Executive Summary

Prospects for global economic growth and sustainable development

The world economy is on the brink of another major downturn

As foreseen in last year’s issue of this report, the world economy weakened considerably in 2012. A growing number of developed economies, especially in Europe, have already fallen into a double-dip recession, while those facing sovereign debt distress moved even deeper into recession. Many developed economies are caught in downward spiralling dynamics from high unemployment, weak aggregate demand compounded by fiscal austerity, high public debt burdens, and financial fragility.

The economic woes of the developed countries are spilling over to developing countries and economies in transition through weaker demand for their exports and heightened volatility in capital flows and commodity prices. The larger developing economies also face home-grown problems, however, with some (including China) facing much weakened investment demand because of financing constraints in some sectors of the economy and excess production capacity elsewhere. Most low-income countries have held up relatively well so far, but are now also facing intensified adverse spillover effects from the slowdown in both developed and major middle-income countries. The prospects for the next two years continue to be challenging, fraught with major uncertainties and risks slanted towards the downside.

Growth of world gross product (WGP) is expected to reach 2.2 per cent in 2012 and is forecast to remain well below potential at 2.4 per cent in 2013 and 3.2 per cent in 2014 (figure O.1). At this moderate pace, many economies will be unable to recover the severe job losses of the Great Recession.

Figure 0.1
Weakening and highly uncertain outlook for the world economy

Percentage change

Source: UN/DESA.
a Growth rate for 2012 is partially estimated. Estimates for 2013 and 2014 are forecasts. See "Uncertainties and risks" section for a discussion of the downside scenario and box I.3 for a discussion of the policy scenario.
The global jobs crisis continues

Global unemployment remains very high, particularly among developed economies, with the situation in Europe being the most challenging. The unemployment rate continued to climb, reaching a record high of nearly 12 per cent in the euro area during 2012, an increase of more than one percentage point from one year ago. Conditions are worse in Greece and Spain where more than a quarter of the working population is without a job. Only a few economies in the region, such as Austria, Germany, Luxembourg and the Netherlands, register low unemployment rates of about 5 per cent. Unemployment rates in Central and Eastern Europe edged up slightly in 2012, partly resulting from fiscal austerity. Japan’s unemployment rate retreated to below 5 per cent. In the United States, the unemployment rate stayed above 8 per cent for the most part of 2012, but dropped to just below that level from September onwards.

At the same time, long-term unemployment (over one year) in developed economies stood at more than 35 per cent by July 2012, affecting about 17 million workers. Such a prolonged duration of unemployment tends to have significant, long-lasting detrimental impacts on both the individuals who have lost their jobs and on the economy as a whole.

In the outlook, greater and more sustainable job creation should be a key policy priority in developed economies. If economic growth stays as anaemic in developed countries as projected in the baseline forecast, employment rates will not return to pre-crisis levels until far beyond 2016 (figure O.2).

The employment situation varies significantly across developing countries. Unemployment rates in most economies in East Asia and Latin America have already retreated to, or dropped below, levels seen prior to the global financial crisis. The growth moderation in late 2011 and 2012 has so far not led to a discernable rise in the unemployment rate in these two regions—a positive sign, with the caveat that a rise in the unemployment rate would usually lag in an economic downturn. If the growth slowdown continues, the unemployment rate could increase significantly. In Africa, despite relatively strong GDP growth, the employment situation remains a major problem across the region,

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

Note: The chart shows percentage changes of total employment (as a moving average) with respect to pre-recession peaks. Projections (dashed lines) are based on estimates of the output elasticity of employment (Okun's law), following a similar methodology to that of ILO, World of Work Report 2011 (Geneva).
both in terms of the level of employment and the quality of jobs that are generated. The latter remains a common challenge for developing countries. The shares of working poor remain high and most workers tend to be employed in vulnerable jobs in still expanding informal sectors. Furthermore, youth unemployment and gender disparities in employment remain key social and economic concerns in many developing countries.

**Poverty reduction and progress towards other MDGs may slow**

The global slowdown and increased risks to the employment situation in developing countries will imply a much slower pace of poverty reduction and a narrowing of fiscal space for investments in education, health, basic sanitation and other critical areas needed for accelerating the progress towards achieving the Millennium Development Goals (MDGs). This holds true in particular for the least developed countries (LDCs); they remain highly vulnerable to commodity price shocks and are receiving less external financing as official development assistance (ODA) declines in the face of greater fiscal austerity in donor countries.

**Global trends in greenhouse gas emissions remain alarming**

Helped by weaker global economic growth, greenhouse gases (GHGs) emitted by the Annex I countries to the Kyoto Protocol are estimated to have fallen by about 2 per cent per year during 2011-2012. This reverses the 3 per cent increase in GHG emissions by these countries in 2010. Emissions fell by 6 per cent in 2009 with the fallout in gross domestic product (GDP) growth caused by the Great Recession. With the more recent decline, GHG emission reductions are back on the long-run downward trend. Given the further moderation in global economic growth, emissions by Annex I countries are expected to decline further during 2013-2014. As a group, Annex I countries have already achieved the target of the Kyoto Protocol to reduce emissions by at least 5 per cent from 1990 levels during the 2008-2012 commitment period.

At the same time, however, GHG emissions in many developing countries are increasing at a rapid pace, and, in all, the world is far from being on track to reduce emissions to the extent considered necessary for keeping carbon dioxide (CO₂) equivalent concentrations to less than 450 parts per million (consistent with the target of stabilizing global warming at a temperature increase of 2°C or less as compared to pre-industrial levels). To avoid exceeding this limit, GHG emissions would need to drop by 80 per cent by mid-century. At current trends and even with the extension of the Kyoto Protocol, this is an unachievable target. “Greener” growth pathways need to be created now. Despite their large investment costs, they would also provide opportunities for more robust short-term recovery and global rebalancing.

**Inflation remains subdued in most developed economies . . . .**

Inflation rates remain subdued in most developed economies. Continuing large output gaps and downward pressure on wages in many countries are keeping inflationary expectations low. Inflation in the United States moderated over 2012, down to about 2.0 per cent from 3.1 per cent in 2011. A further moderation in headline inflation is expected in the outlook for 2013. In the euro area, headline inflation continues to be above the central banks’ target of 2 per cent. Core inflation, which does not include price changes in volatile items such as energy, food, alcohol and tobacco, has been much lower, at about
1.5 per cent, with no evidence of upward pressures. In the outlook, inflation is expected to drift down slowly. Inflation in the new EU members is also expected to lessen. Deflation continues to prevail in Japan, although the central bank has raised its inflation target to boost inflation expectations.

...and is receding in most but not all developing countries

Inflation receded in a majority of developing countries during 2012, but remains stubbornly high in some. In the outlook, anticipated increases in world food prices provoked by droughts in various producer regions, persistently high oil prices and some country-specific supply-side constraints may continue to put some pressures on inflation in developing countries in 2013 and into 2014. In Africa, while inflation moderated in many economies, the rate of inflation is still above 10 per cent in Angola, Nigeria, and elsewhere. Inflation is expected to remain subdued in most of East Asia, but is still a concern for most countries in South Asia, where inflation rates were over 11 per cent in 2012, on average, and are forecast to remain above or near 10 per cent in 2013 and 2014. Inflation remains low in most economies in West Asia, although it is still high (above 10 per cent) in Yemen and very high (30 per cent) in the Syrian Arab Republic. The inflation rate in Latin America and the Caribbean is expected to stay at about 6 per cent.

International trade and commodity prices

The expansion of world merchandise trade is decelerating sharply

Growth of world trade decelerated sharply for the second year in a row, dropping from 12.6 per cent in 2010 to 6.4 per cent in 2011 and 3.2 per cent in 2012. Feeble global economic growth, especially in Europe and other developed economies, is the major factor behind the deceleration. In the baseline outlook, world trade growth will pick up moderately in 2013 and return to near its long-term average growth rate of 5 per cent in 2014. However, developing countries were more resilient to the renewed slowdown and their importance in world trade continues to increase, along with their integration in global value chains.

Commodity prices remain high and volatile

For many commodities, the high price level reached in 2011 extended in 2012 with some significant bouts of volatility. After peaking during the first quarter of the year in the wake of the European Central Bank’s (ECB) long-term refinancing operations having nurtured misperceptions about a rapid economic recovery, most commodity prices declined slightly during the second quarter. Prices of food and oil remained elevated in the third quarter, however, as a result of adverse weather conditions in many countries and renewed strategic risk in the Middle East. By contrast, a grim global economic outlook further depressed prices of minerals, metals and ores. In the outlook, commodity exporters that have benefited from improved terms of trade over the last few years remain exposed to downward price pressures. Financial speculation and the development of new commodity-backed financial products may further amplify commodity price volatility in a context of abundant liquidity. Food prices are expected to moderate somewhat with slowing global demand and assuming favourable weather conditions. However, given that markets are very tight and stock-to-use ratios for most staple foods are very low, even relatively minor supply shocks may easily cause new price spikes.
Expanding trade in services is increasing global greenhouse gas emissions

The strong recovery of trade in services experienced across all regions and groups of countries in 2010 began faltering during the last quarter of 2011. While the financial sector has contracted in some developed countries, the carbon emission-intensive transport and travel sectors keep expanding in developing countries. Freight transport services continue to grow along with the expansion of trade through global value chains. While increasingly important as a source of foreign-exchange earnings, especially for developing countries, expanding freight transport is also significantly contributing to global CO₂ emissions (figure O.3). Policymakers worldwide need to pay greater attention to this negative externality arising from the environmentally suboptimal organization of production through global value chains.

Figure 0.3
CO₂ emissions from transport and share of trade in world gross product move in tandem

International financing for development

Private capital flows remain volatile

Since the crisis, international private capital flows to emerging and developing countries have remained extremely volatile. While some stability appeared in international currency and capital markets during the early months of 2012, there was renewed volatility later, owing in part to growing fears among portfolio investors about the sustainability of public finances in Europe that prompted a “flight to safety”. In addition, many European banks continue to face deleveraging pressures, which has led to cutbacks in lending to developing and transition economies. Signs of an economic slowdown in Brazil, China and India have reduced flows to these countries.
**International reserves accumulation moderated**

The pace of reserve accumulation by developing countries and economies in transition moderated somewhat in 2012, influenced by weaker capital inflows. Yet, the continued accumulation of international reserve holdings is reflective of continued concerns with global economic uncertainties and a perceived need for “self-insurance” against external shocks. The increased monetary reserves held in currencies of the major developed countries by far outweigh capital inflows and, as a result, developing countries and economies in transition continue to make substantial net financial transfers to developed countries. In 2012, these net outflows amounted to an estimated $845 billion, down from $1 trillion in 2011. LDCs, however, received positive net transfers of an estimated $17 billion in 2012 (figure O.4).

![Figure 0.4](image-url)

**Continued net financial transfers from developing to developed countries**

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**Source:** UN/DESA.

**Note:** Figures for 2012 are partly estimated.

**Official development assistance is falling**

Net ODA flows from member countries of the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD) reached $133.5 billion in 2011, up from $128.5 billion in 2010. In real terms, however, this represents a fall of 3 per cent, widening the delivery gap in meeting internationally agreed aid targets to $167 billion. Preliminary results from the OECD survey of donors’ forward spending plans indicate that Country Programmable Aid (CPA)—a core subset of aid that includes programmes and projects that have predicted trends in total aid—is expected to increase by about 6 per cent in 2012, mainly on account of expected increases in outflows of soft loans from multilateral agencies that had benefited from earlier fund replenishments. However, CPA is expected to stagnate from 2013 to 2015, reflecting the delayed impact of the global economic crisis and fiscal policy responses on donor country aid budgets.
Uncertainties and risks

A worsening of the euro area crisis, the “fiscal cliff” in the United States and a hard landing in China could combine to cause a new global recession

The baseline outlook is subject to major uncertainties and risks, mostly on the downside.

First, the economic crisis in the euro area could continue to worsen and become more disruptive. The ongoing perilous dynamics between sovereign debt distress and banking sector fragility are deteriorating the balance sheets of both Governments and commercial banks. The fiscal austerity responses are exacerbating the economic downturn, inspiring self-defeating efforts at fiscal consolidation and pushing up debt ratios, thereby triggering further budget cuts. The situation could worsen significantly with delayed implementation of the Outright Monetary Transactions programme and other supports for those members in need. Such delays could come as a result of political difficulties in reaching agreement between the countries in need of assistance and the troika of EU, ECB and IMF, and/or much larger detrimental effects of the fiscal austerity programmes and more difficulties in structural adjustments than anticipated. In such a scenario, as simulated through the United Nations World Economic Forecasting Model, the euro area could suffer an additional cumulative output loss of more than 3 per cent during 2013-2015 and the world as a whole of more than 1 per cent (see figure O.5).

Second, the United States could fail to avert the so-called fiscal cliff. A political gridlock preventing Congress from reaching a new budget agreement would put automatic fiscal cuts in place, including a drop in government spending by about $98 billion and tax increases of $450 billion in 2013; taken over 2013-2015, the automatic fiscal austerity would amount to about 4 per cent of GDP. In the fiscal cliff scenario, world economic growth would be halved to 1.2 per cent in 2013 and by 2015 global output would be 2.5 per cent lower than in the baseline projection. The output loss for developing countries would be about 1 per cent.
A third downside risk is the possibility of a hard landing of the economies of one or more of the large developing countries, including China. Growth slowed noticeably during 2012 in a number of large developing economies, such as Brazil, China and India, that had enjoyed a long period of rapid growth prior to the global financial crisis and managed to recover quickly at a robust pace in 2010 after the Great Recession. Given the uncertainties about their external demand and various domestic growth challenges, risks of further and larger-than-expected declines in the growth of these economies are not trivial. In the case of China, for instance, exports continued to slow during 2012, owing to weak demand in major developed economies. Meanwhile, growth in investment, which contributed to more than 50 per cent of GDP growth in the past decade, has been decelerating. The reasons for this are tighter housing market policies, greater caution regarding fiscal stimulus measures, and financing constraints faced by local governments in implementing new projects. Because of these factors, there are substantial risks for much lower GDP growth in China. If economic growth in China would slow to about 5 per cent per year (caused by a further deceleration in investment growth, continued tightening of the housing market and absence of new fiscal stimulus), developing countries as a group could suffer a cumulative output loss of about 3 per cent during 2013-2015 and the world as a whole of about 1.5 per cent.

**Policy challenges**

*Present policy stances fall short of what is needed for economic recovery and addressing the jobs crisis*

Weakening economic growth and policy uncertainties cast a shadow over the global economic outlook. As indicated, most developed countries have adopted a combination of fiscal austerity and expansionary monetary policies aimed at reducing public debt and lower debt refinancing costs in order to break away from the vicious dynamics between sovereign debt and banking sector fragility. Hopes are that this will calm financial markets and restore consumer and investor confidence. Together with structural reforms to entitlement programmes, labour markets and business regulation, such an improved environment should help restore economic growth and reduce unemployment. However, controlling debt stocks is proving to be much more challenging than policymakers expected.

An additional problem is that fiscal consolidation efforts of most developed countries rely more on spending retrenchment than improving revenue collection. The former tends to be more detrimental to economic growth in the short run, particularly when the economy is in a downward cycle. In many developed countries, public investment is being cut more severely than any other item, which may also prove costly to medium-term growth. In most cases, spending cuts also involve entitlement reforms, which immediately weaken automatic stabilizers in the short run by curtailing pension benefits, shortening the length of unemployment benefit schemes and/or shifting more of the burden of healthcare costs to households. Moreover, the fiscal austerity measures induce greater inequality in the short run, which could reduce social mobility and productivity growth in the long run.

Most developing countries and economies in transition have relatively stronger fiscal positions. Some have opted to put fiscal consolidation on hold in the face of global economic weakening. Fiscal deficits may rise in most low-income countries with slowing
government revenue from commodity exports and the growing weight of food and energy subsidies. Concerns are also mounting in developing countries about the possible adverse effects of quantitative easing (QE) on the financial and macroeconomic stability of their economies as it may increase volatility in the international prices of commodities, capital flows and exchange rates.

Current policy stances seem to fall well short of what is needed to prevent the global economy from slipping into another recession.

More forceful and concerted actions are needed to generate growth and create jobs

The sobering outlook for the world economy and the enhanced downside risks call for much more forceful action. Those efforts will be challenging. At the same time, however, they will provide opportunities to better align policy actions addressing the immediate challenges with long-term sustainable development objectives.

Addressing policy uncertainties

A first challenge will be to reduce the high degree of policy uncertainty associated with the three key risks discussed in the downward scenario. These risks must be addressed immediately through shifts in policy approach and greater consideration of international spillover effects of national policies. In the euro area, the piecemeal approach to dealing with the debt crises of individual countries of the past two years should be replaced by a more comprehensive and integrated approach so as to address the systemic crisis of the monetary union. Policymakers in the United States should prevent a sudden and severe contraction in fiscal policy and overcome the political gridlock that was still present at the end of 2012. The major developing countries facing the risk of hard landings of their economies should engage in stronger countercyclical policy stances aligned with measures to address structural problems over the medium term. China, for instance, possesses ample policy space for a much stronger push to rebalance its economy towards domestic demand, including through increased government spending on public services such as health care, education and social security.

Making fiscal policy more countercyclical, more supportive of jobs creation and more equitable

In addition, fiscal policy should become more countercyclical, more supportive of jobs creation and more equitable. The present focus on fiscal consolidation in the short run, especially among developed countries, has proven to be counterproductive and to cause more protracted debt adjustment. The focus needs to shift in a number of different directions. A first priority of fiscal adjustment should be to provide more direct support to output and employment growth by boosting aggregate demand and, at the same time, spread out plans for achieving fiscal sustainability over the medium-to-long term. Moreover, fiscal multipliers tend to be more forceful during a downturn, but can be strengthened further by shifting budget priorities to growth-enhancing spending, undoing cuts in public investment and expanding subsidies on hiring. In addition, the distributional consequences of fiscal policies should be duly considered, not only for equity reasons, but also because of their implications for growth and employment generation. Finally, economic recovery can be strengthened in the short and longer run by promoting green growth through fiscal incentives and investments in infrastructure and new technologies.
Global financial market instability needs to be attacked at its root causes

Global financial market instability needs to be attacked where it originates. This challenge is twofold. First, greater synergy must be found between monetary and fiscal stimulus. Continuation of expansionary monetary policies among developed countries will be needed, but negative spillover effects into capital-flow and exchange-rate volatility must be contained. This will require reaching agreement at the international level on the magnitude, speed and timing of QE policies within a broader framework of targets to redress global imbalances. The second part of the challenge is to accelerate regulatory reforms of the financial sector at large, including shadow banking. This will be essential in order to avoid the systemic risks and excessive risk-taking that have led to the low-growth trap and financial fragility in developed countries and high capital flow volatility for developing countries.

Sufficient resources need to be made available to developing countries

Sufficient resources must be available to developing countries, especially those possessing limited fiscal space and facing large development needs. These resources will be needed to accelerate progress towards the achievement of the MDGs and for investments in sustainable and resilient growth, especially for the LDCs. Fiscal austerity among donor countries has also affected aid budgets, as seen in the decline of ODA in real terms in 2011. Further declines are expected in the outlook. Apart from delivering on existing aid commitments, donor countries should consider mechanisms to delink aid flows from their business cycles so as to prevent delivery shortfalls in times of crisis when the need for development aid is most urgent.

A scenario of concerted policies for more sustainable growth and jobs recovery is feasible

A jobs creation and green growth-oriented agenda as outlined above is compatible with medium-term reduction of public debt ratios and benign global rebalancing, according to a policy scenario analysis using the United Nations Global Policy Model. With continued existing policies, but assuming no major deepening of the euro crisis, growth of WGP would average, at best, about 3 per cent per year, far from sufficient to deal with the jobs crisis or bring down public debt ratios. The alternative scenario, based on the agenda outlined above, would support an acceleration of world economic growth to 4.5 per cent per year between 2013 and 2017, while public debt-to-GDP ratios would stabilize and start falling in 2016 or earlier. Employment levels in major developed countries would gradually increase and return to pre-crisis levels in absolute terms by 2014, and by 2017 after accounting for labour force growth. The employment recovery would thus come much sooner than in the baseline, although remaining protracted even with the suggested internationally concerted strategy for growth and jobs. An additional 33 million jobs per year on average would be created in developing and transition economies between 2013 and 2017.