

## Chapter I

# Global economic outlook

## Prospects for the world economy in 2014-2015

### Global growth continues to face headwinds

The world economy has experienced subdued growth for another year in 2013, unable to meet even the modest projections many institutional forecasters made earlier, including the *World Economic Situation and Prospects (WESP) 2013*. According to the information available in November, world gross product (WGP) is estimated to have grown by 2.1 per cent in 2013, lower than the baseline forecast of 2.4 per cent published in *WESP 2013*, but still better than the alternative pessimistic scenario presented in that report.<sup>1</sup>

Underperformance in the world economy was observed across almost all regions and major economic groups. Most developed economies continued struggling in an uphill battle against the lingering effects of the financial crisis, grappling in particular with the challenges of taking appropriate fiscal and monetary policy actions. A number of emerging economies, which had already experienced a notable slowdown in the past two years, encountered new headwinds during 2013 on both international and domestic fronts.

Some signs of improvements have shown up more recently: the euro area has finally come out of a protracted recession, with gross domestic product (GDP) for the region as a whole returning to growth; a few large emerging economies, including China, seem to have backstopped a further slowdown and are poised to strengthen. Premised on a set of assumptions (box I.1), WGP is forecast to grow at a pace of 3.0 and 3.3 per cent for 2014 and 2015, respectively (table I.1, figure I.1). Again, this baseline forecast is made in the context of a number of uncertainties and risks emanating from possible policy missteps and factors beyond the economic domain.

Despite the notable differentials in the growth rates among different groups of countries, cyclical movements in growth remain synchronized (figure I.2). While the average growth of middle-income countries continues to be the highest, growth for the least developed countries (LDCs) is expected to strengthen in 2014-2015 (box I.2).

Among developed countries,<sup>2</sup> the United States of America is estimated to grow at a meagre pace of 1.6 per cent in 2013, significantly lower than the 2.8 per cent growth of the previous year. Fiscal tightening and a series of political gridlocks over budgetary issues during the year have weighed heavily on growth. Monetary policy has been extremely accommodative, but it has had greater effect on boosting equity prices than

The world economy underperformed across almost all regions in 2013

Cyclical movements in growth remain synchronized among world economies

Political wrangling over budgetary issues lingers in the United States

<sup>1</sup> *World Economic Situation and Prospects 2013* (United Nations publication, Sales No. E.13.II.C.2), available from [http://www.un.org/en/development/desa/policy/wesp/wesp\\_current/wesp2013.pdf](http://www.un.org/en/development/desa/policy/wesp/wesp_current/wesp2013.pdf).

<sup>2</sup> Chapter IV contains a more detailed discussion on the economic outlook for different regions and countries.

Table I.1  
Growth of world output, 2007-2015

Annual percentage change	2007-2010 <sup>a</sup>	2011	2012 <sup>b</sup>	2013 <sup>c</sup>	2014 <sup>c</sup>	2015 <sup>c</sup>	Change from WESP 2013 forecast <sup>d</sup>	
							2013	2014
<b>World</b>	1.8	2.8	2.4	2.1	3.0	3.3	-0.3	-0.2
<b>Developed economies</b>	0.3	1.5	1.3	1.0	1.9	2.4	-0.1	-0.1
United States of America	0.3	1.8	2.8	1.6	2.5	3.2	-0.1	-0.2
Japan	0.0	-0.6	1.9	1.9	1.5	1.2	1.3	0.7
European Union	0.2	1.7	-0.4	-0.1	1.4	1.9	-0.7	-0.3
EU-15	0.1	1.5	-0.5	-0.1	1.4	1.8	-0.6	-0.2
New EU members	2.0	3.0	0.6	0.5	2.1	2.7	-1.5	-0.8
Euro area	0.2	1.6	-0.7	-0.5	1.1	1.6	-0.8	-0.3
Other European countries	1.1	1.6	1.9	1.7	2.6	2.9	0.2	0.7
Other developed countries	1.6	2.4	2.5	2.0	2.6	2.9	0.0	-0.4
<b>Economies in transition</b>	2.9	4.6	3.2	2.0	3.3	4.0	-1.6	-0.9
South-Eastern Europe	2.6	1.9	-0.9	1.8	2.6	3.1	0.6	0.0
Commonwealth of Independent States and Georgia	2.9	4.8	3.4	2.0	3.4	4.1	-1.8	-1.0
Russian Federation	2.4	4.3	3.4	1.5	2.9	3.6	-2.1	-1.3
<b>Developing economies</b>	5.9	5.9	4.7	4.6	5.1	5.3	-0.5	-0.5
Africa	4.8	0.8	5.7	4.0	4.7	5.0	-0.8	-0.4
North Africa	4.6	-6.1	7.2	2.3	3.3	4.3	-	-
East Africa	6.5	6.5	6.0	6.0	6.4	6.4	-	-
Central Africa	4.8	3.9	5.8	4.2	4.8	4.1	-	-
West Africa	6.0	6.1	6.7	6.7	6.9	6.8	-	-
Nigeria	6.9	6.8	6.5	6.5	6.9	6.7	-0.3	-0.3
Southern Africa	3.9	4.0	3.5	3.6	4.2	4.4	-	-
South Africa	2.6	3.5	2.5	2.7	3.3	3.7	-0.4	-0.5
East and South Asia	7.6	7.0	5.5	5.6	5.8	6.0	-0.4	-0.5
East Asia	7.7	7.1	5.9	6.0	6.1	6.1	-0.2	-0.4
China	10.8	9.3	7.7	7.7	7.5	7.3	-0.2	-0.5
South Asia	6.9	6.4	4.2	3.9	4.6	5.1	-1.1	-1.1
India	8.1	7.3	5.1	4.8	5.3	5.7	-1.3	-1.2
Western Asia	4.0	6.9	3.9	3.6	4.3	3.9	0.3	0.2
Latin America and the Caribbean	3.4	4.4	3.0	2.6	3.6	4.1	-1.3	-0.8
South America	4.5	4.6	2.5	3.2	3.4	4.1	-0.8	-1.0
Brazil	4.6	2.7	0.9	2.5	3.0	4.2	-1.5	-1.4
Mexico and Central America	1.4	4.1	4.0	1.5	4.0	4.2	-2.4	-0.6
Mexico	1.2	4.0	3.9	1.2	4.0	4.2	-2.6	-0.6
Caribbean	3.5	2.7	2.8	2.4	3.3	3.8	-1.3	-0.5
<b>By level of development</b>								
High-income countries	0.6	1.7	1.5	1.2	2.1	2.5	-0.1	-0.1
Upper-middle-income countries	5.9	5.9	5.1	4.6	5.3	5.4	-0.8	-0.5
Lower-middle-income countries	6.1	5.8	4.4	4.7	5.0	5.4	-0.8	-1.0
Low-income countries	6.1	6.2	6.0	5.7	6.1	6.1	-0.2	0.2
Least developed countries	6.9	3.6	4.9	5.4	5.7	5.7	-0.3	0.2
<b>Memorandum items</b>								
World trade <sup>e</sup>	3.0	6.7	2.9	2.3	4.7	5.2	-2.0	-0.2
World output growth with PPP-based weights	3.0	3.7	3.0	2.9	3.6	4.0	-0.4	-0.4

Source: UN/DESA.

<sup>a</sup> Average percentage change.

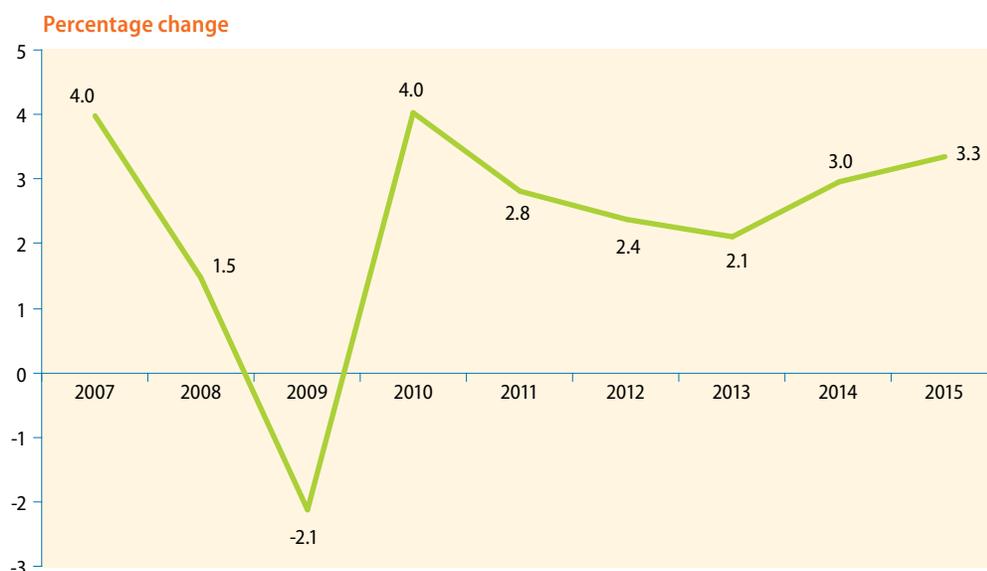
<sup>b</sup> Actual or most recent estimates.

<sup>c</sup> Forecast, based in part on Project LINK and baseline projections of the UN/DESA World Economic Forecasting Model.

<sup>d</sup> See *World Economic Situation and Prospects 2013* (United Nations publication, Sales No. E.13.II.C.2).

<sup>e</sup> Includes goods and services.

Figure I.1  
Growth of world gross product, 2007-2015<sup>a</sup>



Source: UN/DESA.

<sup>a</sup> Growth rate for 2013 is partially estimated; rates for 2014 and 2015 are forecast.

#### Box I.1.

##### Major assumptions for the baseline forecast

This box summarizes key assumptions underlying the baseline forecast, including monetary and fiscal policies for major economies, exchange rates for major currencies, international prices of oil and other primary commodities. Policy assumptions for other countries can be found in the text of chapter IV.

##### Monetary policy

The United States Federal Reserve (Fed) is expected to continue its accommodative stance in the outlook for 2014-2015. In accordance with the forward monetary policy guidance of the Fed, it is assumed that in the forecasting period of 2014-2015 the federal funds interest rate will remain within the range of 0.0 to 0.25 per cent until mid-2015, followed by a gradual increase starting in the third quarter of 2015. The adjustment of long-term assets on the Fed balance sheet will be implemented in three phases: the Fed will taper the amount of its purchases beginning in December of 2013, from the current level of \$85 billion per month, and gradually reach zero by mid-2014; assets will be held on its balance sheet for the period until mid-2015; assets will then be unloaded gradually, beginning in the third quarter of 2015.

The European Central Bank is assumed not to cut its policy interest rates further, but to keep policy rates at the current levels through the end of 2015, followed by a gradual path of increases. The outright monetary transaction programme will remain in place and refinancing operations will continue to meet the needs of the banking sector.

The Bank of Japan (BoJ) is assumed to continue its Quantitative and Qualitative Monetary Easing programme as it was originally designed until the end of 2014. The policy rate for BoJ is also assumed to stay within the range of 0.0 to 0.1 per cent through the end of 2015, to accommodate the second hike of the consumption tax rate that is assumed to be implemented in October 2015.

The People's Bank of China is expected to maintain its prudent monetary policy stance, while making some adjustments to ensure a balance between growth and economic restructuring. Interest rates are likely to remain unchanged over the next few quarters. Money supply growth is expected to moderate slightly in 2014-2015. Meanwhile, continued financial reform—especially further liberalization of interest rates—and increased regulations in the shadow banking sector will have significant impacts on the liquidity conditions in the economy, on top of conventional monetary policy.

## Box I.1.

**Major assumptions for the baseline forecast** (*continued*)**Fiscal policy**

Fiscal policy in the United States is expected to remain restrictive in 2014-2015, but less severe than 2013. The sequestration is assumed to be replaced by an agreement on spending cuts in Medicare, Medicaid and Social Security. Emergency unemployment insurance benefits will be phased out gradually. Government spending in real terms will be flat in 2014-2015.

In the euro area, 12 out of 17 European Monetary Union countries remain under the Excessive Deficit Procedure and will continue to pursue consolidation programmes, with the crisis countries pursuing even more stringent consolidation programmes. The Economic and Financial Affairs Council granted a number of countries an extension of the deadline to correct excessive deficits: 2014 for the Netherlands and Poland; 2015 for France, Portugal and Slovenia; and 2016 for Spain. They also deemed that Italy has corrected its excessive deficit. Fiscal policy in the region will continue to be focused on reducing fiscal imbalances. The debt crisis countries are assumed to continue their adjustment programmes, but the timetable for achieving targets will in some cases be extended, and no countries will ask for formal assistance, under the European Stability Mechanism.

Japan is assumed to increase the consumption tax rate from the current level of 5 per cent to 8 per cent in April 2014. An expansionary package of 5 trillion yen will be included in the budget for the 2014 fiscal year. The package will consist of lower rates for other taxes and higher outlays for certain expenditure categories. The second increase in the consumption tax rate, from 8 per cent to 10 per cent, will be implemented in October 2015.

China is expected to maintain a proactive, mildly expansionary fiscal policy stance. Public spending will continue to increase in the areas of education, health care and other forms of social expenditures. The general government budget deficit is expected to rise slightly to 2.0 per cent of gross domestic product in 2013 and 2014.

**Exchange rates among major currencies**

The dollar-to-euro exchange rate is forecast to fluctuate around its current level, averaging 1.32 dollars per euro in the rest of 2013, with the dollar appreciating gradually, resulting in a full-year average of 1.27 dollars per euro in 2014, and 1.21 in 2015.

The yen-to-dollar exchange rate will average 102.5 and 104.5 for 2014 and 2015, respectively.

The renminbi-to-dollar exchange rate is expected to average 6.07 CNY per dollar in 2014 and 6.03 CNY per dollar in 2015, following an estimated 6.15 CNY/dollar in 2013.

**Oil price**

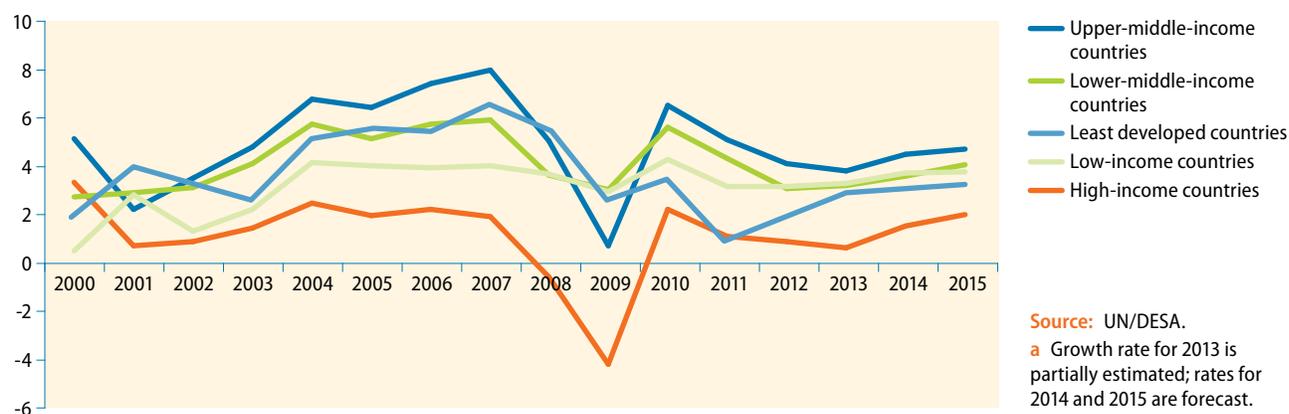
**Source:** UN/DESA. The Brent oil price is expected to be about \$108 per barrel for 2014-2015.

on stimulating the real economy. Expectations arising in mid-2013 about the possible tapering of the quantitative easing programme caused some jitters in financial markets, pushing up long-term interest rates. A moderate improvement earlier in 2013 in such areas as housing and employment lost momentum towards the end of the year. In the outlook, assuming that the future unwinding of the monetary easing will be smooth, GDP is expected to increase 2.5 and 3.2 per cent for 2014 and 2015, respectively. Risks remain on the downside, however, particularly because political wrangling over the budget may linger for several years.

Europe has emerged from recession, but just barely

Western Europe emerged from recession in the second quarter of 2013, led by net exports and, to a lesser extent, private and public consumption, but investment remained weak and unemployment stood elevated. GDP is expected to grow by 1.5 and 1.9 per cent in 2014 and 2015, respectively. Growth remains weak due to a number of factors: fiscal austerity programmes, while reduced in intensity, remain a drag; intraregional demand is

Figure I.2  
Growth of per capita GDP by level of development, 2000-2015<sup>a</sup>



### Box I.2

#### Prospects for the least developed countries

The economies of the least developed countries (LDCs) will continue to expand at a solid rate, with growth forecast at 5.7 per cent in 2014 and 2015 following growth of 5.4 per cent in 2013. However, per capita GDP is expected to increase at only 3.2 per cent in 2014 and 2015, which, in many LDCs, will have only a limited impact on living standards, given the widespread levels of poverty. Major obstacles for stronger economic and social development include institutional deficits, a lack of infrastructure, and political instability.

Performance is diverse among individual countries in the LDCs. In numerous African LDCs, such as Angola, Liberia, Sierra Leone, the United Republic of Tanzania, and Zambia, investment in the natural resource sector will drive growth in 2014. However, the challenge lies in achieving a more comprehensive and lasting impact on development. Infrastructure improvements, for example, should not be tailored exclusively towards natural resource projects, but also towards the broad needs of the population. Moreover, the positive impact on growth from natural resources can prove short-lived, given their finite nature and the exposure to volatile global commodity prices. Consequently, countries face the challenge of using the proceeds from natural resources to promote other sectors in the economy. For example, higher-value-added processing of natural resources should have a positive impact on employment opportunities. Such diversification could also help rebalance the external trade accounts of many LDCs, which are running trade deficits as net food and energy importers.

Numerous LDCs are still coping with the fallout from past natural catastrophes or remain vulnerable to new ones, such as the exposure of harvests to drought risks in the Horn of Africa and the Sahel. A case in point for the accumulation of effects from natural catastrophes is Haiti, where economic activity is expected to have recovered only moderately to 3.5 per cent in 2013 from 2.8 per cent in 2012. This pace of growth is too slow in the light of the destruction wreaked by hurricane Sandy in 2012, which in turn came on the heels of the catastrophic earthquake in 2010. Economic growth remains constrained by a weak agricultural sector damaged by hurricane Sandy and continuing institutional inefficiencies. On a positive note, the industrial sector has improved, stimulated by external demand, for textiles in particular. Although the Haitian economy is expected to perform relatively better in 2014, driven by higher government spending in infrastructure, a revival in the agricultural sector and stronger private consumption supported by aid inflows and remittances, the country remains extremely vulnerable to natural and external economic shocks.

Employment conditions, both in the formal and even more so in the informal labour market, are a further challenge in many LDCs. In Bangladesh, for example, a factory building collapse in April 2013 that killed more than 1,100 workers sparked a debate over employment conditions in the garment industry, triggering a wave of protests. This led to the adoption of a new labour law in July 2013 that strengthens worker rights, including the formation of trade unions. Awaiting approval by the Ministry of Labour, a proposal has been made to raise the minimum wage for garment industry workers by 77 per cent to 5,300 taka (about \$67) per month.

Source: UN/DESA.

still exceptionally low; and extraregional demand has slowed. Lending conditions remain tight for some countries, particularly for small- and medium-sized enterprises (SMEs). Considerable diversity is found across countries, with the United Kingdom of Great Britain and Northern Ireland showing relatively strong growth, followed by Germany, while the crisis countries remain in very weak positions, with Cyprus, Greece and Portugal expected to stay in recession in 2014.

Many of the new European Union (EU) members in Eastern Europe remained in a sustained recession in the first half of 2013, but the situation improved in the second half of the year, with business sentiment and household confidence strengthening in response to the return to growth in Western Europe. For example, the automotive industry in Central Europe showed signs of an upturn and retail sales also increased in the Czech Republic and Poland. The aggregate GDP growth for the region is estimated to be 0.5 per cent in 2013, and is forecast to strengthen moderately to 2.1 per cent in 2014 and further to 2.7 per cent in 2015.

Japan is estimated to grow by 1.9 per cent in 2013, boosted by a set of expansionary policy packages, including fiscal stimulus and large-scale purchases of assets by the central bank. Fixed investment has been a key driver of growth, as a number of public construction projects have been financed by the supplemental budget. The Government is also expected to introduce another package targeting structural reforms soon, but the effects are not certain. Meanwhile, the anticipated increase in the consumption tax rate over the next two years is expected to curb growth. GDP is forecast to moderate to 1.5 per cent in 2014.

Regarding other developed countries, GDP in Canada is estimated to grow at 1.6 per cent in 2013, and is expected to grow by 2.4 and 2.8 per cent for 2014 and 2015, respectively. Residential construction was a positive contributor to GDP growth in 2013, but the pace of construction is near a maximum. GDP in Australia is estimated to grow by 2.6 per cent in 2013 and is forecast to grow by 2.8 per cent in 2014. While export growth will remain solid, investment in the mining sector is expected to peak in 2014. Growth in government consumption and public investment will decelerate. GDP in New Zealand is estimated to grow by 2.6 per cent in 2013 and is forecast to grow by 2.8 per cent in 2014, driven by growth of exports to Asian markets.

Growth prospects in Africa remain relatively robust

Among developing countries, growth prospects in Africa remain relatively robust. After an estimated growth of 4.0 per cent in 2013, GDP is projected to accelerate to 4.7 per cent in 2014. Growth prospects are expected to be supported by improvements in the global economic and regional business environment, relatively high commodity prices, easing infrastructural constraints, and increasing trade and investment ties with emerging economies. Other important factors for Africa's medium-term growth prospects include increasing domestic demand—especially from a growing class of new consumers associated with urbanization and rising incomes—and improvements in economic governance and management. A moderate growth recovery in 2014 in emerging and developing countries, led by China, and projected improvement in major developed economies should also stimulate growth in Africa, through increased trade, investment and capital flows.

Growth in Asia stabilized at a moderate level

After a notable slowdown in 2011-2012, economic growth in East Asia stabilized at a moderate level in 2013. The region continues to be adversely affected by relatively weak external demand from developed economies, as well as an adjustment to slower growth in China. The average growth of the region is estimated to average 6.0 per cent in 2013, almost the same pace as 2012. A moderate pickup to 6.1 per cent is forecast for 2014 and 2015, mainly driven by a gradual recovery in export growth amid improving conditions in

developed countries. In most East Asian economies, private consumption and investment will continue to expand at a solid pace, supported by stable labour market conditions, low inflation and fairly accommodative monetary policies. Fiscal policies will remain moderately expansionary and continue to provide support for growth.

Growth in South Asia remains lacklustre as a combination of internal and external factors hamper activity, particularly in the region's largest economies, such as India, the Islamic Republic of Iran and Pakistan. Growth is estimated to be 3.9 per cent in 2013, nearly the slowest pace in two decades. Growth is forecast to pick up moderately to 4.6 per cent in 2014 and 5.1 per cent in 2015, supported by a gradual recovery in domestic demand in India, an end to the recession in the Islamic Republic of Iran and an upturn in external demand. However, in most economies, growth will likely remain well below the level prior to the global financial crisis. Private consumption and investment are held back by a wide range of factors, including energy and transport constraints, volatile security conditions and macroeconomic imbalances.

Western Asia is estimated to grow by 3.6 per cent in 2013, and will accelerate to 4.3 per cent in 2014. While the member countries of the Gulf Cooperation Council (GCC) have been on a stable recovery path, continuing political instability, social unrest, security incidents and geopolitical tensions have hampered a number of other economies in the region. The Syrian crisis has been impacting the neighbouring countries in a multifaceted way. The subdued cross-border economic activities—including trade, investment and tourism—between GCC countries and the rest of Western Asia continued to fail to bring intraregional positive spillover effects. The stagnation of private capital inflows put Jordan, Lebanon and Yemen under moderate foreign-exchange constraints. Turkey continued to face financial pressures, with its currency depreciating and interbank interest rates rising as a result of the decline in international capital inflows.

Growth in Latin America and the Caribbean decelerated in 2013, to a pace of 2.6 per cent, but is forecast to improve to 3.6 and 4.1 per cent in 2014 and 2015, respectively. In South America, Brazil is still growing at a subdued pace, curbed by weak external demand, volatility in international capital flows and tightening monetary policy. The expected improvement in the outlook will depend on strengthening global demand. Private consumption has been supportive of growth in many South American economies. Growth in Mexico and Central America is expected to accelerate in 2014-2015, supported by better performance of manufacturing exports and stable domestic demand, as well as structural adjustment. Growth in the Caribbean has been hampered by weak external demand—for the tourism sector in particular—and weaker commodity prices, but is expected to strengthen in the outlook.

Growth in Latin America and the Caribbean is forecast to pick up slightly

Among economies in transition, growth in most economies of the Commonwealth of Independent States (CIS) decelerated in 2013, curbed by weak exports and external financing constraints, supply-side bottlenecks, and weak consumer and business confidence. Growth in the Russian Federation weakened further in the first half of 2013, as industrial output remained weak and investment became a drag on growth. The economic slowdown eventually affected previously resilient consumer confidence and led to weakening retail sales growth. The weakness in the Russian Federation has had a negative impact on its neighbours in the CIS through trade, investment and remittance channels. In the outlook, structural problems such as sluggish energy sector expansion, capacity constraints and weak investment will prevent an acceleration of growth to pre-crisis levels.

CIS is constrained by structural problems

Growth in South-Eastern Europe has improved in 2013, but growth is expected to remain marginal in the near term, fluctuating between 1 and 2 per cent, which is insuffi-

cient to address the region's long-standing needs for reindustrialization, increased labour force participation and reduction of excessively high unemployment rates. In the outlook, the external environment for those countries is expected to improve, including the terms of access to external finance. With easing credit conditions, investment is set to recover gradually in 2014-2015, along with strengthening private consumption. GDP growth is projected to accelerate to 2.6 per cent in 2014 and 3.1 per cent in 2015.

### Inflation outlook remains benign

Inflation remains tame worldwide

Inflation remains tame worldwide, partly reflecting output gaps, high unemployment and a continued financial deleveraging in major developed economies. Among developed economies, inflation decelerated in the United States during 2013 and is expected to remain below 2 per cent in 2014 and 2015. Inflation has similarly decelerated in the euro area, but has dipped below 1.0 per cent, which has raised some deflationary concerns. In Japan, the large expansionary policies aiming to reflate the economy managed to end the decade-long deflation in 2013, as the consumer price index (CPI) is estimated to increase by 0.3 per cent, and is forecast to hit the target of 2.0 per cent in 2014.

Among developing countries and economies in transition, inflation rates are above 10 per cent in only about a dozen economies scattered throughout different regions. Several economies in South Asia and Africa, plus a few in the CIS, will continue to face high inflation rates, mainly owing to elevated inflationary expectations, rapid credit growth, localized food price pressures and structural bottlenecks such as energy shortages. On the other hand, most economies in East Asia continue to face benign inflation.

### High unemployment remains a key challenge

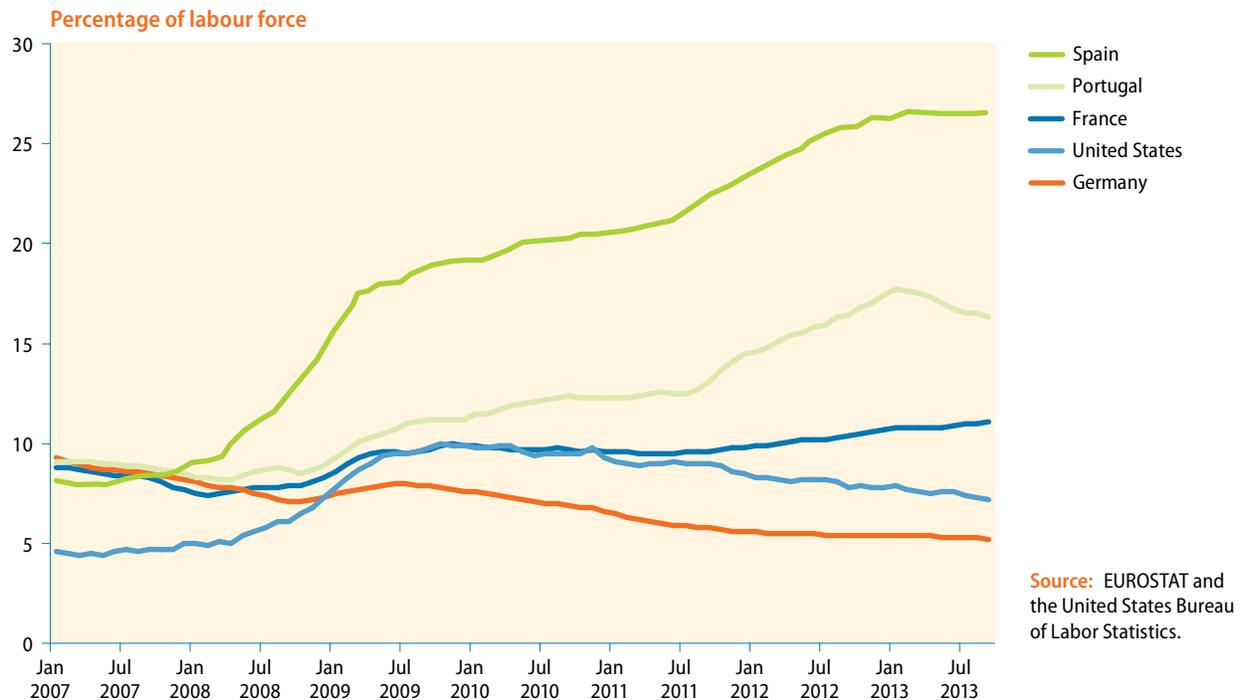
Long-lasting effects from the financial crisis continue to weigh on labour markets

The global employment situation remains challenging, as long-lasting effects from the financial crisis continue to weigh on labour markets in many countries and regions. How much of the unemployment is structural and how much is cyclical is still under debate. The answer appears to differ by region, with some countries, such as the United States facing mainly cyclical unemployment, whereas others, such as Spain, face more structural issues.<sup>3</sup>

Among developed countries, the unemployment rate in the United States has continued its slow decline, down to 7.0 per cent in late 2013, from a peak of 10 per cent in 2010 (figure I.3). A significant portion of this decline, however, is owing to a retreat in labour force participation. The unemployment rate is expected to decline further and reach the United States Federal Reserve's (Fed) critical threshold of 6.5 per cent sometime in mid-2015. Unemployment in the euro area appears to have stabilized during 2013, at the historical high of 12.2 per cent. In the euro area, while the unemployment rate in Germany is near historical lows of about 5 per cent, Greece and Spain are facing extraordinarily high unemployment rates of about 27 per cent, with the youth unemployment at twice this rate. These high rates in the euro area are expected to come down only slightly, as GDP growth will not be strong enough to make significant progress over the forecast period.

<sup>3</sup> Estimates for Spain's structural unemployment rate are somewhat controversial as they also tend to be procyclical—meaning they will overestimate the rate during times of already high unemployment—but they are still below the current unemployment rate with room for improvement.

Figure I.3  
Unemployment rates in selected countries, January 2007–September 2013



In addition, there will be lasting damage to the labour market from discouraged workers who have been unemployed for significant periods of time. The unemployment rate in Japan is relatively low, while the labour force participation rate continues to decline as the working-age population shrinks.

The unemployment situation is mixed across developing countries and economies in transition, with extremely high structural unemployment in North Africa and Western Asia, particularly among youth.

The unemployment rates remain low across much of East Asia, estimated at below 3 per cent in Malaysia, Singapore, Thailand and Viet Nam. In the outlook period, little change is expected, based on the comparatively modest growth forecast for the coming two years. Slowing growth in South Asia appears to have had a considerable adverse impact on employment. Reported unemployment still remains relatively low in India, but has deteriorated somewhat over the past fiscal year. In some of these economies, changes in employment due to structural issues have affected women to a greater degree, aggravating already significant gender gaps, with high female unemployment rates in Pakistan and low female participation in Bangladesh. Modest growth in the outlook period combined with population pressures is likely to exacerbate pressures on the labour market. Positive growth in many African countries has had a limited impact on employment; the informal sector is still large and opportunities remain limited for many of those seeking to enter the labour market, as manifested in high youth unemployment rates and wide gender disparities in earnings. In addition, continual pressure on labour markets from a steady stream of new entrants has meant that even solid GDP growth rates have not been sufficient to make measurable impacts. Even as growth slowed down in major economies in South America,

such as Brazil and Mexico, unemployment remained at about 6 per cent or below. Labour market indicators are likely to remain solid over the remainder of the year for the region; however, there may be no further improvement in the near future, despite improvements in growth, due to the fact that unemployment growth is barely equal to the growth of the labour force for a number of countries. The unemployment rate remains at historical lows in the Russian Federation, between 5 and 6 per cent, despite a noticeable slowdown and in-migration from surrounding countries in the CIS.

More concerted efforts are needed to address labour market issues

A number of countries are making concerted efforts at addressing labour market issues, such as aligning macroeconomic policies appropriately with domestic conditions, promoting training for youth and other excluded segments of the labour force, and taking steps to induce advances in productivity and innovation.<sup>4</sup> The expectation is that these measures will be enacted through a coordinated and integrated policy framework that will balance labour demand and labour supply, with sufficient efforts to ensure sustainable social protection. This also includes promoting an environment that is conducive to job creation with access to finance, necessary infrastructure, and support for SMEs. Further steps to activate labour through skills training and upgrading will be necessary to integrate those groups that have been excluded or that have been forced to subsist through intermittent and vulnerable employment.

## Trends in international finance and trade

### Capital inflows to emerging economies declining

Net private capital inflows to emerging markets,<sup>5</sup> a subgroup of developing countries, and the economies in transition have shown a measurable decline during 2013. At the same time, volatility in the financial markets of emerging economies has increased significantly, featuring equity market sell-offs and sharp depreciations of local currencies—both partly triggered by the Fed announcement that it might taper the amount of its monthly purchases of long-term assets later in the year. Waning growth prospects for emerging economies have also played a role in triggering the decline of capital inflows.

QE is having a significant influence on the net capital inflows to emerging economies

The unconventional monetary policies, or so-called quantitative easing (QE), adopted by major central banks in the aftermath of the global financial crisis have had a significant influence on the net capital inflows to emerging economies. The QE programmes injected substantial liquidity into global financial markets and at the same time repressed long-term interest rates in developed countries. As a result, in a search for higher yields, a significant amount of capital flows was driven to markets of primary commodities and markets of equities and bonds in emerging economies in the period 2009-2012. However, in late 2012 and early 2013, as systemic risks associated with the sovereign debt crisis in the euro area abated and the prospects for economic recovery in the United States and Japan

<sup>4</sup> See the G20 Labour and Employment and Finance Ministers' Communiqué, Moscow, 19 July 2013, available from <http://www.g20.org/documents/#p3>.

<sup>5</sup> Data and definition of private capital inflows in this section are based on Institute of International Finance, "Capital flows to emerging market economies", IIF Research Note, 7 October 2013, while the forecasts for 2014 are revised based on Project LINK baseline forecasts. The data differ from those presented in chapter III, which cover all developing and transition economies and apply the "net net flows" concept, which is net inflows less net outflows. The use of "net inflows" would focus on the effects of volatility in foreign capital inflows, while the use of "net net flows" focuses on the effects of balance-of-payment.

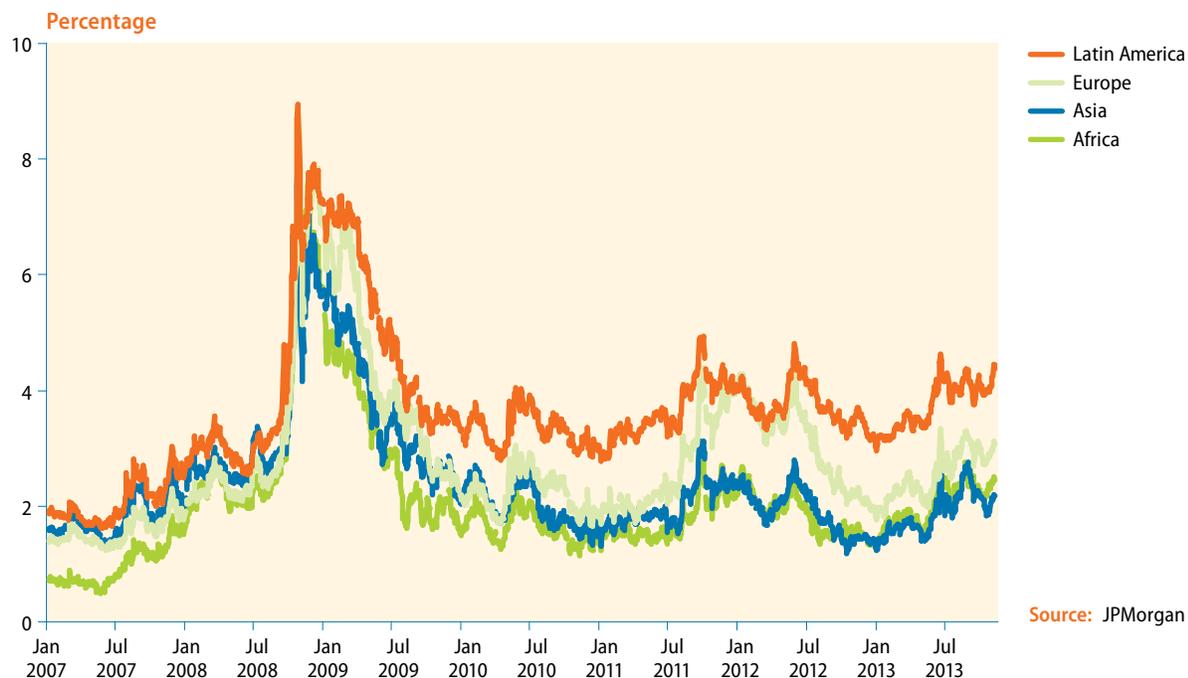
improved, international capital flows started to move away from emerging markets back to developed markets, particularly developed equity markets. More recently, on the expectation that major central banks will taper their purchases of long-term assets and eventually sell their assets back to the markets, international investors have ratcheted up the repricing of assets and rebalancing of portfolios. This has led to the latest wave of declines in capital inflows to emerging economies. Given the prodigious size of the assets accumulated by major central banks through QE in the past few years, and the challenges for determining the timing and magnitude for unwinding these assets, more volatile movements of capital inflows to emerging economies are expected to occur in the next few years.

Among emerging economies, declines and volatility in capital inflows have been most pronounced in Asia. While growth in foreign direct investment (FDI) inflows to China seems to have resumed some strength recently, portfolio equity inflows to India and Korea and non-bank credit flows to Indonesia have registered significant falls. Latin America has also seen a notable retrenchment of inflows, mostly in portfolio equities. In contrast, Africa, Western Asia and emerging European countries continue to see increases in capital inflows. For example, in the past year Nigeria has registered significant increases in capital inflows to both its equity and bond markets. Egypt has, however, witnessed sharp declines in net private capital inflows due to continued political instability.

External financing costs for developing countries and transition economies have also risen in the second half of 2013, triggered by the anticipation of QE tapering. The spreads between yields on sovereign bonds issued by emerging economies and the benchmark yields on government bonds of major developed countries surged by more than 100 basis points in the two weeks immediately following the Fed's announcement in May 2013 of the possibility for reducing the size of its QE purchases (figure I.4). By taking into

External financing costs for developing countries are rising

Figure I.4  
Daily yield spreads on emerging market bonds, January 2007 to 14 November 2013



account that the benchmark yields on government bonds in major developed countries also increased by about 100 basis points, the costs of external financing for emerging economies, in terms of the yields, actually increased 200 basis points on average. Among emerging economies, the spreads for Latin America are wider than others.

Outward capital flows from emerging economies have continued to increase. In addition to a continued increase in official foreign reserves, which are counted as part of outward capital flows and stood at about \$7.5 trillion by mid-2013 for emerging and developing countries as a whole, private outward capital flows of emerging economies have increased in the past few years at a robust pace, reaching an estimated amount of about \$1000 billion in 2013, almost to the same level as the net capital inflows to these countries. Among emerging economies, China has significantly increased its outward direct investment in recent years, supported by more encouraging government policies promoting its enterprises to “walk abroad”. After registering a total of \$88 billion in outward direct investment in 2012, available data have indicated another increase of about 20 per cent in 2013. Many economies in Latin America, such as Brazil, Chile, Colombia, Mexico and Peru, have also increased outward capital flows, mostly in the form of portfolio investments, reflecting the need by companies, banks and pension funds in Latin America to internationally diversify their assets.

ODA to developing countries has contracted in the past two years

Official development assistance (ODA) flows to developing countries contracted in the past two years, falling cumulatively 2 per cent in 2011 and 2012, down to \$126.4 billion.<sup>6</sup> Of the 25 Development Assistance Committee (DAC) members, 16 decreased their ODA, mainly owing to fiscal austerity measures. Preliminary data show that bilateral aid from DAC donors to sub-Saharan Africa fell for the first time since 2007, with assistance totalling \$26.2 billion in 2012, a decline of 7.9 per cent in real terms. Aid to landlocked developing countries (LLDCs) and small island developing States (SIDS) also fell. In 2012, the combined DAC donors’ ODA was equivalent to 0.29 per cent of their combined gross national income (GNI), far from the United Nations target of 0.7 per cent. ODA flows in 2013 are estimated to remain at the same level as in 2012. Slight increases are expected for 2014-2015, as more DAC members see improvement in their economies and fiscal situations. A strengthening of political commitment in the international community spurred by the United Nations campaign for accelerating progress in the Millennium Development Goals (MDGs) is also expected to support increases.

### Currencies of developing countries under depreciation pressures

Foreign-exchange markets experienced two distinctive episodes during 2013: the early part of the year was highlighted by a dramatic depreciation of the Japanese yen, and in May-June, a number of emerging and developing countries saw the sharp devaluation of their currencies. In the outlook for 2014-2015, major uncertainties and volatility in foreign-exchange markets will still be associated with the currencies of emerging economies.

Among major currencies, the yen devalued significantly vis-à-vis the United States dollar, from 80 yen per dollar by the end of 2012 to about 100 yen per dollar in March 2013, partly reflecting a set of drastically expansionary policies adopted by the

<sup>6</sup> For more detailed information and analysis, see *MDG Gap Task Force Report 2013: The Global Partnership for Development—The Challenge We Face* (United Nations publication, Sales No. E.13.I.5), available from [http://www.un.org/en/development/desa/policy/mdg\\_gap/mdg\\_gap2013/mdg\\_report\\_2013\\_en.pdf](http://www.un.org/en/development/desa/policy/mdg_gap/mdg_gap2013/mdg_report_2013_en.pdf).

new Japanese Administration. The yen has since stabilized within a small range of about 98 yen per dollar. The euro-to-dollar exchange rate saw some fairly wide swings, between 1.28 and 1.34, but with no clear direction during the first half of 2013, and followed by a period of appreciation in the third quarter (reaching 1.38 before dropping to 1.34 during November). Changes in relative risk perceptions were an important driving force. For the last few years these have been evenly balanced between eruptions of the euro area debt crisis and United States fiscal impasses. As the year progressed, however, risks stemming from the European debt crisis subsided significantly, while those in the United States remained in play. In addition, the euro area current-account surplus began to widen notably, but stronger growth in the United States provided some counterbalance. Going forward, however, the shifting balance of monetary policies is expected to play an important role. The European Central Bank (ECB) cut its policy rates in November (the second time in 2013) leading to a sharp drop in the euro. In terms of unconventional policies, the United States is expected to taper its QE programme soon, while the ECB is still entertaining new forms of stimulus. The balance of expected policies in the three areas, coupled with the stronger growth outlook in the United States, leads to an expectation of the dollar appreciating moderately against both the yen and the euro.

Currencies in many developing countries and economies in transition have depreciated vis-à-vis the United States dollar and other major currencies in 2013. Currencies in a number of emerging economies depreciated by the greatest amount in May-June 2013, particularly in Brazil, India, Indonesia, South Africa and Turkey (figure I.6), at the same time that capital inflows to these economies declined. In contrast, the renminbi of China continued to appreciate gradually against the United States dollar and other major currencies. The difference between the trends in the exchange rates of China and other large emerging economies can be accounted for by a number of factors, including much larger foreign reserves, a less open capital account, higher domestic savings, and more concentration of FDI in the capital inflows to China (when compared with the other emerging

Currencies in many developing countries have depreciated

Figure I.5  
Dollar exchange rates among major currencies, January 2007 to 14 November 2013

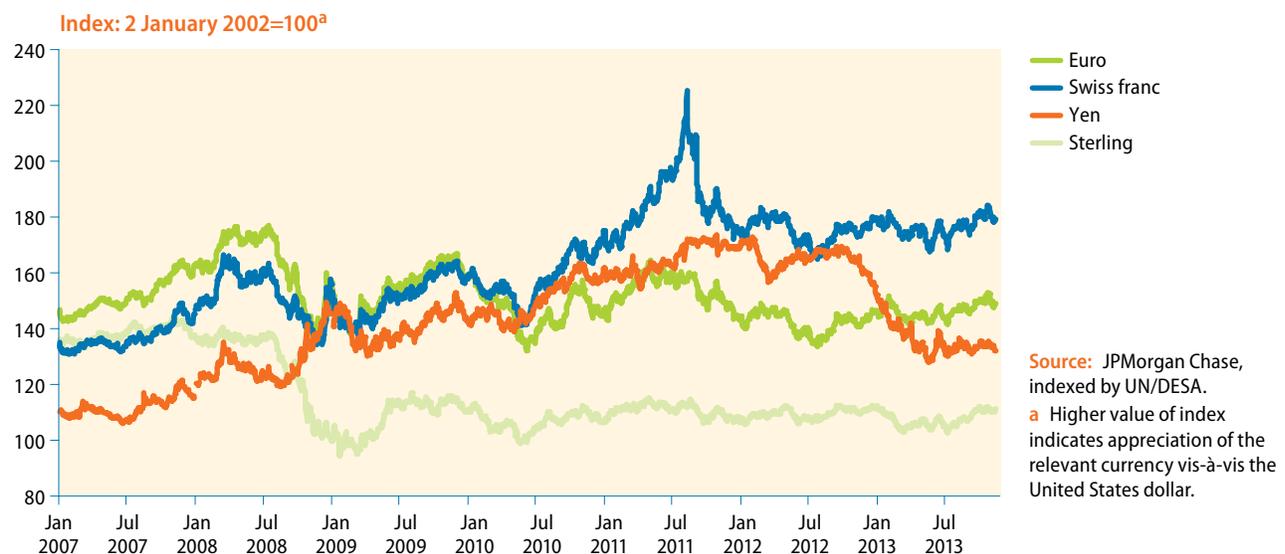
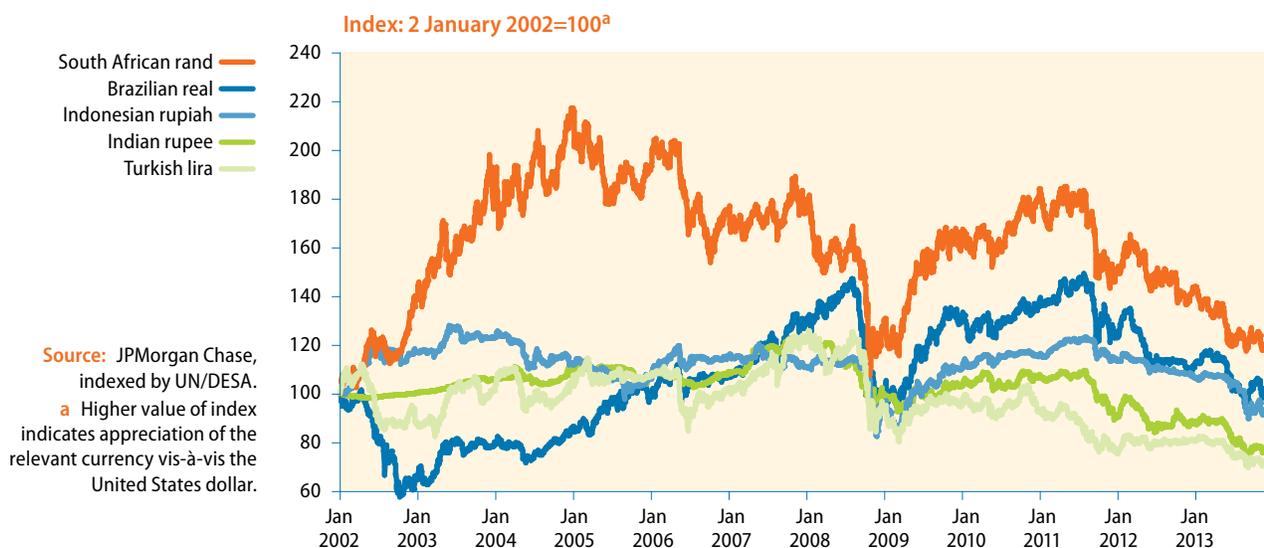


Figure I.6  
Dollar exchange rates of selected emerging economies, January 2007 to 14 November 2013



economies). Given the remaining current-account surplus of China vis-à-vis the United States, the renminbi is expected to further appreciate slightly against the dollar in 2014-2015, unless China liberalizes its capital and financial accounts soon, which could trigger more capital outflows and renminbi depreciation. The currencies of other emerging economies are likely to remain under depreciation pressures.

### Prices of primary commodities on a moderate downtrend

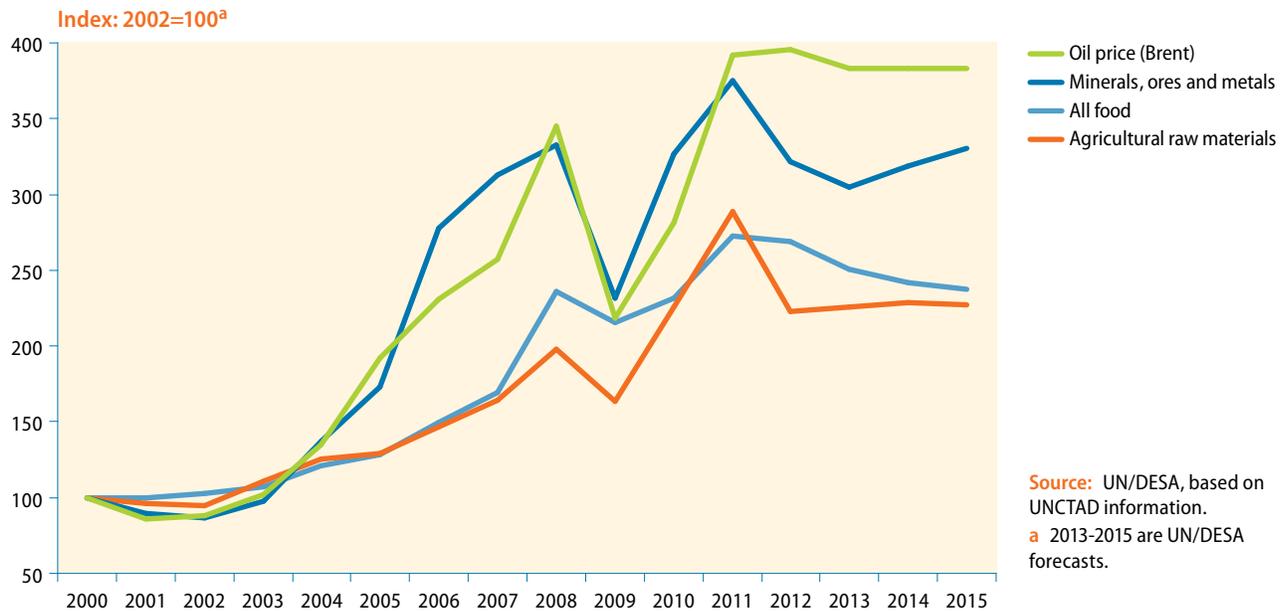
The downturn in commodity prices is expected to stabilize

The prices of most primary commodities have declined moderately during 2013 (figure I.7), mainly driven by generally weak global demand as global economic growth remained anaemic (see chapter II for more information). Different patterns continue to be evident across different commodity groups, as prices are also determined by various factors on the supply side. In the outlook, with global demand expected to pick up moderately in 2014-2015, commodity prices are expected to stabilize, although they are still subject to changes in supply-side factors, such as weather conditions (for agricultural commodities) and geopolitical tensions (for oil).

Oil prices were on a downward trend in the first half of 2013, as global demand for oil weakened along with the deceleration in world economic growth overall. Geopolitical tensions can entail a large risk premium on oil prices, particular when oil supply is also tight. Most recently, global oil supply has been declining modestly: increased oil supply in North America has been offset by declines in the North Sea, while high Saudi output only partly counterbalanced a collapse in Libyan production. In the outlook, by assuming no further significant eruptions in geopolitical tensions, the Brent oil price is expected to be about \$108 per barrel (pb) for 2014-2015, compared with an estimated average of \$108.1 pb for 2013 and \$111.6 pb in 2012.

As production is expected to increase by a large margin in 2013-2014, food prices declined steadily during 2013, with prices for wheat, maize and rice declining by about

Figure I.7  
Price indices of commodities, 2000-2015



5-10 per cent. In the outlook, food prices are projected to moderate further in 2014-2015 based on the assumption of continued increases in the global production of these grains.

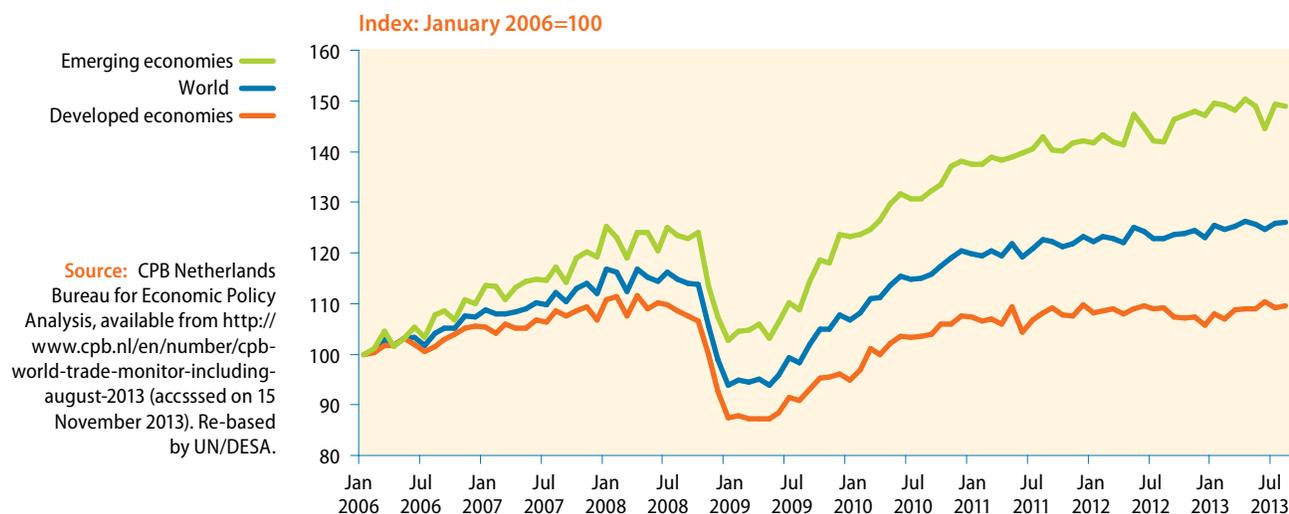
Prices of minerals, ores and metals strengthened in early 2013 but fell markedly in the latter part of the year, owing to weaker than anticipated global growth—the deceleration in the growth of emerging economies being particularly notable. For example, price indices for aluminium, copper, nickel, and zinc registered a steady decline during 2013, while the price of iron ore also declined significantly. In the outlook for 2014-2015, the prices of minerals, ores and metals are projected to stabilize and register modest gains as global demand improves.

### International trade flows remain sluggish

International trade as the engine for global growth has shifted to a low gear over the past two years. After growing at a sluggish pace of less than 3 per cent in 2012, as measured by the volume of world exports, international trade flows are estimated to have grown by 2.3 per cent during 2013 (figure I.8). Notably, the ratio between the growth of world trade and the growth of global output is at a historical low. While protracted anaemic import demand from major developed countries can explain part of the cyclical downturn in trade activity, the lack of any progress in multilateral trade negotiations over the past decade may have reduced the momentum in creating new trade flows in the world economy. On the other hand, South-South trade is still demonstrating more dynamic patterns and becomes a major driver for the growth of international trade as a whole. The feedback effects of slow international trade growth have in turn dragged down the growth of global output. In the outlook, international trade is expected to pick up the momentum gradually, growing at 4.7 and 5.2 per cent in 2014 and 2015, respectively.

Trade as the engine for global growth has shifted to a low gear

Figure I.8  
Index of world merchandise trade, January 2006–August 2013



## Global imbalances narrowing to a benign level

Effort is needed to prevent imbalances from widening to excessive levels in the longer run

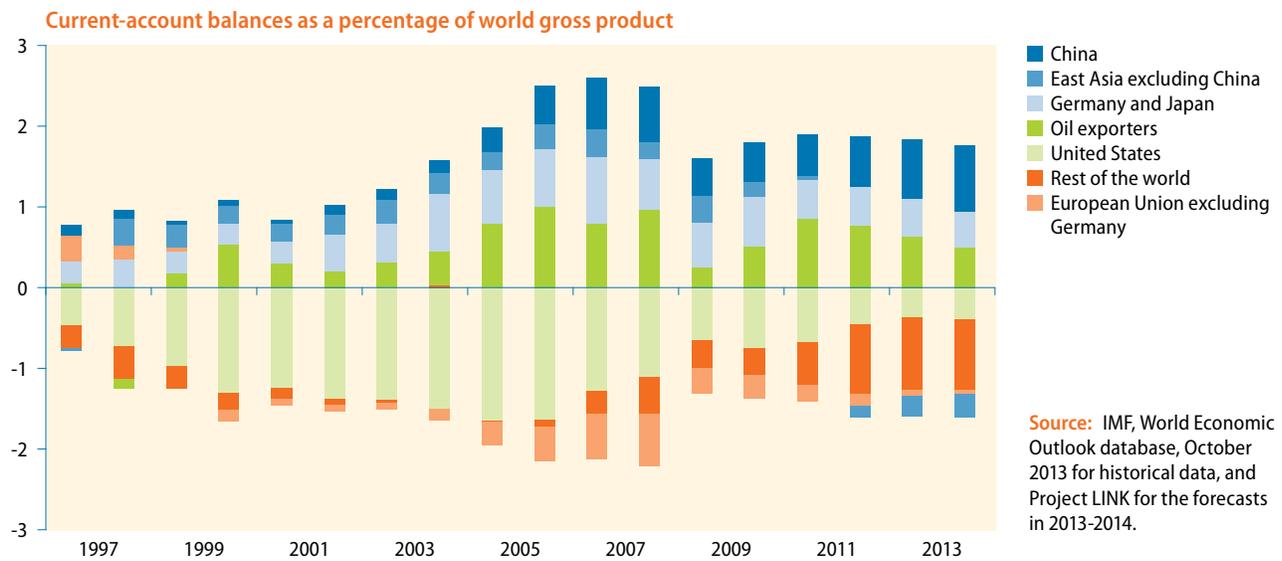
Global imbalances, namely, the current-account imbalances across major economies, continued to narrow to a benign level in 2013 (figure I.9). Such narrowing is not considered to be an imminent threat to the stability of the world economy, although efforts to strengthen international policy coordination should continue in order to prevent the imbalances from widening to excessive levels again in the longer run.

The United States remained the largest deficit economy, with an estimated external deficit of about \$410 billion (2.4 per cent of GDP) in 2013, down from \$450 billion in 2012, and substantially lower than its peak of \$800 billion (6.0 per cent of GDP) registered in 2006. The external surpluses in China, the euro area, Japan and a group of fuel-exporting countries, which form the counterpart to the United States deficit, have narrowed accordingly, albeit to varying degrees. China, for instance, is estimated to register a surplus of just above 2 per cent of GDP in 2013, a sharp decline from a high of 10 per cent of GDP in 2007. Japan is expected to register a surplus of about 1 per cent of GDP in 2013, also a significant reduction from its peak level of 5 per cent of GDP reached in 2007. The current account for the euro area as a whole is in surplus of 2.5 per cent of GDP, with Germany's surplus remaining above 5 per cent of GDP. Large surpluses relative to GDP are still present in oil-exporting countries, reaching 20 per cent of GDP or more in some of the oil-exporting countries in Western Asia. These countries plan to share the wealth generated by the endowment of oil with future generations through a continued accumulation of surpluses in the foreseeable future.

Adjustment of the imbalances is both structural and cyclical

While some of the adjustment of the imbalances in major economies reflects certain improvements in the unbalanced domestic structure of these economies, a large part of the adjustment reflects a cyclical downturn—that is, a weakening in external demand from the deficit countries, rather than a strengthening of external demand from the surplus countries. In the United States, a corresponding narrowing of the saving-investment gap reflects a slight decline in the savings rate in 2013 and a large moderation in investment. In the outlook for 2014–2015, the current-account deficit in the United States is expected

Figure I.9  
Global imbalances, 1997-2014



to remain at the same level relative to GDP. In the surplus countries, the narrowing in the external surplus of China reflects a confluence of a more flexible exchange rate, and the policy measures to move the economy towards greater reliance on domestic demand. Global imbalances are not expected to widen by a significant margin in the next two years.

## Uncertainties and risks

The baseline outlook presented above is subject to a number of uncertainties and risks, mostly on the downside. In *WESP 2013*, three major downside risks were identified, namely, a much more detrimental adjustment in the euro area, a “fiscal cliff” in the United States, and a hard landing in some large emerging economies. All three risks manifested themselves to some extent during 2013 and entailed certain costs for the global economy, although not to the full scale that was presented in the downside scenarios. In the outlook for 2014-2015, these risks remain relevant. While the systemic risks in the euro area abated, owing to a number of policy measures adopted over the past year, the real economy in the euro area, particularly in those member countries under debt distress, remains fragile. The United States averted a fiscal cliff in 2013, but fell into fiscal sequestration, and uncertainties remain high about the debt ceiling and the budget for 2014. The slowdown in a number of emerging economies in 2013 was “hard” enough, and many of these emerging economies remain vulnerable in the outlook.

In addition to these remaining risks, new risks are also emerging. One of them is the risk associated with the unwinding of the unconventional monetary policies by the central banks of major developed countries over the course of 2014-2015. As indicated by the mini-financial crisis of mid-2013, sparked by the Fed simply mentioning the possibility of tapering its purchases of assets (tapering should have far less impact than unwinding, as the former continues to add liquidity while the latter withdraws liquidity), this risk could cause substantial instability for the world economy. Moreover, beyond economic risks, geopolit-

Old risks remain and new risks are emerging

ical tensions in Western Asia and elsewhere in the world might spiral out of control. Such tension could lead to economic disruptions directly, or indirectly through rising oil prices. These and other risk factors, unfolding unexpectedly, could derail the world economy far away from the projections outlined in the baseline forecast.

### Uncertainties and risks associated with QE

Great uncertainties and risks for global economic growth and the financial stability of the world in the coming years are inextricably associated with the unconventional monetary policies adopted in major developed countries, or, more precisely, with the process in which the central banks of these countries start to change their stances on these policies.

Since the eruption of the global financial crisis in 2008, central banks in major developed countries have implemented quantitative easing policies to purchase and hold increasingly large amounts of long-term assets. These policy measures have played a critical role in stabilizing financial markets, injecting liquidity to the beleaguered banks and providing necessary support for economic recovery in general, although the significance of these positive effects is still in question. However, by moving a prodigious amount of financial assets from markets to their own balance sheets, these central banks have also created non-trivial market distortions that repress the risk premiums for certain classes of financial assets and generate moral hazard for commercial banks (allowing them to delay the clean-up of the balance sheets).

QE has led to increased volatility for developing countries

Certain side effects generated by QE have already manifested themselves in the past few years. For example, developing countries have repeatedly complained about the spillover effects of QE on their macroeconomic stability, seeing it lead to increases in volatility in capital inflows, in prices of primary commodities, and in their exchange rates (box I.3). The extra liquidity injected through QE turned out to be beyond the control of the central banks that issued it. From the first round of QE occurring in late 2008 to the current open-ended, ongoing QE, international capital flows have been moving erratically back and forth across developed equity markets, emerging markets and international commodity markets.

During the summer of 2013, the Fed signaled the possibility of tapering the size of its monthly purchases of long-term assets and triggered global financial turmoil. Both equity and bond markets worldwide experienced a sharp sell-off. While equity prices in developed countries recuperated, bond yields remain elevated relative to the level before May 2013. For instance, the yield on the 10-year United States Treasury bond soared by about 100 basis points, reaching the highest level since late 2011. By this measure, all the efforts by the Fed to lower long-term interest rates through the latest round of QE that began in late 2012 were completely undone by the market reaction in just a few weeks. The shocks to emerging markets were more pronounced, leading to substantial declines of capital inflows for the first time since 2009. Equity prices in emerging markets plummeted by about 20 per cent in two months and in the same period, the risk premia, as measured by the spreads of the bond yields, increased by 30 per cent on average. Declines of capital inflows were found to be more acute in such countries as Brazil and India because of the relatively high degree of liquidity in these markets, accompanied by sharp depreciations of the local currencies. Even in China, a seize-up of interbank lending in late June—although rooted mainly in the problems of its own banking system—was to some extent also related to the global financial turmoil.

Both policymakers and financial markets are aware that, in the future, when the central banks start to taper the pace of their asset purchases and eventually unwind the process

## Box I.3

**Spillover effects of unconventional monetary policies in major developed countries<sup>a</sup>**

In the aftermath of the global financial crisis, the central banks of the major developed economies lowered their policy interest rates to close to zero, while also aggressively pursuing unconventional monetary policy measures, including quantitative easing (QE)—an expansion of the monetary bases through purchasing and holding of long-term assets (figures I.3.1 and I.3.2).

As a result, developing countries and economies in transition have experienced waves of capital flows over the past few years. These capital flows have directly impacted equity and bond prices in developing countries as well as exchange rates, while also indirectly affecting other variables in developing countries, such as monetary growth, real GDP, exports and imports, and inflation. A number of recent studies have attempted to assess the size and importance of these spillover effects for developing

Figure I.3.1

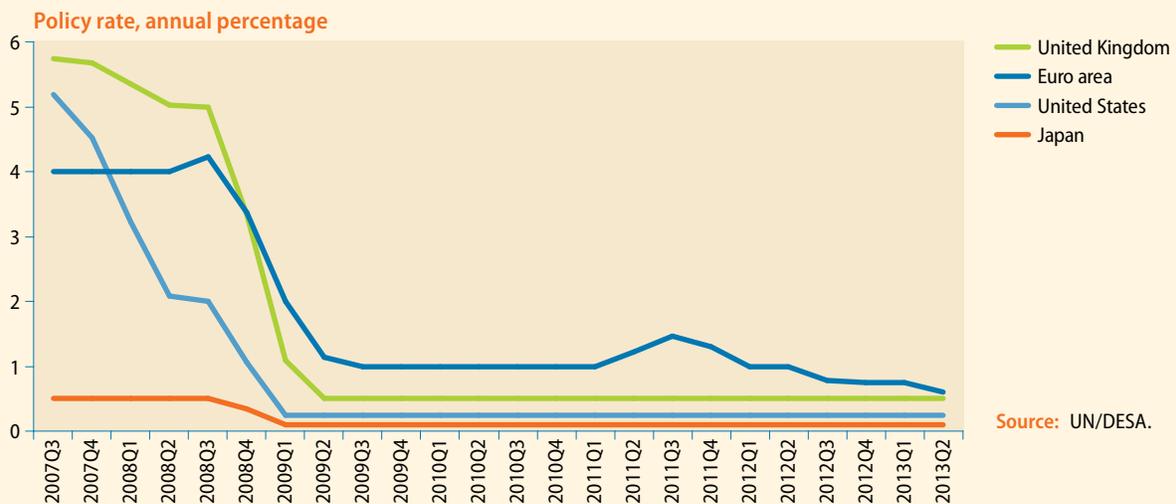
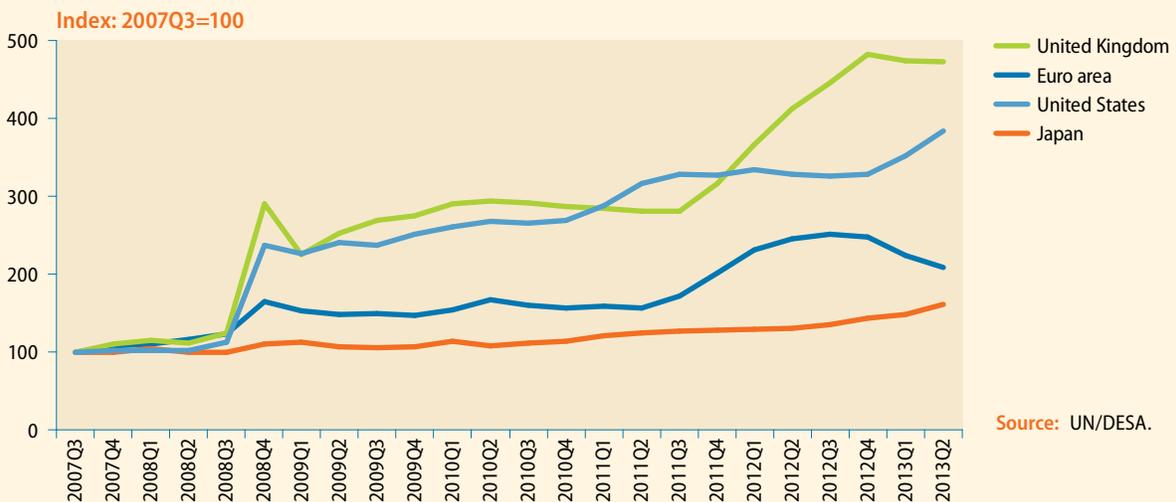
**Monetary policies for selected countries**

Figure I.3.2

**Assets held in major central banks**

## Box I.3

**Spillover effects of unconventional monetary policies in major developed countries<sup>a</sup>**  
(continued)

economies.<sup>b</sup> While some controversies remain over the exact magnitude of the effects on the different variables, several important findings are summarized as follows.

First, the impact of QE on the developing economies has varied across countries, reflecting the scale of their exposure to developed countries (in terms of both trade and financial linkages), their individual cyclical positions, and the type and scale of responses to capital inflows by the national monetary authorities.

Second, QE seems to have exacerbated the procyclical aspects of capital flows to developing countries. The QE measures enacted in the midst of the global financial crisis—which successfully aimed at market repair and provision of liquidity to financial institutions—contributed to the increased moving of assets out of developing countries. The QE programmes in 2010–2011, by contrast, added significantly to the capital flows that were already moving to the rapidly recovering emerging economies.

Third, QE likely had a significant impact on financial market variables in developing countries, but the impact on the real economy has been much smaller. Overall, QE led to a decline in long-term bond yields, an increase in equity prices, and an appreciation of some, but not all, currencies. Among the largest developing economies, Brazil appears to have experienced the most significant spillover effects from the QE measures, including a significant appreciation of its currency in 2011–2012, which probably hampered the export sector.

Fourth, the availability of ample credit in low yields for an extended period of time led to an increase in household and corporate debt in some countries in East Asia (Indonesia, Malaysia and Thailand, for example) and Latin America (Brazil, among others).

In recent months, the focus of policymakers has shifted towards the upcoming tapering and eventual unwinding of the asset purchase programmes in developed economies, the United States in particular. The main financial stability risks of such an exit are associated with the following factors: potential shifts in market sentiment, which may lead to sharp increases in bond yields; financial market turbulence, due to massive global portfolio rebalancing; and funding challenges faced by banks, which may negatively impact the availability of credit to households and businesses.

The degree to which developing countries will be affected by the exit of QE policies could mirror—at least to some extent—the degree to which they were affected initially and will likely depend on similar factors, such as: trade and financial linkages with developed economies; the depth of their financial markets; the scale of their external imbalances; the size of the corporate and household debt levels; and the policy responses undertaken. However, as previous capital crises in developing countries have shown, reversals in capital flows can be much more abrupt and disruptive. Vulnerable countries should therefore take action to strengthen balance sheets, reduce external imbalances and improve macroprudential regulation.

(by selling the assets back to markets), investors will inevitably have to reprice the assets and rebalance their portfolios. The hope is that, by then, banks, investors and the economy at large will be in a more robust position to endure such adjustments and the central banks will be able to engineer a smooth exit.

However, the market reaction—or over-reaction—in the summer of 2013 to the mere possibility of tapering QE in the United States has dimmed this hope and provided a vivid and timely alert to the risks for a bumpy rather than smooth exit.

A bumpy exit from QE programmes could lead to a number of problematic developments: a surge in long-term interest rates, not only in developed economies but also in developing countries; a sell-off in global equity markets; a sharp decline of capital inflows to emerging economies; and a spike in the risk premia for external financing in emerging economies. Exactly because of the large scale of the assets the major central banks have accumulated in the past few years through QE, the magnitude of these shocks from the unwinding could be equally significant. For example, the QE programmes have led to a broad-based shift into fixed-income assets with longer durations; the increased duration has

<sup>a</sup> This box draws from Tatiana Fic's presentation at the UN/DESA Expert Group Meeting on the World Economy held on 21–23 October 2013 in New York, "The spillover effects of unconventional monetary policies in major developed countries on developing countries", available from [http://www.un.org/en/development/desa/policy/proj\\_link/](http://www.un.org/en/development/desa/policy/proj_link/).

<sup>b</sup> In addition to the study by Fic (ibid.), this includes, for example, Qianying Chen and others, "International spillovers of central bank balance sheet policies", BIS papers, No. 66 (October, 2012), Basel, Switzerland: Bank for International Settlements; and Marcel Fratzscher, Marco Lo Duca and Roland Straub, "On the international spillovers of US quantitative easing", ECB Working Paper Series, No. 1557 (June, 2013), Frankfurt, Germany: European Central Bank.

A bumpy QE exit could lead to a surge in long-term interest rates

significantly increased the potential losses to the holders of those portfolios when interest rates rise. Moreover, as QE moved a large proportion of the long-term bonds out of the markets, it reduced market liquidity, which in turn could intensify the shocks and lead to an overshooting of long-term interest rates.

More importantly, those first-round shocks in international financial markets could transmit quickly to the domestic real economic sectors of both developed and developing countries. For example, in major developed countries, such as the United States, a marked increase in long-term interest rates would be detrimental not only to banks, in terms of funding challenges, but also to households and businesses, in terms of higher financial costs. This could stifle the fledgling recovery in private consumption and business investment. In fact, the 100-basis-point increase in benchmark long-term interest rates during the financial turmoil of May-June 2013 has already left a measurable imprint on the housing sector in the United States. As mortgage interest rates spiked, the recovery in the housing sector weakened notably.

In emerging economies, higher benchmark interest rates, rising risk premia on external financing, and the decline in capital inflows would exacerbate the challenges they are already facing—that is, a slowdown in GDP growth and a further narrowing of policy space—especially for those economies with large twin deficits and elevated inflation (see more discussion below).

Shocks in international financial markets could transmit quickly to the real economy

### Vulnerability of emerging economies to external shocks

Many large developing countries, including Brazil, China, India and the Russian Federation, saw a significant deceleration in GDP growth in the past two years (box I.4), due to a combination of challenging external conditions and domestic impediments. In the baseline outlook discussed earlier, growth in these economies is expected to strengthen in some cases, such as Brazil and India, and to stabilize in others, such as China. Risks remain, however, for a hard landing for some of these economies.

The financial turbulence encountered by many emerging economies during 2013 has reminded the world of the Asian financial crisis of 1997-1998. Several aspects prompt comparison between the vulnerability facing emerging economies today and the situation in the run-up to the Asian financial crisis. A few indicators are selected from three Asian economies involved in the Asian financial crisis (Indonesia, the Republic of Korea and Thailand) to compare with five economies most affected by the current episode (Brazil, India, Indonesia, South Africa and Turkey).

#### Box I.4

##### Growth slowdown in the BRICS

In many large developing countries, including the BRICS (Brazil, the Russian Federation, India, China and South Africa), economic growth has weakened considerably over the past two years and is now well below the pre-crisis level. For 2013, weighted gross domestic product (GDP) growth in the BRICS is projected at 5.6 per cent, down from an annual average of about 8 per cent during the period 2000-2008.

An important question is how much of the recent slowdown in these emerging economies is cyclical and temporary, and how much is structural and longer-term. The former implies that growth in these economies could return to the same high growth paths they enjoyed prior to the global financial crisis, once the cyclical conditions (such as external demand from developed countries) improve. The latter, on the other hand, suggests that these economies would, in the longer-term, face a “new normal” growth path that is notably slower than before the crisis.

## Box I.4

Growth slowdown in the BRICS (*continued*)

A standard growth decomposition exercise for the BRICS for the period 1996-2012 can reveal some interesting features about the growth deceleration in these countries.<sup>a</sup> By a production function approach, GDP growth can be decomposed into the contributions from three sources: growth in labour inputs, accumulation in capital, and increase in total factor productivity (TFP)—a catch-all category that measures the overall efficiency of the economy in transforming labour and capital into output. As illustrated in the figure below, most of the decline in GDP growth triggered by the eruption of the global financial crisis of 2008 can be attributed to a drop in the growth of TFP. However, the contributions from growth in labour (measured as total employment (quantity) adjusted for changes in the composition of labour) and capital have also been on a downward trend in recent years. One caveat about this exercise is that since TFP is estimated as the residual, a large part of its fluctuation in the aftermath of the financial crisis may reflect a cyclical movement caused by changes in aggregate demand, rather than a structural change in technological advance or other supply-side factors.

A number of recent studies, with various more sophisticated approaches, including structural modelling and time-series analysis techniques, have offered more information.<sup>b</sup> Estimates of potential output and output gaps (the gap between actual GDP growth and potential growth) in the BRICS suggest: First, prior to the crisis, from 2005-2008, actual GDP grew faster than potential output, resulting in a significant positive output gap at the onset of the crisis. The rising output gap was associated with a marked increase in inflation in all of these economies, except Brazil. The output gap was probably largest in the Russian Federation and South Africa. Second, potential GDP growth seems to have declined in the aftermath of the crisis in all five economies, with the decline most pronounced in China and India. And third, small negative output gaps are currently estimated for these economies, with the largest gap in India.<sup>c</sup>

The estimated decline in the potential growth, combined with relatively small negative output gaps, suggests that the pace of economic expansion in the BRICS will remain notably below the pre-crisis period. A moderate cyclical upturn is expected in the near term, particularly in India, but more lasting progress will depend on policies and reforms to remove supply-side bottlenecks to growth. In most economies, this will require increased efforts to stimulate capital accumulation, promote technological advances, strengthen human capital and improve the functioning of labour markets.

<sup>a</sup> See The Conference Board *Total Economy Database™*, January 2013, available from <http://www.conference-board.org/data/economydatabase/>.

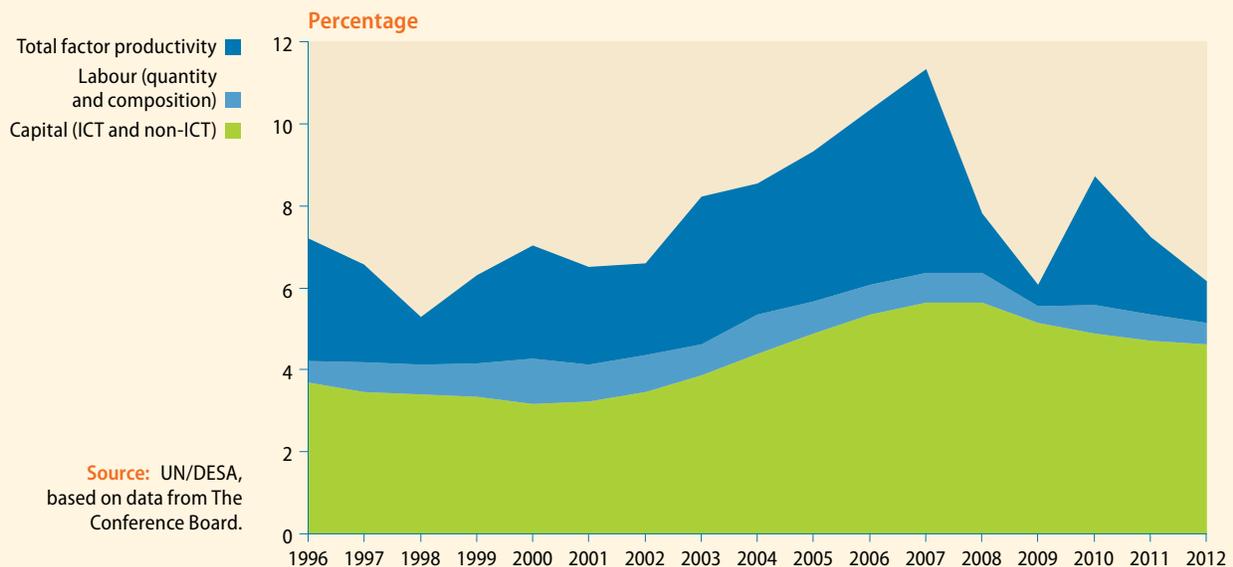
<sup>b</sup> These analyses include work by the World Bank, including the *Global Economic Prospects: Less volatile but slower growth* (June, 2013), the IMF, as well as national authorities.

<sup>c</sup> Despite a significant negative output, inflationary pressures in India have remained elevated, largely owing to structural bottlenecks. This recently led India's central bank to raise interest rates even as current output growth is considered to be below potential.

Source: UN/DESA.

Figure I.4.1

## Growth decomposition for the BRICS, 1996-2012



### Volatility of capital inflows

As in the Asian financial crisis, the latest financial turmoil experienced by emerging economies has also been driven by procyclical movements in fickle international capital flows.

In the run-up to the Asian financial crisis, net private capital inflows to emerging economies increased by about 90 per cent from 1994 to 1996, followed by a sharp decline of 50 per cent. Currently, net private capital inflows to emerging economies increased by 85 per cent from the trough of 2008 to 2012, followed by an estimated decline of 12 per cent in 2013.

Procyclical and fickle movements pervade international capital flows

### Current-account balances

In the three years before the Asian financial crisis, the three selected economies all experienced increases in their current-account deficits, with Thailand registering the greatest increase, from 5.4 per cent of GDP in 1994 to 8 per cent in 1996 (figure I.10). In comparison, all five sampled economies have been running current-account deficits in the past few years, with the largest deficit in Turkey, at 9.7 per cent of GDP in 2011. India's deficit was also sizeable at more than 5 per cent of GDP.

### External debt

Measured by the ratio of foreign debt to GDP (figure I.11), among the three selected economies for the Asian financial crisis, Thailand had the highest external debt ratio of 50 per cent in 1996. In the current episode, India and Turkey have the highest external debt-to-GDP ratio of about 20 per cent.

In addition, currency and maturity mismatches in emerging markets' balance sheets (particularly of the private sector) played a central role in the Asian financial crisis, but are less pronounced this time. In South Africa, for instance, approximately two thirds of the total external debt is in domestic currency and only about 10 per cent of total external debt is short-term debt denominated in foreign currency. Similarly, India's short-term external debt accounts for only about 5 per cent of GDP.

Figure I.10  
Current-account imbalances for selected countries

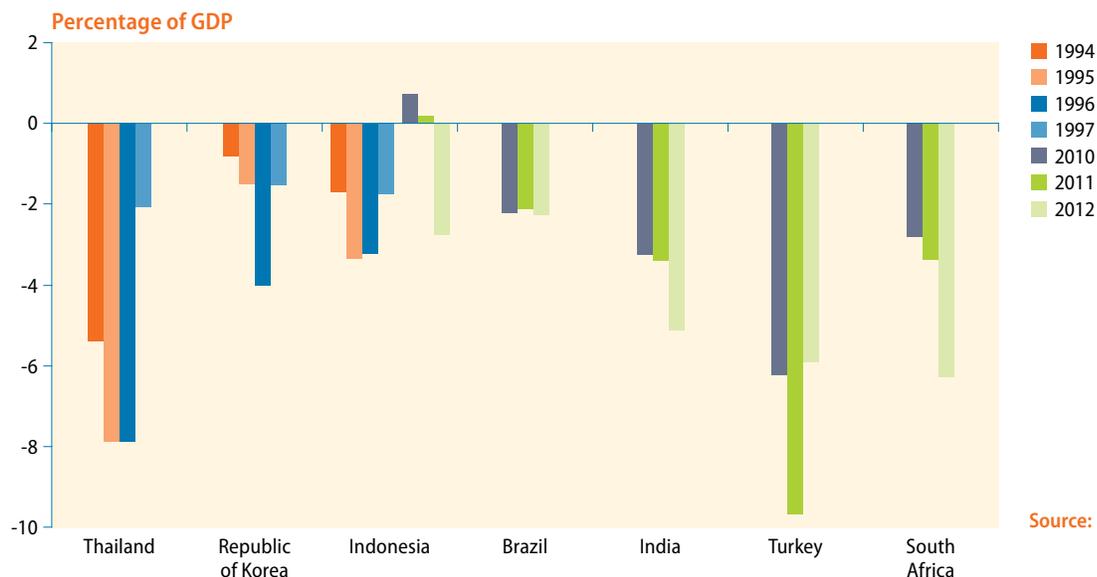
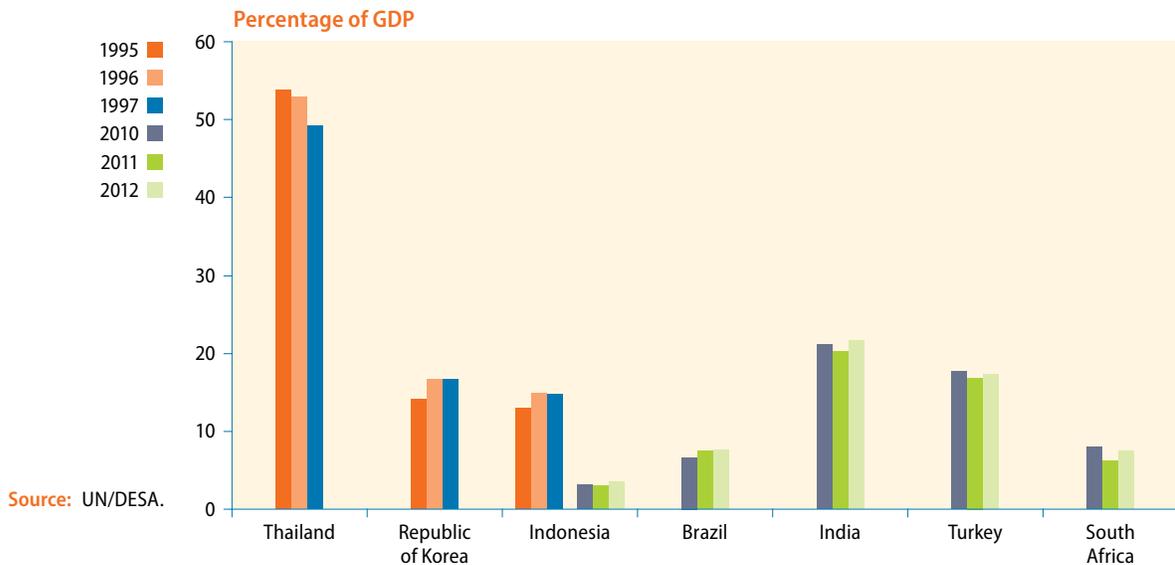


Figure I.11  
External debt for selected countries



### Exchange-rate regimes

In the 1990s, most emerging economies adopted a fixed exchange-rate regime, pegging their currencies to the United States dollar, or other major currencies. The fixed exchange-rate regime caused at least two types of problems. First, in the run-up to the financial crisis, the fixed exchange-rate regimes tended to lead to overvaluation of the local currencies when these countries experienced higher inflation than that in the United States, and/or when they encountered adverse shocks to their exports. Second, when the crisis erupted, the fixed exchange-rate regime also obligated these countries to defend their currencies by selling their foreign reserves, only to watch those hard-earned reserves quickly drain away.

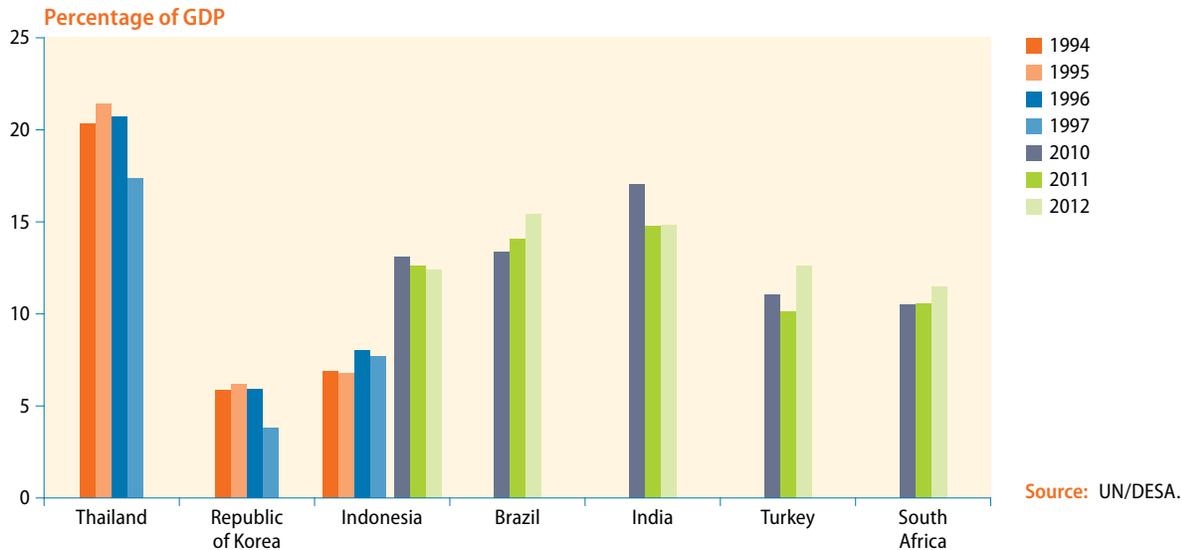
Most emerging economies have recently adopted more flexible exchange-rate regimes

In contrast, most emerging economies have recently adopted floating, or managed floating exchange-rate regimes. A sharp devaluation of the local currency in a short period is still harmful for emerging economies, in terms of the adverse effects on inflationary pressures and losses on the balance sheets of businesses. But a flexible exchange-rate regime can, to some extent, act as a relief valve—it offsets part of the external demand shocks on the domestic economy, through adjustments to relative prices between the external sector and the domestic sector. Because of the flexible regime, the authorities do not have to vigorously defend their currencies at any preset level, thus avoiding rapid exhaustion of their foreign reserves.

### Foreign reserves

Before the Asian financial crisis, foreign reserves in the Republic of Korea were at about 5 per cent of GDP, Indonesia about 8 per cent and Thailand about 20 per cent (figure I.12). When they began defending their currencies from depreciation, foreign reserves were rapidly depleted, forcing these economies to seek aid from international financial institutions. Currently, foreign reserves in most emerging economies are substantially higher. For example, even in the five economies that are under financial pressure, each of them has accumulated foreign reserves above 10 per cent of GDP, not to mention a group of other emerging economies with much higher foreign reserves.

Figure I.12  
Foreign reserves for selected countries



### Other aspects

Since the Asian financial crisis of the 1990s, as well as a few financial crises in other emerging economies in the late 1990s and the early 2000s, these economies have made a number of improvements. There is a greater transparency in the disclosure of financial information, including data on foreign reserves and non-performing loans; banking supervision and regulation has been strengthened so as to reduce mismatches in currencies and terms of debt; policy measures in managing capital inflows are more flexible; and better macroeconomic positions, in terms of more prudent fiscal and monetary policies and lower government debt-to-GDP ratios, have been achieved.

In the outlook, as major central banks (particularly the Fed) are expected to taper and eventually unwind their QE programmes, emerging economies are bound to face more external shocks, especially marked declines of capital inflows. Some of these economies, particularly those with large external imbalances, remain vulnerable. Nevertheless, economic fundamentals and the policy space in these economies are better than when the Asian financial crisis erupted.

Economic fundamentals in emerging economies are stronger now than when the Asian financial crisis erupted

### Remaining risks in the euro area

The crisis in the euro area has cooled significantly but remains a significant risk factor for the world economy. The Outright Monetary Transactions (OMT) programme adopted by the ECB and other policy initiatives since late 2012 have significantly reduced sovereign risks and the risk of a euro area break-up. The OMT in particular has acted as a circuit breaker between the eruption of country-specific crises and sovereign bond markets. This explains why the political impasse in Italy and the Cypriot bank bailout during 2013 caused only limited disturbances. Despite this progress, considerable banking and fiscal risks remain.

A large number of banks still have weak balance sheets, particularly in the southern region, and could face insolvency. The Cypriot bailout in March 2013 actually raised risks in the banking sector by bailing in additional classes of creditors, thus increasing the pos-

A large number of European banks still have weak balance sheets

sibility of bank runs in the future. This has heightened the urgency to create a region-wide banking union. EU finance ministers have agreed on the first stage of a banking union, and the ECB will become the top bank supervisor in the euro area. However, in the continuing discussion over the form of the future banking union, the issue of bank resolution is far from resolved, so that the problem of weak banks remains a major concern. One side effect of the OMT policy has been that banks have added more sovereign debt to their balance sheets and would therefore be more vulnerable to sovereign instability if it were to return.

The dangerous feedback loop between fiscal consolidation and economic weakness remains a risk. The growth performance of the region is improving, but most of the crisis countries remain in recession. The pressure to enact austerity measures has been reduced somewhat, as the Economic and Financial Affairs Council granted some countries extensions on the deadlines for hitting their fiscal targets. But the targets remain challenging, and will continue to hinder recovery. Considerable risk remains that these targets will be missed, owing to growth shortfalls and/or political difficulties in implementation. This could lead to a return to crisis; and, as was seen during the Cypriot episode, the support for assistance to countries in crisis has weakened.

### Uncertainties and risks from lingering budget issues in the United States

Over the course of 2013, the United States has experienced a series of small-scale fiscal crises caused by political divides over budget issues in Congress. At the beginning of the year, a full-scaled fiscal cliff was averted when an agreement was reached to permanently maintain a large part of the temporary tax cuts after they were due to expire. But Congress failed to agree on a long-term deficit reduction plan, triggering automatic, across-the-board spending cuts (sequestration) worth \$1.2 trillion over the next nine years, with a cut of \$85 billion for 2013. In early October, a failure in Congress to agree on the 2014 budget and to raise the debt ceiling led to a partial shutdown of the federal Government and heightened the risk of a default on the United States debt. At the last minute, an agreement was reached to fund the Government through 15 January 2014 and suspend the debt limit through 7 February 2014, merely postponing the issues.

There are two different types of economic costs associated with these uncertainties and risks. First, the recurrent uncertainties about the government budget, even if no large-scale crisis erupts, discourage business investment and hiring, thereby leading to lower growth and higher unemployment in the short run and damaging potential growth in the longer run.

Second, should a crisis occur if the debt ceiling were not raised, for example, the consequences would be devastating not only for the United States, but also for the world economy. With the federal government budget deficit at more than 4 per cent of GDP, if no more net borrowing were allowed, the Government would be forced to take actions which would entail a combination of defaulting on the debt and cutting expenditures. Given that the United States has never defaulted, that the dollar is the major international reserve currency, and that half of the United States government debt is held by foreigners, including foreign central banks, it is difficult to make a plausible estimate for the costs of such a default. On the other hand, the impact of a cut in government spending can be estimated through model simulation (as the one simulating the fiscal cliff in *WESP 2013*, for example, which remains valid today).

If the debt ceiling were not raised, the consequences would be devastating

## Policy challenges

Macroeconomic policy stances in the world economy have become more diverse across countries, and some critical transitions are expected to occur in 2014-2015. While policies in most developed countries, except Japan, will continue to feature a combination of tightening fiscal policy and accommodative monetary policy, the degree of fiscal tightening will be less restrictive and the extent of monetary easing will taper off. The central banks of major developed countries have the primary responsibility for providing adequate and stable global liquidity, as they are the issuers of the international reserve currencies. Managing a smooth tapering of the QE will be the key challenge for the monetary authorities in major developed countries, as the risks associated with this transition will pose a threat not only for developed economies, but also for the rest of the world.

Managing a smooth tapering of the QE will be the key challenge

In developing countries and economies in transition, policymakers are facing a more challenging international economic environment, as well as more demanding domestic economic situations, that require tough tradeoffs amid a confluence of different policy needs. Moreover, some of the challenges facing developing countries and economies in transition may go beyond the reach of standard macroeconomic policies, requiring institutional and structural reforms. A number of developing countries, such as Brazil, China and India, have indeed embarked on various reforms, including reforms in social security, income distribution, the financial sector, taxation, energy, transportation, education and health care.

## Fiscal policy

Most developed economies, with Japan as the exception, have continued fiscal tightening during 2013 by reducing government spending, raising taxes, and, in some cases, liquidating public assets. The average budget deficit of developed countries is estimated to have been reduced by 1.4 per cent of GDP to 4.5 per cent of GDP by 2013, compared with the peak of 8.9 per cent in 2009 at the height of the financial crisis. The average debt stands at 108.5 per cent of GDP. In the outlook, fiscal tightening will likely continue in most of these economies, but with a notably less acute stance.

In the United States, fiscal policy has tightened markedly in 2013, through increases in taxes and automatic spending cuts (sequestration). As a result, government spending in real terms is estimated to have declined by about 5 per cent in 2013 from the previous year. The outlook for fiscal policy in 2014-2015 is clouded by uncertainties emanating from political wrangling. Fiscal policy is expected to remain restrictive, but less severe than in 2013. In Western Europe, fiscal policy remains dominated by the need to reduce deficits under the euro zone rules and was reaffirmed by the ratification of the new fiscal compact this year. Progress has been made, but twelve out of seventeen euro area countries remain under the Excessive Deficit Procedure of the Stability and Growth Pact. The fiscal compact of the euro area entered into force in 2013, adding additional fiscal targets: the structural deficit should now be less than 0.5 per cent of GDP, and remedial action will now be required for countries with debt-to-GDP ratios above 60 per cent. Japan, despite facing the largest debt-to-GDP ratio in the world, has adopted expansionary fiscal policy during 2013, through a supplemental budget to increase government spending by about 2.2 per cent of nominal GDP. The Government decided to implement plans to raise the consumption tax rate from the current level of 5 per cent to 8 per cent in April 2014 and 10 per cent in October 2015. A new complementary package of about 5 trillion yen was introduced to compensate the negative impacts of the higher consumption tax.

A number of low-income countries are experiencing high budget deficits

Compared with developed economies, most developing countries and economies in transition have a better fiscal position in terms of budget deficits and public debt. However, their fiscal position has deteriorated measurably in 2013, with a number of low-income countries experiencing high budget deficits.

The fiscal deficit has deteriorated in much of Africa, as Governments across the continent are under continuous pressure to increase spending on public services, wages in the public sector and provision of subsidies on food and fuel. The deterioration is largely due to lagging revenues in oil-importing countries, while oil-exporting and mineral-rich countries have sizeable fiscal surpluses. In East Asia, fiscal policy has remained generally expansionary, as a number of countries adopted various stimulatory measures, including tax relief, expenditures in support of job creation, and infrastructure projects, to counter the slowdown in domestic demand. As a result, fiscal positions have worsened slightly in 2013. A similar stance is expected for 2014. Public finances in South Asia are under pressure, with Governments increasing already large deficits and regularly missing deficit reduction targets by a wide margin. Given the weak growth momentum in the region and the difficulties in raising tax revenues and curbing expenditure growth, fiscal deficits will remain large in the near term. In Western Asia, the active fiscal policy employed by oil exporters will remain, in contrast to more pronounced fiscal constraints of the non-oil exporters. In Latin America and the Caribbean, the fiscal position has deteriorated slightly in the past two years, mainly due to higher public expenditures in South America, but public revenues are also vulnerable to a softening of the prices of the primary commodities that the region exports.

In the CIS, the Russian Federation has maintained a prudent fiscal stance as budget revenue increased less than anticipated. While Ukraine is restrained by high fiscal deficit, a few oil and natural gas exporting countries, such as Azerbaijan, Kazakhstan and Turkmenistan, continued massive fiscal spending on public wages and public infrastructure.

## Monetary policy

Major developed countries share a number of common features in their monetary policy. In addition to maintaining policy interest rates at zero or near zero, and adopting large-scale purchases of long-term assets (see box I.3 in previous section), central banks in these countries have also increasingly turned to “forward guidance” as a policy tool, thus providing additional stimulus by anchoring expectations that interest rates will remain low for an extended period.

The Fed was the first central bank to adopt forward policy guidance; it stated publicly that it would keep the target range for the federal funds rate at exceptionally low levels as long as the unemployment rate remains above 6.5 per cent, or inflation between one and two years ahead is projected to be no more than a half percentage point above the two per cent longer-run target.

The Bank of England (BoE) has joined the Fed in framing its guidance as refraining from raising the bank rate from its 0.5 per cent level at least until the unemployment rate has fallen to a threshold of 7 per cent. The BoE also made it clear that the unemployment threshold is not expected to be breached until at least the second half of 2016. The Bank of Japan (BoJ) has announced that it will continue the Quantitative and Qualitative Monetary Easing until the CPI inflation rate reaches the target of 2 per cent. In comparison, the forward guidance recently instituted by the ECB is to confirm that their current policy setting will stay in place for an extended period of time without specifying a numerical target for exiting this setting.

Enhanced guidance by the central banks is seen as necessary for increasing policy transparency and reducing uncertainties, thereby limiting the risk of financial market volatility that diminishes policy effectiveness. In reality, however, confusion can still occur. For example, when the Fed announced in May 2013 the possibility of tapering the amount of its purchases of long-term assets by late 2013, financial markets reacted immediately by pushing up long-term interest rates significantly. When the Fed did not reduce its purchases in September 2013, markets seemed to be confused again. Managing public expectations, if possible, remains a big challenge for policymakers.

Enhanced guidance by the central banks is necessary

As delineated in box I.1 above, central banks in major developed countries are expected to maintain the policy interest rates at their current low levels at least until mid-2015, to be followed by a gradual increase in the rates. The Fed is expected to taper QE in 2014.

Among central banks in developing countries and economies transition there is no apparent common trend in monetary policy, as some of them are tightening while others are easing. In the outlook, the monetary authorities in these countries are expected to adopt appropriate monetary policy stances in accordance with the challenges they face, including the responses to spillovers from the changes in QE of major developed countries, fluctuations in exchange rates, volatility in capital inflows, and the movements in inflation, unemployment and growth. More details about monetary policy in these countries can be found in chapter IV.

### Policy challenges in managing the risks associated with the unwinding of QE

The tapering and unwinding of the unconventional monetary policies in major developed economies in the next few years pose significant risks for global growth and the stability of the world economy. It is a challenge for policymakers in these countries to harness a smooth process for this transition. Central banks should develop a clear communication strategy to articulate the timing and the targets of the policy action, and avoid repeating the episodes resulting from the actions of the Fed in May-June and September of 2013. At the macroeconomic levels, the timing and the pace of the unwinding are crucial: a premature and rapid unwinding may risk choking off the economic recovery, but a delayed unwinding could risk creating financial bubbles. At the technical level, contingency plans are also needed to deal with the overreaction of financial markets and prevent contagion. Efforts are needed to enhance supervision, regulation and surveillance of financial markets, in order to be able to identify and mitigate risks and vulnerabilities associated with the liquidity of some assets, market structure, and other problems in advance.

For developing countries and emerging economies, the challenge is to shield themselves from the spillover effects of the unwinding of QE in major developed countries, which will be transmitted through international finance and trade. As shown by the financial market turmoil in the summer of 2013, the spillover shocks to these countries can be consequential and costly, particularly to those emerging economies that are highly exposed to international capital markets and have large external imbalances financed by short-term external capital flows. Before the next episode of shocks arrives, these economies need to address external and internal imbalances and build policy space. Supervision and regulation should also be strengthened to prevent a build-up of mismatches in foreign currency funding on bank balance sheets. Prudential oversight should be tightened, particularly for shadow banking activity.

A challenge for developing countries will be to shield themselves from the spillover effects of the QE exit

Many emerging economies today have gained policy flexibility from adopting a more flexible exchange-rate regime, compared with the Asian financial crisis of the 1990s. However, central banks in these economies may still have to defend their currencies from sharp depreciation in case of a significant decline in capital inflows. How to do it effectively remains a challenge.

During the most recent financial turmoil of mid-2013, some countries, such as Brazil, India and Indonesia, raised interest rates in an attempt to curb currency depreciation. Alternatively, the central bank of Turkey has adopted a different policy scheme by creating an interest-rate corridor without increasing the policy interest rate. Individual countries can and should adopt measures that are most suitable to their institutional settings and policy targets.

### International policy coordination

Stronger recovery should be the primary focus of the globally coordinated policy

The multiple and complex challenges in the world economy call for strengthening of international policy coordination. While the primary focus of globally-concerted and coherent policy actions should be a stronger recovery—particularly the recovery of jobs—increasing attention should also be given to mitigating the spillover effects emanating from the large-scale, unconventional monetary policies adopted by major developed countries regarding developing countries and economies in transition.

Maintaining an open multilateral dialogue on the economic policy intentions of all countries, particularly the major economies, is a crucial element in international policy coordination to promote policy coherence and concerted action. Such dialogue has so far been frequently held in the context of the Group of 20 (G20), but it should also be promoted to more broadly representative international forums, particularly the United Nations.

Most recently, at the G20 Summit held in St. Petersburg on September 5 and 6, 2013, members reaffirmed the framework for strong, sustainable and balanced growth. The G20 has committed to undertaking further policy adjustments towards rebalancing global demand between surplus and deficit countries. The surplus countries will achieve stronger domestic demand while the deficit countries will increase savings, and countries are encouraged to make their exchange rates more flexible. The Summit also called for urgent action to increase the momentum of the global recovery and generate higher growth and better jobs. The effectiveness of the G20 policy coordination, however, will still need to be enforced by compliance at the individual country level.

Advancing the reforms of the international financial system

International policy cooperation and coordination are needed to advance the reforms of the international financial system on several fronts. Progress in financial regulatory reform has been slow, encountering growing resistance from the financial industry. Some progress has been made in amending the global financial safety standards for the banking sector. A dozen countries have issued final regulations to implement Basel III and more countries have committed to do so during 2013. Progress has also been made in implementing over-the-counter derivatives reforms. On the other hand, the question of ending the “too big to fail” approach is still pending, and recommendations from the Financial Stability Board for the oversight and regulation of the shadow banking sector have yet to be issued. More forceful efforts are needed to address the issues of international tax avoidance and evasion, particularly through tax havens.

The current phase of reforming both the International Monetary Fund (IMF) and the World Bank needs to be completed to make their governance structures more representative, responsive and accountable. While there has been progress in ratifying the 2010

IMF quota and governance reforms, the process has not been finalized. The new review of the IMF quota formula should be resolved quickly to enhance the voice and participation of developing economies.

International policy cooperation should ensure that sufficient resources are made available to developing countries—especially the least developed countries—and countries that possess limited fiscal space and face large financing needs for sustainable development and poverty reduction. The decline in ODA flows over the past two years should be reversed. As the target date for the MDGs is approaching, international donors should redouble their efforts to deliver on existing commitments. These resources are greatly needed in order for developing countries to accelerate progress towards the achievement of the MDGs by the end of 2015, and to build a solid foundation for long-run sustainable development beyond 2015.

Sufficient resources must be ensured for the least developed countries