

Chapter IV

Regional developments and outlook

Developed market economies: recovery weakens with ominous overtones

Growth in the developed market economies is slowing and the risks of recession have increased dramatically. The post-recession recovery was already weak, which is typical of recoveries following financial crises where bank lending is constrained as balance sheets are repaired and consumers increase savings rates to make up for large losses in wealth and high levels of debt. Due to the loss of revenue and increased expenditures incurred, the recession also left Governments with greatly elevated levels of budget deficits and debts that have now led to considerable pressure for budget consolidation in most countries. High levels of unemployment in many developed countries are a most bitter legacy of the recession. These have hardly budged since the onset of the recovery, and threaten to become entrenched.

The recovery to date has been heavily dependent on external demand emanating from the emerging markets and the remnants of fiscal and monetary stimuli enacted during the recession. Headwinds began to emerge as oil prices spiked early in the year, the multifaceted disaster in Japan disrupted global manufacturing supply lines and demand from emerging markets began to decelerate. The largest shock, however, was the emergence of the sovereign debt crisis in Europe. The crisis is having multiple negative impacts on economic activity. It has forced affected countries to adopt extreme fiscal tightening programmes that have pushed them close to or into recession and generally increased pressure for fiscal austerity across the region. It has led to renewed financial crisis where sharp increases in sovereign bond spreads for the affected countries have weakened the balance sheets of banks holding this debt, causing further turmoil in an already delicate banking system, currency swings as investors search for safe havens and general turbulence in financial markets. It has also plunged the confidence of both producers and consumers, thereby affecting consumption and investment spending. The baseline forecast assumes that the crisis remains contained (see box I.1 for a more complete discussion of the underlying assumptions), but the risks of a considerably less favourable outcome have increased.

North America

United States of America: growth decelerating and dangers from fiscal impasse

During the first half 2011, economic growth in the United States decelerated significantly to an annualized rate of 0.8 per cent from 3.0 per cent for 2010 as a whole. Among other things, the spike in world oil prices beginning in late 2010 and the impact of the earthquake in Japan on the supply chains to industrial producers were two important causes for this slowdown. During the third quarter, many survey-based indicators plummeted close

to recession levels. Nevertheless, hard data covering this period showed that growth actually accelerated. For the whole of 2011, gross domestic product (GDP) is expected to grow by 1.7 per cent, followed by 1.5 per cent and 2.0 per cent for 2012 and 2013, respectively (see annex table A.1).

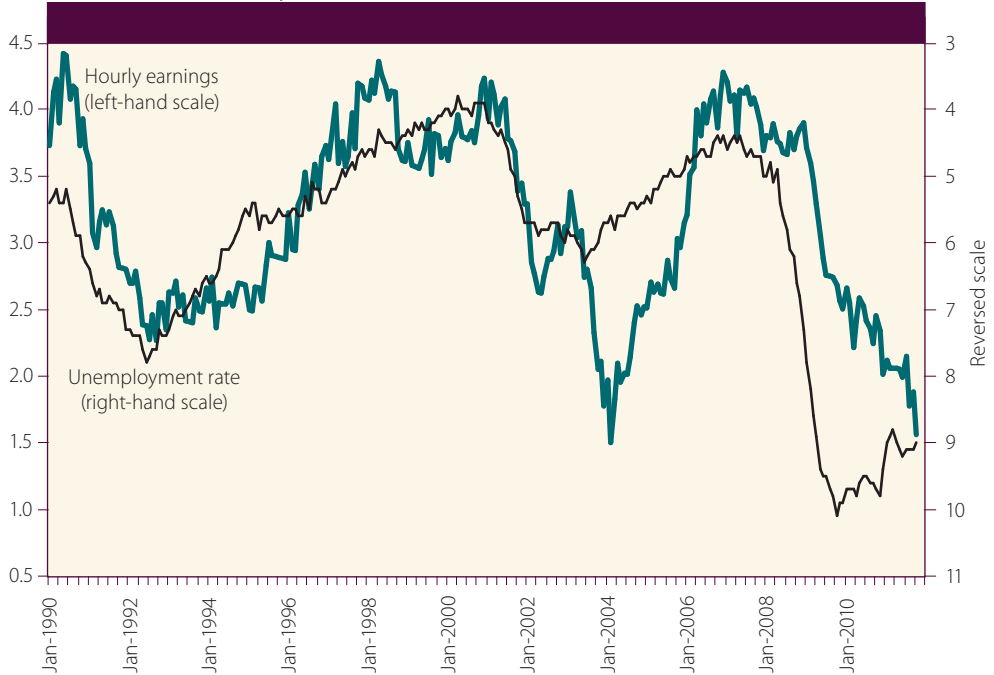
Personal consumption expenditure is expected to remain modest in the outlook conditioned on three major factors: a historically weak labour market, a continued balance-sheet adjustment by households and the impact of the shift to fiscal austerity. First, the situation for employment has been dismal, with the unemployment rate staying at about 9 per cent throughout 2011. Almost no improvement is expected in 2012 and 2013 (annex table A.7). After almost two years of recovery, the number of payroll employees is still more than 4 per cent lower than its pre-crisis peak. The slack in the labour market also dampened wage growth (figure IV.1). Consequently, total labour income for households in nominal terms was only about 2 per cent higher in 2011 than in 2008. Second, households have yet to fully repair their balance sheets, damaged from the financial crisis and the collapse in the housing market. Although house prices seemed to be approaching stabilization in late 2011, their level is still more than 25 per cent below their peak in 2006. The value of real estate owned by households suffered a loss of similar magnitude, while on the liability side, outstanding mortgages declined by only about 6.5 per cent over the same period. Financial assets held by households almost resumed their pre-crisis level by mid-2011, but the volatile developments in global equity markets have contributed to a heightened level of caution by consumers. Under all these pressures, private consumption growth is projected to be about 2 per cent per year over the baseline forecast period.

The third restraining factor comes from public finance. It is assumed that the economy will receive only minor fiscal stimulus over the forecast period. After the

Households are cautious about increasing spending

Fiscal support for growth is declining fast

Figure IV.1
Unemployment rate^a and hourly earnings^b in the United States, January 1990–October 2011



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

a Seasonally adjusted civilian unemployment rate (percentage).

b Annual percentage of average hourly earnings of production and non-supervisory employees, total private sector.

acceleration in federal Government debt accumulation during the recession, policy shifted towards a strategy to stabilize the debt situation over time. Unfortunately, since the 2010 mid-term elections, the decision-making-process has become extremely protracted. The federal Government budget for fiscal year 2011, which ended in September 2011, was not finalized until April 2011, and the impasse during that process almost forced a shutdown of the federal Government. In July 2011, the battle resumed, this time over raising the debt ceiling, which became coupled with a major political struggle over how to cut the fiscal deficit, and raised the spectre of a possible default. Although a stop-gap agreement was finally reached at the last minute to avoid the much feared default on the Treasury securities, it was not enough to stop one credit rating company (Standard & Poor's) from downgrading the rating for United States Treasury long-term securities by one notch. The low level of consumer and business confidence observed in August and September 2011 was strongly connected to these developments. The special committee set up under that agreement failed to reach a deal for deficit reduction by the sanctioned deadline, and long-term action to cut spending may take effect in 2013. In the baseline scenario outlook, it is assumed however, that two elements of the proposed American Jobs Act—the payroll tax holiday and emergency unemployment compensation—will be enacted in 2012. The federal fiscal deficit is projected to decline from a level of 8.6 per cent of GDP for fiscal year 2011 to 5.2 per cent for fiscal year 2013.

In the forecast, residential fixed investment, while not expected to provide significant support to growth, will not have the same dampening effect that it did over the period 2008-2010. Business investment, however, is expected to provide noticeable support. Many large profit-making corporations have accumulated huge amounts of very liquid assets over the course of the recovery. Interest rates remain low due to the continuing expansionary monetary policy. For those businesses with access to bank lending or those that can raise funds from financial markets, the financing cost for new investment is very low by historical standards. Investment in equipment and software, which has been expanding strongly since the onset of the recovery, is expected to continue to grow, albeit at a reduced pace over 2012 and 2013.

The United States dollar has depreciated by about 25 per cent over the past decade,¹ despite the period of appreciation that occurred during the recession. As a consequence, the trade balance has improved in real terms, and helped support growth particularly during the recession. Going forward, net exports are expected to continue to support growth, but will make a smaller contribution. This is because part of the boost to growth during the recession was technical in nature, stemming from the dramatic drop in imports. In the outlook, real export growth is projected to continue to outpace that of real imports, but given the large external deficit at the start of the forecast, the level of the current-account deficit will hardly change. However, as a ratio to nominal GDP, it will average about 3.5 per cent over forecast period, much lower than the level observed before the crisis.

During the recession, the United States Federal Reserve (Fed) introduced two rounds of quantitative easing (QE) actions, under which it purchased large amounts of long-term securities from the market. By doing so, it brought down the interest rate on long-term securities. According to the Fed's communications, market concerns regarding a possible double-dip recession and deflation were the motivating factors behind these actions. In September 2011, the Fed announced a new policy stating that by the end of June

Investment may be solid despite heightened uncertainty

The external balance has improved somewhat

Monetary policy is still providing limited support

¹ Measured on a broad index against other currencies.

2012, it would swap \$400 billion worth of Treasury securities maturing within 3 years or less into Treasury securities maturing within 6 to 30 years, the so-called Operation Twist. The Fed is hoping to further reduce long-term interest rates. However, long-term interest rates were already very low, even before the Fed's last action, and it remains to be seen how much further downward adjustment this operation can create. In the outlook, it is assumed that there will be no more large-scale quantitative easing actions.

Downside risks abound

The risks to the baseline outlook for the United States economy are unfavourable. The key external risk is that the euro area sovereign debt crisis will evolve into a disorderly default and lead to crisis in European financial markets and economic recession. The direct impact on the financial institutions in the United States and linkage effects through lower profit-earning from Europe and reduced exports would retard growth. Domestically, the top concern is the fiscal adjustment. The Budget Control Act of 2011 set up a framework to reach an agreement to cut at least \$1.2 trillion from the federal budget deficit over ten years, with a default clause stating that if no agreement is reached, there will be automatic spending cuts of \$1.2 trillion. In addition, the debt ceiling will need to be raised and the Government will again go through the same fraught political procedure discussed previously. This may damage the confidence of consumers, businesses and financial markets, dragging down growth prospects. The housing market poses another domestic risk. A significant proportion of homeowners will still be holding negative home equity at the end of 2011. If house prices decline significantly, it could trigger another vicious circle of foreclosures and falling prices that would severely damage the balance sheets of banks and households.

Canada: facing increasing headwinds

After seven quarters of expansion, the Canadian economy declined slightly in the second quarter of 2011. Exports fell at the annualized rate of 8.3 per cent (quarter over quarter) causing GDP to decline by 0.4 per cent. Although growth has since resumed, many indicators suggest that the momentum is weak. For 2011 as a whole, GDP is expected to grow by 2.1 per cent, followed by 1.7 per cent and 2.3 per cent for 2012 and 2013, respectively.

The sharp drop in exports during the second quarter of 2011 was largely due to the disruption of the supply chain for auto production caused by the earthquake in Japan. Nevertheless, even after this impact faded, the external sector continued to hamper growth. The Canadian currency has appreciated significantly against the dollar over the past few years, weakening competitiveness in the United States market, which is the destination for more than 75 per cent of its exports. The tepid growth of the United States economy also limits the expansion of manufacturing exports. Consequently the current-account balance is expected to remain in deficit over the forecast period.

The current governing party gained a majority in parliament for the first time following a federal election in May, an outcome that will enhance its capacity to balance the federal budget by 2016. Based on this, it is assumed that Government expenditure (as a share of GDP) will fall over the forecast period.

Favourable financial conditions have boosted business investment, especially in machinery and equipment. This upward trend is expected to continue, though at a slower speed. The housing market expanded quickly in 2010, but has since shifted into lower gear. Household debt as a ratio of disposable income has increased from 110 per cent to the current 150 per cent over a decade, and may pose a risk going forward. For Canada, the most significant risk is a renewed recession in other developed economies, especially in the United States.

Developed Asia and the Pacific

Japan: earthquake recovery, but one threatened by slowing global demand

In the first half of 2011 and in the aftermath of the devastating earthquake in March, the economy of Japan contracted by about 3 per cent. While the recovery was strong in the third quarter, it tapered off towards the year's end. Though GDP is estimated to have fallen by 0.5 per cent for 2011 as a whole, growth of about 2 per cent, driven by post-quake reconstruction, is forecast for 2012 and 2013. However, much weaker demand in other major economies and challenges in the Government budget to finance the reconstruction could drag the economy of Japan down to a much weaker growth rate than baseline projections.

The employment situation was aggravated by the earthquake and related disasters, but has since been gradually improving. The unemployment rate declined to about 4 per cent in late 2011, the lowest since it peaked at 5.6 per cent in 2009. The ratio of job offers to applicants has been increasing, but nominal wages per employee nonetheless declined somewhat during most of 2011.

In 2011, higher international prices of oil and other primary commodities and the disruptive shock of the earthquake pushed up the general price level in Japan, lifting the economy out of a protracted deflation. The consumer price index (CPI) is estimated to have risen by about 0.8 per cent in 2011, from the deflation of about 1 per cent in the previous two years. In the outlook, however, prices may fall again in 2012-2013.

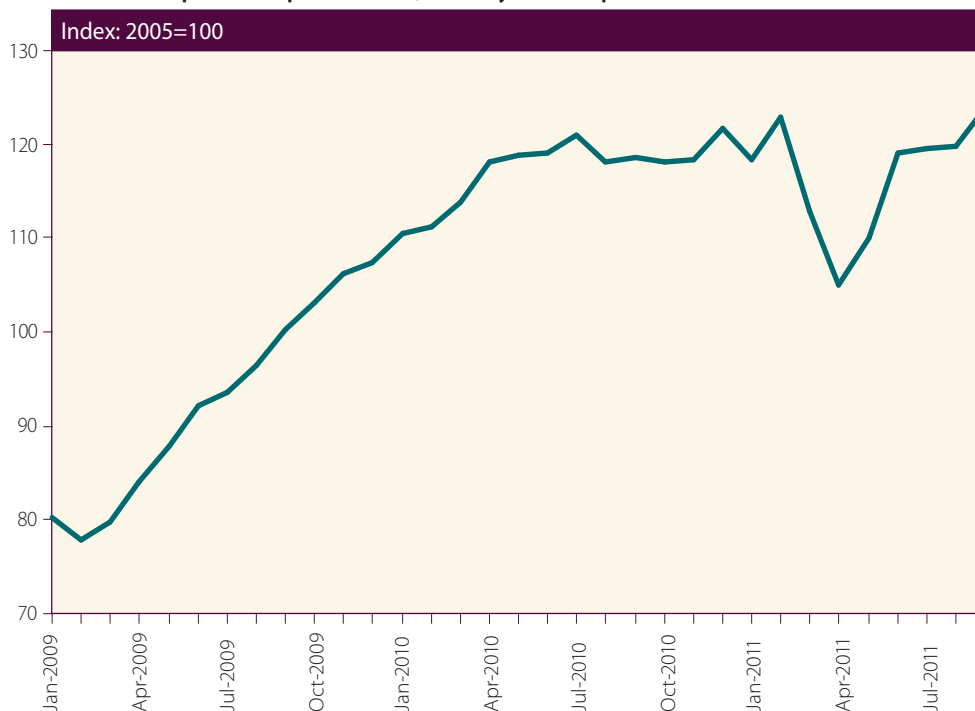
In May 2011, exports began to rebound from the major disruptions of March, but export growth decelerated later in the year as global demand softened (see figure IV.2).

The employment situation has improved

Deflationary conditions have temporarily abated

Japan rebounds from natural disasters, but exports face headwinds

Figure IV.2
Index for Japanese export volume, January 2009-September 2011



Source: Bank of Japan.

The steady appreciation of the yen likely also curbed exports, but past experience shows that global demand has a more important impact on Japan's exports than exchange-rate shifts. Shortly after the natural disaster, imports rose notably, pushed mainly by higher demand for food, but import growth has since slowed. Japan's trade surplus dropped significantly during 2011, while the current-account surplus decreased by about 1 percentage point of GDP. In the outlook, the surplus is expected to stay somewhat below 3 per cent of GDP.

Monetary policy continues to rely on unconventional measures

With policy interest rates near zero for many years, monetary policy in Japan has mainly featured the expansion of the balance sheet of the country's central bank. Throughout 2011, the Bank of Japan (BoJ) continued to increase the size of the Asset Purchase Program (APP), including the purchase of risky assets, such as commercial paper and corporate bonds, in addition to Government bonds. In the outlook, the BoJ is expected to continue relying on the APP, combined with intervention in the foreign-exchange market to prevent the further appreciation of the yen.

Fiscal policy is hovering between post-disaster reconstruction needs and debt sustainability

In order to limit the impact of reconstruction spending on the budget deficit, the Government is employing various options, including tax increases and the sale of some Government assets. The gross Government debt of Japan is currently more than 200 per cent of GDP, the highest among developed countries. The Government has proposed an increase in the consumption tax, to 10 per cent by 2015, but it is highly uncertain whether this will be sufficient to bring the debt-to-GDP ratio to more sustainable levels.

Australia: recovering from record flooding

In Australia, the recovery from the mammoth flood in the eastern states has been slower than expected. GDP is estimated to grow by only 0.5 per cent during 2011. While a gradual recovery in coal production from the flood damage and a continued increase in mining sector investment supported growth, investment in other sectors has been weakening, along with a weak labour market and consumer sentiment. GDP is expected to grow about 2.6-2.8 per cent in the outlook for 2012-2013. Any increase in the policy interest rate is expected to be limited. Fiscal policy has been tightening as the Government aims to return the budget to surplus in 2013, although the extra spending on reconstruction related to the flood damage may challenge the budget target.

New Zealand: earthquake reconstruction boosts growth

In New Zealand, the damage from the earthquake that occurred in February 2011 in the Canterbury region was tremendous, but an economy-wide recession was avoided. GDP increased by about 1.4 per cent in 2011. Business investment has been recovering since the earthquake, but private consumption remains lacklustre. GDP is expected to recover to about 2.5-3.0 per cent in the baseline forecast for 2012-2013. Two of the three major international rating agencies downgraded New Zealand's sovereign debt rating in September 2011, triggered by concerns over the elevated level of the country's external debt, which stands at about 80 per cent of GDP. The Government has planned a number of measures, including significant spending cuts in the medium term and some partial privatization of State-owned assets, aimed at returning to budget surplus in 2014-2015.

Europe

Western Europe: sharply slowing growth as the debt crisis grips the region

Western Europe grew strongly in the first quarter of 2011, but activity decelerated significantly thereafter and is expected to stall by the end of the year. To some extent, the initial sharp deceleration in the second quarter was heavily influenced by unusual factors, including the German nuclear power plant closures, supply chain disruptions from the multiple disasters in Japan, normalization in the construction sector after its sharp rebound in the first quarter from the bad winter weather and the sharp rise in oil prices. But GDP growth was no better in the third quarter (although there was large diversity across countries), and a wide variety of leading indicators have shown a clear and substantial decline in sentiment across countries and sectors.

Growth is hindered by a number of factors. The global manufacturing cycle has peaked and is now in a downturn as global demand slows, particularly in East Asia and the United States. Fiscal austerity programmes are in force across the region. The sovereign debt crisis that erupted in Greece in May—which subsequently spread, first to Ireland and Portugal and then to Spain and Italy—has led to plunging confidence of both producers and consumers, as well as to a weakening of the already delicate banking system. Growth is expected to be 1.5 per cent in the European Union-15 (EU-15) in 2011, similar to the spring forecast, but only due to a much stronger-than-anticipated first quarter balanced by a much weaker-than-expected rest of the year. Given the extremely low momentum going into 2012, GDP growth is expected to be only 0.5 per cent, a substantial downward revision from the spring forecast, and with only a modest upturn expected for 2013, growth is expected to be only 1.6 per cent (see annex table A.1).

High frequency hard data and indicators of sentiment through the first quarter of 2011 depict a recovery led by a sharp rebound in the manufacturing sector, with services following a more muted path and construction playing a restraining role. In April 2011, a wide variety of measures indicated a clear change of direction with broad-based declines across both country and sectoral surveys. These declines continued throughout the year and have reached levels consistent with a contraction in activity. The hard data, however, at least through August, showed no evidence of a downturn: industrial production continued to increase, albeit with signs of deceleration; construction remained only marginally above its recession-era trough, clearly weak, but showed no sign of a downturn; and retail trade also showed some deceleration, but again no major downturn. The September release for these data, however, does show a significant decline. Comparing industrial production with industrial confidence and quarterly GDP growth rates, the pattern is worryingly similar to the period prior to the Great Recession of 2008-2009 (see figure IV.3), and indicates that the brunt of the slowdown will be concentrated in the final quarter of 2011 and the beginning of 2012.²

In the first quarter of 2011, private consumption was an important driver of growth. It was supported by greatly growing confidence and a moderate improvement in real disposable income through a combination of good labour market performance in a number of countries, falling unemployment, rising nominal wages and low inflation. Then

After a strong start, growth decelerated sharply to near stagnation in 2011

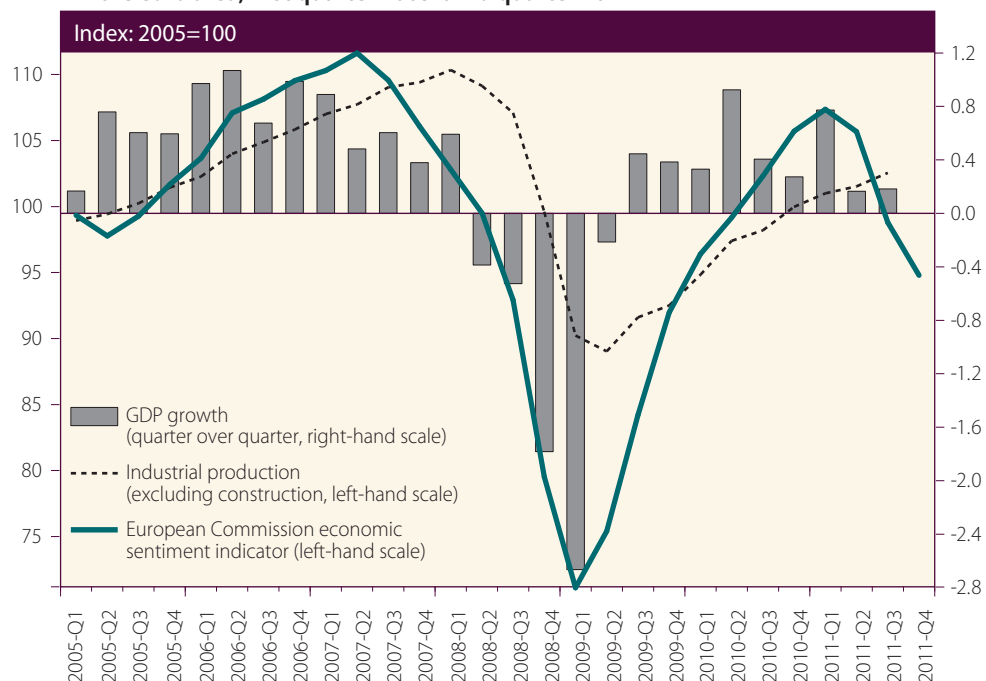
Multiple headwinds batter the region

High frequency data are sending warning signals

Domestic demand showed promise, but then lost vigour

² The continuing strength of the industrial sector helps explain the strength of the rebound in Germany and France in the third quarter after the unusual one-off events depressed second quarter growth.

Figure IV.3
GDP, industrial production and industrial confidence
in the euro area, first quarter 2005-third quarter 2011



Sources: Eurostat, European Commission and OECD Main Economic Indicators.

higher oil prices started to hit disposable income and the sovereign debt crisis led to a dramatic drop in confidence, and in some cases far tighter fiscal policy. In the outlook, consumption is expected to remain very subdued, constrained by continuing fiscal consolidation measures, less certain labour market prospects, uncertainty from the debt crisis and tightening bank-lending conditions. Slowing inflation on the other hand, provides some support. In the crisis-affected countries, consumption is expected to continue to contract.

Fixed investment in plants and machinery was the other major component of domestic demand that drove GDP growth in the first quarter of 2011, particularly in those economies most geared to export markets and capital goods. The strong rebound in manufacturing industries, fuelled by external demand coupled with increasing capacity utilization (which in the euro area reached 81.6 per cent in the second quarter of 2011), rising business profits and stabilizing financing conditions, supported investment growth. Confidence was at record highs in Germany. Going forward however, investment is expected to weaken significantly, impacted by now decelerating external demand coupled with deteriorating financing conditions and declining capacity utilization and, more generally, by increasing uncertainty. Housing investment has been a drag on activity since the beginning of the recovery and is expected to remain lacklustre.

The dynamic growth of export volumes has been a key factor driving the recovery, both through its impact on net exports as a source of growth and through its influence on investment spending. However, it is decelerating in line with the slowdown in global growth. In the first quarter of 2011, there was some evidence of a maturing of the recovery, with domestic demand becoming a more prominent source of growth and net exports becoming neutral, as import volumes accelerated. This was short-lived, however, and going forward, despite the slowing of global demand, the sharp deceleration of activity in the region is again leading to a growth profile dominated by net exports.

Growth relies too heavily
on slowing exports

At the aggregate level, labour markets have shown very little change since the end of the recession, with unemployment remaining near 10 per cent in the euro area since September 2009. This result comes from balancing countries, including those that have seen large improvements, such as Austria, Belgium and Germany, with those that have seen large deteriorations, including all the crisis countries. These different outcomes can be attributed to relative growth performances (heightened by the tremendous fiscal consolidations taking place in some countries), different degrees and types of labour market policies and structural differences. Given the subdued outlook, unemployment is expected to remain near current levels for the EU-15, with the crisis countries deteriorating further, or at best, remaining at elevated levels (see annex table A.7).

Labour markets show diverging trends

Headline inflation, as measured by the Harmonised Index of Consumer Prices (HICP), rose steadily throughout 2010, reaching 2.9 per cent in the second quarter of 2011 in the euro area, and then after receding for a few months, began to rise again, reaching 3.0 per cent in September. Core inflation, on the other hand, remained quite stable in 2010, but traced a similar pattern to that of headline inflation in 2011, rising to 1.6 per cent in September. The rising prices of oil and other commodities were key factors in explaining this movement, though in the first quarter, growth was insufficient to make much headway in closing the output gap, and real wage growth lagged productivity improvements. Going forward, weakening activity is expected to put downward pressure on prices (see annex table A.4).

Rising inflation will be short-lived

The euro area fiscal deficit increased substantially during the recession from 2.1 per cent of GDP in 2008, to 6.4 per cent in 2009, and dipped only slightly, to 6.2 per cent, in 2010. All members of the euro area, except Finland, Luxembourg and new member Estonia, registered deficits greater than 3 per cent of GDP in both 2009 and 2010, which is the limit enshrined in the Stability and Growth Pact (SGP). Under the Excessive Deficit Procedure (EDP) these countries had to submit stability programmes with explicit plans for bringing their deficits back to below 3 per cent. Most members of the euro area are tightening their budgets, with a minimum requirement of an improvement in budget deficits of 0.5 per cent of GDP per annum. The annual consolidations, however, are much higher in the crisis affected countries and may need to be strengthened if there are shortfalls in revenues. After its deficit rose sharply, the United Kingdom of Great Britain and Northern Ireland also came under pressure, and is pursuing a dramatic consolidation programme.

Fiscal austerity grips the region

After leaving its main policy rate at 1.0 per cent for more than a year and a half following the recession and relying solely on unconventional policy measures, the European Central Bank (ECB) surprised the markets by raising interest rates in early and mid-2011 by a total of 50 basis points. Part of the surprise lay in the fact that it was widely believed at the time, that the unconventional policies would be phased out prior to any resumption of conventional interest-rate policy moves, but the unconventional policy measures were still in active use. They were, however, targeted almost exclusively to support the banks and the sovereign debt of the crisis-affected countries, rather than to support the banking system as a whole, so there could be a separation of policies. But as the euro area debt crisis has worsened, embroiling more countries and banks, this distinction is fading. These unconventional policies consist of various ways to supply liquidity to the affected banks: refinancing operations at various term lengths, the purchase of covered bonds and, in concert with other major central banks, the provision of United States dollar liquidity. They also (and more controversially) include the purchase of Government bonds in secondary markets.

The ECB reverses course, reducing its main policy interest rate, and steps up the use of unconventional measures

The worsening crisis led the ECB to change course in November, cutting its main policy rate by 25 basis points. With another similar cut assumed in December, the main policy rate will return to 1.0 per cent, after which conventional policy will again be on hold. It is also assumed that unconventional policies will remain in use throughout the forecast period.

Downside risks are substantial and centre on sovereign debt crises

Key risks to the forecast are weighted downward. They are led by the still deepening and expanding sovereign debt crisis, with threats of further contagion to the larger economies of the region and to the fragile banking system, both of which would place far larger demands on financing needs, and in the case of the banking system, cause a renewed financial crisis. A related risk is that the current fiscal austerity programmes could be strengthened, as a result of the pressures from the crisis, or that their impact on growth would be more than anticipated. Finally, the prolonged period of low growth, and hence high unemployment, in many regional economies risks increasing the rate of long-term unemployment in the region, making it far more difficult to reduce unemployment in the future. This would also reduce the growth rate of potential output.

The new EU members: dangers from a weakening in the rest of the EU

During 2011, the economies of the new EU member States from Eastern Europe continued to recover from the deep recession that started in late 2008. The recovery, however, is still mired by weak labour markets, feeble consumer and business confidence and strong social discontent towards the Governments' fiscal austerity measures. In a number of economies, the initial export-led expansion has evolved into a more broad-based recovery with strengthening household consumption and investment, while in others, exports still remain the sole driving force. Mirroring their main export markets in the euro area, many of the new EU economies lost steam in the second half of 2011. Stock markets tumbled, reflecting worries about the short-term prospects of those countries. For many reasons, including much improved current accounts, the new EU members are not as vulnerable to the sovereign debt crisis or possible banking crisis in the euro area, as they were to the global financial crisis in 2008. At the same time, however, they are now more vulnerable because they have exhausted most of their fiscal space for conducting counter-cyclical policies to mitigate the impact of another global downturn. The capital position of the banking system improved, but there is no guarantee that foreign banks operating in these economies will keep their promise not to withdraw vast amounts of resources during a new crisis, much as they did in 2008-2009.

Exports will provide little impetus to growth in 2012

Against the backdrop of an anticipated slowdown in the euro area in 2012, the nature and speed of the recovery in domestic demand will determine the short-term macroeconomic prospects for the region. However, the cycle of inventory rebuilding that had been supporting growth is virtually complete, while private consumption remains constrained by household indebtedness and many investment projects have been put on hold. Consequently, in 2012, domestic demand is unlikely to bolster growth. Growth of the aggregate GDP of the new EU members, which accelerated from 2.3 per cent in 2010 to 2.9 per cent in 2011, is therefore expected to slow to 2.6 per cent in 2012, strengthening later to 3.1 per cent in 2013. However, forecast growth remains significantly below pre-crisis levels (see annex table A.1).

The largest and least export-dependent economy in the new EU, Poland, maintained its strong economic momentum in 2011, with GDP increasing by 4 per cent, largely

supported by domestic demand. The construction sector expanded rapidly, boosted by preparations for the UEFA Euro 2012 football championships and public infrastructure spending supported by EU funds. Provided that robust investment spending is sustained and a more competitive exchange rate offsets weaker import demand from the EU, the economy could expand by over 3 per cent in 2012. However, a weaker currency may also dampen consumption, as households repay their foreign currency loans.

For the smaller economies of Central Europe, growth in 2011 was predominantly driven by exports, especially by the automotive and electronic sectors. Foreign direct investment (FDI) flows into those countries have modestly recovered and are expected to rise in coming years. The Baltic States have registered the highest growth rates, but they are bouncing back from deep recessions, and income remains significantly below pre-crisis levels. In the Czech Republic and in the Baltic countries, domestic demand recovered somewhat in 2011, but it remains depressed in Bulgaria, Hungary and Romania. The appreciation of the Swiss franc placed strong pressure on households and businesses in Hungary and Poland, which had borrowed heavily in that currency. If this appreciation is sustained, it may seriously affect consumer spending and investment (see box IV.1). Most of these economies are expected to grow by 2 to 3 per cent in 2012.

The spike in oil and food prices led to higher inflation in the region in early 2011, although its impact on the overall CPI varied across the countries. One-off factors such as higher value added tax (VAT) rates fed into consumer prices, but these were offset by weak domestic demand and subdued wage growth. Inflation moderated in the second half of the year as food prices retreated. In some countries, including in the Baltic States, however, core inflation started to rise. Similar one-off factors, such as higher VAT rates in Hungary and the liberalization of energy prices in Romania are expected to influence inflation in 2012. Nonetheless, slower export growth and stagnating nominal wages and credit should keep inflation in the low single digits (see annex table A.4).

Estonia adopted the euro in January 2011, and in line with the ECB rules, reduced mandatory reserve requirements for commercial banks. The central banks in Hungary and Poland raised interest rates in 2011 to keep inflation within the target range. Provided that inflationary pressure is contained, however, monetary policy should remain accommodative in 2012. In any case, even though banks in the new EU countries are not facing liquidity constraints and the number of non-performing loans has probably peaked, they remain reluctant to lend.

Labour markets of the new EU member States continue to recover even as unemployment rates remain high, at more than 10 per cent in over half of the countries in 2011. Improvements were largest in the countries with the highest unemployment rates, for instance, the Baltic States. Elsewhere, progress has been slower. Conditions are expected to continue improving in 2012, even if at a rather slow pace (see annex table A.7). The rise of structural unemployment and the substantial skill mismatches in the supply and demand for labour will affect the growth of potential output in the long run. Governments are constrained in stimulating employment growth given their limited fiscal space.

On the fiscal policy side, most of the Governments of the new EU members have yet to reduce their budget deficits to the EU target of less than 3 per cent of GDP. In parallel, they are aiming to reform public finance, especially by improving the sustainability of pension systems, in the light of impending unfavourable demographic developments. Reaching political consensus on specific policies, however, is proving to be difficult. The proposed budgets for 2012 envisage further austerity measures, such as reductions in the size of the public sector, as well as increases in indirect taxes. The Government of Hungary

Oil and food prices pushed up inflation in early 2011

Credit supply is slow to pick up

Employment is steadily recovering in the Baltic States, but skill mismatches remain problematic

Fiscal policies are shifting to greater austerity

Box IV.1

The impact of the appreciation of the Swiss franc on the economies of Eastern Europe

Foreign currency denominated loans account for a sizable percentage of loans in a number of the new European Union (EU) member States and South-Eastern European economies (see figure). This would make these countries vulnerable to rising debt-servicing costs should these foreign currencies appreciate substantially with respect to their national currencies. Indeed, several economies, mostly new EU member States, have been adversely affected by the steep appreciation of the Swiss franc, which investors took in as a safe-haven currency during the financial turmoil of 2011. Homeowners and investors acquired substantial foreign currency loans (especially mortgages), as these carried much lower interest rates than domestic ones, and residents anticipated (incorrectly in retrospect) that their national currencies would appreciate against the euro and Swiss franc. The interest rates on Swiss franc loans were particularly low and hence the most popular. For example, in Hungary, the Swiss franc rate for a home equity loan was 4.8 per cent in 2005, while it was 17.6 per cent for loans in Hungarian forint. As a result, more than half of all mortgages in Hungary are denominated in Swiss francs and total private sector loans in francs amounted to 20 per cent of GDP in 2011. In Poland, 700,000—or over half of total mortgage loans outstanding—were denominated in Swiss francs. Over a quarter of these loans (or one half of those issued in 2006–2008) went under water in 2011 as a result of the appreciation of the franc, substantially increasing the domestic currency value and debt-servicing costs of these loans.

In some economies, borrowing in foreign currency by commercial businesses and, in some cases, local governments is also widespread. The losses of financial wealth and higher borrowing costs caused by the foreign currency appreciation have drained purchasing power from these economies at a time when unemployment is high. In Hungary, the Government has felt compelled to provide assistance to homeowners holding foreign currency mortgages. Under the programme, homeowners are allowed to pay back their loans at below market exchange rates (180 forint to the Swiss franc instead of the market rate, which was about 235 forint in the fall of 2011), while the banks are forced to accept the losses. The measure could affect bank lending and the investment climate, possibly affecting future growth. The large share of foreign currency loans also limits the scope of economies with flexible exchange rates to allow their currencies to depreciate in order to stimulate exports and output growth as such devaluations may trigger a wave of debt defaults.

Share of foreign currency denominated loans, 2010



Sources: Jarko Fidrmuc, Mariya Hake and Helmut Stix, "Households' foreign currency borrowing in Central and Eastern Europe", Österreichische Nationalbank Working Paper, No. 171 (Vienna, Austria, September 2011).

intends to retain the extra taxes introduced in 2010 on financial institutions and on large corporations until 2013.

Most of the new EU member States would be affected by further deepening of the sovereign debt crisis in the euro area, since in such a scenario, weaker exports may lead to even lower growth rates in 2012. Moreover, there is a risk, as indicated earlier, that many large EU-15 banks present in those countries, in the instance that their balance sheets are damaged, may decide to deleverage and withdraw capital from the region, thereby stifling credit growth. Possible worsening of the terms of access to capital markets would complicate the refinancing of external debt obligations of the new EU members.

The new EU members are vulnerable to the euro zone crisis

Economies in transition

In 2011, aggregate GDP of the transition economies expanded by 4.1 per cent. Growth was largely driven by stronger export performance and domestic demand, although continued deleveraging of the financial sector kept investment subdued. While labour market indicators improved during 2011, inflation accelerated despite a slowdown in price increases in some countries in the second half of 2011. A weaker external environment contributed to a softening of growth in the second half of 2011, such that overall, the increase in aggregate GDP remained unchanged from 2010. Performance diverged across the economies in transition, however. In the economies of South-Eastern Europe, the economic recovery that commenced in 2010 gained a stronger foothold and aggregate GDP growth accelerated from 0.6 per cent in 2010 to 1.7 per cent in 2011, in particular as Croatia exited from its recession. In contrast, growth in the Commonwealth of Independent States (CIS) decelerated from 4.5 per cent in 2010 to 4.3 per cent, reflecting the impact of weaker commodity prices on the larger economies of the region (see annex table A.2).

The economies in transition remain vulnerable to external economic developments. This is due to structural factors, including their pattern of export specialization and a high dependence on external funding. Thus, while the continued fragility of the financial sector and the dependence on international commodity prices remains a cause for concern in the CIS, spillover effects of the European debt crisis through financial channels pose more of a threat to South-Eastern Europe. Continued financial turbulence and more fragile growth prospects for developed economies will therefore lead to a more moderate expansion of aggregate GDP in the outlook. Growth rates are expected to remain well below those observed in the pre-crisis era.

South-Eastern Europe: an already slow recovery threatened by euro area troubles

The tentative economic recovery in the economies of South-Eastern Europe that began in 2010 gained further ground in 2011, driven initially by export growth and by rising domestic demand thereafter. Nevertheless, the region continues to experience below-trend growth as household consumption and investment remain subdued by weak consumer sentiment, limited availability of credit, slow real wage growth and tepid FDI inflows. The continued financial turbulence and weak growth in the euro area threaten to spill over into the region via trade and financial channels, and could easily unsettle the recovery.

GDP growth was positive in 2011 in all economies of the region, averaging 1.7 per cent, up from less than 1 per cent in 2010 (see annex table A.2). Since their major export markets are in the EU—which is facing the prospect of a protracted slowdown—none of the economies in the region is expected to see strong output growth in the outlook.

for 2012. In addition, Governments are adopting fiscal austerity programmes; however, their impact is cushioned to some extent by attempts to preserve and, in some cases, boost public investment. Domestic consumption and investment are expected to pick up only marginally, although investment in Croatia is expected to recover from its long period of contraction. Aggregate GDP of South-Eastern Europe is expected to expand by only 2.3 per cent in 2012, well below trend growth, but slightly higher than in 2011 due to the slight acceleration of growth in Croatia and Serbia. Growth should strengthen to 3.2 per cent in 2013, in line with the improving economic environment.

Food and energy prices
raised inflation in
early 2011

One-off factors have continued to influence consumer inflation, which picked up throughout the region during 2011. This reflected the impact of increased world market prices for energy and food. In 2010, strongly expansionary monetary policy fanned inflation into the double digits in Serbia. Inflation moderated in the course of 2011, along with monetary tightening and the stabilization of world energy and food prices. Nonetheless, annual inflation averaged more than 11 per cent.

In 2012, absent any serious supply-side shocks, inflation is expected to hover around 3 per cent for the region as a whole, with slow wage growth and cautious consumer demand curbing its growth. Inflation in Serbia may still be above the regional average (see annex table A.5).

Labour markets remain
slack but show some
positive trends

In the first half of 2011, unemployment increased further from already high levels in most of the countries in the region, especially in Croatia and Serbia, as job growth lagged the output recovery. In the second half of the year, unemployment started to decline, driven by the cyclical upturn and continued labour market reforms. These reforms are aimed at boosting incentives to work and increasing formal employment, while at the same time maintaining social protection. If these trends persist, unemployment is likely to decline throughout the region in 2012 (see annex table A.8). Nevertheless, much of the unemployment is structural and will require fundamental supply-side reforms in labour market, education and competition policies.

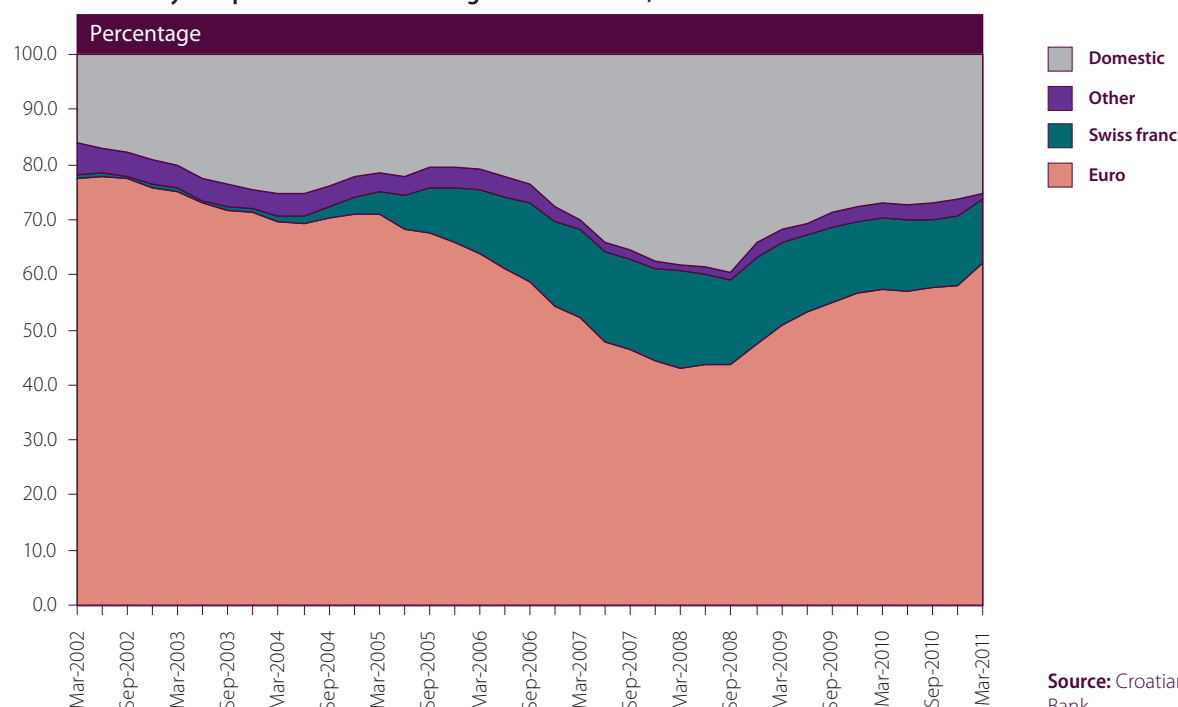
Credit supply remains
subdued, while the
stronger Swiss franc
affects borrowers

Formal or de facto currency pegs constrain the conduct of monetary policy in most South-Eastern European countries. Growth of credit to the private sector remains weak in the region, reflecting concerns about the health of the banking sector that is predominantly controlled by foreign banks. Concerns centre on the volume of non-performing loans, the need for further deleveraging and the continued weak demand for credit. The appreciation of the Swiss franc has dampened household spending in Croatia, where over 40 per cent of mortgages and almost 50 per cent of car loans are pegged to the Swiss currency (figure IV.4; see also box IV.1). As a result, the Government has offered a fixed exchange-rate loan repayment scheme that only defers financial obligations. Households are thus likely to save much of the income freed from reduced payments. Increased payments for foreign-currency denominated loans have also affected households in Serbia, as its currency has depreciated against both the euro and the franc. The risk has been less acute in other South-Eastern European countries that have higher shares of euro-denominated loans and their currencies pegged to the euro.

FDI remains below
pre-crisis levels

FDI inflows into the region declined further in 2010 after significant falls in 2009, with the exception of Albania where they reached record levels. A prompt return to the very high levels of FDI inflows these countries enjoyed in the years before the global crisis is unlikely, given the lasting impact of the Great Recession, the ongoing euro area debt crisis and continued ethnic tensions in parts of the region, which will also likely hold back prospective investors. Even so, foreign investment in Croatia might increase in 2012, provided that the country's accession to the EU remains on track for 2013.

Figure IV.4
Currency composition of outstanding loans in Croatia, 2002-2011



Source: Croatian National Bank.

After enacting counter-cyclical policies during the crisis, Governments across the region are consolidating their finances while preserving capital expenditure levels. Resources directed through development banks have promoted business lending in support of economic diversification, but progress in the use of those funds has been slow. To a large extent, critical social spending has also been protected throughout much of the region (Bosnia and Herzegovina, Serbia and the former Yugoslav Republic of Macedonia) with the assistance from international financial institutions.

The region remains exposed to spillover risks from the Greek debt crisis, mostly through finance, given the heavy presence of Greek banks and reduced FDI flows. In addition, Albania, Montenegro and the former Yugoslav Republic of Macedonia may experience a contraction in remittances and weaker exports. An intensification of the debt crisis in Italy would have an even more disruptive impact on the region through the same channels.

While consolidating budgets, Governments are also trying to protect infrastructure spending

The region remains vulnerable to developments in the euro area

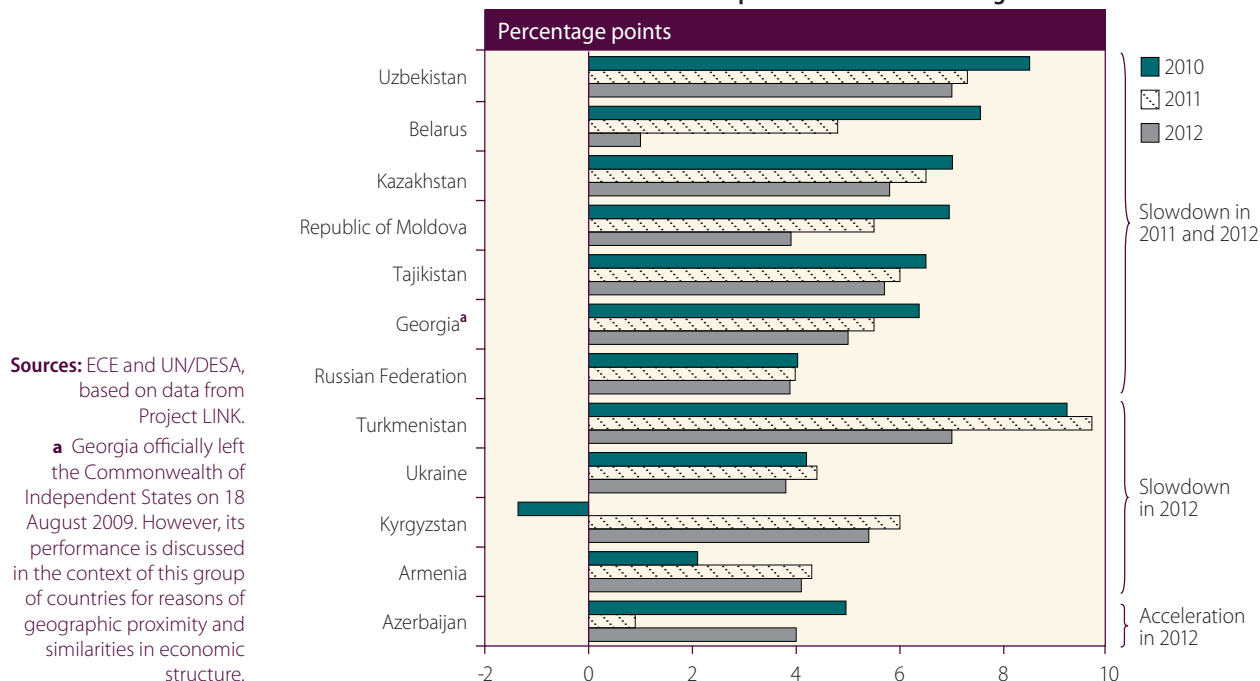
The Commonwealth of Independent States: recovery continues, but risks increase

In 2011, economic activity expanded in the CIS, although growth was subdued in comparison to the faster pace observed in the period prior to the 2009 crisis.³ A somewhat weaker performance is expected in the outlook due to the deterioration of the global economic situation (figure IV.5). In 2011, stronger commodity prices gave impetus to the expansion of output in several economies, including the largest economy, the Russian Federation, which remained the major force of economic dynamism in the CIS. The deterioration of

Growth remains steady but unimpressive

³ Georgia's performance is discussed in the context of this group of countries for reasons of geographic proximity and similarities in economic structure.

Figure IV.5
The general slowdown in GDP growth rates in the Commonwealth of Independent States and Georgia^a



the external environment towards the end of the year resulted in softer commodity prices and reduced prospects for external finance. Aggregate GDP in the region rose by about 4.3 per cent in 2011, compared to 4.5 per cent in 2010 (see annex table A.2). While aggregate growth is expected to decelerate to 4.0 per cent in 2012 before accelerating somewhat in 2013, the high growth rates achieved in the pre-crisis era will remain elusive.

Domestic demand is fuelling expansion

Improved terms of trade and better employment prospects supported the growth of domestic demand in the region. However, the fragility of the banking sector and continued deleveraging constrained investment activity, despite some improvement in the Russian Federation and Ukraine. In Belarus, domestic demand contracted, but exports rose strongly as a consequence of a sharp devaluation of the rouble. This was triggered by significant pressures on foreign-exchange reserves as large State spending and unsustainable growth in wages and credit fuelled import demand. In Azerbaijan, repair works at some drilling platforms disrupted oil production and contributed to a sharp deceleration in growth. By contrast, gas exports increased in Turkmenistan due to new infrastructure. The recovery from political unrest in 2010 and donor-funded infrastructure significantly boosted output in Kyrgyzstan. The region experienced a significant rebound in agriculture after a bad harvest in 2010. This was especially important for Armenia, as well as Ukraine, which also benefited from increased construction in preparation for the UEFA Euro 2012 football championships.

Unemployment is falling

The economic recovery has been accompanied by a modest improvement in labour market indicators, with unemployment rates falling in the largest countries in the region (see annex table A.8). In Kazakhstan, the impact of the substantial employment growth on unemployment rates was partially offset by a rapid increase in the labour force. By contrast, Georgia and the Republic of Moldova showed limited ability to generate

employment, despite continued output growth. Outward migration alleviated pressures on labour markets in these countries. In the outlook, labour market indicators are expected to improve modestly in the region.

Inflation for the region accelerated to 9.6 per cent in 2011, up from 7.1 per cent in 2010 (see annex table A.5). However, inflation patterns have been rather uneven in the region. In most non-energy exporters, the acceleration in 2011 was mainly due to increasing food and fuel prices, and in some cases, also to growing demand pressures. The larger weight of food in consumer price indices in several economies explains some of the observed inflation dynamics. By contrast, headline inflation peaked in the Russian Federation and declined sharply in the second half of the year as the impact of the 2010 drought diminished. In Belarus, the devaluation of the rouble resulted in a sharp acceleration of inflation. In Kazakhstan, the one-off effects of the customs union with Belarus and the Russian Federation resulted in price increases, as some imports became more expensive. In the outlook, more subdued economic growth due to the global economic slowdown will lead to more moderate increases in prices in the region. Inflation for the region is expected to decelerate to 7.8 per cent in 2012 and is likely to decline further in 2013.

As the economic recovery continued and food and fuel prices increased, many countries raised interest rates and tightened liquidity throughout 2011. Monetary measures were complemented in some cases with price controls and support to agriculture to ease the situation in food markets. In Belarus, the authorities tried to contain the inflationary pressures unleashed by the devaluation of the rouble through price controls and sharp increases in interest rates. By November 2011, the refinancing rate had been increased during the year by over 2900 basis points to 40 per cent. In the Russian Federation, a moderation of price pressures in the last part of 2011 and the deterioration of the economic outlook led to a pause in interest-rate increases. However, foreign-exchange interventions to support the rouble amid worsening risk perceptions resulted in tighter liquidity. In 2012, growing downside risks to the global economy and lower inflationary pressures may prompt a loosening of the monetary stance in the region. This has already taken place in Armenia and Georgia, where key interest rates were reduced in the second half of 2011; in Georgia, reserve requirements were loosened to stimulate the long-term financing of commercial banks.

Economic growth strengthened fiscal positions throughout the region in 2011, especially in the energy-producing economies. However, increased spending in response to external shocks limited such improvements in fiscal balances in some cases. In Azerbaijan, the authorities sought to offset the depressing effect of oil sector problems with significant fiscal outlays. In the Russian Federation, despite high oil prices, payroll tax reform and increased tariff revenue, the budget ended roughly in balance, which indicated its vulnerability to changes in the external environment. In Kazakhstan, a doubling of the duty on oil in 2011 to \$40 per tonne helped reduce the deficit. Meanwhile, several countries in the region continued to receive external resources to support their economies. Among these, fiscal consolidation was substantial in Ukraine, while in Kyrgyzstan increased social and infrastructure spending widened the deficit. With a weakening of oil prices, deficits are likely to widen in the outlook unless revenue is strengthened. This is particularly applicable in the Russian Federation, where social and public spending is likely to increase in the run-up to the presidential elections.

Higher commodity prices and increased export volumes have driven an increase of exports in the region (see annex table A.16). The aggregate current-account surplus of the region widened, mainly due to the improved performance of Kazakhstan and the Russian Federation. The latter's surplus financed significant capital outflows of

Inflation is declining from early peaks

Monetary policy tightening may be put on hold

Expansion is supporting fiscal balances

The current-account surplus for the region is widening

\$49.3 billion for the first nine months of 2011. Regardless of the depreciation of the exchange rate, the current-account deficit remained large in Belarus, which is increasingly relying on official sources to finance the deficit; support from the Eurasian Economic Community in response to the crisis became critical in avoiding a sharper adjustment. High food and fuel prices contributed to the large deficits observed in the non-energy-exporting countries, which continued to increase, despite growing remittances, with the exception of Armenia. In Ukraine, strong import demand, in part due to investment and construction related to the UEFA Euro 2012 football championships, offset higher exports and led to a widening of the current-account deficit.

Downside risks have increased

Growth in the region remains well below that observed in the pre-crisis period. External factors, in particular commodity prices, are the dominant influence on economic performance. Foreign financing remains critical for the region, in particular for Ukraine and other non-energy-exporting countries that continue to have large current-account deficits. The increased likelihood of slower global economic activity and heightened risk aversion are likely to depress commodity prices and impair access to global capital markets. Although the adjustments induced by the recent crisis have reduced reliance on external funding in Kazakhstan and the Russian Federation, thus lowering their vulnerability, the financial sector remains fragile in several other economies. This is dampening domestic demand. Further global turmoil may take its toll and expose the region to multiple shocks given its continued high reliance on exports of natural resources and external financing, and its vulnerability to external events, especially those in Europe.

Developing economies

Despite a significant deceleration by developed economies, developing countries exhibited strong growth performance in 2011, and are expected to continue on a significantly higher growth path than the former group over the forecast period. Yet, the average growth rate of 6.0 per cent in 2011 and the expected growth rates of 5.6 per cent in 2012 and 5.9 per cent in 2013 remain below the average 7.5 per cent of the pre-crisis period. In the aggregate, the better growth performance of developing countries reflects both the fact that the economic crisis of 2008-2009 did not originate within this region and the fact that policy stimuli on various fronts were enacted promptly and were kept in place until recovery of either investment or consumption was well under way. In addition, for many of the countries in this group, most notably those in East Asia, domestic demand drivers reinforced trade linkages, especially South-South relations. In a number of other countries, policy stimuli appeared to be stronger during 2011 than before, as social unrest triggered by high unemployment and rising prices of food, among other factors, made Governments more aware of the pressing need to address unresolved employment and social challenges.

Of course, the confluence of the positive factors does not apply equally to all countries in the developing world. Many countries in Africa or in South Asia were not able to enjoy the policy space or were threatened by rising inflation owing to reasons beyond Government control—factors that eroded the ability to sustain domestic demand when other growth drivers faltered. In another example, some countries have not benefited from the favourable terms of trade experienced by exporters of energy and minerals. In particular, food-importing countries have run into food-inflation problems, while countries in the Horn of Africa have in addition to other challenges, experienced sustained droughts and famine. Similarly, social unrest in some countries of North Africa and Western Asia

continues to challenge policymakers, as well as neighbouring regions and trade partners. Critical challenges mount when social unrest leads to either direct military intervention by other countries or economic sanctions.

The deteriorating economic situation in developed economies is also taking a toll. Developing countries with close economic ties to the United States and Europe have seen less-than-expected growth of exports and/or remittances. The reverberations of financial and equity markets in the developed world have caused greater volatility of capital flows, exchange rates and equity markets, particularly in Latin America and the open economies of East Asia. This outcome reduces the freedom of policy makers to operate.

The outlook, even if more positive in the baseline than that of other regions, remains uncertain and subject to downside risks. This is particularly the case if combinations of sluggish global trade activity, declining international prices, unremitting unemployment, high food prices, inflationary pressures, fiscal constraints and/or volatility of exchange and equity markets unleash a chain of downward pressure.

Africa: growth remains on a high, but uneven and uncertain path

Africa is forecast to see an increase in its overall growth from 2.7 per cent in 2011 to 5.0 per cent in 2012, marking a pronounced recovery from the disruptions caused by political unrest, as well as a return to the solid growth trend that had emerged after the economic slowdown at the peak of the global economic crisis. Important driving forces for this trend, which is forecast to lead to growth of 5.1 per cent in 2013, will be relatively strong commodity prices, solid external capital inflows and a continued expansion of demand and investment from Asia (see annex table A.3). However, countries across the continent will continue to have widely divergent growth outcomes owing to a number of circumstances, such as military conflicts, a lack of infrastructure, corruption and severe drought conditions. In some countries, these factors will severely depress growth and, much more importantly, will likely have a grave humanitarian toll.

Dramatic political problems and change continue to grip economic growth in North Africa. The economy of Libya is estimated to have contracted by 22 per cent in 2011 in the wake of recent regime change, but reconstruction is expected to drive a rebound in 2012. Egypt, Morocco and Tunisia will all see a more pronounced increase in economic growth in 2012, largely due to the lower base for comparison in 2011 owing to the fallout from political unrest. However, economic performances will remain constrained by the uncertain political conditions in the subregion, negatively affecting the tourism sector in particular.

In sub-Saharan Africa, South Africa is forecast to see stronger economic growth in 2012, underpinned by favourable external demand, continued fiscal stimulus and rising consumption driven by higher wages. Elevated oil prices will continue to create significant upside potential for oil-producing economies such as Angola, Ghana and Nigeria. However, infrastructure shortfalls, especially in the energy sector, as well as political instability in the Niger Delta will prevent Nigeria from exploiting its full growth potential. In Angola, the start of operations at a new liquefied natural gas project will boost growth in 2012.

In East Africa, Kenya will see continued strength in its headline GDP growth figure, driven by infrastructure investment, the expansion of the telecommunication sector and increased banking participation rates. Similarly, Uganda is expected to see solid

Regional growth increases, albeit unevenly

North Africa should see a post-conflict growth bounce, but important uncertainties remain

South Africa and other energy producers continue to grow

Parts of East Africa are facing severe drought, exacerbating hunger

growth on the back of large energy investments, for example, in a new refinery project, although political unrest poses an increasing downside risk. Strong growth in Ethiopia will reflect continued infrastructure improvements, especially in the energy sector, which overshadow the negative impact of drought conditions on agricultural output in some areas. In contrast, large areas in the Horn of Africa have been hit by a severe drought that is taking a high humanitarian toll, forcing many people to flee their home areas and prompting the United Nations to officially declare the situation a famine (box IV.2). Conditions are especially precarious in Somalia, where a combination of drought, poverty and military conflict have trapped many people in life-threatening situations where survival is tied to external assistance.

Box IV.2

Drought in the Horn of Africa takes a heavy human and economic toll

The drought and its human and economic impacts

East Africa—particularly the Horn of Africa, which includes Eritrea, Ethiopia, Djibouti and Somalia—is experiencing the worst drought in 60 years, caused by a prolonged lack of rain (for two consecutive seasons) and resultant dry conditions since late 2010. The drought has severely degraded vegetation throughout the region and depleted pastoral land, leading to serious crop failure and the loss of thousands of livestock.^a South-eastern Ethiopia, northern and eastern Kenya, and southern Somalia, are the worst affected areas. The severity and scale of the drought has raised concerns because the majority of the population (80 per cent) in this subregion depend upon crops and livestock for their livelihoods and food security, but only about 1 per cent of the arable land is irrigated.^b While droughts are not uncommon in the area, a spike in the prices of food staples and an unusually dry climate have deepened the severity of the impact of the most recent drought. In the case of Somalia, a protracted military conflict has compounded the crisis.

The drought has led to a humanitarian crisis and heavy economic costs. Currently, more than 13 million people are estimated to be in need of emergency food aid and livelihood assistance in Djibouti, Ethiopia, Kenya and Somalia.^c Somalia has been suffering the most, the food crisis there having escalated to famine in parts of the central and southern regions of the country.^d In 2011, for example, the cereal crop harvest in southern Somalia was estimated at only 19 per cent of total production in 2010. This has forced hundreds of thousands of Somalis to seek refuge in Ethiopia and Kenya, where the host population itself faces a severe food security crisis.

The drought has induced a sharp rise in prices of food staples and, hence, overall inflation rates, creating severe hardships for both the rural and urban populations of the region. In Kenya, for example, inflation has spiked to double digits because of significantly increased food prices. The affected countries are also facing significant fiscal pressures due to increased public spending on emergency food supplies, the cost of which is only partially covered by international agencies responding to the drought. Because of the dependence on hydroelectricity, many of these countries have faced power shortages and will consequently face higher import bills as they are forced to buy fuel to facilitate power generation.

The economic and social impacts of the drought will last well beyond the immediate future. The already high poverty levels in the region will most likely rise because of the dependence on pastoralism.^e Recovering lost livestock, which is the region's essential economic asset, will take several years. The acute malnutrition suffered by the population is likely to have an irreversible toll on the health of children and adults alike. Moreover, limited food, animal feed and water resources may fuel tensions and escalate existing political conflict and instability in the area.

Underlying factors

Although the region has long been plagued by cyclical drought because of its arid and semi-arid climate, the onset of the current humanitarian crisis and famine is a direct result of a combination of these natural disasters, failed policies, recurrent conflicts and an adverse global economic

^a Food and Agriculture Organization of the United Nations (FAO), "Emergency in the Horn of Africa", August 2011, available from <http://www.fao.org/crisis/horn-africa/key-documents/en/>.

^b Ibid.

^c World Bank, "Drought in the Horn of Africa", Situation Brief, No. 5 (Washington, D.C., 12 September 2011).

^d See World Food Programme website on Horn of Africa crisis, available from <http://www.wfp.org/crisis/horn-of-africa>, accessed on 7 October 2011.

^e World Bank, op. cit.

Box IV.2 (cont'd)

environment. While the majority of the population depend upon rain-fed crops and livestock for a living, public investment in agriculture has remained low or even absent in rural areas.

Prolonged regional conflicts and political instability have resulted in insufficient social safety nets. There has been no public spending on agricultural infrastructure and social protection programmes in Somalia because of the lack of governance. The political situation in Somalia is so dire that it has, at times, prevented United Nations humanitarian assistance from reaching the most drought-affected people in a timely manner.

While the people of the region have traditionally coped well with occasional droughts, the population has expanded rapidly in recent years, putting increased pressure on local farm and pastoral lands and an already fragile ecosystem. Adverse weather conditions, caused by global climate change, have exacerbated this trend. To meet the expanding food consumption gap, countries in the region have relied on food imports and food aid, solutions which have often proved to be unsustainable.

Short- and long-term responses to the drought

Responding effectively to the humanitarian emergency requires implementing short-term and long-term interventions simultaneously.^f The short-term interventions should ensure that food security needs are fully met, by providing and expanding social safety nets that protect vulnerable households and their livestock assets from the drought and rising food prices. Since the onset of the drought, various United Nations agencies, along with other international organizations, have been engaged in food distribution and other humanitarian assistance. However, the unstable political situation and infrastructure deficit are hindering the smooth flow of foreign aid to those people most in need in some areas of Somalia.

In terms of long-run solutions, a permanent peace settlement of the political conflict in Somalia is the precondition for any success of relevant economic or social policies in the Horn of Africa. At the subregional level, long-term interventions should focus on addressing the technical and policy environment that limits the region's potential to design a sustainable livelihood system conducive to arid and semi-arid climates. Concerted efforts are also required in order to build regional economic resilience to negative shocks, such as adverse weather conditions, by supporting intraregional markets and expanding intraregional, as well as intra-African, trade to ensure the availability of affordable food staples to countries facing shortages from other parts of the region. Regional coordination institutions and mechanisms are essential in this regard. In this context, in early 2011, the United Nations Economic Commission for Africa (ECA) led the initiative to establish a food security programme for East Africa, which was anchored in four components involving agricultural markets, research and technology, natural resource management and social safety nets.^g

For individual countries in the region, emphasis should be placed on designing economic and social policies that establish and strengthen their long-term capability to enhance food security and ameliorate the adverse impacts of droughts. Governments should scale up public spending on agricultural infrastructure and technologies, and intensify efforts to continue to diversify their economies away from heavy dependence on agriculture and natural resources. In regard to social policy, countries need to expand the coverage and depth of social safety nets in order to mitigate the impact of droughts as well as external shocks.^h

^f See goodwill message by Abdoulaye Janneh, Executive Secretary of the United Nations Economic Commission for Africa, to the FAO meeting on "Emergency in the Horn of Africa: Follow-up and Response Actions", held in Rome, Italy on 18 August 2011, available from http://www.fao.org/fileadmin/templates/horn_africa18/documents/Goodwill_Message_Abdoulaye_Janneh.pdf.

^g Ibid.

^h The United Nations High-level Task Force on the Global Food Security Crisis, "Comprehensive Framework for Action", July 2008, provides guidance on building resilience to food insecurity at the country level.

Inflation rates are expected to fall back slightly on average across the continent in 2012, following a more pronounced impact of higher fuel and food prices in 2011. The Communauté Financière Africaine (CFA) franc zone is expected to see average inflation of less than 4 per cent in 2012 assuming normal forecast harvest patterns. At the other extreme lies West Africa, where inflation will recede slightly but remain in solid double digits in 2012. In Nigeria, for example, strong Government spending and high liquidity will remain sources of inflationary pressure, implying a continued tightening stance by the central bank. Similarly, Ghana will also see double-digit inflation of about 10 per cent in 2012, partially driven by subsidy cuts and wage increases. However, a tighter fiscal

Inflation in the CFA franc zone remains moderate while the rest of West Africa copes with double-digit rates

policy and strong agricultural output may contribute to a relatively more stable inflation picture. In East Africa, the catastrophic drought has also led to a strong jump in food prices. However, the baseline envisages more normal harvest patterns in 2012, resulting in reduced inflation pressure. In South Africa, rising wages and electricity rates are expected to be partially offset by spare capacity in some sectors, resulting in an inflation rate of about 5.3 per cent in 2012. Across the continent, monetary policy is expected to maintain a tightening bias over the forecast horizon.

The continuing need for further fiscal policy action is facing a bias towards fiscal restraint

Fiscal policy remains subject to a number of frequently conflicting factors. The need for significant investment in infrastructure and a lack of employment opportunities, compounded by fallout from the global economic crisis, are expected to underpin continued targeted increases in fiscal spending. At the same time, a number of Governments will likely maintain a bias against substantial increases of spending, seeking to achieve the sustainability of public finances. For example, South Africa is projected to register a budget deficit of about 5 per cent of GDP in 2012, but moderation of fiscal spending, combined with positive growth prospects, is expected to lead to a subsequent decline in the budget deficit to about 4 per cent of GDP, while the debt level will remain below 50 per cent of GDP. The assumed slight decline of oil prices will limit fiscal space for oil exporters such as Nigeria, whose budget deficit is expected to remain at about 4 per cent over the forecast period.

External balances should improve in North Africa, but may deteriorate in sub-Saharan Africa due to increased imports

In North Africa, Egypt, Morocco and Tunisia are expected to see lower current-account deficits in 2012 on the back of relative improvements in the tourism sector following disruptions due to regional political unrest. At the same time, a recovery in oil production in Libya is projected to boost its current-account surplus to about 20 per cent of GDP in 2012. In sub-Saharan Africa, oil producers such as Nigeria and Angola are expected to see sharply lower current-account surpluses in 2012, with stronger private consumption, as well as infrastructure investments, underpinning relatively strong import growth. Similarly, in South Africa, strong capital good imports combined with weak demand from developed countries on the export side likely will result in a deeper current-account deficit in 2012. However, a major risk in this respect is a sharper-than-expected slowdown in China, the largest export destination for South Africa, which would lead to an even bigger external deficit.

Unemployment and poverty remain high despite positive headline growth figures

High urban unemployment rates and, consequently, poverty remain a major problem across the continent despite the relatively solid expected growth trajectory. The underlying causes include a lack of economic diversification, particularly into activities generating higher value added, a shortage of skilled workers and low productivity. In South Africa, for example, unemployment will decrease only marginally in 2012 and 2013, remaining above 20 per cent in both years. In North Africa, high unemployment, especially among youth, was a major catalyst for the protests that led to the change in Government in Egypt and Tunisia. In the short term, the disruption to economic activity resulting from the political change will lead to a further increase in unemployment, but more significant reforms, including privatizations, could provide significant impetus for a more dynamic private sector. Correspondingly, in Egypt, for example, the unemployment rate will continue to rise, from 9 per cent in 2010 to about 12 per cent in 2011, before moderately receding to about 10 per cent after 2012.

Downside risks are tied to conditions in developed countries and adverse weather

The outlook is subject to a number of downside risks. For example, a more pronounced slowdown in growth and the debt crisis in the developed countries might push the global economy into stagnation, while emerging economies are at risk of overheating. Under these adverse developments, Africa's external sector may contract significantly if

commodity demand and prices, as well as tourism receipts, decrease. In parallel to this, flows of official development assistance (ODA), FDI and remittances would all likely fall as well, negatively affecting African financial markets. Adverse weather conditions are another significant downside risk given the large role of agriculture across the continent.

East Asia: growth drivers lose momentum

East Asia's strong growth momentum moderated in 2011, particularly in the second half of the year, as the region felt the impact of increased global uncertainty and weaker demand in developed economies (figure IV.6). The region's GDP is estimated to have expanded by 7.2 per cent in 2011, down from 9.2 per cent in 2010. With exports projected to slow further in the coming quarters, average growth is forecast to decline to 6.9 per cent in 2012 and 2013 (see annex table A.3).

While the region's recovery from the global financial crisis was initially driven by a rebound in exports and investment, private consumption has become a more important factor over the past year. In almost all economies, with the notable exceptions of Thailand and Viet Nam, consumption growth gained further strength in 2011. This trend has been supported by rising wages and incomes, as well as persistently low real interest rates. Export growth slowed considerably in the course of 2011, as demand in the major developed economies weakened.

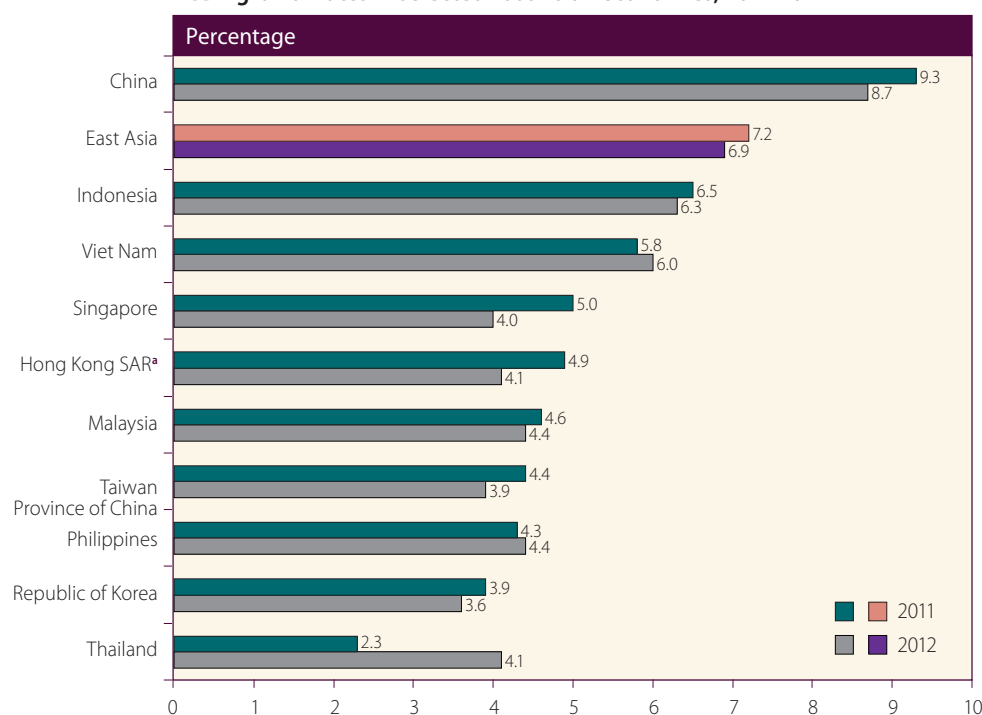
Since this trend is projected to persist in 2012, countries with large domestic demand bases, notably China and Indonesia, will be in a better position to maintain high growth than the more export-oriented economies. In Thailand, the worst floods in half a century caused major damage to agriculture and manufacturing, lowering full-year

Growth is forecast to moderate further...

...as exports and investment lose momentum

Domestic consumption is helping to offset falling developed country demand

Figure IV.6
GDP growth rates in selected East Asian economies, 2011-2012



Source: UN/DESA, based on data from Project LINK.

^a Special Administrative Region of China.

growth in 2011 by a significant margin. China's economy remains the engine of growth in the region, expanding by 9.3 per cent in 2011. In the outlook, growth in China is expected to slow gradually to 8.7 per cent in 2012 and 8.5 per cent in 2013, as strong consumption growth will only partly offset the slowdown in investment and exports.

Labour market conditions
remain favourable

Unlike in other regions, labour market conditions in East Asia remain favourable for now, as employment in the manufacturing and services sectors continues to increase in 2011 amid strong domestic demand and solid exports. In most economies, unemployment rates are near or below the pre-crisis levels of 2007-2008, but subject to risks of a turnaround resulting from falling developed country demand. The Republic of Korea has the lowest unemployment rate among the Organization for Economic Cooperation and Development (OECD) countries, estimated at 3.1 per cent in October 2011. Unemployment rates in Hong Kong Special Administrative Region (SAR) of China and Indonesia fell to decade lows of 3.2 and 6.8 per cent, respectively, in 2011. However, despite recent progress, the proportion of vulnerable employment in total employment remains high in several countries, notably Indonesia, Thailand and Viet Nam. Unemployment rates are expected to show little change in 2012 and 2013, as growth is projected to remain fairly robust. Real wages continued to move up in 2011 on the back of productivity gains and policy measures, such as minimum wage hikes. This trend is expected to continue in the outlook period, especially in the economies with lower per-capita income and large domestic demand bases such as China, Indonesia and Viet Nam. China's 12th Five-Year Plan (2011-2015) aims to increase the minimum wage by at least 13 per cent per year.

Inflation has started to
ease, but remains high

After accelerating earlier in the year, consumer price inflation moderated in the second half of 2011, as food and commodity price gains eased. However, price pressures abated only slowly, and in many economies inflation has remained above the central bank's target range. For the region as a whole, consumer price inflation is estimated to have averaged 5.1 per cent in 2011, up from 3.2 per cent in 2010 and ranging from 1.5 per cent in Taiwan Province of China to 18.5 per cent in Viet Nam. In most economies, higher food prices were the main contributor to accelerating consumer price inflation. The sharp upturn in food prices reflects the impact of supply disruptions, higher input costs (particularly for fuel) and rapidly growing demand in the wake of rising incomes. Inflation has also been fuelled by strong credit growth, notably in China and Viet Nam, significant capital inflows during the first half of 2011, and higher inflationary expectations. While robust consumption demand across East Asia is likely to be sustained by strong wage growth, a softening of international commodity prices will likely reduce inflationary pressures in the outlook. Average consumer price inflation is projected to decline gradually, to 3.9 per cent in 2012 and 3.4 per cent in 2013.

Central banks have started
to shift their focus towards
growth and away
from inflation

With the world economy facing a renewed downturn and price pressures across the region slowly easing, most central banks, including the People's Bank of China, have gradually started to shift their focus towards stimulating economic growth and away from fighting inflation. Bank Indonesia has been the most proactive in supporting domestic demand, cutting its main policy rate by 75 basis points in the fourth quarter of 2011. The recent policy shift in the region follows a period of gradual monetary tightening in the form of interest-rate hikes and increases in reserve requirements. The People's Bank of China and the Bank of Korea raised the main interest rates five times between July 2010 and July 2011, by a total of 125 basis points each. Generally, however, central banks remained reluctant to tighten monetary policy aggressively owing to concerns over the global recovery and fears that interest-rate hikes could stimulate short-term capital inflows. Thus, in most countries, average real interest rates were negative in 2011. In 2012, East Asia's central banks are expected to further ease monetary policy unless global economic conditions improve.

Most East Asian economies continue to have strong fiscal positions, with relatively low levels of public debt. Government spending expanded at a solid pace in 2011, albeit more slowly than in the aftermath of the crisis. To mitigate the impact of slowing exports, several Governments, including those of Indonesia, the Philippines and Thailand announced new, moderate-sized fiscal stimulus measures in the fourth quarter of 2011. After fiscal balances across the region improved considerably in 2010 as rapid economic growth boosted revenues, trends were more mixed in 2011. In the Philippines, the Republic of Korea and Singapore, budgets strengthened further, with the latter two countries and Hong Kong SAR registering a fiscal surplus. By contrast, Indonesia, Malaysia and Thailand saw a slight widening of deficits as Government spending increased markedly. China's central Government deficit stood at about 1.5 per cent of GDP in 2011. Though precise local and state government deficits are not known, and may even be larger in the aggregate than the deficit of the central Government, the general view is that the fiscal situation is very manageable. While most Governments have ample fiscal space, large-scale stimulus packages may be implemented only if the growth and employment outlook deteriorates significantly.

Fiscal positions remain strong as Government spending expands

East Asia continued to see strong growth in exports and imports in 2011, despite some moderation in the second half of the year as demand from developed economies weakened and international commodity prices eased. Compared to 2010, total nominal export receipts are estimated to have increased by about 20 per cent in China, Indonesia and the Republic of Korea. This primarily reflects rapidly growing trade within the region, as well as with other emerging countries. Sluggish global demand for electronics adversely affected the region's export sectors, most notably in the Philippines, where electronics shipments account for more than half of total exports.

Trade activity has started to slow down

In most economies, import spending increased at a rate similar to that of export revenues, which resulted in largely unchanged trade balances in 2011. With the exception of Viet Nam, all East Asian economies recorded a current-account surplus in 2011. China's current-account surplus, which had reached 10.6 per cent of GDP in 2007, declined to about 3.5 per cent of GDP in 2011. Since demand in developed economies is projected to remain sluggish in the outlook period, imports are expected to grow faster than exports, leading to a slight narrowing of external surpluses across the region.

East Asia experienced significant net outflows of portfolio capital in the third quarter of 2011 amid increased risk aversion among global investors and concerns that the crisis in developed economies could severely affect growth across the region. These outflows, mostly in the form of equity investment, led to a drop in the value of national currencies against the dollar. This marks a sharp reversal of the trend observed over the past two years, when the region saw large portfolio investment inflows resulting in considerable appreciation pressure on national currencies. To dampen the volatility of short-run capital inflows and limit currency appreciation, several economies, notably Indonesia, the Republic of Korea, Taiwan Province of China, and Thailand have been imposing new capital management measures since 2009. Despite the recent episode of portfolio capital outflows, East Asia is set to record significant net inflows of private capital for 2011 as a whole. Given the region's comparatively strong growth outlook and widely available liquidity, this trend is likely to continue in 2012 and 2013, with most currencies in East Asia projected to appreciate gradually.

Portfolio capital flows are still volatile, leading to more capital controls

While East Asia is not immune to a downturn in developed economies, the region is in a strong position to tackle the challenges arising from weaker external demand. However, deep and prolonged recessions in major developed economies would

Slower growth in developed economies and China pose downside risks

have a severe impact on economic growth in the region as falling exports and increased uncertainty could trigger a slowdown in private investment and consumption. In addition, should China's growth in 2012-2013 decelerate to the 7 per cent target rate of the 12th Five-Year Plan (2011-2015), the rest of the region would also see a more pronounced slowdown than currently expected.

South Asia: robust domestic demand drives growth

Economic growth is expected to remain resilient....

Economic growth in South Asia moderated in 2011, primarily owing to a slowdown of the Indian economy. After expanding by 7.2 per cent in 2010, real GDP is estimated to have grown by 6.5 per cent in 2011. The region is expected to remain fairly resilient to the global economic downturn and sustain its growth momentum in the outlook period. Driven by robust domestic demand, average growth is forecast to accelerate slightly to 6.7 per cent in 2012 and 6.9 per cent in 2013 (see annex table A.3).

...but is diverging widely across South Asia

Private consumption and investment continued to be the main growth drivers in the region, with domestic demand supported by strong agricultural output and robust remittance inflows. Strong exports, particularly in the first half of the year, and a solid expansion of Government spending also contributed positively to growth. However, growth disparities within the region remained wide with Bangladesh, India and Sri Lanka recording GDP growth of 6.5 per cent or higher, and the Islamic Republic of Iran, Nepal and Pakistan registering growth rates of less than 4 per cent.

India's economy has slowed over the past year as monetary policy was tightened in order to bring down inflation. With domestic demand moderating, GDP growth is estimated to have declined from 9 per cent in 2010 to 7.6 per cent in 2011. Assuming a gradual easing of inflationary pressures and an end to the monetary tightening cycle, growth is forecast to increase slightly to 7.7 per cent in 2012 and 7.9 per cent in 2013. Buoyant domestic demand and a recovery in exports underpinned strong growth in Bangladesh and Sri Lanka in 2011. In the Islamic Republic of Iran, Nepal and Pakistan, long-standing structural problems such as weak policy implementation, security concerns and low investment in physical and human capital constrain growth. In all three countries, economic conditions are expected to improve slightly in the outlook period, but growth will remain well below potential.

Employment is improving in India and Sri Lanka but remains weak elsewhere in the region

The latest labour force surveys in South Asia provide a mixed picture. While the employment situation in the fast-growing economies of India and Sri Lanka has improved, it remained weak in other parts of the region, notably in the Islamic Republic of Iran and crisis-ridden Pakistan. In Sri Lanka, the unemployment rate declined to an all-time low of 4.3 per cent in early 2011 on the back of a strong expansion in the services and industry sectors. By contrast, in the Islamic Republic of Iran and Pakistan, sluggish growth over the past few years has had a negative impact on employment. The average unemployment rate has increased in the Islamic Republic of Iran from 11.9 per cent in the fiscal year 2009-2010 to 14.6 per cent in 2010-2011 and in Pakistan from 5.6 per cent in the fiscal year 2009-2010 to 6.0 per cent in 2010-2011.

In addition to elevated unemployment rates, South Asia's labour markets face deep-rooted structural challenges, such as the highest share of vulnerable employment among all developing regions and widespread youth unemployment. Moreover, in all countries of the region, unemployment rates among women are far higher than among men.

Consumer price inflation remained high across South Asia in 2011, presenting a major challenge for policymakers. Regional inflation averaged 10.3 per cent, down only slightly from 11.6 per cent in 2010 and ranging from 7.0 per cent in Sri Lanka to 17 per cent in the Islamic Republic of Iran. The increases in consumer prices were driven by a variety of factors, including higher international food and energy prices, domestic supply shortages, the reduction of fuel subsidies in several countries (including the Islamic Republic of Iran) and buoyant demand conditions in Bangladesh, India and Sri Lanka. In the outlook, inflation is projected to decline slowly, averaging 9.1 per cent in 2012 and 8.0 per cent in 2013, as pressure from higher food and commodity prices eases and the impact of monetary policy tightening is felt in Bangladesh and India. However, there are substantial upside risks to inflation, including renewed supply shocks such as insufficient monsoon rains and a rise in international commodity prices.

Inflation remains high, but is projected to decline slowly

Facing high and persistent inflation, several central banks in South Asia, most notably the Reserve Bank of India, continued to tighten monetary policy in 2011. However, with risks to the world economy again rising, the focus of monetary authorities has started to shift towards supporting domestic demand. The Reserve Bank of India signalled an end to the current tightening cycle in October 2011 after hiking its key policy rates for the thirteenth time since early 2010. In Pakistan, a slowdown in inflation during the third quarter of 2011 led the State Bank to cut its main policy rate from 14 per cent to 12 per cent in an attempt to stimulate private investment and growth. Bangladesh Bank by contrast, stepped up measures to contain accelerating inflation, lifting interest rates and restraining credit flows, especially to sectors considered unproductive. Looking ahead, central banks are likely to continue to move towards a growth-supportive monetary policy if inflationary pressures ease.

Monetary policies diverge across countries depending on their inflation rates

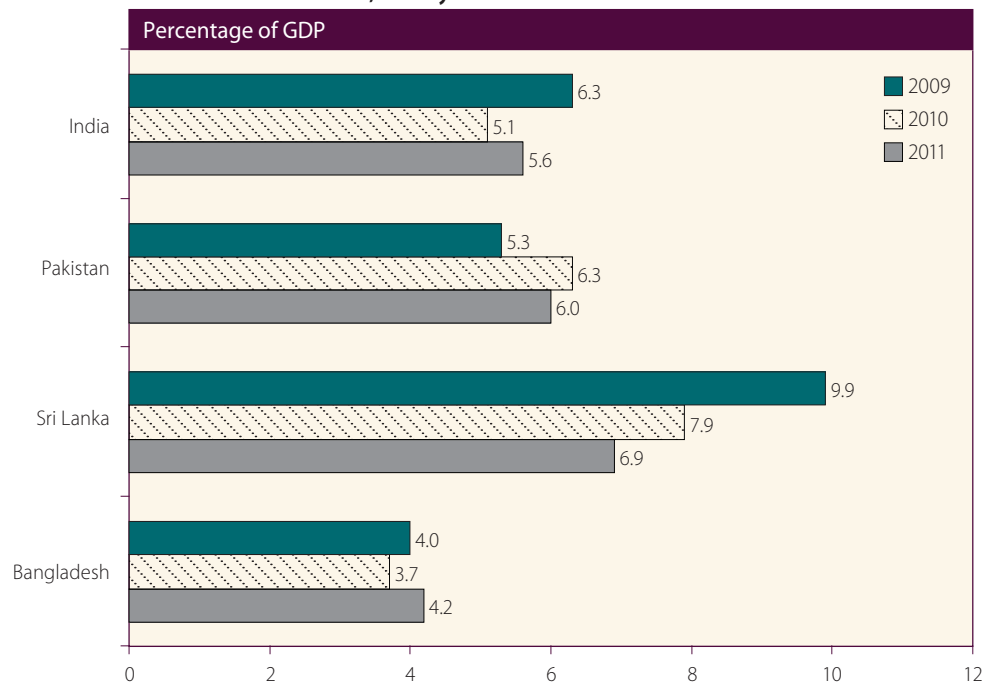
Despite some progress in recent years, fiscal deficits continue to be high in most South Asian countries, particularly in India, Pakistan and Sri Lanka (figure IV.7). Government spending rose significantly in 2011 as development expenditures (such as education, health and infrastructure spending), non-development expenditures (such as civil service pay and defence spending) and interest payments increased. Pakistan recorded a deficit of about 6 per cent of GDP in the fiscal year 2010-2011, missing the International Monetary Fund (IMF) target of 4.7 per cent. This can be mainly attributed to the devastating floods in 2010, higher security expenditures and failed efforts to implement a general sales tax due to domestic political opposition. India's fiscal deficit declined to 5.1 per cent of GDP in the fiscal year 2010-2011, as strong growth boosted tax revenues and the sale of 3G telecommunications licences increased non-tax revenues. However, India's Government is unlikely to reach the deficit target of 4.7 per cent of GDP for the fiscal year 2011-2012, as slowing growth is leading to a shortfall in tax revenues and the disinvestment of stakes in State-run companies is put on hold.

Fiscal deficits remain high

After recovering rapidly in the first half of 2011, South Asia's export sectors experienced a moderation in demand owing to deteriorating conditions in developed economies. Nonetheless, in most countries of the region, total export earnings in 2011 were about 20 per cent higher than a year ago. Bangladesh, Pakistan and Sri Lanka benefited from a strong recovery in demand for textiles and garments, partly as a result of significant cost increases in China and political turmoil in North Africa and Western Asia. In India, exports of engineering goods, petroleum products, gems and jewellery soared. High oil and commodity prices and strong domestic demand boosted import spending in 2011, notably in Bangladesh, India and Sri Lanka. Since, in most countries, imports had started from a higher base than exports, merchandise trade deficits widened further in

Trade deficits are widening further despite strong export growth

Figure IV.7
Central Government deficits in selected
South Asian countries, fiscal years 2009-2011



Sources: UN/DESA, based on data from national sources, the Economist Intelligence Unit and the IMF.

Note: In India, the fiscal year begins in April; in Bangladesh and Pakistan, the fiscal year ends in June; and in Sri Lanka, the fiscal year corresponds to the calendar year.

2011. This was partly offset by improvements in the services balance and higher current transfers, although workers' remittances grew at a slower rate than in previous years. In 2012, export growth is likely to decelerate, resulting in a further widening of trade deficits in most countries.

A prolonged recession in Europe will pose serious downside risks

A prolonged recession in Europe could have a significant impact on growth across South Asia as European countries continue to be a key export market for the region and a main source of tourism revenues. Renewed increases in international commodity prices also represent a risk for South Asia, as this would complicate fiscal deficit reduction and monetary policy decisions while also leading to a widening of current-account deficits.

Western Asia: growth trajectories shaken by political unrest

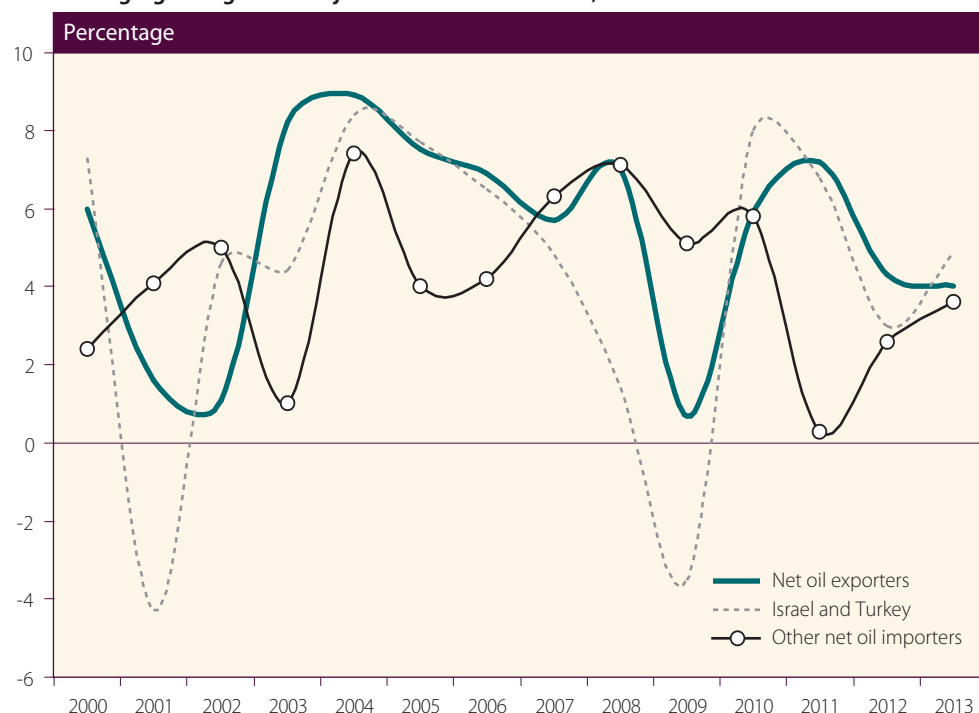
Political unrest is having strong asymmetric effects on regional economies

Western Asia's economic prospects have been subject to high uncertainty since the start of the Arab spring. As spreading political unrest pushed up oil prices despite weakening global aggregate demand, the economic performance of net oil exporters and importers diverged sharply in 2011, the former growing much faster than the latter. Violent clashes further affected economic activity in several countries. In Israel and Turkey, robust economic activity weakened during the second half of the year. In 2012, regional growth is forecast to decline from 6.6 per cent to 3.7 per cent with economic activity slowing down in most countries (see annex table A.3 and figure IV.8).

Growth in oil-exporting countries is driven by rising oil prices, public spending and domestic demand

Economic growth in oil-exporting countries strongly benefited from rising oil prices, as well as strong public spending and private consumption. Amidst growing volatility and widening spreads between two of the major oil price benchmarks (see chapter II), average yearly price levels have reached unprecedented highs in 2011 with the basket

Figure IV.8
Diverging GDP growth trajectories in Western Asia, 2000-2013



Source: UN/DESA, based on data from Project LINK.

price of the Organization of the Petroleum Exporting Countries (OPEC) remaining above \$100 per barrel (pb) during most of the year compared to an average of \$77 pb in 2010.⁴ Furthermore, when the conflict in Libya reduced global oil supply by 1.6 million barrels per day (mbd), Bahrain and the United Arab Emirates stepped up oil production, as did Saudi Arabia, which increased its crude supply to a record high of 9.8 mbd in August, well over the OPEC quota of 8.05 mbd. Qatar also benefited from rising energy prices as its liquefied natural gas production increased by 40 per cent during the first half of 2011.

The generous social spending measures announced by many Arab Governments in reaction to popular protests further boosted economic growth by increasing public and private consumption. As a result, most Gulf Cooperation Council (GCC) countries, as well as Iraq, fared even better in 2011 than they did in 2010. In 2012, growth is forecast to decline on the back of fading political turmoil and slackening economic activity in developed economies.

Lasting protests and violent clashes with authorities have dented growth in several countries. Bahrain, which promptly responded with military support from GCC countries to protests that had erupted in March, will experience positive though lower-than-expected growth in 2011. The unresolved sectarian divide, however, may discourage investors and harm Bahrain's ambition of becoming a regional hub for financial and other services. Yemen, as well as the Syrian Arab Republic, registered negative growth in 2011. Prospects for 2012 are dependent upon domestic political developments and the potential internationalization of Western economic sanctions.

Fuel importers experienced continued growth on sometimes shaky ground. Modest economic support measures stimulated private consumption on the back of

Unresolved domestic political issues may hamper growth in some countries

Oil-importing countries are expected to see slower growth

⁴ See chap. II, section on the oil market for further discussion based on the analysis of Brent price.

growing budget deficits. Regional unrest, however, in addition to rising oil prices and import bills, affected trade and tourism revenues, most starkly in Lebanon. In Turkey, strong private consumption supported economic activity, especially in the construction, trade, transportation and communication sectors. The economy grew by 7.5 per cent in 2011, but momentum faded during the second half of the year. The Turkish economy, along with that of Israel and many other countries in the region, is expected to see its growth slowing down in 2012 in the context of weakening external demand.

Despite low female participation in labour markets, unemployment remains high, especially among youth

Recent political unrest highlights the poor employment situation as well as the common problematic features of many labour markets in the region. Despite extremely low female participation rates, unemployment rates in the region are among the highest in the world, especially among educated youth. At the same time, migrant workers represent on average more than 70 per cent of the labour force in GCC countries. These conditions point, *inter alia*, at a longstanding lack of coherence between education and economic development policies. In order to counter the threat of spreading unrest, many Governments promised to quickly create jobs for nationals in the public sector and increase wages. Saudi Arabia is trying to impose quotas for nationals in private businesses.

In Turkey, after peaking above 14 per cent in 2009, the unemployment rate oscillated around 10 per cent during 2011. In Israel, unemployment receded to 5.6 per cent, below its pre-crisis level. Despite this apparent improvement, in July and August of 2011, rising income disparities and the high cost of living led the struggling working class to organize the largest social protests the country has experienced since its creation.

Inflationary pressures have weakened

During the first half of 2011, inflation was on the rise in all countries of the region as a result of increasing food and energy prices. In countries with pegged currencies, the weakness of the dollar further contributed to the rise in imported inflation. Over the same period, price levels rose significantly in Israel and Turkey driven by strong private consumption and credit growth. In Israel, this was compounded by the dramatic rise in housing prices, which have soared by 60 per cent since 2007. During the second half of the year, inflationary pressures in the region lessened with the weakening of aggregate demand and receding world food and energy prices. In Turkey, however, inflation remained above the central bank's target, and is expected to moderate further in 2012.

Many countries are pegged to the dollar, while others are tightening policies to deal with inflation

Monetary authorities in the region pursue different objectives. In most Arab countries, currencies are pegged to or closely managed against the dollar, and monetary policy is tied to the stance of the Fed in order to limit unhealthy carry trades. Inflation-targeting led the Bank of Israel to raise its policy rate four times in a row in 2011 before lowering it twice as weakening demand from its main export markets threatened to affect domestic demand. Like other emerging markets, Turkey has to deal with the effects of large capital inflows and outflows. Since the end of 2010, the central bank's policy mix has consisted of capping loan growth instead of raising interest rates to avoid overheating. This initially allowed it to simultaneously stabilize inflation while discouraging carry trade. However, as capital kept moving out of the country, the effective nominal exchange rate depreciated by almost 20 per cent and pushed up imported inflation. Indeed, as external demand declined in an increasingly depressed international environment, import demand remained high given continued strong domestic demand growth and typically slow responsiveness of imports to exchange-rate changes. In October, annual inflation rose sharply to 7.7 per cent, up 1.5 percentage points compared to the previous month. Although the central bank forecasts inflation of 8.3 per cent this year, 2.8 percentage points above the target, it has kept the policy interest rate unchanged in a bid to sustain economic growth. Monetary tightening occurred, however, through the sharp rise in

October of the overnight rate from 5.75 per cent to 12.5 per cent, while reserve requirements were loosened to ensure adequate liquidity.

Fiscal policy in Western Asia was significantly affected by political turmoil, forcing rulers to devise unprecedented social spending measures to quench claims for domestic political reform. In Saudi Arabia, for instance, two extraordinary spending packages worth a combined 30 per cent of GDP have been announced, which aimed to increase employment, wages and consumption in the short run as well as address housing shortages in the long run. Other countries threatened by political unrest adopted similar, although more modest spending packages. Such measures were financed out of existing budget surpluses in oil-exporting countries, but they widened fiscal deficits in oil importing countries, whose Governments had to recur to international development assistance and financial markets to raise funds. Policies aimed at increasing consumption instead of stimulating economic diversification and productivity growth may become a drag on public budgets and economic development over the long run.

External balances in fuel-exporting countries showed solid surpluses in 2011 as a result of the combination of higher oil prices and increased production. Oil importing countries saw their import bills rise substantially with the oil price increase. Their external environment worsened further with the region-wide repricing of risk that weighs more on the oil-importing countries. All countries registered portfolio investment outflows, and FDI into the region is estimated to have declined for the third consecutive year, by 14 per cent in 2011. The impact in oil-exporting countries, however, has been cushioned as the financing for large-scale oil projects remained uninterrupted.

In Turkey, the weak lira improved the competitiveness of Turkish tradable goods and services. However, in the context of strong domestic and weak external demand, exports have not kept pace with imports, causing the current-account deficit to widen to about 10 per cent of GDP in 2011. In Israel, exports representing about a quarter of GDP were negatively affected by declining demand from its main export markets starting in the second half of 2011, and the current-account balance may turn slightly negative for the first time since 2002.

In the outlook, Western Asia faces three major downside risks. First, the region may be destabilized by the revival of international tensions or by sprawling domestic political unrest. Second, if the financial woes and deeper fiscal austerity in developed countries were to trigger a global downturn, oil prices could drop below break-even prices for fiscal sustainability in oil-exporting countries. In the long run, 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 stability and prosperity in the region.

Spending packages have been devised to address political unrest

Oil exporters continue to have strong external balances...

...but the rest of the region is facing current-account deficits

Continued political unrest, a possible global downturn and lack of economic diversification pose serious downside risks

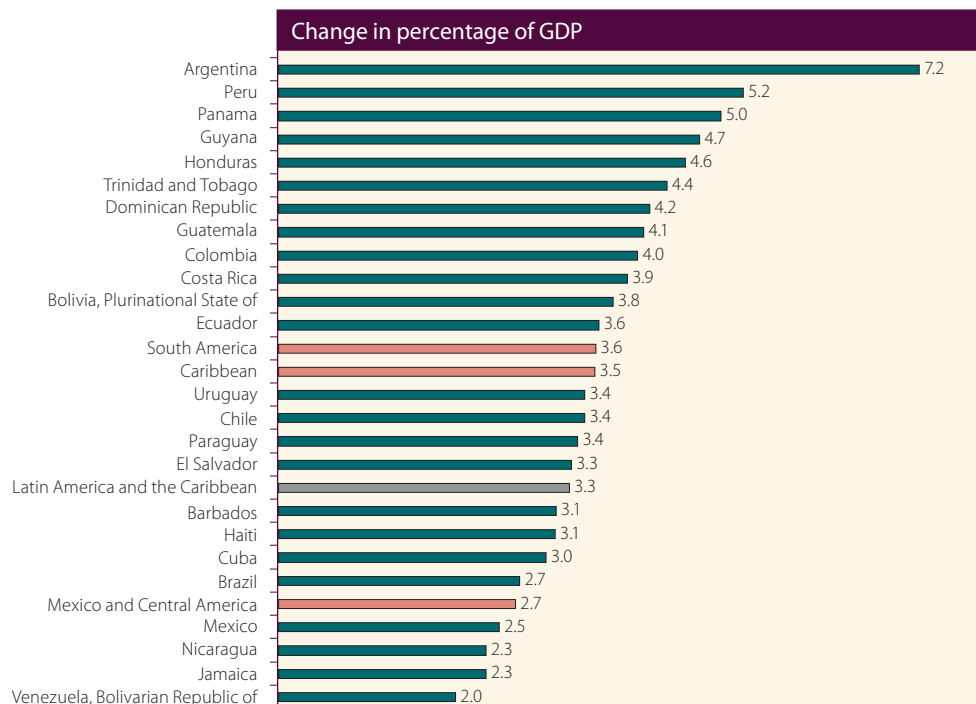
Latin America and the Caribbean: robust but uneven recovery

Economies in Latin America and the Caribbean experienced, on average, robust growth in 2011, with an estimated 4.3 per cent increase of GDP, though this did mark a deceleration from the 6 per cent growth rate achieved in 2010. The average masks important differences in performance across countries (figure IV.9). Growth trends also differed starkly between the first and second halves of the year.

South America's GDP grew on average by an estimated 4.6 per cent in 2011. It boomed in the first quarter of the year only to gradually decelerate thereafter. Both

South American growth is robust but slowing

Figure IV.9
Growth forecast for Latin America and the Caribbean, 2012



Source: UN/DESA, based on data from Project LINK.

internal and external factors drove the expansion. Internally, increasing employment reduced poverty and inequality, thereby boosting private consumption. This occurred most markedly in Brazil, the region's largest and most populated economy, but also in the rest of South America, where urban unemployment is currently lower than before the crisis. Meanwhile, private and public investment increased too, fuelled by expanding credit and underpinned by solid bank balance sheets. Rising commodity prices pushed up export revenues, providing Governments with additional revenue through royalties, State-owned commodity operations and taxes.

The economies of Mexico and Central America grew by a more moderate average of 3.8 per cent and the Caribbean grew by 3.4 per cent in 2011. On average, private and public consumption saw a downward trend, while unemployment rates remained virtually unchanged compared to 2010. Exports, typically a major driver of growth in Central America and the Caribbean, were held back by the economic slowdown of the United States and other high-income countries that are their major market destinations. Also, several Central American and Caribbean economies heavily rely on remittances and tourism, which decreased during the global recession and have since remained below their long-term average as recovery in advanced economies has faltered.

Fiscal policies tightened in several South American countries in the first and part of the second quarter of 2011. In Brazil and Peru, several stimulus programmes put in place in response to the 2009 global crisis were phased out. In the third quarter, as fears of overheating faded and concerns about a second global downturn mounted, Governments announced the preparation of additional expansionary measures to be deployed in the event of an actual new downturn. The Governments of some commodity-exporting countries, such as Chile and Peru, announced their intention to tap the funds accumulated

The recovery in Mexico, Central America and the Caribbean is slowing as growth in developed countries weakens

New fiscal stimuli under way to counter a global downturn...

during the period of rallying commodity prices and deploy additional resources to expand social cash-transfer programmes. In November, Brazil returned to fiscal expansion with a \$1.5 billion programme targeting food purchases and consumption of other goods. In the same month, the Government of Ecuador presented an expansionary fiscal budget for 2012 featuring a strong investment push.

Compared to 2008-2009, however, the fiscal space for large-scale counter-cyclical measures is relatively limited. Indeed, the additional spending aimed at containing the impact of the global recession, combined with an incomplete restoration of tax revenues, raised the public debt-to-GDP ratio by more than 5 percentage points.

On the monetary front, policy has been active, too. Monetary policies in most parts of the region were initially characterized by repeated increases of the policy interest rates amid fears of inflation. On average, inflation was slightly above 7 per cent in Latin America and the Caribbean in 2011. Monetary stances have differed strongly, however. Monetary authorities in Brazil, Chile, Colombia, Mexico, Peru and Uruguay have focused primarily on price stability, adopting inflation targeting. Yet, they recorded consumer price indices near the upper bound of their target range. Among these, the inflation rates of Brazil, Peru and Uruguay were above their upper bounds, between 3 per cent and 7.5 per cent.

In these economies, inflation remained high because of rapid growth of internal demand and rising food and asset prices. In the fourth quarter of 2011, upward pressure on nominal wages intensified in Brazil. In Mexico, Nicaragua and Central America, the impact of rising food prices on overall inflation was stronger as food expenditures weighed more heavily on household budgets than they did in South America.

Two large economies in the region, Argentina and the Bolivarian Republic of Venezuela, recorded double-digit inflation in 2011. In the latter, annual inflation reached approximately 24 per cent in September 2011, driven by growing consumption and the depreciation of the bolivar. In Argentina, inflation, as measured through the GDP deflator, was 17 per cent, while nominal wages and the monetary base grew by 25 per cent and 30 per cent, respectively.

As economic activity slowed in the second and third quarters, central banks in Brazil, Chile, Colombia and Peru changed course, interrupting tightening trends and increasing liquidity. In Mexico, concerns over another possible downturn of the United States economy dominated monetary policy considerations. The stance was kept accommodative throughout 2011.

International commodity prices recorded sustained increases in the first half of 2011. They have slowed since, but stayed above long-term averages. On balance, terms of trade improved on average by an estimated 6 per cent in 2011, but with commodity-exporting countries recording large gains and commodity importers suffering losses. Exporters of metals and minerals (Chile and Peru) benefited the most, followed by oil and gas exporters (the Bolivarian Republic of Venezuela, Colombia, Ecuador and the Plurinational State of Bolivia) and exporters of agricultural commodities (Argentina, Brazil, Chile, Paraguay and Uruguay). On the other hand, when commodity prices, especially those of non-precious metals, retreated in the second half of 2011, the economies of Chile and Peru were affected the most. Argentina was affected by the fall in grain prices.

Despite the slowdown of commodity prices in the second half of the year, early increases allowed Jamaica, Suriname and Trinidad and Tobago, to record current-account surpluses. Several Caribbean countries, in contrast, faced adverse conditions due to rising

...but fiscal space is more limited for counter-cyclical responses

Inflation and slowing economic growth across the region pose dilemmas for central banks

Rising commodity prices have helped improve the terms of trade of primary commodity-exporting countries

food and energy prices. Haiti was hit particularly hard by higher food prices and poor crops in 2011, and was listed by the Food and Agriculture Organization of the United Nations (FAO) among those countries requiring external food assistance.

Financial markets have been volatile, but the banking sector remains stronger than in other regions

Asset prices also showed high volatility throughout the year. Major financial markets in the region also suffered from contagion of the global financial turmoil during the third quarter of 2011, reflected in a sell-off in stock markets and sudden reversals of short-term capital flows. Speculative capital flows affected the non-banking financial sector more than Latin American banks. Banks' balance sheets have remained solid, with a relatively low share of non-performing loans. One concern, however, is the strong presence of Spanish banks whose exposure in the European sovereign bonds market, especially those of Italy and Portugal, tops €120 billion. Sovereign defaults in the euro area or further capital requirements beyond those already under way may prompt these banks to reduce credit or liquidate assets in Latin American operations to repatriate capital to Spain.

External volatility has prompted various countries to intervene in foreign-exchange markets

In order to respond to external volatility, monetary authorities, in particular those of Argentina, Brazil, Colombia, Costa Rica, Mexico, Peru and Uruguay adopted various forms of intervention in foreign-exchange markets. While exchange rates have generally been free to fluctuate, several central banks intervened in the second and third quarters of 2011 in order to mitigate currency appreciation and preserve export competitiveness. Both Brazil and Peru enhanced capital account regulations, while some countries experimented with indirect measures such as stockpiling international reserves and pre-paying external debt. Brazil has been particularly active in trying to stabilize the value of its currency. Amidst concerns of overvaluation and deindustrialization, the Government intervened to lower the exchange rate in September, and soon after, a free fall of the real forced it to change course and support the rate. As capital movements remained very volatile, Brazil introduced mild forms of capital-account regulation aimed not only at stabilizing the currency but also at gaining better control over monetary policy.

Growth is forecast to slow moderately across the region

In the outlook for 2012, South American economies are expected to continue the deceleration that set in during 2011, reaching a modest 3.6 per cent GDP growth in the baseline forecast. The economies of the Caribbean, Central America and Mexico are expected to slow down as well, with growth projected to average 3 per cent in 2012.

Risks to the outlook are mainly on the downside. Economic growth prospects in the Caribbean, Central America and Mexico will darken considerably with a possible downturn in Europe and the United States. This could then trigger a downward spiral of lower tax revenues, difficulties in servicing public debts, greater fiscal austerity and even lower demand growth. A slowdown of the Chinese economy, a major buyer of the region's commodities and major investor in South America, may weaken demand for manufacturing exports and soften commodity prices, further affecting the South American economies. A deepening of the sovereign debt crises in Europe and fears of dollar funding drying up could spill over through rising spreads on emerging market bonds and make public and private financing more expensive or unavailable for some countries in the region. Finally, if such financial spillover effects lead to tighter domestic credit supplies, investment and consumer demand growth would be held back further. Some financial institutions, including the IMF and some central banks, optimistically see possible upside risks in the event that sovereign debt crises in the developed countries unwind more quickly than expected, allowing for stronger rebounds in demand and FDI.