour force. For low-income countries, migration and remittances remained a channel to alleviate labour market tensions and support domestic demand.

Inflation declines, but tensions re-emerge

Inflation fell throughout the region in 2012. Following sharp increases in food and fuel prices last year, inflation slowed down markedly in the non-energy exporters. Inflation accelerated again in the second half of the year, however. In the Russian Federation, the implementation of postponed administrative price increases and a poor grain harvest resulted in growing inflationary pressure in the last months of the year and annual inflation is estimated to exceed 5 per cent. In other CIS economies, inflation rates varied in 2012 from about 0.5 per cent in Georgia to over 60.0 per cent in Belarus, where the currency drastically depreciated in the aftermath of a balance-of-payments crisis. Except for Belarus, inflation is expected to stay up during 2013 as the disinflation process will be counteracted by further increases in regulated prices across the CIS. Other factors pushing prices up include expected nominal wage increases in energy-exporters and higher foreign-exchange earnings pushing up money supply and domestic demand.

Monetary policy loosening comes to a standstill

Despite the continued strength of domestic demand and, in some countries, accelerating credit growth, benign inflationary trends created room for some monetary loosening early in the year. However, renewed inflationary pressures put an end to the monetary easing. In the Russian Federation, capital outflows tightened monetary conditions, obviating the need for further increasing the policy interest rate. In Belarus, the improvement of financial indicators after last year's devaluation led to large cuts in the refinancing rate, which were accompanied by rapid monetary growth in the presence of still significant inflationary expectations. Despite low inflation, there was no strong move

towards monetary easing in Ukraine, because of concerns regarding the stability of the national currency. Monetary authorities moved to support the currency by limiting domestic and import demand through limits on the supply of credit after imposing stricter reserve requirements for commercial banks. Despite a more complicated inflationary outlook, further weakening of the CIS economies may require further monetary easing.

Sustained economic growth has boosted revenues, although non-energy exporters have continued to face difficult fiscal positions. By contrast, the Russian Federation and other oil- and natural gas-rich countries continue to enjoy the fiscal space required to support their recoveries in the face of a difficult global environment. In Ukraine, after a large adjustment in 2011, fiscal consolidation was undermined by rapid expenditure growth in the run-up to the parliamentary elections and the negative impact of a slowing economy on revenues. Delays in rising gas tariffs resulted in continued large financial transfers to the state-owned oil and gas company Naftogaz. Oil funds of several CIS countries, which were partially depleted during the financial crisis, have been quickly rebuilt, such as in Kazakhstan and the Russian Federation, in particular. By contrast, the non-energy exporting countries continue to face fiscal tensions. In the Kyrgyz Republic, for instance, slowing GDP growth owing to the problems in the gold sector and growing pressures to increase agricultural subsidies sharply widened the fiscal deficit.

Export growth moderated throughout the region as a result of lower global demand. While oil prices remained elevated, current-account surpluses shrank in most energy-producing countries, including the Russian Federation, which makes the largest contribution to the aggregate surplus balance in the region. By contrast, Belarus made some progress in reducing its large current-account deficit, partly thanks to reduced energy import bills from the Russian Federation. The deficit also fell in most small non-energy exporters, but the gap is still very large and a major source of economic fragility in Armenia, Georgia and the Republic of Moldova, in particular. Lower cotton prices contributed to a shrinking surplus in Uzbekistan. The high cost of energy imports and falling steel prices kept the deficit large in Ukraine, despite sharply declining growth.

The fragility of the world economy continues to weigh on the economic prospects of the region, which remains exposed to a worsening of the global situation, particularly in Europe, the main economic partner. Any further deterioration in the external environment will result in falling export demand, lower commodity prices and difficulties in accessing finance. Growing expenditures in the Russian Federation have increased the region's vulnerability to a decline in oil prices, but the implementation of fiscal consolidation plans and a lower dependence on capital inflows are expected to increase resilience. In Ukraine, fragile fiscal and international reserve positions reduce the policy space for addressing a further deterioration in the global environment. Other medium-term risks emerge from a weak banking sector and a high share of non-performing loans, especially in Kazakhstan and in a number of smaller CIS economies.

Economic growth has boosted government revenue

Risks for CIS economies remain elevated

Developing economies

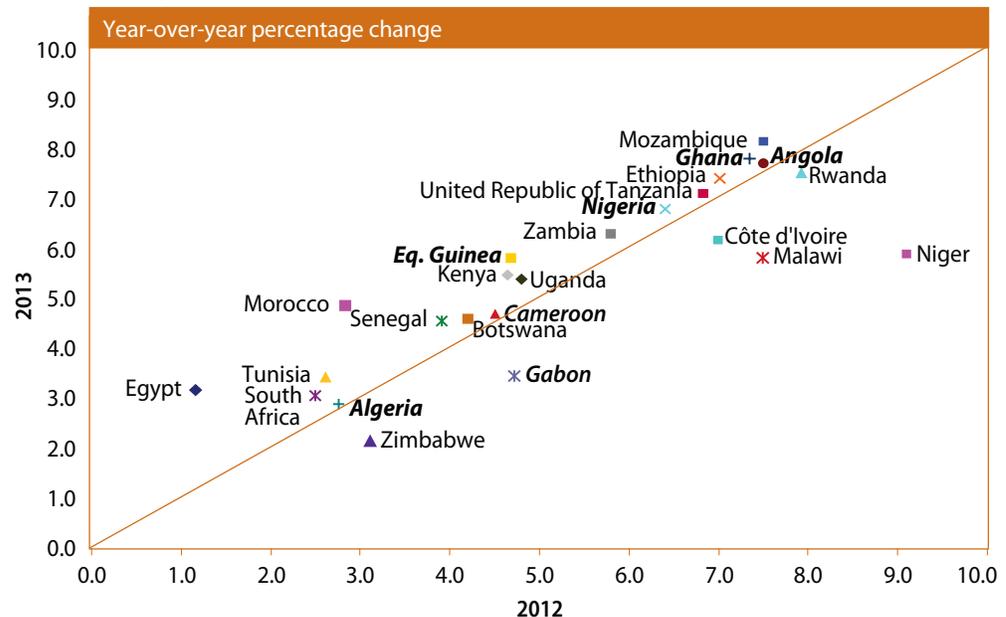
Developing economies saw a slowdown in their aggregate growth rate in 2012 to 4.7 per cent, compared with 5.7 per cent in 2011. There were two major outliers from this performance: Africa, which registered a sharp increase in growth to 5.0 per cent in 2012 after a more pronounced slowdown in 2011 caused by the political changes in North Africa; and Western Asia, where growth decreased markedly, mainly owing to the weaker performance of the oil-importing countries in the subregion.

In the outlook, developing economies will register a moderate acceleration in economic growth to 5.1 per cent in 2013 and 5.6 per cent in 2014. An outlier will again be Africa, which will experience a modest slowdown in growth in 2013 stemming from the vanishing base effect of the rebound in growth in North Africa. While these rates remain below those achieved in the years before the economic crisis, they still set developing economies apart from the much lower growth rates of developed economies. The reasons for this include relatively greater policy space in a number of developing economies to address weakening demand, expanding trade and finance ties between developing economies, as well as the still solid price levels for a number of export commodities.

Africa: solid growth expected with a more favourable risk profile

Despite the global slowdown, Africa's economic growth rate (excluding Libya) will see a visible rebound to 4.5 per cent in 2013 compared to 3.4 per cent in 2012 (figure IV.6). The upward trend is expected to continue in 2014, with growth reaching 5.0 per cent. Key factors underpinning Africa's strong growth prospects include solid growth in oil-exporting countries, supported by increased oil production, and still elevated oil prices (box IV.2), as well as increased fiscal expenditure, especially on infrastructure. At the same time, Africa's increasing trade and investment ties with emerging and developing economies are likely to mitigate the impact of negative shocks emanating from the recession in Europe. Similarly, other growth factors, such as increasing domestic demand associated with rising incomes and urbanization, will help reduce vulnerability to external shocks. Increasing diversification into services, such as telecommunication, construction and other non-primary commodity sectors, including manufacturing, also contribute to Africa's positive growth outlook in the medium term.

Figure IV.6
GDP growth rates for selected African economies, 2012–2013



Source: UN/DESA.

Note: Oil exporters in bold.

Box IV.2

New oil discoveries and the implications for growth in Africa

Recent discoveries and key features

In 2012, Kenya became the latest frontier for new oil discoveries in Africa, following a series of previously announced discoveries, notably in Ghana, Sierra Leone and Uganda. Ghana's Jubilee field, with an estimated total reserve of 490 million barrels of high quality oil, is expected to yield government revenues of \$1 billion on average per year between 2011 and 2029, based on a long-run price assumption of \$75 per barrel. In Uganda, the Lake Albert Rift Basin is estimated to have oil reserves of 1.1 billion barrels, translating into 100,000 to 300,000 barrels of oil per day.^a Oil production started in Ghana in 2010 and there are plans to begin production in Uganda in the coming years. These discoveries potentially add to the nine existing major oil-exporting countries (Algeria, Angola, Cameroon, Chad, Congo, Equatorial Guinea, Gabon, Libya and Nigeria).^b

Past performance of oil-exporting African countries

Examining the economic performance of the African countries already exporting oil shows that, in general, oil exporters have tended to fare better in terms of average income growth than non-oil exporters. However, one of the major issues is that the relatively high overall growth of oil exporters has not delivered the expected benefits. The enormous revenues from oil have not measurably boosted per capita incomes in many countries, and where they have, it has been unequally distributed. For example, Nigeria has exported over \$700 billion in oil between 1980 and 2010^c (which breaks down to almost 40 per cent of per capita income on a yearly basis), and yet the country's per capita income is barely above the average for Africa. As well, despite having one of the highest GDP per capita in Africa, Equatorial Guinea is still only ranked 136 in the United Nations Human Development Index, whereas Kenya, with a per capita income less than one tenth that of Equatorial Guinea, is ranked 143. This points to either severe mismanagement of the revenue or significant concentration of the oil wealth.

Natural resource dependence of selected oil-exporting African countries, 2010

	Resource exports (percentage of non-resource GDP)	Resource revenue (percentage of total revenue)	GDP per capita (United States dollars)
Angola	110.6	75.9	4,423
Cameroon	10.5	26.6	1,143
Chad	60.2	67.6	676
Congo	224.1	79.0	2,943
Equatorial Guinea	171.6	88.1	19,998
Gabon	116.3	53.9	8,643
Nigeria	54.3	72.2	1,222

Source: IMF, *Regional Economic Outlook: Sub-Saharan Africa*, October 2012.

As a result of the oil wealth, the economies of a number of these oil-rich countries have been distorted and they are now heavily dependent on the revenues from oil production (table). The size of the oil revenues relative to the rest of the economy has resulted in real exchange-rate appreciation and lack of economic diversification. The reliance on and ample availability of those revenues has weakened governance and become a source of rent-seeking behaviour.^d Evidence suggests that countries that are fiscally dependent on oil experienced significantly higher volatility in exports, revenue and non-oil GDP growth.^e This is largely attributed to the high volatility in world market prices of natural resources compared to other goods, which leads to higher volatility of budget revenues and risks macroeconomic stability in fiscally dependent countries. In addition, the net barter terms of trade have depended heavily on changes in oil prices, which declined in the 1980s, remained flat

^a Ernest Aryeetey and others, "Foresight Africa: The Continent's Greatest Challenges and Opportunities for 2011" (Africa Growth Initiative at Brookings, January 2011), pp. 22-24.

^b Prior to the breakup, Sudan would have been included in this list. Given recent conflicts between Sudan and South Sudan, it is difficult to estimate what combined exports for the two countries are likely to be going forward.

^c International Monetary Fund, World Economic Outlook database, October 2012.

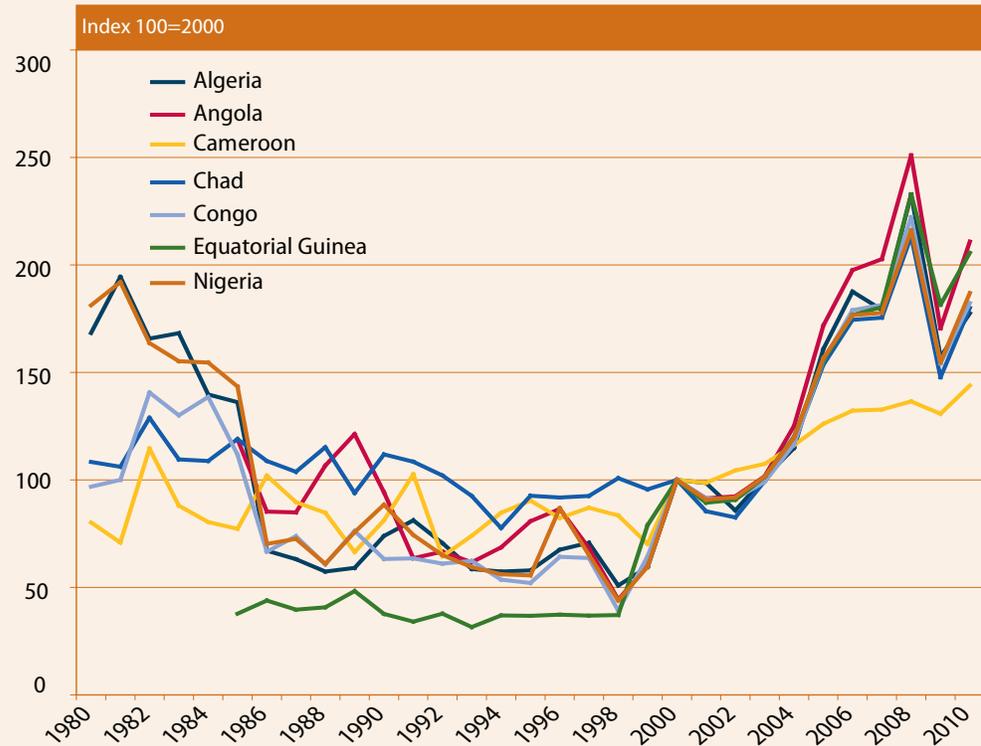
^d Pedro Conceição, Ricardo Fuentes and Sebastian Levine, "Managing natural resources for human development in low-income countries", Working Paper, No. 2011-002 (UNDP Regional Bureau for Africa, December 2011).

^e International Monetary Fund, *Regional Economic Outlook: Sub-Saharan Africa—Sustaining Growth amid Global Uncertainty* (Washington, D.C., October 2012).

Box IV.2 (cont'd)

in the 1990s and jumped up significantly in the last decade, particularly between 2004 and 2008 (figure). This implies that the countries with new oil discoveries will have to be well served by countercyclical macroeconomic policies, including through the use of oil stabilization funds, to smooth use of the newly acquired wealth over time.

Net barter terms of trade for selected African oil exporters



Source: World Bank.

Policy options for African countries

The recent discoveries have occurred in countries with low levels of income per capita and high economic and social inequalities. It is natural that expectations of their citizens would be raised and hopes for improved conditions voiced. The track record of managing and redistributing oil wealth has been less than stellar among most of the existing oil exporters in the region. Yet, if well-managed, new oil discoveries could present unique opportunities for accelerated growth and development in Africa. While it seems likely that the new oil discoveries will boost the GDP of these countries, the real questions are whether those gains are sustainable and how they are distributed. Achieving sustainability and equitable distribution requires a mix of policy options that addresses short-term fiscal issues and long-term investments and sustainability concerns. There are a few primary-exporting countries in the region that have been moderately successful in meeting these goals, such as Botswana, through its Community Based Natural Resource Management (CBNRM). While CBNRM in Botswana was not based on management of oil revenues, it is nonetheless a good example of establishing the appropriate relationships between the communities directly affected by the extraction operations, the Government and the resource extractors (or end users). There have also been relatively recent efforts by Angola to establish an oil-financed sovereign wealth fund to aid in diversification of the economy through investments in domestic agriculture, water, power and transportation projects. The planned creation of Stabilization and Heritage Funds outlined in Ghana's Petroleum Revenue Management Bill would utilize oil revenues both to cushion against oil price volatility and to support future social programmes.

Economic growth in North Africa is forecast to rebound strongly in 2013 and 2014 in the aftermath of the Arab Spring, despite continued uncertainty. Egypt is expected to grow at 3.2 per cent in 2013 as concerns over stability dissipate with increased external support. Libya's economy is expected to recover to its pre-crisis level, while growth in Algeria, Mauritania, Morocco and Sudan will benefit from the end of the drought. However, the protracted and unresolved euro area sovereign debt crisis still threatens the economies of the subregion through the trade and tourism channels.

North Africa is forecast to see a strong recovery in the wake of the Arab Spring

Central, Eastern, Southern and West Africa's economies continue to see a generally vibrant development in domestic demand, based on strong investment in view of the shortfall in infrastructure and the expansion of service sectors such as telecommunications and construction. This applies, for example, to Kenya, which is expected to maintain relatively robust growth of 5.4 per cent in 2013, with a rebound in domestic investment helped further by lower interest rates.

In the rest of Africa, infrastructure investment and expanding service sectors drive domestic demand

South Africa will register accelerating growth of 3.1 per cent in 2013 in view of a stabilizing international economic environment that is particularly relevant for its resources and manufacturing sector. On the domestic side, however, growth will be held back by continued high unemployment. In addition, further labour unrest and social tensions emanating from pervasive inequalities continue to form a significant downside risk to economic growth.

South Africa will see solid growth that is tempered by high unemployment and inequality

The oil-producing economies in Central, Southern and West Africa will benefit from sustained strong demand for oil and elevated export prices. In Nigeria, growth is forecast to accelerate to 6.8 per cent in 2013, with non-oil sectors such as telecommunications and construction providing significant impetus to economic activity. The positive impact of the oil and services sectors on growth is similar in Ghana, where solid agricultural output and increasing production by gold mines are forecast to lend additional support to the economic performance. Other economies that will benefit from conditions in the oil market include Angola, Cameroon, Chad, Equatorial Guinea and Gabon. However, this exposure to the international oil market also implies a major downside risk in the case of a significant fall in oil prices that could be triggered, for example, by a more pronounced global slowdown. Capacity-increasing investments in their mining sectors will be important drivers of GDP growth in countries like United Republic of Tanzania and Zambia, even though these mineral and metal exporting countries will also be vulnerable to volatile commodity prices and slowing international demand, especially from China.

Despite the positive growth picture, the employment situation remains a major problem across the region, both in terms of the level of employment as well as the quality of jobs that are generated, especially in North Africa. Wide gender disparities in employment and earnings remain a major concern. Women face unemployment rates at least double that of men in countries such as Algeria and Egypt. High youth unemployment is a further concern. With the fast growth of the labour force, the solid rates of GDP growth have proven far from sufficient to absorb all new labour market entrants, given the current pattern of production and employment generation. The lack of economic diversification away from the heavy dependence on resource extraction or agriculture is a key reason why labour demand is not more dynamic. Continued growth in other sectors like telecommunications and construction in countries such as Ghana, Kenya and Nigeria is helping to change this situation, however. At the same time, labour conflicts and social unrest constitute a major downside risk to the economic performance of the region. In South Africa, for example, a labour conflict in the mining sector caused the loss of numerous

Unemployment remains a pressing problem

lives and major disruptions in a crucial sector of the economy in 2012. Strikes by public sector workers also occurred in Kenya and the United Republic of Tanzania, causing major disruptions in the health and education sectors.

Inflation is moderating,
but remains high in
some countries

On average, inflation rates will recede moderately across the region in view of the weakening international environment and the fading one-off impact of drought conditions on harvest yields and domestic food prices. In South Africa, upward inflation pressure from wage growth and higher regulated prices will increasingly be offset by weakening commodity prices, resulting in an expected inflation rate of 4.2 per cent in 2013. Côte d'Ivoire will register one of the lowest inflation rates in the region; a more stable political situation and the normalization of trading activities on local markets will keep price increases limited to 2.1 per cent in 2013. By contrast, some of the oil-exporting economies are expected to see high inflation. In the case of Nigeria, government spending, especially at the state level, will keep inflation above 10 per cent in 2013, while strong domestic consumption will keep inflation in Angola and Ghana at about 10 per cent and 8 per cent, respectively, in 2013. A number of countries will see a continuation of a pronounced downward trend in inflation rates. In Kenya and Uganda, for example, the high inflation rates of late 2011 and early 2012 have been brought down mainly through decreases in food price inflation and by aggressive interest-rate policies which contained currency depreciation in these countries. Barring a return of significant drought conditions, inflation will continue to moderate and remain in single digits in 2013.

Fiscal budgets will have
to address multiple
policy challenges

Fiscal budgets will remain under pressure on a number of fronts. The lack of adequate infrastructure will require significant investments, while extremely low coverage of social security and high unemployment levels will create continuing pressure to initiate new spending to address at least some of the urgent welfare problems. At the same time, generating sufficient revenues will remain challenging for a host of reasons: many countries have only limited tax collection capabilities; oil prices will provide no additional boost to fiscal revenues for oil-exporting countries; and official development assistance (ODA) is also expected to remain under pressure, given the fiscal austerity measures among many of the donor countries. In the forecast, fiscal policies will remain relatively loose in 2013, with many economies running budget deficits, while some move towards consolidation is expected in 2014.

Although Africa's average current-account deficit narrowed to just 0.6 per cent of GDP in 2012, oil-exporting countries recorded a surplus of 3.7 per cent compared to a deficit of 6.9 per cent for oil-importing countries. Current-account deficits widened in many countries because of large food and energy imports and dependence on imported services. With increased pressure exerted by widening current-account deficits, domestic currencies depreciated against the United States dollar in several oil-importing countries. The pressure is forecast to continue in the medium term owing to increased demand for imported capital goods in many countries and the knock-on effect of the recession in Europe on demand for African exports.

The global economic
picture will put pressure
on ODA

Aid flows to Africa are expected to stabilize or even decline in 2013 and 2014 following the global economic slowdown and fiscal difficulties in many donor countries. Africa's external debt is expected to rise because of increased external financing needs of some of the Arab Spring countries, such as Egypt and Tunisia, and borrowing in private capital markets by countries such as Ghana, Senegal and South Africa.

The outlook is subject to a number of risks and uncertainties. A more severe and broader global economic slowdown encompassing emerging economies would hold the potential to inflict significant damage on the region's performance through a contraction

in trade, tourism and remittances. Moreover, the fiscal problems in developed economies continue to create uncertainty regarding future ODA flows. In addition, unexpected adverse weather conditions that would negatively affect harvest yields pose another downside risk, given the significant role of the agricultural sector in many economies.

East Asia: slowdown in China and recession in Europe weigh on regional growth

Sluggish demand in developed economies and a sharper-than-expected slowdown in China have weighed on economic growth in East Asia over the past year. The region's aggregate gross domestic product expanded by 5.8 per cent in 2012, down from 7.1 per cent in 2011 and 9.2 per cent in 2010 as export growth faltered and investment spending in many economies slowed. Household consumption continued to grow at a robust pace in most countries, supported by resilient labour markets and a decline in inflation. In the outlook, GDP growth in the region is forecast to pick up to an average of 6.2 per cent in 2013 and 6.5 per cent in 2014, supported by a modest recovery in external demand and more expansionary monetary and fiscal policy.

In China, the pace of economic expansion declined from 9.2 per cent in 2011 to 7.7 per cent in 2012, the lowest rate in more than a decade. Weaker export demand and a sharp decline in investment growth, especially in the real estate sector, dampened overall output growth. Because of more structural problems, there is a risk of a possible hard landing of the Chinese economy (see chapter I), but it is not considered very high in the immediate outlook. In 2013, consumption and investment demand in China will be supported by the loosening of monetary and fiscal policy, with full-year growth projected to pick up slightly to 7.9 per cent. Weaker domestic demand in China, along with the recession in the euro area and subdued demand in Japan and the United States, weighed heavily on activity in East Asia's higher-income and export-dependent economies. Hong Kong Special Administrative Region of China, the Republic of Korea, Singapore and Taiwan Province of China saw a sharp drop-off in growth in 2012 as subdued demand for exports led to lower capital spending. Along with a modest expected improvement in global conditions, these economies are likely to see moderate recovery in 2013 and 2014, but growth is projected to remain well below potential.

The slowdown in China and the higher-income economies of East Asia contrasts with the solid growth momentum in Indonesia, Malaysia, the Philippines and Thailand, where buoyant consumption and investment demand largely offset lower net exports. The strong growth performance in the Philippines and Thailand was supported by significant rises in public investment spending, but also reflects a base effect following weak growth in 2011. Growth in this group of countries is forecast to remain fairly stable in 2013.

Labour markets in East Asia have so far remained resilient to the slowdown in growth, although unemployment rates edged up in some of the region's export-dependent economies in the course of 2012. In several countries, including Malaysia, the Republic of Korea and Singapore, the unemployment rate continues to be close to historic lows as robust domestic demand helped offset the impact of weaker exports and manufacturing activity. In Indonesia, unemployment declined to 6.3 per cent in the first quarter of 2012, about half the rate of 2006. As in other East Asian countries, most of the new jobs in Indonesia have been created in the service sector, where productivity continues to be much lower than in the manufacturing sector. As a result, the share of workers in vulnerable

Export-dependent economies have seen the largest drop-off in growth

Labour market conditions have so far remained fairly resilient to the slowdown

employment conditions remains high, ranging from about 20 per cent in Malaysia according to International Labour Organization (ILO) estimates to 50 per cent in Thailand and 60 per cent in Indonesia. Since labour markets tend to react with a lag to weakening economic activity, employment growth in many countries is likely to slow in the quarters ahead. Unemployment rates are expected to show little change in 2013 and 2014.

Inflationary pressures are projected to remain low

Inflation has declined significantly in East Asia over the past year as domestic demand softened and many international commodity prices eased. For the region as a whole, consumer price inflation averaged 2.9 per cent in 2012, well below the rate of 4.9 per cent recorded in 2011. In most economies, including China, Indonesia and the Republic of Korea, the current rate of inflation is firmly within the target ranges set by central banks. The recent hikes in the international prices of several food commodities, notably corn, soybeans and wheat, have not led to a significant increase in food price inflation across the region. This can be attributed to the relatively small weight of these grains in consumer price index baskets and the fact that prices of rice, East Asia's staple food, have remained stable. Looking forward, consumer price inflation across the region is projected to remain relatively low as more moderate economic growth will not lead to significant demand-pull pressures. In addition, the strength of regional currencies against the dollar and the euro is expected to contain imported inflation. Regional inflation is projected to average 3.1 per cent in 2013 and 3.5 per cent in 2014, in line with an expected gradual recovery in growth. Upside risks to inflation include the re-emergence of strong capital inflows following the new round of quantitative easing (QE) policies in developed economies, the impact of planned subsidy reductions (for instance, in Indonesia and Malaysia) and strong nominal wage growth, especially in China, Thailand and Viet Nam.

Central banks have shifted focus from inflation to growth

Against the backdrop of slowing economic activity and reduced inflationary pressures, East Asia's monetary authorities have shifted focus from containing inflation to stimulating growth. After tightening monetary policy in 2010/11, many central banks have cut interest rates over the past year to support domestic demand. The People's Bank of China (PBC) reduced the one-year benchmark deposit rate by a total of 50 basis points to 3 per cent and the one-year benchmark loan rate by 56 basis points to 6 per cent. The PBC also lowered the reserve requirement ratio for deposit-taking institutions and used open-market operations to inject liquidity into the banking sector. Similarly, the central banks in Indonesia, the Philippines, the Republic of Korea and Thailand eased monetary policy in the course of 2012. In contrast to the cautious approach taken by other monetary authorities in the region, the State Bank of Viet Nam cut interest rates aggressively in the first half of 2012 amid rapidly declining inflation and weakening growth. However, the re-emergence of inflationary pressures in the third quarter reduced the scope for further monetary easing in Viet Nam. The monetary authorities in Hong Kong Special Administrative Region of China, Singapore and Taiwan Province of China have so far refrained from loosening monetary policy despite markedly lower growth. In the quarters ahead, some further monetary easing in East Asia may take place. However, unless the regional outlook deteriorates significantly, most central banks will maintain their cautious approach.

Fiscal policy has become more expansionary to counter the slowdown

Across East Asia, Governments adopted a more expansionary fiscal policy in the course of 2012 as the economic slowdown became increasingly apparent. In Indonesia, Malaysia, the Republic of Korea, Thailand and Viet Nam, the authorities introduced low-interest loans, cash transfers to low-income households, lower tax rates and tax breaks to fuel private sector demand and mitigate the social impact of the slowdown. The Governments in China, Indonesia and the Philippines also announced increases in public infrastructure spending. The size of these fiscal injections is, however, small relative to the unprecedented

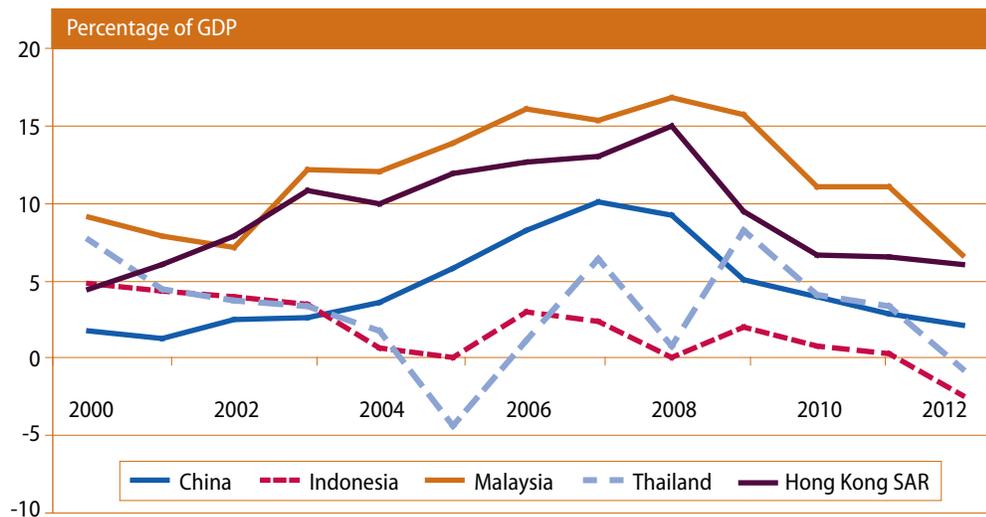
policy responses in the wake of the global financial crisis. As a result of rising expenditures and weaker revenue growth, fiscal balances deteriorated in 2012. Still, budget deficits remained below 3 per cent of GDP in all East Asian economies, except Malaysia and Viet Nam. Going forward, fiscal deficits are projected to narrow as a share of GDP in most countries, as income growth and government revenues are expected to recover gradually and authorities remain committed to long-term fiscal sustainability. While low deficit and debt levels imply that most Governments have ample room for additional fiscal stimulus measures, they are only expected to do so if growth prospects deteriorate more sharply.

Trade and current-account surpluses in most East Asian economies narrowed in 2012 (figure IV.7) as exports decelerated more rapidly than imports. The weakness in export earnings across the region reflects subdued import demand in developed economies, slowing demand in China and a decline in the prices of many export commodities, such as rubber and copper. The region was particularly affected by the fall in EU demand for machinery, transport equipment and other manufactures. Compared to 2011, the dollar value of merchandise exports remained flat or declined slightly in most East Asian economies, including Indonesia, Malaysia, the Republic of Korea and Taiwan Province of China. At the same time, import bills continued to grow in most countries, although much more slowly than in the past two years. In Indonesia, however, import growth remained robust owing to strong domestic demand, resulting in a sharp contraction of the trade surplus and the first annual current-account deficit in 15 years. China's external surplus, in contrast, did not decline, as export earnings continued to grow in 2012. Although export growth was weaker than in 2011, it outpaced import growth. In 2013, East Asia's exports and imports are projected to grow at a subdued pace given the continuing weakness in global conditions. Trade and current-account balances are expected to improve slightly.

Current-account surpluses decline owing to a slump in exports

Figure IV.7

Current-account balances of selected East Asian economies, 2000-2012



Source: UN/DESA based on data from EIU and national sources.

Note: Figures for 2012 are partly estimated.

Even though economic fundamentals remain strong, risks to the region's economic outlook remain tilted to the downside. A further deterioration of the sovereign debt crisis in Europe remains a major risk for East Asia's economies since it would likely lead to renewed turmoil on financial markets and a sharp contraction in global trade activity.

Euro area crisis and a possible hard landing of China's economy remain key risks

A sharp deceleration in the pace of growth in China would have a severe impact on economic activity in the region, with Hong Kong Special Administrative Region of China, Singapore and Taiwan likely to suffer most from lower demand for their exports. Fiscal policy uncertainty in the United States and continued geopolitical risks in oil-producing areas represent additional risk factors for regional growth.

South Asia: internal and external headwinds further weaken economic activity

Economic activity in South Asia slowed further in 2012 as internal and external headwinds persisted. After growing by 5.8 per cent in 2011, the region's gross domestic product expanded by 4.4 per cent in 2012, the slowest pace in a decade. Persistent high inflation, political uncertainties, and transport and energy constraints have weighed on household consumption and business investment. At the same time, the exports of most countries in the region have been affected by weakening global demand. In most countries, the scope for macroeconomic policies to support growth is limited. Central banks are trying to walk a fine line between supporting demand and curbing inflation, while Governments face pressures to bring down budget deficits. Going forward, economic growth in the region is projected to accelerate moderately to 5.0 per cent on average in 2013 and 5.7 per cent in 2014, led by a gradual recovery in India.

India's economic growth slows to a ten-year low

India's economy, which accounts for almost three quarters of the region's GDP, has slowed markedly over the past two years. Annual growth declined from more than 9 per cent in 2010 to 5.5 per cent in 2012, the slowest pace in 10 years. The slowdown primarily reflects weaker consumption and investment demand as a result of persistent inflation, high nominal interest rates, large fiscal deficits and political gridlock. These factors will likely remain a drag on economic growth in the outlook period. Nonetheless, GDP growth is forecast to accelerate moderately to 6.1 per cent in 2013, as a result of stronger growth of exports and capital investment. Investment demand is expected to respond to the more accommodative monetary policy stance and slightly improved business confidence.

Nepal and Pakistan continue to experience subdued growth as ongoing political instability and security concerns weigh on domestic demand. In Pakistan, investment has been in decline for four consecutive years, down to only 12.5 per cent of GDP in 2011/12. Economic activity in the Islamic Republic of Iran contracted in 2012 as international sanctions led to a sharp decline in oil exports and a sharp fall in the value of the rial. Economic prospects for Bangladesh and Sri Lanka, in contrast, remain largely favourable despite a moderate slowdown in 2012. In both countries, the economic expansion is based on strong growth in private investment and consumption, which is supported by a steady increase in worker's remittances.

South Asia continues to struggle with deep-rooted structural challenges in its labour market

Given the lack of sufficiently up-to-date labour market data in South Asia, the employment impact of the recent economic slowdown is not yet clear. The fourteenth report on employment changes in selected sectors, published by India's Labour Bureau in May 2012, indicates that employment growth in the country's manufacturing sector had slowed considerably during 2011/12. According to the survey, employment continued to increase in India's exporting firms, but declined in the non-exporting sector amid weakening domestic demand. Although open unemployment rates in the region are low—the ILO projects an average unemployment rate for the region of only 3.8 per cent in 2012—there are deep-rooted structural challenges in the labour market. These challenges include the dominance of low-productivity jobs in the large informal sector, high shares of working

poor, low female participation rates and high youth unemployment. Recent labour market reports for India and Pakistan illustrate the magnitude of these challenges. In India, less than 20 per cent of persons are classified as wage earners, whereas about 80 per cent are either self-employed or temporary workers. The female labour force participation rate in India is estimated at 25.4 per cent, compared to 77.4 per cent for males. In Pakistan, three quarters of employed women work in the agricultural sector, the large majority of them in vulnerable employment conditions.

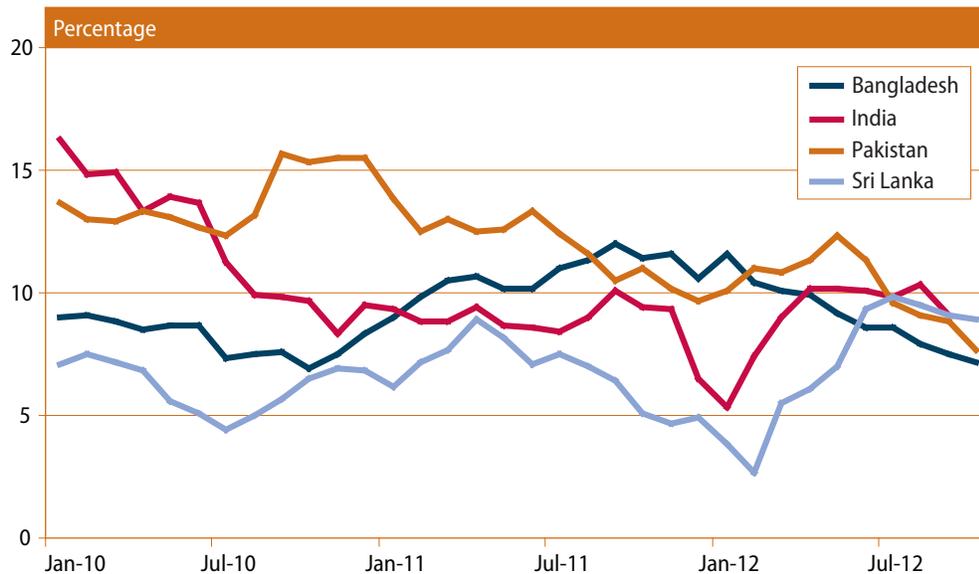
Inflationary pressures remained persistently high in most South Asian economies over the past year (figure IV.8). Consumer price inflation averaged 11.6 per cent in the region in 2012, slightly up from 11.2 per cent in 2011. The renewed rise in inflation can be attributed to several factors: droughts in parts of the region, higher world food prices, significant depreciation of local currencies, and increases in administered fuel and electricity prices. Deeply entrenched inflationary expectations and large fiscal deficits, particularly in India and Pakistan, further added to the price pressures. Year-on-year inflation rose to about 25 per cent in the Islamic Republic of Iran in late 2012, as the removal of government subsidies and the fall of the rial against the dollar drove up domestic prices.

Bangladesh and Pakistan, in contrast, experienced a moderate decline in inflation over the course of 2012, partly owing to more subdued growth of private sector credit. In the outlook, consumer price inflation is projected to decline slightly in most economies, averaging 10.6 per cent in 2013 and 9.9 per cent in 2014 for the region as a whole. More stable local currencies, lower global food prices and slower money supply growth are expected to reduce price pressures. However, persistently high inflation expectations, severe supply bottlenecks and the need to further raise administered energy prices will impede progress in reducing inflation.

Inflation remains persistently high

Figure IV.8

Consumer price inflation in selected South Asian countries, January 2010–October 2012 (year-on-year percentage change)



Source: UN/DESA, based on data from national sources.

Notes: For India, inflation in consumer price index numbers for industrial workers was used, provided by the Labour Bureau of the Government of India.

Persistent inflationary pressures and large fiscal deficits continue to limit the scope for monetary policy easing in response to slowing economic growth. The central

banks of Bangladesh and Sri Lanka raised policy rates in early 2012, but left the monetary stance unchanged in the remainder of the year. Authorities of both countries are expected to maintain the current policy stance unless growth slows more sharply than expected. The Reserve Bank of India (RBI), which had increased its benchmark repo rate 13 times between March 2010 and October 2011, cut interest rates only slightly in 2012, even though investment demand slumped. To boost liquidity in the banking system, the RBI also reduced the cash reserve ratio for banks. While India's monetary authorities remain focused on containing inflation and anchoring inflation expectations, continued weakness in private capital spending is expected to prompt further monetary easing in the quarters ahead. Unlike the RBI, the State Bank of Pakistan (SBP) has fully shifted its focus to strengthening private investment, which has declined for four consecutive years, and supporting domestic demand. The SBP cut its main policy rate from 12 per cent to 10 per cent in 2012. If inflation continues to slow in the coming quarters, additional interest rate reductions are likely.

Slower growth and higher subsidy bills weigh on fiscal balances

Weakening growth of tax revenues, rising expenditures on energy, food and fertilizer subsidies, and higher security spending have all put additional pressures on fiscal balances in South Asia. In almost all countries, the deficit reduction targets for the past fiscal year were missed by a considerable margin. Despite increased efforts to lower spending on subsidies, this trend is likely to continue as Governments face major fiscal challenges, including strong expenditure demands that will address energy shortages, enhance welfare spending, and narrow tax bases. In India, the government deficit widened to 5.8 per cent of GDP in 2011/12, well above the target of 4.6 per cent. The shortfall can be primarily attributed to lower-than-expected corporate tax revenues, following the marked economic slowdown, and higher subsidy expenditure as food and fuel prices remained elevated. Actual government deficits also exceeded initial targets in other South Asian economies during the past fiscal year, accounting for 5.2 per cent of GDP in Bangladesh, 6.2 per cent in Sri Lanka and 6.3 per cent in Pakistan.

Trade deficits widened further as exports were hit by the global slowdown

In most South Asian economies, trade and current-account deficits widened significantly in 2012. Exports were hit hard by weakening demand in key markets, including the EU, the United States and China. The annual value of merchandise exports declined moderately in India, Pakistan and Sri Lanka, reflecting both lower volumes and lower prices of major export commodities like rubber and cotton. In the Islamic Republic of Iran, export earnings contracted by more than 25 per cent in 2012 following the tightening of sanctions. In most South Asian countries, import spending growth also declined sharply in 2012, although import bills continued to be pushed up by high oil prices and still robust consumer spending. An important factor behind the slowdown in import spending was the sharp depreciation of local currencies. The Indian rupee, for example, lost more than 25 per cent of its value against the dollar between June 2011 and June 2012. The weakness in the region's currencies can be attributed to large and rising current-account deficits as well as a sharp decline in portfolio inflows amid recurring concerns over the regional and global outlook. Workers' remittance flows to Bangladesh, Pakistan and Sri Lanka continued to grow at a strong pace in 2012, partially offsetting the large trade deficits. In the outlook period, South Asia's economies will continue to record large and partly widening current-account deficits.

Downside risks to the economic outlook for South Asia are related to the continued weakness of the global macroeconomic environment and to regional or domestic economic vulnerabilities. On the external side, a further economic downturn in

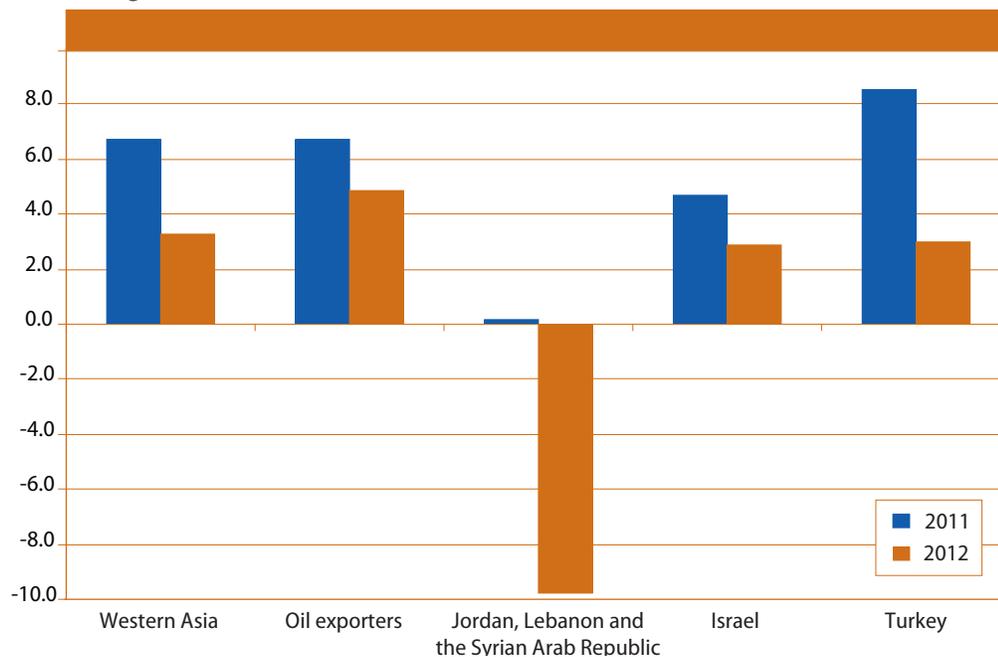
the United States or Europe or a hard landing of China's economy would further weaken South Asia's exports, while also reducing inflows from workers' remittances. Widening current-account deficits, coupled with lower portfolio capital inflows, could add pressure on the balance of payments, possibly requiring contractionary policy adjustment. Political instability and deteriorating security conditions represent downside risks for several countries, notably the Islamic Republic of Iran, Nepal and Pakistan.

Western Asia: economic growth diverges between oil and non-oil economies

Economic performance in Western Asia strongly diverged in 2012, with most oil-exporting countries continuing to experience robust though decelerating growth, supported by record-high oil revenues and government spending. By contrast, economic activity weakened sharply in oil-importing countries, burdened by higher import bills, declining external demand and shrinking policy space. The divergence is expected to continue in the outlook for 2013, but there may be some convergence in 2014. On average, GDP growth in the region is estimated to decline from 6.7 per cent in 2011 to 3.3 per cent in 2012 (figure IV.9). It is forecast to stagnate in 2013 before picking up to 4.1 per cent in 2014.

Figure IV.9

GDP growth in Western Asia



Source: UN/DESA.

Most oil-exporting countries benefitted from record-high oil prices and rising oil output in 2012, especially Iraq, Kuwait and Saudi Arabia. Strong growth in Saudi Arabia was further underpinned by the expansion of domestic demand and a dynamic real estate sector. Public and private investments bolstered growth in Qatar. Economic activity grew more modestly in Bahrain, Oman and the United Arab Emirates as the financial and real estate sectors gradually recovered. Political instability delayed any possible recovery in Yemen.

Negative spillover from the Syrian crisis affected neighbouring countries and the region at large

Social unrest and political instability, notably the civil war in the Syrian Arab Republic, weighed on risk perception in the entire region (box IV.3). Neighbouring Jordan and Lebanon were further affected by subdued cross-border economic activities, including trade, investment and tourism.

Box IV.3

The economic impact of the Syrian crisis

Lasting armed violence in the Syrian Arab Republic caused a humanitarian crisis and inflicted significant economic damage, including the destruction of commercial and residential properties, infrastructures and production facilities. In his address to the parliament on October 2, the Syrian Prime Minister estimated the cost of total damages at 2000 billion Syrian pounds,^a which amounts to 55 per cent of the 2010 GDP after adjusting for inflation. Furthermore, at least one third of the 2010 capital stock may have been destroyed as of October 2012. Despite the Government's effort to increase employment in the public sector, unemployment increased significantly from an annual average rate of 8.6 per cent in 2010 to 14.9 per cent in 2011^b and the situation worsened significantly in 2012 as a growing number of workers became unemployed, underemployed, were deterred from reporting to work, were displaced domestically or became political refugees abroad. Under these conditions, the Syrian economy will need several years to recover after the internal armed conflict comes to an end.

Economic sanctions imposed by the United States, the EU and the League of Arab States also negatively impacted the Syrian economy. The oil embargo caused an export revenue loss of about \$4 billion, cutting government revenue by about 25 per cent in 2012. Financial sanctions further hampered trade by complicating trade financing and exerting pressures on the Syrian currency. In January, the central bank had to introduce a managed float of its exchange rate, allowing the Syrian pound to devalue by more than 30 per cent before stabilizing around SYP70/\$. Although imports of many essential goods were liberalized, trade of non-sanctioned goods, such as wheat and pharmaceuticals, declined significantly. Despite the imposition of a profit ceiling on wholesalers, prices kept rising rapidly, and in August 2012, the year-on-year consumer inflation rate reached 39.5 per cent. As a consequence of ongoing armed violence and sanctions, the number of tourists had dropped by 76 per cent year on year in the first quarter of 2012 and investments from Gulf countries in tourism infrastructure have been put off indefinitely.

The Syrian economy showed some signs of resilience, however, as the public and private sectors both made efforts to maintain basic infrastructure and business activities during disastrous economic, social and security conditions.

Spillover effects on neighbouring countries and intraregional trade

Political instability and precarious security conditions affected risk perception across the region, especially regarding Iraq, Jordan and Lebanon. Capital inflows and tourist arrivals, which were the main drivers of the recent economic expansion in Jordan and Lebanon, came to a halt. As demand for foreign currencies surged in the region, the Jordanian central bank had to raise interest rates and sell foreign reserves to defend the Jordanian dinar, and the Iraqi dinar depreciated against the United States dollar. Higher risk profiles and weak currencies kept funding costs elevated in those countries, even as they declined in other parts of the region.

The Syrian crisis further affected intraregional trade (table). Bilateral trade flows between the Syrian Arab Republic and neighbouring countries decreased substantially in the first half of 2012, with the exception of Lebanon through which a rising share of Syrian imports transit to Damascus and Southern regions. The transit of goods through Syrian territory almost came to a halt, diverting to alternate routes, and new trading partnerships and networks are being formed. Turkey may have benefitted most from the partial reshuffling of bilateral trade flows in the region. Iraqi exports to Lebanon and Turkey expanded as well, whereas Jordanian exports, by contrast, appear to have suffered from the precarious security conditions along its border with the Syrian Arab Republic. Bilateral trade flows with Turkey nonetheless expanded, albeit from very low initial levels.

^a Syrian Arab News Agency (SANA), "Premier al-Halqi: Syria Paying for Its Stances", October 2, available from <http://sana.sy/eng/21/2012/10/02/444919.htm> - (accessed on 10 October 2012).

^b Data from Syrian Arab Republic Central Bureau of Statistics, available from <http://www.cbssyr.org/work/2011/compare/TAB2.htm> (accessed on 10 October 2012).

Box IV.3 (cont'd)

Prolonged armed violence is affecting sensitive social fabrics. While the ongoing destruction of physical and human capital in the Syrian Arab Republic will complicate efforts to rebuild the country and create a new form of social cohesion, the Syrian crisis is also progressively dismantling and reshaping trade and knowledge networks in the region with potentially long-lasting effects.

Year-on-year change in goods trade flow, January–July, 2011 and 2012

Percentage				
	<i>From Jordan</i>	<i>From Lebanon</i>	<i>From Syrian Arab Republic</i>	<i>From Turkey</i>
To Iraq	-14.2	-3.2	N.A.	37.2
To Jordan		14.6	-51.6	30.2
To Lebanon	-19.0		-14.4	17.1
To Syrian Arab Republic	-17.6	28.5		-67.4
To Turkey	102.2	-35.3	-82.9	

Sources: Jordan Department of Statistics, available from http://www.dos.gov.jo/dos_home_e/main/index.htm (accessed on October 15, 2012); Lebanese Customs <http://www.customs.gov.lb/customs/index.htm> (accessed on October 15, 2012); Turkish Statistical Institute, available from <http://www.turkstat.gov.tr/Start.do> (accessed on October 15, 2012).

The deteriorating external environment increasingly affected economic activity in Israel, while weakening domestic demand contributed to a sharp decline in economic growth in Turkey.

Social unrest associated with the Arab Spring surged in part because of the weak absorption capacity of labour markets across the region, which generates underemployment and unemployment. Low official unemployment rates disguise the true extent of underutilization of labour because of low participation rates. Governments of the Gulf Cooperation Council (GCC) countries have responded to social unrest by raising wages and creating new jobs in the public sector, including by strengthening security forces. Meanwhile, migrant labour represents about 90 per cent of the private sector work force across GCC countries, as a consequence of uncompetitive compensation compared to the public sector and poorly coordinated education and industrial policies that result in a skills mismatch. In Saudi Arabia, for instance, the unemployment scheme created in the wake of the Arab Spring, attracted more than a million unemployed workers, many of them women not previously considered part of the labour force.

In Jordan, the unemployment rate declined by 0.9 percentage points to average 12.0 per cent over the first three quarters of 2012, but underemployment and vulnerable employment is widespread. In Turkey, unemployment declined slightly to almost 9 per cent in 2012. In Israel, new unemployment estimates (now aligned with OECD definitions) showed an increase in the rate by more than one percentage point to almost 7 per cent in 2012, contrasting with earlier estimates and thereby undermining claims that the country would be coping with the global slowdown with relative ease.

Fiscal policy in Western Asia was durably affected by the Arab Spring. Temporary and permanent increases in public expenditures will drag on public finances in many countries in the years ahead. While medium-run fiscal balances remain strong in many Gulf countries, the break-even price of oil for GCC countries as a whole is estimated

New unemployment scheme in Saudi Arabia reveals large hidden unemployment

Budget deficits increased in oil-importing countries

to have increased from \$49 per barrel in 2008 to \$79 in 2012, with Bahrain and Oman being most vulnerable to a potential drop in oil price.

Oil-importing countries possessing limited policy buffers reacted more cautiously to political unrest. Civil servant pay raises and energy subsidies widened the budget deficit to over 6 per cent of GDP in Jordan. Lebanon's fiscal stance remained neutral during the first half of 2012, but a proposed public sector salary increase may widen the budget deficit.

In Israel, several recommendations of the Trajtenberg Committee, created in 2011 in the wake of social unrest, have been accepted by the Government, but the projected rise of the budget deficit to 3.4 per cent of GDP in 2012 is more directly related to steady military spending, which amounted to more than 6 per cent of GDP. In Turkey, slowing growth is expected to have increased the budget deficit from an estimated 1.4 per cent of GDP in 2011 to more than 2.0 per cent in 2012. Fiscal balances in Turkey and across the region are forecast to deteriorate next year.

High food and energy prices spurred weak inflationary pressures

Inflation declined across the region during the first three quarters of 2012 in the context of high commodity prices but weakening external and domestic demand. In GCC countries, inflation remained at about 3 per cent or below, except in Saudi Arabia. The housing component of the consumer price index was negative in Bahrain, Qatar and the United Arab Emirates, caused by excess supply and limited domestic demand pressures. The pass-through effect of high food and energy prices may keep inflation above 10 per cent in Yemen. In Jordan and Lebanon, inflation is likely to remain above 4 per cent in 2012, a slight decline compared to 2011.

In Israel, the consumer price index grew by 2.1 per cent during the first three quarters of 2012 following high food and housing prices, about one percentage point lower than last year. In Turkey, demand-led inflationary pressures progressively weakened during the year, but higher food and energy prices as well as value-added tax increases pushed up inflation, which may decelerate to 7 per cent at the end of the year. Barring a revival of domestic and external demand pressures or a crisis that pushes up commodity prices, inflation will likely decline further across the region in 2013.

Borrowing costs declined in most countries

Policies related to the use of conventional monetary instruments remained unchanged in most countries of the region in 2012. Policy rates in GCC countries that have their currencies pegged to the dollar remained constant, almost mirroring the stance of the Fed. Growing money stock improved liquidity conditions, contributing to slightly lower funding costs, which had increased in the wake of the Arab Spring. Meanwhile, Jordan raised its policy rate by 50 basis points in February to defend the national currency, setting the overnight repurchase agreement rate at 4.75 per cent.

The depreciating Turkish lira stabilized against the dollar at the end of 2011, as the central bank tightened monetary policy by raising overnight lending rates and widening the interest rate corridor. In parallel, reserve requirement ratios were reduced in order to prevent an undesirable tightening in liquidity conditions. In 2012, as the current-account deficit progressively declined along with domestic demand, monetary authorities continued to reduce the effective funding rate from 11 per cent in January to less than 7 per cent in September. Inflation remained above target. In Israel, weakening demand-driven inflationary pressures led the central bank to loosen monetary policy three times during the first half of the year, setting the interest rate at 2.25 per cent. As most countries across the region tie their monetary policy to the stance of central banks in advanced economies, the monetary loosening required to respond to the a grim growth perspective may only occur in those countries with independent monetary policies in 2013.

The diverging economic performance in the region is also reflected in differing trends in external imbalances. While record oil revenues boosted external surpluses in oil-exporting countries, higher import bills burdened existing deficits in oil-importing countries. In the GCC countries, current-account surpluses range from about 8 per cent of GDP in the United Arab Emirates to more than 40 per cent in Kuwait. Oil production outages caused by pipeline attacks in Yemen contributed to the external deficit.

Jordan's and Lebanon's current-account deficits widened as a result of high commodity prices and related increases in import bills, weaker export demand and declining revenue from tourism. Foreign reserves dropped by 37 per cent in Jordan over the first half of the year and reserve accumulation stalled in Lebanon.

The trade deficit also widened in Israel, putting the current-account balance into deficit in 2012. Weakening external demand led to a drop in manufacturing exports, including for high-tech goods. Turkish manufactures have started to penetrate markets in Asia, making the country less dependent on exports to European markets. The current-account deficit is expected to remain high at about 7 per cent in 2010. While external imbalances across the region are structural, their magnitude in the years ahead largely depends on commodity price developments. The discovery of gas resources in the Mediterranean is expected to generate external surpluses for Israel from 2014.

In the outlook, Western Asia faces three major downside risks. First, a more pronounced jump in oil prices—owing, for example, to renewed domestic social unrest or rising tensions around the Strait of Hormuz—could raise the oil-price risk premium and exacerbate existing current-account and fiscal imbalances. Second, if the financial woes and deeper fiscal austerity in developed countries were to trigger a global downturn, a sustained drop in the oil price would negatively affect fiscal and, eventually, social stability in oil-exporting countries. Finally, inaction in relation to the dire employment situation and, more broadly, the failure to implement effective diversification strategies based on a more inclusive development paradigm represent major risks to long-run stability and prosperity in the region.

Record-high oil prices widened external imbalances in oil-exporting and importing countries

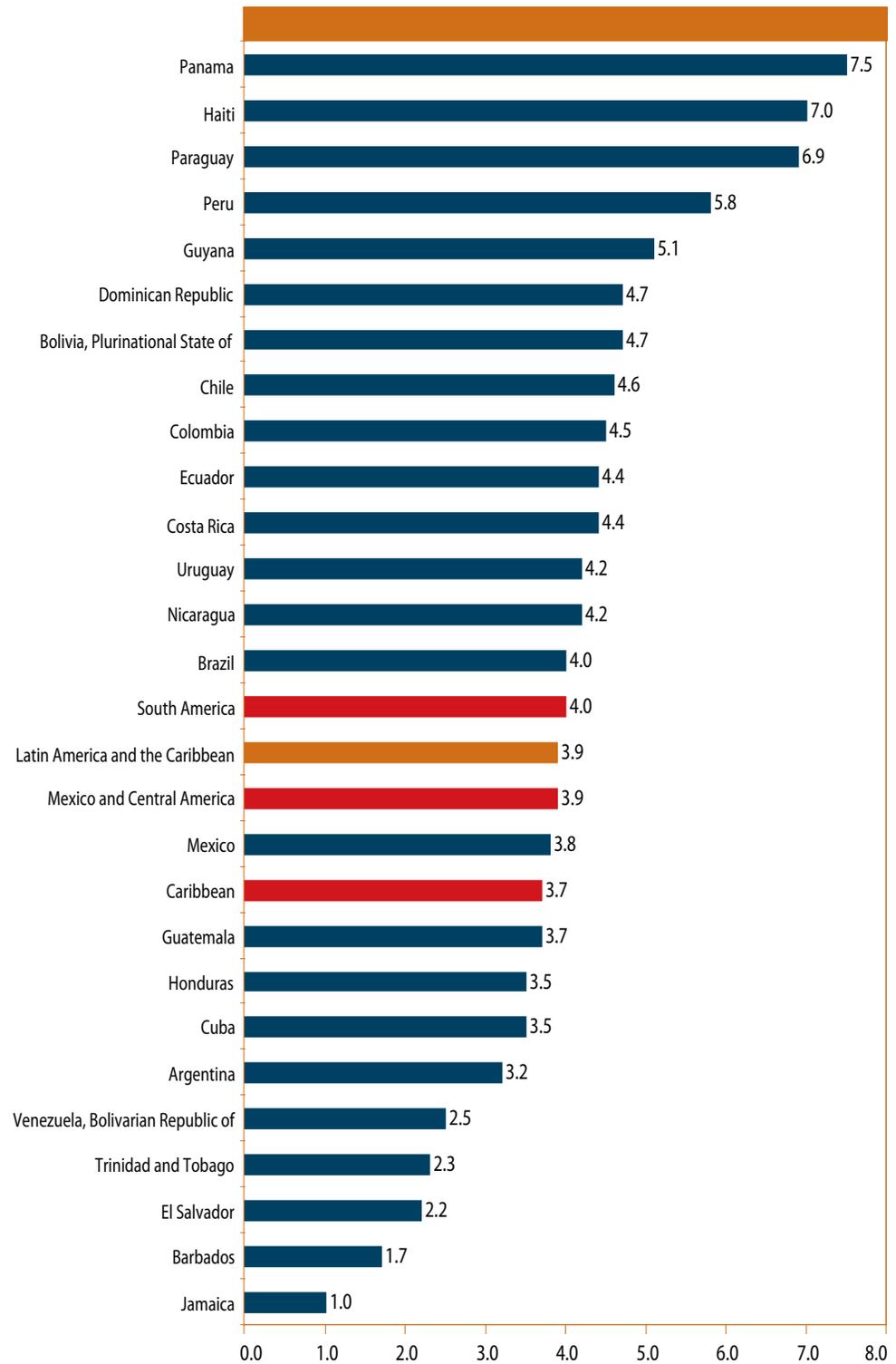
Uncertain outlook for oil prices weighs on risk perceptions in the region

Latin America and the Caribbean: a modest acceleration in growth is expected

Latin America and the Caribbean are expected to see a modest acceleration in growth to 3.9 per cent in 2013, up from 3.1 per cent in 2012. This continued solid growth trajectory is closely tied to the performance of the Brazilian economy, which is expected to expand by 4.0 per cent in 2013. Mexico and Central America are forecast to average a growth rate of 3.9 per cent, similar to that of 2012, but vulnerable to economic conditions in the United States. In line with the regional picture, the Caribbean countries will register an acceleration in growth to 3.7 per cent in 2013, 0.8 percentage points higher than in 2012 (figure IV.10).

During 2012, economic conditions deteriorated as the stagnation in the developed world and the slowdown in China affected exports from the region. As a result, GDP growth decelerated to 3.1 per cent in 2012, from 4.3 per cent in 2011 and 6.0 per cent in 2010. Economic growth in South American countries slowed to 2.7 per cent, with Brazil and Argentina contributing greatly to the overall picture. Resilient domestic demand continues to drive growth in most of Latin America. Net export demand expanded in Mexico and Central America, benefitting from the fragile recovery in the United States, while South American economies were mainly affected by the economic slowdown in China

Figure IV.10
GDP growth forecasts in Latin America and the Caribbean, 2013



Source: UN/DESA.

and the euro area recession. Indeed, the trade sector constitutes the main impact channel of the global downturn in the region (box IV.4). The dire economic situation in Europe is further transmitted to the region through lower workers' remittances, affecting Colombia and Ecuador in particular.

Despite the 2012 slowdown, labour market indicators continued to show a good performance, evidenced by continued increases in employment rates, higher real wages, increased female participation rates and lower unemployment. For the region as a whole, urban unemployment reached a historic low of 6.4 per cent in 2012. In the first half of the year, it was less than 6 per cent in Brazil, Ecuador, Mexico, Panama and Uruguay. Improved employment conditions strengthened private consumption, a key driver of GDP growth in recent years. During 2012, however, some signs of weakening emerged. Job creation slowed in Argentina, the Bolivarian Republic of Venezuela, Paraguay and Peru. Nonetheless, employment conditions are likely to remain steady without much further improvement during 2013.

The outlook for inflation is fairly stable. The average annual inflation rate for the region was 6.0 per cent in 2012, down by 0.9 percentage points from 2011, and is expected to average 6.0 per cent in 2013. Increasing inflationary pressures might emerge if the shifts towards more expansionary monetary policies are pushed much further, or if there is a new surge in international food prices, especially for grains, which would affect inflation in Central America and the Caribbean in particular. However, there is no clear sign that core inflation is trending upward.

Most countries in the region still have monetary policy space to promote economic activity should global or domestic economic conditions deteriorate in 2013. However, given already robust private consumer demand, monetary expansion would need to be cautious. About half of the economies in the region began providing more monetary stimulus when the global downturn began to affect exports and economic growth. The most notable case is Brazil, which started to reduce interest rates in August 2011. The central bank has since reduced the reference rate by 525 basis points to a historic low of 7.25 per cent. Colombia, the Dominican Republic, Guatemala and Paraguay also reduced policy rates.

The exchange rates remain at higher levels compared to those before the global downturn, but there were diverging trends during 2012. Colombia, Chile and Peru have experienced an appreciation of their domestic currencies, while Brazil and Argentina saw theirs depreciate. The volatile behaviour of capital markets and exchange rates led many central banks, for example those of Argentina, Bahamas, Brazil, Colombia, Peru and Uruguay, to intervene actively in foreign-exchange markets. The tendency towards foreign-exchange purchases suggests that central banks were more concerned about avoiding local currency appreciation than depreciation. As a result, most countries increased their level of international reserves in the last year. Looking ahead, the QE measures in developed economies will likely underpin further appreciation pressures, which might lead to additional interventions. Some countries continued to implement other macroprudential policies, like financial regulation reforms, changes to the reserve requirements and liquidity injections. The Government of the Plurinational State of Bolivia, for example, implemented a temporary tax on dollar sales, amounting to 0.7 per cent of the transaction value.

Fiscal balances are expected to move towards further consolidation in 2013. The budget deficit averaged 2.0 per cent of GDP for the region as a whole in 2012. The primary budget balance also showed a small deficit of 0.1 per cent of GDP. Nevertheless, fiscal conditions vary widely across countries. Many have ample space to conduct countercyclical

Labour market indicators will remain strong

Monetary policy has shifted from targeting inflation to promoting economic activity

Many countries are well positioned to implement countercyclical fiscal policies

fiscal policies. South American countries like Chile, Peru and the Plurinational State of Bolivia have relatively more fiscal space. In addition, Chile, Ecuador and Peru recently introduced tax reforms aimed at increasing the tax base. By contrast, chronic deficits in Central America have become a concern, but recent tax and other fiscal reforms in El Salvador, Guatemala, Honduras, Nicaragua and Panama are expected to improve fiscal balances in the coming years. Meanwhile, Caribbean public deficits also widened during the crisis owing to increased spending. In most Caribbean countries, public debt as a percentage of GDP remains very high.

The region's current-account deficit is widening

Given the slowdown in exports, current-account balances in the region are expected to deteriorate for the mineral exporters, in particular. For the region as a whole, trade surplus declined in value terms in 2012, as export growth slowed to 2.0 per cent while import growth accelerated to 7.5 per cent. The export growth slowdown is attributable mainly to the fall in exports from South America to the EU and China, with Argentina, Brazil and Chile being especially affected by the decline in exports to China (box IV.4). By contrast, exports from Central America and Mexico to the EU still increased. In addition, international prices for the region's main export commodities showed declines in 2012, so that the regional terms of trade also suffered a slight decline. Only the hydrocarbon-exporting countries and exporters of food products, like Argentina, Paraguay and Uruguay, posted an increase in their terms of trade.

Downside risks will affect South America more strongly

The major risks are tilted towards the downside of the baseline estimations. A more pronounced slowdown or renewed financial turmoil in the euro area would have a relatively modest effect in the region as a whole, but it would affect South America more strongly. South American countries in particular, however, have policy space left to respond with countercyclical measures. A worsening scenario in the United States would most strongly affect the Caribbean, Central America and Mexico through export, tourism and workers' remittances channels. Additionally, a hard landing in China would strongly affect the countries in South America that are heavily reliant on primary commodity exports. Finally, there is also an increasing concern in relation to the QE measures implemented in developed countries, particularly regarding the potential effects of capital flow and exchange-rate volatility. Considering the current slowdown in regional exports, further currency appreciation would provide a disincentive to economic diversification.

Box IV.4

The effects of the global downturn on Latin American exports

Over the past decade, a main driver of growth in Latin America and the Caribbean has been the higher demand for its export products, most notably the primary goods exported by South American countries. However, the current global economic slowdown reduced the region's growth rate of merchandise exports from 28 per cent in the first half of 2011 to a mere 4 per cent in the first half of 2012. This slowdown reflects less rapid growth in volumes and a fall in the prices of export goods. The most significant decline has been seen in shipments to the EU, with export values falling by 4 per cent during the period (table). While the average price of export goods decreased by 3.4 per cent, the prices for mineral and metal exports declined more significantly by 9.1 per cent.

The global downturn has brought about a deceleration in growth across the board for Latin American exports, but the severity of the impact varies considerably. South American countries have been most adversely affected, largely owing to their heavy dependence on primary commodities as principal export products. The mineral and metal exporters (Chile, Peru), and Brazil have seen the highest reduction in the value of their exports during the first half of 2012. Although this result

Box IV.4 (cont'd)

can partly be attributed to a deceleration in the growth of export volumes, it is predominantly owing to a significant drop in the prices of the raw materials exported by these countries. In the first half of 2012, prices of raw materials declined on average by 6 per cent from a year ago. A second factor behind the fall in the value of South American exports is the relative importance of the EU as a destination market. In fact, the most severe drop in exports for these countries in 2012 was registered in their trade with the euro area. By contrast, South America's energy exporters experienced a significant increase in the export value, averaging 9.9 per cent in the first half of 2012. This can be attributed to the sustained high price of oil and increased oil demand from European countries, following the tightening of EU sanctions against the Islamic Republic of Iran.

While Mexico and the Central American countries have also seen a significant slowdown in export growth in 2012, these countries still continued to register a moderate increase compared to the previous year. Costa Rica even saw a higher growth rate in the first half of 2012 compared to 2011, rising from 8 per cent to 12 per cent. The relatively stronger performance of this subregion reflects the greater share of manufactured goods in the export basket and the predominance of the United States as trading partner. Over the past year, growth of import demand in the United States, while still sluggish, outpaced that of other developed regions.

In sum, the global downturn has affected the economies of Latin America and the Caribbean primarily through the export channel, with significant reductions in the prices of many major export products. This slowdown in export growth not only affects GDP growth directly but also indirectly through cutbacks or delays in investment. Indeed, many investment decisions in natural resource sectors in Latin America are mainly driven by the fluctuations of international commodity prices. This situation highlights the prospective additional constraints that the current quantitative easing measures in the developed world—through their potential effect on the region's currencies—might put on regional growth.

Latin America: year-on-year export changes, first half of 2012

Percentages							
Region/Countries	Value	Volume	Price	Value by destination			
				USA	EU	Asia	Latin America
Latin America	4.1	7.5	-3.4	4.3	-4.0	7.5	3.1
Central America	4.2	7.4	-3.2	4.8	2.5	10.1	5.5
Exporters of hydrocarbons ^a	9.9	10.9	-1.0	-2.9	4.7	18.2	12.6
Exporters of minerals & metals ^b	-1.0	8.1	-9.1	-3.1	-16.0	4.4	2.2
Exporters of food ^c	-0.6	2.6	-3.2	8.7	-17.0	-1.4	-0.6
Brazil	-0.9	6.7	-7.6	17.4	-6.2	5.3	-7.9
Mexico	7.6	6.4	1.2	5.5	19.2	18.0	18.6

Source: UN/ECLAC.

^a Plurinational State of Bolivia, Ecuador, Bolivarian Republic of Venezuela and Colombia.

^b Chile and Peru.

^c Argentina, Paraguay, Uruguay.