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World Economic Situation and Prospects 2012

Euro area debt crisis biggest threat to world economy, UN reports

Fundamental policy shift away from austerity needed to tackle jobs crisis and promote green growth

New York, 7 June: The euro area debt crisis remains the biggest threat to the world economy, according to a UN report released today. An escalation of the crisis could result in severe turmoil in financial markets and a sharp rise in global risk aversion, leading to a further weakening of global growth, says the *UN World Economic Situation and Prospects (WESP)* 2012 mid-year update.

The report notes that the world economic situation continues to be challenging. Following a marked slowdown in 2011, global growth will likely remain tepid in 2012, with most regions expanding at a pace below potential. In the baseline outlook, the world gross product (WGP) is projected to grow by 2.5 per cent in 2012 and 3.1 per cent in 2013, following growth of 2.7 per cent in 2011. These projections constitute a slight downward revision from the forecasts presented in the *WESP 2012* in January.

Most developed economies are still struggling to overcome the economic woes originating from the 2008-09 global financial crisis. The report cites four major weaknesses that continue to conspire against any robust economic recovery. First, deleveraging by banks, firms and households continues to restrain normal credit flows and consumer and investment demand. Second, unemployment remains high, a condition that is both cause and effect in preventing economic recovery. Third, the fiscal austerity responses to rising public debts not only deter economic growth, but also make a return to debt sustainability more difficult. And fourth, bank exposures to sovereign debts, along with the weak economy, perpetuate financial sector fragility and, in turn, spur continued deleveraging.

The report points out that developed countries, especially in Europe, are struggling to break this vicious cycle. Even if further deepening and spreading of the euro area crisis can be avoided, economic activity in the European Union is expected to stagnate in 2012.

The report estimates that world trade growth will slow further to 4.1 per cent in 2012, down from 13.1 per cent in 2010 and 6.6 per cent in 2011.

Faced with weakening external demand and increased global uncertainties, developing countries and economies in transition are projected to see notable output growth moderation to 5.3 per cent and 4.0 per cent, respectively, in 2012. Average economic growth in these economies is forecast to pick up slightly thereafter, providing that downside risks do not materialize.

The jobs crisis continues

In the face of subdued growth, the jobs crisis continues. Global unemployment remains above its pre-crisis level and is rising rapidly in the euro area. Employment-to-population ratios remain below their 2007 levels in all major economies, except Brazil, China and Germany. By the end of 2011, an estimated 48 million additional jobs were required for employment ratios to return to pre-crisis levels.

In the United States, despite recent improvements, the unemployment rate remains high at over 8 per cent, well above pre-crisis levels. The unemployment rate in the euro area as a whole increased to a historic high of 10.9 per cent in March 2012, up by one percentage point from a year ago. In the crisis-struck economies of the euro area, unemployment has reached alarming levels. In Greece, Ireland and Spain, the unemployment rate is more than 10 percentage points higher than it was in 2007. Furthermore, long-term unemployment continues to rise in developed economies, accounting for about 40 per cent of the unemployed in many countries.

By contrast, employment rebounded in developing countries more strongly than elsewhere, especially in East Asia and Latin America. Large job deficits remained, however, at the end of 2011 in many countries in South Asia (including in India), Western Asia (particularly in countries affected by political instability), Africa (including in South Africa), and Latin America (including in Mexico and Venezuela).

Policy recommendations

Given the subdued outlook of the world economy, the UN report says that global policymakers face enormous challenges. Clearly, the efforts at regaining debt sustainability through fiscal austerity are backfiring. More concerted and coherent efforts on several fronts of national and international policy making are needed to break out of the vicious cycle of continued deleveraging, rising unemployment, fiscal austerity and financial sector fragility.

On the fiscal front, *WESP* says the current policies in developed economies, especially in Europe, are heading in the wrong direction, driving the economies further into crisis and increasing the risk of a renewed global downturn. The severe fiscal austerity programmes implemented in many European countries, combined with mildly contractionary policies in others, such as Germany and France, carry the risk of creating a vicious downward spiral with enormous economic and social costs.

The UN report says it is essential to change course in fiscal policy and shift the focus from short-term consolidation to robust economic growth with medium to long-term fiscal sustainability. Premature fiscal austerity should be avoided and, while necessary, fiscal consolidation should focus on medium-term, rather than short-term adjustment.

The report stresses that the reorientation of fiscal policies should be internationally coordinated and aligned with structural policies that support direct job creation and green growth. It further recommends that monetary policies be better coordinated internationally and regulatory reforms of financial sectors be accelerated in order to stem exchange rate and capital flow volatility, which pose risks to the economic prospects of developing countries. There is also a need to secure sufficient development assistance to help the poorest nations accelerate progress towards achievement of the millennium development goals and invest in sustainable development. Fiscal adjustment should not come at the expense of development and donors should deliver on existing aid commitments, the report says.

Western Europe

WESP paints a pessimistic view for Western Europe. The economic recovery has come to a complete halt. After growing by 1.5 per cent in 2011, aggregate GDP is expected to contract by 0.3 per cent in 2012 with only a modest rebound of 0.9 per cent predicted for 2013. This represents a significant downward revision from the January 2012 forecasts. The more sombre outlook stems mostly from the impact of the euro area debt crisis combined with a slowing of international demand and high energy prices. The debt crisis has resulted in increasingly stringent fiscal austerity programmes in those countries facing acute financing difficulties, weakened the banking system in the region, and raised uncertainty to such an extent that confidence is falling.

The aggregate picture masks important differences across the region, however. Germany's economy, for example, is expected to grow by 1.0 per cent in 2012, while the debt-ridden countries will remain mired in recession. For the euro area, average unemployment is expected to increase from 10.2 per cent in 2011 to 11.1 per cent in 2012 and remain at an 11.0 per cent high in 2013.

Austerity impacts growth

Fiscal austerity has already pushed many European countries further into recession. Defeating the point of fiscal consolidation, this is particularly relevant for the debt-ridden euro area economies, including Greece and Portugal; but other economies in the region have also fallen back into recession, following fiscal retrenchment over the past two years.

At present, the biggest danger for the euro area is posed by the situation in Italy and Spain as the size of their debts would likely challenge the region's rescue funds. The main fear is that Spain will slide deeper into recession, driving up its borrowing costs, leading to increased market turmoil and eventually requiring a bailout. This would leave insufficient funds available for Italy and renew speculation on a break-up of the euro area, further unsettling financial markets and triggering a downturn in global economic activity.

The new EU members

Among the new EU members, some countries, such as Hungary, may slip back into recession. Poland's economy is less export-dependent and, as a result, may escape a sharp slowdown. Consumer confidence remains fragile as fiscal austerity measures encompass wage and employment reductions in the public sector. The slowing growth will delay the recovery in employment.

The United States and Japan

The UN report takes a less sombre view of the US economy, which, it notes, started 2012 on a stronger footing. Job creation has exceeded expectations; stock market indices have registered solid gains and credit conditions have eased notably while consumer confidence and spending have increased markedly. Economic activity is expected to grow by 2.1 per cent in 2012 and 2.3 per cent in 2013, a slight upgrade from the previous forecast and above the 1.7 per cent recorded in 2011.

But the economy is not out of the woods yet. The unemployment rate remains much higher than before the crisis, and job creation in April slowed again to a level below what is needed to absorb the natural increase of the labour force. Weak employment conditions, along with the continued fragile housing market and risk of foreclosures, are holding back consumer spending. With the fiscal stimulus measures injected during the crisis now phasing out, Government spending has declined, slowing output growth. Furthermore, the upcoming presidential election creates uncertainties over the fiscal policy outlook, clouding economic prospects overall.

In Japan, the report projects that the economy will recover moderately in the outlook period. In 2011, falling net exports dragged GDP growth, resulting in a 0.7 per cent contraction. However, economic activity is projected to grow by 1.7 per cent in 2012 and 2.1 per cent in 2013.

Economies in transition

After growing at a robust pace in 2011, the economies of the Commonwealth of Independent States (CIS) are expected to see a mild slowdown in the outlook period. Output is projected to expand by 4.3 per cent on average in 2012, compared with 4.7 per cent in 2011. For major regional energy exporters, such as the Russian Federation and Kazakhstan, steady economic growth remains contingent on oil prices staying near present levels.

The economies of South-Eastern Europe are expected to stagnate in 2012, owing to weak external and domestic demand, with Croatia likely to fall back into recession. Economic activity in the region is forecast to expand by only 0.6 per cent in 2012 and 1.8 per cent in 2013.

Developing economies

Economic growth in Africa will remain solid in the outlook period, but slightly below the level forecast in *WESP 2012*. The region is expected to see its GDP grow by 4.2 per cent in 2012 and 4.8 per cent in 2013, a downward revision by 0.7 and 0.3 percentage points, respectively.

Weak demand in developed countries and a slowing Chinese economy are likely to weigh on economic growth in East Asia. Average regional growth is projected to slow from 7.1 per cent in 2011 to 6.5 per cent in 2012. In 2013, the pace of growth is projected to pick up slightly as global demand recovers, with regional GDP forecast to expand by 6.9 per cent. While the risk of a hard landing of China's economy in the outlook period is low, growth in China is forecast to slow from 9.2 per cent in 2011 to 8.3 per cent in 2012.

Economic growth in South Asia is projected to moderate to 5.6 per cent in 2012, down from 6.1 per cent in 2011 as the region continues to face significant regional and global headwinds. In 2013, average GDP growth is expected to accelerate again to 6.1 per cent. India's economy is forecast to expand by 6.7 per cent in 2012, after growing by 7.1 per cent in 2011.

Western Asia's growth momentum decelerated in the second half of 2011 and early 2012. This was due to weakening external demands, coupled with a moderation of public spending growth, following the exceptional measures taken in the wake of the Arab Spring. As a result, average regional growth is expected to decline from 6.9 per cent in 2011 to 4.0 per cent in 2012 and 4.4 per cent in 2013.

Economic growth in Latin America and the Caribbean is expected to slow from 4.3 per cent in 2011 to 3.7 per cent in 2012, before accelerating again to 4.2 per cent in 2013. In many countries, the phasing out of fiscal and monetary stimulus measures has curbed domestic demand growth. The Caribbean economies are projected to see a mild acceleration of GDP growth to 3.3 per cent in 2012 and 4.0 per cent in 2013, up from 2.5 per cent in 2011.

The least developed countries are forecast to grow by an average of 4.1 per cent in 2012, almost 2 percentage points lower than originally projected in *WESP 2012*. This significant downward revision is largely the result of much weaker than expected growth performances in Sudan and Yemen where entrenched conflict continues.

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