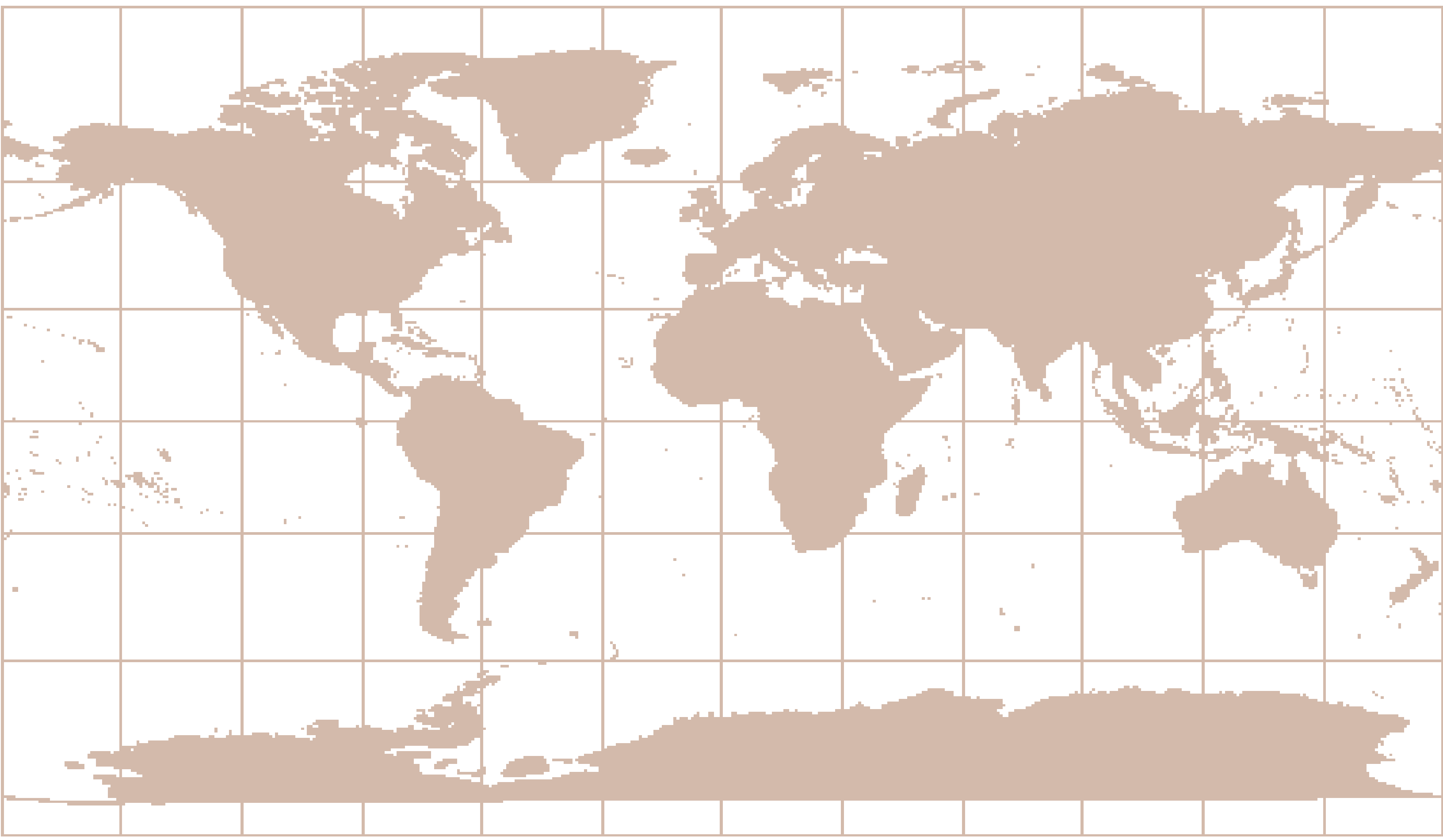
ADVANCE UNEDITED VERSION

World Economic Situation and Prospects 2011

Update as of mid-2011*



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* The present document updates *World Economic Situation and Prospects 2011* (United Nations publication, Sales No. E.11. II.C.2), released in January 2011.

http://www.un.org/en/development/desa/policy/wesp/index.shtml

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Update as of mid-2011*

Summary

The recovery of the global economy continues, with strong output growth in developing countries and weaker economic performance in developed countries. Higher energy and food prices have put upward pressure on inflation rates, underpinning monetary policy tightening especially in many developing countries. Employment trends have been improving, but major challenges, such as rising long-term unemployment and high youth unemployment in a number of economies, remain. World trade of goods and services expanded stronger than expected last year, marking a strong rebound from the severe contraction in 2009 with developing countries, particularly Asian economies with large shares in the trade of manufactured goods, leading the recovery. At the same time, net private capital inflows to emerging economies continued to recover from their pronounced decline during the global financial crisis, a trend that is expected to continue, as higher output growth and rates of return will attract more capital flows to emerging economies. The baseline outlook for 2011 and 2012 is subject to a number of risks, including problems regarding the sustainability of public finances in developed economies, the remaining vulnerability of the private financial sector, continued high and volatile commodity prices and the possible collapse of the United States dollar. In the area of policy making, numerous challenges remain, such as how to time the unwinding of fiscal support, the redesign of fiscal policy to promote employment and sustainable development, greater synergy between monetary and fiscal policy, the provision of sufficient funding to developing countries and more effective international policy coordination.

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Global macroeconomic trends

A still fragile recovery

The world economy continues to recover from the global economic crisis, but the pace remains uneven across countries. Output growth is strong among developing countries and feeble in many developed economies. Legacies from the global financial crisis continue to weigh on global growth, while new challenges have emerged. In the baseline outlook, world gross product (WGP) is expected to grow by 3.3 per cent in 2011 and 3.6 per cent in 2012 (see table 1); only a slight upward adjustment from the forecasts released in the *World Economic Situation and Prospects (WESP) 2011* at the beginning of the year.

At the present pace of output growth, it would take another four or five years before employment is back at pre-crisis levels in developed countries. Despite some progress in rebuilding balance sheets in the financial sector, the banking sectors of the major developed countries still look vulnerable to multiple risks from continued weak housing markets, sovereign debt stress, and continued overall economic weakness. In addition, fiscal policies are shifting towards austerity in response to heightened concerns about the sustainability of public debt levels, but weakening growth prospects in the short run.

Developing countries and economies in transition, in contrast, have contributed significantly to the post-crisis expansion of the world economy. The strong recovery continues to be led by the large emerging economies in Asia and Latin America, particularly China, India and Brazil. However, also in these economies, the growth outlook is moderating owing to several increasingly pressing concerns. Those concerns include persistently rising inflation and emerging domestic asset price bubbles, fuelled by large capital inflows and related upward pressure on their exchange rates. Many countries are responding by significant tightening of monetary policies and moderation of fiscal expansion.

Surging oil and food prices

New headwinds have also emerged in 2011. The earthquake, tsunami and nuclear crisis in Japan also shook world financial markets and disrupted in important global supply chains. While these effects on the global economy may be shortlived, uncertainties remain, particularly those associated with the leakage of radioactivity at a Japanese nuclear power plant.

In addition, primary commodity prices have surged during the first four months of 2011, much more forcefully than anticipated in WESP 2011. The surge was driven in part by the political unrest in Western Asia and North Africa, which—inter alia—led to a disruption to oil production in the Libyan Arab Jamahiriya. The near term trend in oil prices is hard to predict because of uncertain political factors and the influence of financial variables, but supply and demand conditions do not warrant a continued upward trend. Even though global oil demand has been growing faster than supply, inventories and spare capacity remain above the average of the past five years. In the baseline outlook, assuming no major supply disruptions, oil prices are forecast to average $99 per barrel for the year 2011 and $90 per barrel in 2012.

Table 1
Growth of world output, 2005–2012

Annual percentage change						Change from January 2011 forecast	
	2005-2008[a]	2009	2010[b]	2011[c]	2012[c]	2011	2012
World	3.3	-2.1	3.9	3.3	3.6	0.2	0.1
Developed economies	2.0	-3.7	2.5	2.0	2.4	0.1	0.1
United States of America	1.9	-2.6	2.9	2.6	2.8	0.4	0.0
Japan	1.3	-6.3	4.0	0.7	2.8	-0.4	1.4
European Union	2.2	-4.2	1.8	1.7	1.9	0.1	-0.1
EU15	2.0	-4.3	1.7	1.7	1.7	0.2	-0.2
New EU Members	5.3	-3.6	2.2	3.1	4.0	-0.1	-0.3
Euro zone	2.0	-4.1	1.7	1.6	1.6	0.3	-0.1
Other European	2.6	-1.8	1.5	2.0	2.0	-0.1	-0.2
Other developed countries	2.5	-0.8	2.7	2.8	2.7	-0.2	-0.3
Economies in transition	7.0	-6.7	4.3	4.4	4.6	0.4	0.4
South-Eastern Europe	5.1	-3.7	0.5	2.2	3.1	-0.3	-0.3
Commonwealth of Independent States and Georgia	7.2	-7.0	4.6	4.6	4.8	0.5	0.5
Russian Federation	6.9	-7.9	4.2	4.4	4.6	0.7	0.7
Developing economies	6.9	2.4	7.4	6.2	6.2	0.2	0.1
Africa	5.6	1.8	4.4	3.6	5.4	-1.4	0.3
North Africa	5.1	1.5	4.1	0.7	5.0	-4.3	-0.7
Sub-Saharan Africa	5.9	2.0	4.6	5.1	5.5	0.1	0.7
Nigeria	6.0	6.9	7.6	5.7	6.3	-0.8	0.5
South Africa	5.0	-1.8	2.8	3.7	4.8	0.5	1.6
Others	6.6	3.0	4.7	5.9	5.7	0.1	0.1
East and South Asia	8.2	5.1	8.7	7.2	7.2	0.1	-0.1
East Asia	8.4	5.0	9.1	7.3	7.2	0.1	-0.2
China	11.3	9.1	10.3	9.1	8.9	0.2	-0.1
South Asia	7.5	5.7	7.1	6.9	7.0	-0.1	-0.2
India	8.5	7.0	8.6	8.1	8.2	-0.1	-0.2
Western Asia	5.9	-0.6	5.8	5.8	4.2	1.1	-0.2
Latin America and the Caribbean	4.9	-2.2	5.9	4.5	4.9	0.4	0.6
South America	5.6	-0.4	6.4	5.0	5.2	0.5	0.4
Brazil	4.6	-0.6	7.5	5.1	5.3	0.6	0.1
Mexico and Central America	3.5	-5.9	5.3	3.8	4.3	0.4	0.8
Mexico	3.3	-6.5	5.5	3.7	4.3	0.3	0.8
Caribbean	7.1	0.9	3.7	4.0	4.7	0.9	1.3
Least developed countries	7.7	4.1	4.7	5.6	5.8	0.1	0.1
Memorandum items:							
World traded	7.1	-11.1	11.9	7.1	6.8	0.5	0.3
World output growth with PPP-based weights	4.4	-0.8	4.8	4.1	4.4	0.1	0.0

Source: UN/DESA
a Average percentage change.
b Partly estimated.
c Forecast, based in part on Project LINK.
d Includes goods and services.

Food prices also soared in early 2011. Nonetheless, prices of major grains, such as rice and wheat, are still substantially below their peaks of 2008. Global food demand has remained strong, especially in developing countries, but also demand for biofuel feedstock increased along with higher oil prices. Food supply growth fell short, being affected by a number of weather-related shocks, including droughts, wildfires and a strong La Niña weather pattern. A weaker United States dollar bolstered the upward trend in world market prices. In the short-term outlook, however, better harvests are expected to moderate food prices in the second half of 2011.

Accelerating headline inflation

Worldwide, the higher energy and food prices have pushed up headline inflation. In most economies, however, core inflation, which excludes food and energy prices, has so far remained low, although it has been creeping up somewhat. This has been a reason for monetary authorities in most developed economies to show reluctance in tightening monetary policies, but many developing countries have been raising interest rates in attempts to temper inflationary pressures. Higher food and energy prices have eroded real incomes of many of the world's poor. In Asia, home to two third of the world's poor, for instance, food prices have risen by 10 per cent and this could push 64 million people below the poverty income threshold of $1.25 per person a day if prices remain at current levels. Furthermore, soaring inflation is complicating the fiscal situation in many countries trying to protect consumers through subsidies and cash transfers. Governments in a number of developing countries, including in North Africa and Western Asia, have stepped up subsidies in response to social and political unrest.

More jobs, but employment concerns remain

The labour market situation has generally improved, but continues to be a reason for concern. Unemployment rates in developed economies have fallen in an increasing number of countries, but output recovery is only slowly translating into jobs creation. At the same time, however, the number of people without a job for six months or longer continues to increase in a range of developed countries, creating a problem more difficult to deal with than transitory short-term employment. Unemployment rates also fell because many without a job stopped looking for work. Among the economies in transition, employment conditions improved in the Commonwealth of Independent States (CIS), but remained problematic in South-Eastern Europe. Employment levels generally have returned to above pre-crisis levels in developing countries, especially to East Asia. Aggregate numbers mask the major employment challenges which many countries are still facing. In West Asia, for example, employment opportunities for young workers continue to be dire and this has been a factor in recent political uprisings. In the global outlook, the still solid growth picture will also have some positive impact on employment.

Strong, but moderating rebound of world trade

World trade of goods and services expanded by almost 12 per cent in 2010, more than previously estimated, representing a strong rebound after the steep decline by 11 per cent in

2009. By the end of 2010, the volume of world merchandise exports had fully recovered to the pre-crisis peak, although it remained markedly below its long-term trend. Developing countries, particularly Asian economies with large shares in trade of manufactured goods, continue to lead the recovery. The trade volume of developing countries as a group has already surpassed the pre-crisis peak, but that of developed economies is still lagging. Commodity-exporting developing countries experienced a strong recovery in the value of exports, owing to a significant upturn in primary commodity prices, but did not see much growth in the volume of exports. In the outlook, growth of world trade is expected to moderate to around 7 per cent in 2011 and 2012. While emerging economies are expected to continue to see robust growth in trade, the recovery in major developed economies remains weak.

Surging capital flows to developing countries

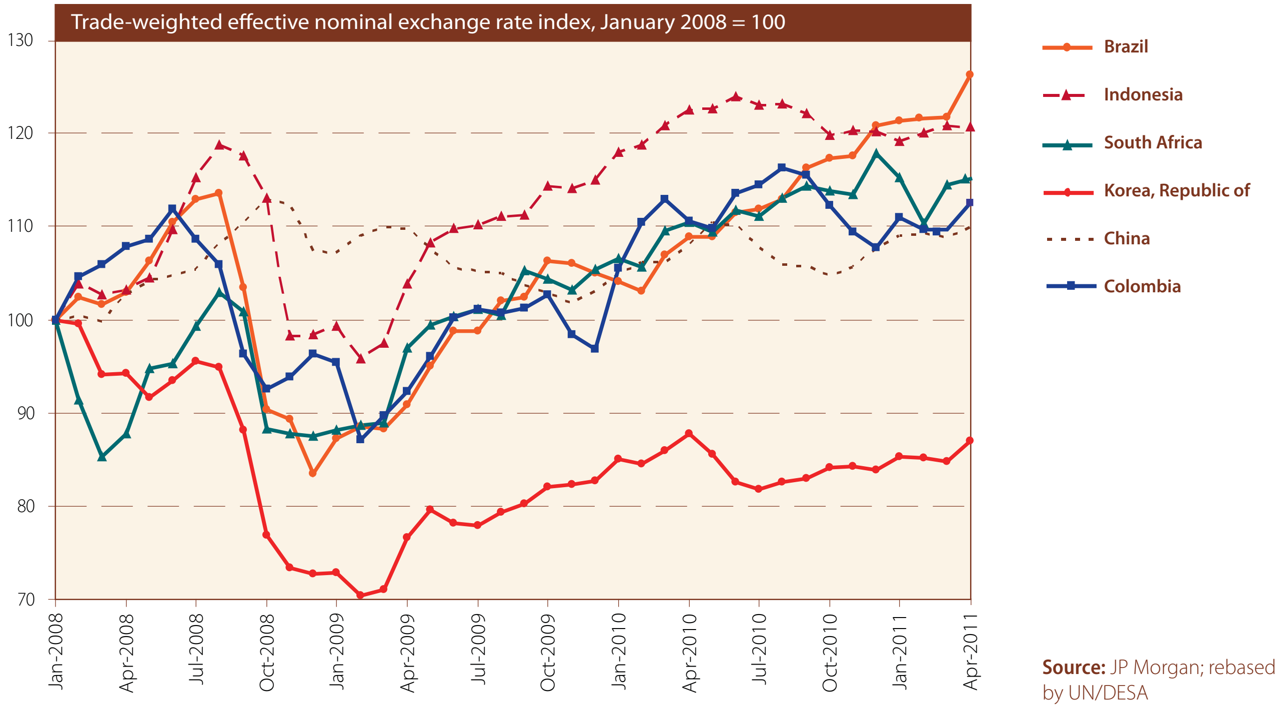
Net private capital inflows to emerging economies continued to recover from their precipitous decline during the global financial crisis of 2008-2009. In the outlook for the rest of 2011 and for 2012, higher output growth and rates of return will continue to attract more capital flows to emerging economies. After totalling about $950 billion in 2010, net private capital flows to emerging economies are expected to stabilize at this level in 2011 and increase somewhat in the forecast for 2012. The current level is still about $300 billion below the pre-crisis peak levels registered in 2007 and the ratio of capital inflows to GDP of these economies stands at about 4 per cent, only about half of its peak level.

Policy makers in emerging markets have become increasingly concerned with large capital inflows leading to appreciating currencies and inflating asset price bubbles and fear sudden reversals in mostly short term portfolio investment flows. Among the currencies of emerging economies, Brazil's real appreciated most, by about 25 per cent in terms of the trade-weighted effective exchange rate, followed by the currencies of Indonesia and South Africa (see figure 1). In response, Governments of many emerging economies are intervening in their currency markets and trying to dampen capital flow volatility through a variety of capital control measures (see table 2). In the outlook though, the upward pressure on the currencies of major developing countries is likely to continue, given persistent financial sector weakness in major developed countries and substantial rate-of-return differentials, implying that measures taken to counteract the risks associated with high capital inflows may need to be strengthened.

Weakening dollar

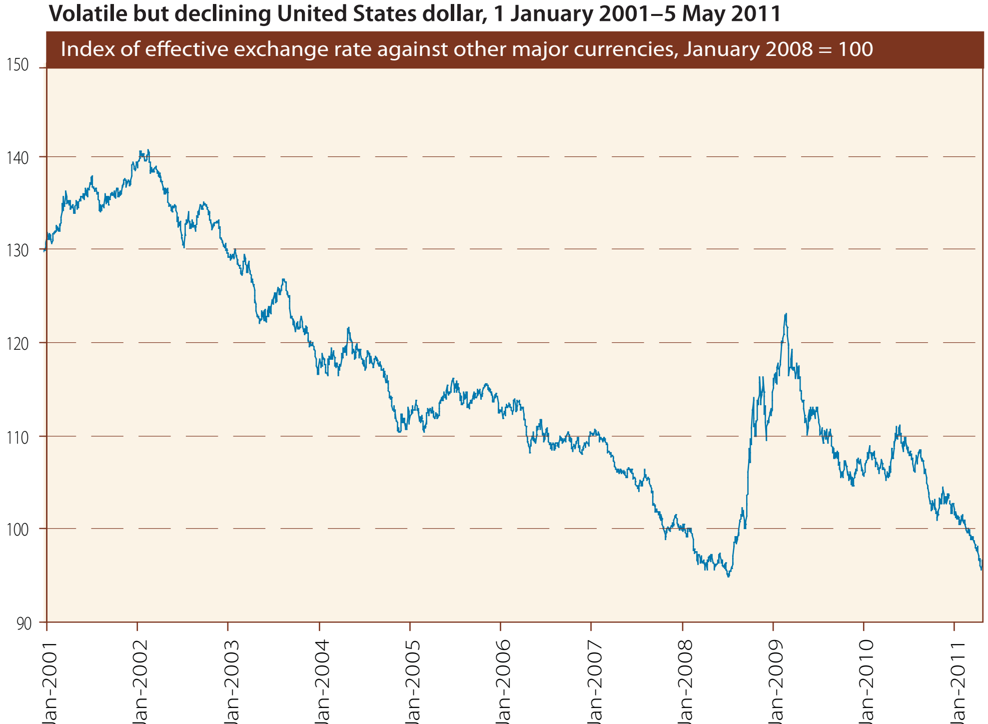
The dollar has continued its downward trend against other major currencies (figure 2). Despite lingering risks associated with sovereign debt levels in some European economies, the euro appreciated against the dollar in the first quarter of 2011, buttressed by the expectation of faster monetary tightening in the euro area. This trend is expected to continue until late 2011, when the United States Federal Reserve (Fed) may raise interest rates. The dollar/euro exchange rate is assumed to be 1.38 in 2011 and 1.28 in 2012. The yen has fluctuated around a high of about 82 yen/dollar since late 2010, but the earthquake in March 2011 triggered extraordinary exchange rate volatility until joint intervention by the finance ministers of the Group of Seven (G7) mitigated the situation.

Figure 1
Appreciating exchange rates in selected developing countries, January 2008–April 2011



Source: JP Morgan; rebased by UN/DESA

Figure 2
Volatile but declining United States dollar, 1 January 2001–5 May 2011



Source: JP Morgan; rebased by UN/DESA

Table 2
Selected capital control measures taken by developing countries (since 2009)

Instrument	*Country*	*Policy Measure*	*Effective Date*
Tax Measures and Fees	Korea, Republic of	Reintroduced a 14% withholding tax on interest income and 20% capital-gains tax on Korean government bonds (KTBs) and monetary stabilization bonds (MSBs).	January 2011
	Thailand	Removed a 15% tax exemption for foreigners on capital gains and interest payments earned from investing in domestic bonds.	October 2010
	Brazil	Raised tax on fixed-income foreign investment to 6% (introduced in October 2009 at 2%).	October 2010
	Peru	Increased fee on non-resident purchases of central bank certificates of deposit (CDs) from 10 basis points to 400 basis points.	August 2010
Quantitative Limits	Korea, Republic of	Instituted a cap on banks' holdings of foreign-exchange derivative contracts (250% of equity capital for foreign bank branches and 50% for domestic banks).	June 2010
		Reduced the limit on currency forward transactions from 125% to 100% of the real transactions being hedged.	June 2010
		Instituted a cap on derivative positions (in response to an options sell-off on 11 Nov 2010), limiting the number of speculative options and futures contracts an institutional investor can hold to a maximum of 10,000 per day (Previously, institutions could hold 7,500 futures, with no limit on options contracts).	January 2011
	Indonesia	Reintroduced a 30% cap on lenders' short-term overseas borrowing.	January 2011
	Taiwan, Province of China	Introduced a ban on foreign investors placing funds into time deposits.	November 2009
		Reactivated regulation that caps foreign investment in Taiwan government bonds and money market products at 30% of investors' total portfolio. (Previously, the 30% cap had only applied to debt maturing in less than 1 year).	November 2010
Minimum Investment Periods	Indonesia	Imposed a minimum 1-month holding period for Bank Indonesia Certificates (SBIs).	July 2010
Reserve Requirements	Indonesia	Raised the reserve requirement ratio for foreign currency deposits from 1% to 5% (proposed to increase to 8% in June 2011).	March 2011
	Brazil	Introduced requirement for local banks to deposit 60% of their short positions in U.S. dollars interest-free at the Central Bank after deducting 3 billion dollars or their capital base, whichever is smaller.	April 2011
	Peru	Increased the marginal reserve requirements for short-term domestic currency deposits to 120 per cent (from 65 per cent)	September 2011

Diverging policy stances

In the context of the uneven and incomplete recovery, as well as the new challenges, policy stances have become notably diverse among major economies and the appetite for effective global macroeconomic policy coordination has lessened further. Nonetheless talks among the Group of Twenty (G-20) have continued as to how to implement the *Framework for Strong, Sustainable, and Balanced Growth*, launched at the G-20 Summit in Pittsburgh in 2009, and some progress has been made to monitor global imbalances. Yet, in terms of actual policy making there has been remarkably little progress, despite recognition of the worldwide repercussions of volatile food and energy prices and capital movements as well as the strong international spillover effects of national policies.

Regional outlook

Developed economies

The *United States* economy expanded by 2.9 per cent in 2010, mainly driven by domestic demand, while weaker net exports had a dampening effect on growth. Personal consumption increased by 1.7 per cent, while strong corporate balance sheets helped investment in equipment and software increase by more than 15 per cent. Government expenditure rose by only 1.0 per cent owing to the weak fiscal positions at the state and local levels. Headline inflation was stable until the recent spike in energy and food prices, while core inflation remains low. Labour market slack has kept wage growth in check, while firms increased productivity and reduced costs. The Fed has kept the federal fund rate at an historical low. In November 2010, the Fed started the second round of quantitative easing, targeting the purchase of $600 billion of longer-term Treasury securities by June 2011. The Fed may start to raise its policy rate in early 2012. Government expenditure is expected to be cut in the outlook period. In April 2011, the credit-rating company Standard & Poor's downgraded its outlook on United States sovereign debt, underscoring the urgency for policymakers to set up a credible framework to address its public debt. GDP growth for 2011 and 2012 is projected at 2.6 per cent and 2.8 per cent, respectively, accompanied by a fall in the unemployment rate to 8.2 per cent in 2012. The potential risks for the United States include sustained elevated commodity and oil prices, a further worsening of its public finances and continued weakness in the housing market and financial sector.

Japan's economy suffered a severe shock from the earthquake of March 2011 and the subsequent tsunami and nuclear power plant crisis. Some 27,000 people lost their lives or were still missing and the damage to buildings and infrastructure is estimated at about 25 trillion yen (5 per cent of GDP). These disasters hit the country when the recovery of the economy was still fragile. Disruptions in production of many firms are expected to push the economy back into contraction in the second quarter of 2011. The reconstruction efforts likely will induce a recovery thereafter, however. GDP growth is projected at 0.7 per cent in 2011 and 2.8 per cent in 2012. A large amount of additional government spending for the reconstruction will further increase the public debt ratio, which already stands at more than 200 per cent of GDP. Uncertainties and major challenges remain: the nuclear power plant has still not been brought under control and, in the medium run, the aging and shrinking population and attempts to bring down the huge public debt will be a drag on domestic demand.

The recovery in *Western Europe* continues at a modest and uneven pace. Industrial business confidence indicators returned to pre-crisis peaks in early 2011, but economies will face strong headwinds in the rest of the year: slower external demand, higher inflation stemming from higher oil and food prices, region-wide fiscal austerity and tighter monetary policy, while the housing market continues to languish in most countries. GDP growth in the euro area is expected to average 1.6 per cent in both 2011 and 2012. The averages mask starkly differing performances within the region, however. At the upper end, Germany is expected to grow by 2.9 per cent in 2011, while the countries mostly affected by fiscal crisis—Greece, Ireland, Portugal and Spain—will either remain in recession or, at best, register modest positive growth rates. Private consumption expenditure is expected to gradually strengthen over the forecast period. This will not provide much impetus to overall GDP growth, however, as the positive demand effects from slowly improving employment conditions will be dampened by the negative impact of higher food and energy prices on disposable incomes as well as by fiscal retrenchment. Investment in equipment is expected to gradually pick up and become an important growth driver, as capacity utilisation rates have been rising since mid-2009, order books continue to improve, business profit prospects are favourable and financing conditions have stabilized. Stagnant housing investment in a number of countries will remain a major drag on activity, however. Employment rates have stabilized and are improving in several countries, with only a very gradual decline in unemployment rates expected in the near outlook. Headline inflation continues to increase, boosted by the sharp rise in energy and food prices, but is expected to remain contained.

The recovery in most new EU member states in *Eastern Europe* strengthened in the last quarter of 2010, with aggregate GDP expanding by 2.2 per cent in 2010 supported by strong export performance and restocking of inventories. The recovery continued in early 2011 building on the same factors. During 2011, the effect of inventory restocking is expected to taper off, however. Except in Poland, domestic demand remains weak in most economies. Private consumption is constrained by slow wage growth, high household debt-servicing obligations, stagnant employment creation, higher indirect taxes and rising inflation. Public spending is also unsupportive, as many Governments are undertaking austerity measures aiming to reduce budget deficits to below 3 per cent of GDP in the medium-term, ostensibly to ensure public debt sustainability. Private investment is still weak, being constrained by credit rationing by banks and high debt payment obligations of companies, despite a moderate increase in inflows of foreign direct investment. In early 2011, inflation accelerated owing to higher food and energy prices and several countries with already relatively high inflation rates, including Hungary and Poland, tightened monetary policy. Other central banks may follow suit, which could further weaken the still fragile recovery. Job creation is lagging output recovery, but even so, unemployment rates started to decline from mid-2010. The perception of lack of fiscal space has constrained more active policies to stimulate employment. Assuming a continued strong export performance, GDP growth in the new EU member states is expected to accelerate to 3.1 per cent on average in 2011 and to 4.0 per cent in 2012.

In *Canada*, GDP growth is projected to decline from 3.1 per cent in 2010 to 2.6 per cent in 2011 and 2.5 per cent in 2012, given reduced fiscal spending and the negative impact of a stronger currency on exports. Employment has fully recovered to its pre-crisis level, but the unemployment rate remains high because of the growth of the labour force. The Bank of Canada raised its policy interest rate in September 2010, but has kept the rate steady since over concerns regarding the stability of the recovery, with the high indebtedness of households being one major risk.

Australia suffered the worst floods in decades, disrupting production and exports of coal and farm produce. However, the negative impact on growth will be only short-lived. GDP is expected to grow by about 3 per cent in 2011 and 2012 as the economy continues to benefit from the global resources boom. The earthquake that hit *New Zealand* in February 2011 caused substantial damage and disrupted business activity, pushing the economy into recession in the first quarter of 2011. GDP is expected to grow by 0.8 per cent in 2011 and by 3 per cent in 2012.

Economies in transition

Growth in the *CIS* bounced back to 4.6 per cent in 2010 after a contraction by 7 per cent in 2009. The recovery was fuelled by higher oil and metal prices and stronger domestic demand. Higher commodity prices and GDP growth also helped reduce fiscal deficits through higher government revenues, particularly in the net-energy exporting countries of the CIS. The improved economic environment led to a further decline in unemployment, particularly in the Russian Federation, Kazakhstan and Ukraine. Migrants from Armenia, Kyrgyzstan, Tajikistan and Uzbekistan also saw their employment opportunities improve again and remittance flows to those countries increased again by, on average, more than 20 per cent in 2010. However, unlike in the case of other emerging economies, capital has been moving out of the region, especially out of the Russian Federation, as investors have grown increasingly insecure about government policies, as certain measures are perceived to be harmful to their interests. Outflows from the Russian Federation alone exceeded $21 billion in the first quarter of 2011 and is expected to be part of an ongoing trend in the near outlook. The appreciation of the rouble is mainly on account of the boom in commodity prices. Since late 2010, inflationary pressures have increased significantly, mainly in response to the impact of adverse weather on agriculture. Averaging 7.3 per cent in 2010, annual inflation in the CIS is forecast to accelerate to 9.9 per cent in 2011, before subsiding in 2012. Monetary policy has been tightened in response to the inflationary pressures. Several countries have also widened their exchange rate trading bands to accommodate upward pressure on nominal exchange rates. Output growth in the CIS is expected to continue at a pace of 4.6 per cent in 2011 and accelerate to 4.8 per cent in 2012.

The economies of *South-Eastern Europe*, except Croatia, showed a modest rebound in 2010, but the recovery remains feeble. Strong export growth, including of tourism services, and a modest recovery in remittances pulled the region out of its recession. Domestic demand continues to be weak. GDP growth is projected to continue to be led by exports and accelerate to 2.2 per cent in 2011 and 3.1 per cent in 2012. Private consumption is projected to strengthen only modestly, as wage and credit growth are lagging and consumer confidence remains subdued. Investment may show a higher growth rate but reflecting an increase from a very low base level. These short-term growth prospects are conditioned on the expectation that export performance will outweigh the adverse effects of fiscal austerity. Inflation has picked up with the surge in global energy and food prices. Slow wage growth and weak consumer confidence are expected to mitigate these inflationary pressures, however. In most countries, average annual inflation in 2011 should stay in the low single digits. Unemployment remains a serious concern in the region, especially with the joblessness rate increasing further in Croatia and Serbia in early 2011. There are no signs of improvement on the short-term horizon. Monetary policies remain accommodative in general, aiming to induce banks to start lending again to the private sector. The Central Bank of Serbia, however, did nonetheless increase its policy rate several times in early 2011 to stay within the inflation target.

Developing economies

Economic growth in *Africa* will moderate to 3.6 per cent this year, but is forecast to accelerate to 5.4 per cent in 2012. This rather upbeat baseline outlook is surrounded by great uncertainty. In North Africa, public protests have already led to significant changes in political governance, but also will come at an economic cost, and the forecast for output growth in 2011 has been substantially downgraded. Increased internal tensions and the inherent risks and uncertainties associated with political reforms could cause further disruptions to economic activity in the transition period. In sub-Saharan Africa, many countries will see continued strong growth, supported by expansionary fiscal policies and infrastructure investments. Higher oil prices will provide a boon to oil-exporters, while non-oil exporters will have to cope with rising external deficits and domestic price levels. A number of countries are benefiting from a recovery in worker remittances. This trend is expected to continue in 2011, although the political unrest in North Africa and Western Asia and the resulting displacement of migrant workers likely will have some negative impact on remittances. Overall, internal conflicts, weak institutions and infrastructure deficits are important obstacles to higher and more sustained growth, while growth will remain below potential in the outlook for the remainder of 2011 and 2012. Without major shifts in income distribution, growth will also be far from sufficient to accelerate poverty reduction in most sub-Saharan African countries. Inflation is projected to rise in many countries owing to higher commodity prices, stronger domestic demand and, in some cases, the lagged impact on prices of recent adverse weather conditions.

After a strong recovery, *East Asia's* economies are expected to record solid growth in the outlook period. While average GDP growth is projected to moderate from 9.1 per cent in 2010 to 7.3 per cent in 2011 and 7.2 per cent in 2012, East Asia continues to be the fastest-growing region. The expected slowdown reflects a tightening of monetary and credit conditions in response to increased inflationary pressures, as well as a higher comparison base and continuing subdued demand in developed countries. In many economies, growth of investment and exports is likely to weaken in 2011, and household consumption will become a more important driver of growth. Countries with large domestic markets, such as China and Indonesia, are expected to see only a minor slowdown or none at all. By contrast, countries with a high share of manufacturing exports in GDP, such as Malaysia and Singapore, will experience more pronounced decelerations. Reflecting the positive growth profile, labour markets have mostly recovered from the crisis. Unemployment and labour participation rates are close to pre-crisis levels, with little change expected in 2011 and 2012. Fiscal balances have also continued to improve as the recovery boosted revenues. Inflation has accelerated markedly due to higher food and energy prices, strong domestic demand and rising wages. Many central banks, in particular the People's Bank of China, have responded by tightening monetary policy, despite concerns that higher interest rates could trigger further portfolio capital inflows and lead to further currency appreciation. More aggressive monetary tightening measures could lead to a sharper-than-expected moderation in GDP growth in the outlook period, while possibly also enhancing volatility in asset markets.

Led by strong performances in India and Sri Lanka, GDP growth in *South Asia* is expected to average 6.9 per cent in 2011 and 7.0 per cent in 2012, compared with 7.1 per cent in 2010. Economic prospects vary significantly in the region, ranging from 3 per cent GDP growth in the Islamic Republic of Iran to 8 per cent in India and Sri Lanka.

While private consumption and investment remain the main growth drivers, government consumption has also expanded in most economies. Exports have rebounded over the past year as demand for textiles and garments, gems and jewellery, and engineering goods strengthened. At the same time, rising fuel prices and resurgent domestic demand pushed up import spending, leading to a slight widening of trade and current account deficits in most countries. The average unemployment rate is estimated to have fallen to its pre-crisis level, but immense labour market challenges remain, including widespread underemployment. While fiscal spending likely will continue to grow, budget deficits are expected to narrow as a share of GDP in the fast-growing economies of India and Sri Lanka. Inflation has accelerated owing to a sharp increase in commodity prices, combined with aggregate demand pressures and lower fuel subsidies in several countries. The central banks of Bangladesh, Pakistan and India in particular responded by further tightening monetary policy, with additional interest rate increases expected in the second quarter of 2011. If inflationary pressures continue to rise, authorities may feel a need for more aggressive monetary tightening, which would likely weaken domestic demand and economic growth in the outlook period.

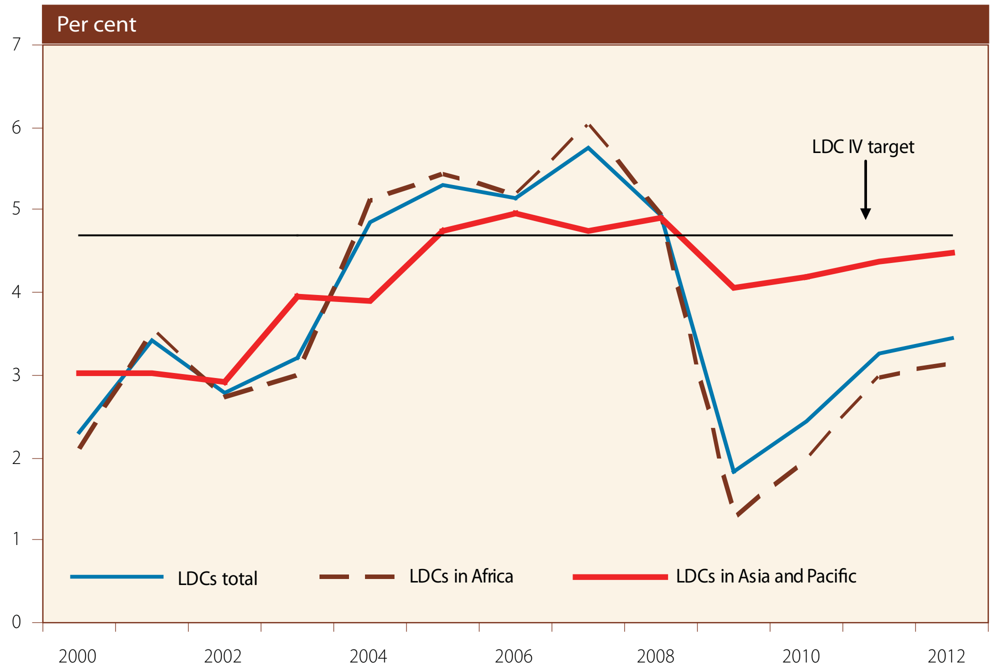
Western Asia experienced a regionally balanced recovery in 2010 with most economies growing by more than 4 per cent. Prospects for 2011 and 2012 are more mixed, as uncertainties created by continuing and spreading political unrest and higher oil prices are strengthening the fuel-exporting economies and highlighting the vulnerabilities of fuel importers. Among the former, Governments have enough fiscal space to offer generous economic support measures to their populations aiming to quench political unrest. Among the latter, export volume growth has been insufficient to offset the deterioration in the terms of trade. Furthermore, their already large fiscal deficits have widened further. Inflationary pressures are strong as a result of increasing food and energy prices and domestic demand expansion. The Gulf Cooperation Council countries and Yemen have their currencies pegged to the United States dollar and have limited control of monetary policy to curb inflation. The employment situation, which was one of the catalysts to the spreading political unrest, remains dire. In the long run, policy inaction in relation to youth unemployment in particular represents a major risk.

After a strong recovery in 2010, economic growth in *Latin America and the Caribbean* is expected to decelerate to 4.5 per cent in 2011 and 4.9 per cent in 2012, down from 5.9 per cent in 2010. Fiscal policy support is fading, and rising inflation has prompted tighter monetary policies. The Central American economies rebounded in 2010, but their prospects for 2011 are weaker, in part because they are net importers of food and energy. Continued surges in capital inflows in Brazil, Colombia and Mexico are inducing further upward pressures on currencies. Rising interest rates induced by tighter monetary policies are further fanning these pressures. The strong output recovery during 2010 pushed employment levels back up, but with much of the job growth taking place in informal, low-productivity sectors.

The l*east developed countries* (LDCs) have benefited from the generally more positive international economic environment, but their performance has been uneven. LDCs in Asia are benefiting from the strong regional growth performance, while oil-exporting LDCs in Africa are seeing gains from higher oil prices while most net-energy importers have suffered deteriorating terms of trade, moderating their growth outlooks. On the whole, average per capita income growth among LDCs in Asia is expected to be close to the growth target set at the Fourth United Nations Conference on LDCs, held in

Istanbul in May 2011,[1] while per capita income growth in African LDCs is projected to fall well short of this target in the outlook for 2011 and 2012 (figure 3).

Figure 3
Diverging per capita income growth among LDCs,[a] but falling short of target of the Fourth United Nations Conference on LDCs[b]



Source: UN/DESA.

Note:

a In the graph, not all LDCs are included. The group of African LDCs includes Haiti.

b The target refers to that set at the United Nations Fourth Conference on the LDCs, which is 7 per cent of GDP growth per annum. In the figure the target is redefined in per capita terms.

Risks and uncertainties

The baseline outlook for 2011 and 2012 is subject to a number of risks. These include problems regarding the sustainability of public finances in developed economies, the remaining vulnerability of the private financial sector, continued high and volatile commodity prices, and the still looming risk of a collapse of the United States dollar.

Fiscal austerity and sovereign debt stress in developed economies

With slight improvements, fiscal deficits in 2010 remained sizeable in developed G-20 economies, averaging above 8 per cent of GDP. In the Euro area, the economic recovery, even if weak, and fiscal austerity measures are projected to reduce budget deficits to 4.4 per cent of GDP on average in 2011, but deficits in Japan and the United States are expected to widen further.

1 The so-called Istanbul Plan of Action for LDCs (para. 12(a)) states that LDCs would need to sustain 7 per cent GDP growth per annum over the next decade in order to ensure more countries can graduate from the category. In figure 3, this target is redefined in per capita terms.

Major concerns remain over the still rising trend in public indebtedness, which many stakeholders perceive to be unsustainable in the medium and long run. The average public debt ratio for developed economies has already surpassed 100 per cent of GDP in 2011. Such concerns have already triggered further downgrading of the sovereign debt ratings of several developed economies, including Greece, Ireland, Japan, Portugal and Spain. As indicated, one rating agency recently also presented a negative outlook for the debt burden of the United States. Despite financial support from the European Financial Stability Facility (EFSF), borrowing costs for the Governments of Greece, Ireland and Portugal have increased further to almost prohibitive levels. But these are still exceptions. For most developed economies, interest rates on sovereign bond issues have remained low so far. Net borrowing costs in France, Germany, Italy, Japan, the Netherlands and the United States in fact fell under pre-crisis levels, as a result of both low interest rates and 'quantitative easing' policies involving large purchases of sovereign bonds by a number of central banks. In the medium term, sovereign borrowing costs are expected to increase as a result of tighter monetary policies with higher interest rates and the unwinding of the government bond holdings of central banks.

In response to these concerns and to try to anchor expectations of low long-term interest rates, many developed economies have already committed to fiscal consolidation. For instance, fiscal austerity measures in the United Kingdom aim to cut the deficit by an estimated 8 percentage points of GDP by 2015. Varying across countries, fiscal consolidation plans include measures to cut government spending, measures to raise tax rates or to broaden the tax basis and to reform social welfare systems.

It is not obvious that such commitments are enough to stave off sovereign debt crises. If the commitment to fiscal consolidation is not credible enough to bring public debt down, interest rates in financial markets may increase anyway, heightening the risk of default. If austerity measures are too drastic and come too soon given the stage of the recovery, economic growth and employment could suffer and the still fragile banking sector could weaken further. If this then pulls the plug out of the recovery, public debt ratios may continue to increase despite (or owing to) austerity measures, further increasing the risk of default. So far, most European countries seem mainly worried about the first risk, rather than about the second one. The problem is, however, that it is not about a simple choice between addressing one or the other risks, as the two are interdependent: a weaker recovery (e.g. caused by premature austerity) could easily undermine the credibility of fiscal consolidation plans as it will make reducing public debt ratios increasingly difficult.

Financial sectors in developed economies remain vulnerable

Given the large-scale government bailout programmes over the past two years, risks in the private financial sector, particularly banking, have been transferred to the public sector. Nevertheless, the banking sector in major developed economies remains vulnerable, which also exposes their economic recovery to significant downside risks. For example, many banks in Europe will face increasing pressure to ensure funding for the rollover of their debts in the second quarter of 2011. The increased interdependence between the balance sheets of banks and Governments exacerbates sovereign debt risks and enhances the vulnerability of the banking system. In the United States, a protracted slide in housing prices and a large number of foreclosures continue to put pressure on the broader financial system.

Recently, financial reforms have been instituted in many developed countries and also internationally a new capital and liquidity reform package ("Basel III"), was agreed upon, requiring banks to hold larger amounts of capital and reserves against outstanding loans. The measures aim to increase their resilience under more turbulent financial market conditions. However, these new capital and liquidity standards apply only to banks. The indicated risks are not confined to the banking system, but affect the broader financial system through derivatives trading and general interconnectedness across financial market segments. A fall out in one part of the developed country financial system may still have strong ripple effects worldwide. Low interest rates coupled with financial sector weakness in developed countries have driven much more liquidity into commodities trading and equity and portfolio markets in emerging economies. As happened in 2008-2009, a fall out in a major developed economy financial market could induce significant reversals in financial flows due to a new round of deleveraging.

Risks associated with further surges in commodity prices

In the baseline outlook, the prices of oil and other primary commodities will moderate in the second half of 2011 and 2012. However, the risk lies in an aggravation of the supply shocks, for example stemming from the situation in Western Asia and North Africa. This would push commodity prices even higher and reduce global economic growth compared to the baseline forecast.

A simulation using the United Nations Global Policy Model[2] suggests that continuation of the rising trend in the prices of oil and other primary commodities since mid-2010 (to 15 per cent over baseline assumptions) in combination with further monetary tightening in response to higher inflation, would cause growth of WGP to slow by 0.7 percentage points in 2011 and 1.0 points in 2012. Asian economies would be hit harder than others, as inflation would accelerate more because of the heavy reliance on primary commodity imports. The impact on domestic demand would likely be exacerbated by the further monetary tightening. Developed economies would also register weaker demand. Oil and other commodity-exporting economies would benefit from improved terms of trade, but these gains would not be big enough to offset the reduction in aggregate demand in the rest of the world.

This risk is mostly associated with adverse supply shocks. Even though the precise impact remains difficult to quantify, commodity price increases and volatility tend to be exacerbated by financial factors, including large-scale speculation in futures markets and a volatile and downward trending United States dollar.

Global imbalances and the risk of a collapse of the dollar

Figure 2 showed the continued weakening of the dollar over the past decade. The trend has been interrupted periodically; recently as a result of deleveraging in the immediate aftermath of the global financial crisis and during various phases of the sovereign debt

2 By using the UN/DESA Global Policy Model (http://www.un.org/en/development/desa/policy/un_gpm.shtml)

crises affecting the euro area. The downward trend over the longer term is associated with the dollar's role as the world's major reserve currency and the uneven global growth exacerbating the global imbalances. The imbalances have led to cumulative increases in external liabilities of the United States as its growth pattern induces large trade deficits, which, have a counterpart in large trade surpluses, elsewhere, such as Germany, Japan, China and other major Asian exporters and oil-exporting countries. The large external debt position of the United States is keeping downward pressure on the dollar.

The global imbalances narrowed as a result of the collapse in world trade and the aggregate demand compression. With the recovery they have started to widen again, albeit moderately. The deficit of the United States declined from its peak of 6 per cent of GDP before the recession to a trough of 2.7 per cent in 2009 and widened again to 3.2 per cent of GDP in 2010, and is expected to stay at about 3.5 per cent of GDP in 2011-2012. China's surplus declined from the peak of 10.6 per cent of GDP in 2007 to about 5 per cent in 2010, and is expected to narrow further to below 4 per cent in 2012, as a result of the accumulated appreciation of the renminbi in recent years and policies to support domestic consumption. Germany's surplus has also narrowed slightly, but has remained at about 6 per cent of GDP in 2010, and is expected to stay above 5 per cent in the near outlook. However, the current account for the euro area as a whole is approximately in balance. Japan's surplus stood at about 3 per cent of GDP in 2010, and is expected to decline notably in 2011-2012. The surplus of oil-exporting countries in West Asia and North Africa decreased from more than 15 per cent of GDP in the years before 2008 to about 2 per cent in 2009. The surpluses have since recovered slightly but are expected to stay below 5 per cent in 2011-2012.

In the near-term outlook, the global imbalances should not be expected to return to the levels observed prior to the global financial crisis. However, even if the global imbalances do not edge up significantly in the near term, the underlying adjustment in international asset and liability positions would continue to move in a risky direction. The most recent wave of dollar devaluation has also been driven by other factors, including interest rate differentials between the United States and other economies, and growing concern about the sustainability of the public debt of the United States, half of which is held by foreigners. Measured by the exchange rate index of the dollar vis-à-vis the basket of other major currencies, the dollar has reached the lowest level since the 1970s. The depreciation of the dollar against the currencies of many emerging economies has also been significant. As a result, further (expected) losses of the book value of the vast foreign reserve holdings could trigger a crisis of confidence in the reserve currency, which would put the entire global financial system at risk.

Policy challenges

Dealing with these risks and uncertainties poses serious policy challenges to Governments across the globe. All risks are cross-border and are, by and large, interdependent. Macroeconomic policies in most developed countries shifted during 2010 and early 2011 towards a combination of monetary accommodation and fiscal austerity, while many developing countries have shifted to monetary tightening accompanied by relatively accommodative fiscal stances. In the outlook for the rest of 2011 and for 2012, more and more countries are expected to further unwind both monetary and fiscal support measures. Challenges differ across countries, warranting different policy stances, but—as indicated—current national policy stances are far from adequate to address the risks to the global economy and, instead may exacerbate them. In order to make the global economic recovery more robust, balanced and sustainable, the five policy directions discussed in the *World Economic Situation and Prospects 2011* still apply.

First, developed countries, in particular, should be cautious not to embark prematurely on fiscal austerity policies given the still fragile state of the recovery and prevailing high levels of unemployment. Several still possess ample fiscal space for additional stimulus in the short run. Credible fiscal consolidation plans should focus on public debt sustainability in the medium term. Such action should be adequately coordinated among the major economies to ensure reinvigorating global growth that will also provide external demand for those economies which have exhausted their fiscal space. Absent new net fiscal stimulus and faster recovery of bank lending to the private sector, growth is likely to remain anaemic in many countries in the foreseeable future. For a number of developing countries the challenge is to avoid that rising food and commodity prices and exchange rate appreciation caused by surging capital inflows will not undermine growth and lead their economies into another boom-bust cycle. Fiscal and, more broadly, macroeconomic policies will need to be part of a transparent countercyclical framework which also needs to include macro-prudential financial and capital controls to mitigate the impact of volatile capital inflows. Strengthened social policies would need to offer sufficient income protection for the poor and vulnerable against higher food and energy prices.

Second, at the same time, fiscal policy needs to be redesigned to strengthen its impact on employment and to promote structural change for more sustainable economic growth over the medium and long run. For both developed and developing countries, a prudent policy would be to target public investments with a view to alleviate infrastructure bottlenecks that hamper growth prospects and addressing environmental challenges, including by accelerating the 'greening' of energy sectors through promoting technological innovation for enhancing energy efficiency and widespread diffusion of renewable low-carbon sources of energy.[3] For many developing countries, and LDCs in particular, an additional priority is to invest in sustainable food agriculture and to support economic diversification in order to improve food security and reduce vulnerability against shocks emanating from global markets over the medium run.

The third challenge is to find greater synergy between fiscal and monetary stimulus, while counteracting damaging international spillover effects in the form of increased exchange rate tensions and volatile short-term capital flows. This will require reaching agreement at the international level about the magnitude, speed and timing of quantitative easing policies within a broader framework of targets to redress the global imbalances. This in turn will require stronger bilateral and multilateral surveillance, including through more thorough assessment of spillover effects and systemic risks. While

3 For the related challenges and opportunities, see United Nations Environment Programme, *Towards a Green Economy: Pathways to Sustainable Development and Poverty Eradication* (Paris, United Nations, 2011) (http://www.unep.org/greeneconomy/Portals/88/documents/ger/GER_synthesis_en.pdf) and *World Economic and Social Survey 2011: The Great Green Technological Transformation* (United Nations publication, Sales No. E.11.II.C.1). Both reports suggest that at least 2 per cent of WGP would need to be spent towards green technology investments in order to overcome major global ecological challenges, including averting the catastrophic risk of climate change, making food production more sustainable, stopping loss of biodiversity, and enhancing resilience to natural hazards.

this need has been recognized by the G-20 and the International Monetary and Financial Committee of the IMF, accelerated progress needs to be made to come to an operational framework to enable timely concerted action to be taken to address the present major risks in global currency and financial markets and signal when, for example, monetary policies in major developed countries are likely to influence the size and composition of flows to emerging and other developing countries. Cooperative policy solutions should therefore take precedence as they can achieve better outcomes for the global economy and offload pressure on developing countries to take strong measures to mitigate the impact of volatile capital flows. Such cooperative policy solutions should also comprise deeper reforms of (international) financial regulation, including those for addressing risks outside the traditional banking system (investment banks, hedge funds, derivatives markets, and so forth). Requiring higher reserve requirements and/or collateral on cross-border portfolio investments by non-banking institutions and setting limits on positions that financial investors can take in commodity futures and derivatives markets may also help stem some of the volatility in capital flows and mitigate commodity price volatility. Such measures will, by no means, provide enough safeguard against continued volatility in food, energy and other commodity prices. For that, much more will need to be done to improve conditions for a more sustainable supply of these commodities. These sets of financial reforms will need to be complemented by deeper reforms of the global reserve system reducing dependence on the dollar as the major reserve currency, including through better pooling of reserves internationally (e.g. through closer cooperation between the IMF and regional mechanisms of financial cooperation) and enhancing the role of special drawing rights (SDRs) as international liquidity, while expanding the basket of SDR currencies including with currencies from major developing countries.

The fourth challenge is to ensure that sufficient resources are made available to developing countries, especially those possessing limited fiscal space and facing large development needs. These resources will be needed to accelerate progress towards the achievement of the MDGs and for investments in sustainable and resilient growth, especially for the LDCs. Apart from delivering on existing aid commitments, donor countries should consider mechanisms to delink aid flows from their business cycles so as to prevent delivery shortfalls in times of crisis, when the need for development aid is most urgent.

The fifth challenge is to find ways to arrive at credible and effective policy coordination among major economies. In this regard, there is some urgency in operationalizing the G-20 framework for sustainable global rebalancing.

For further information,

see http://www.un.org/en/development/desa/policy/wesp/index.shtml

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