Monthly Briefing
World Economic Situation and Prospects

No. 21 UN/DESA 8 July 2010

Summary

- Global growth may decelerate in the second half of 2010, as the effects of both the upward inventory adjustment and fiscal stimuli fade
- G-20 leaders agreed to ensure a full return to growth with quality jobs, to reform and strengthen financial systems, and to create strong, sustainable and balanced global growth
- China resumed more flexible exchange rate mechanism, while other East Asian Governments introduced measures to manage short-term capital inflows

Global issues

The momentum of global recovery is tapering

World financial markets experienced another month of turbulence in June. Concerns about the sustainability of sovereign debt in some European economies continued to linger, and there were increasing uncertainties about the consequences of the fiscal consolidation measures announced by a number of developed countries. Equity markets in major economies erased all the gains made in the early part of the year, and credit risk premiums edged up discernibly.

Recent data has also shown a waning of the recovery in the real economy. For example, the growth in industrial production and trade in many major economies, although still positive, has declined significantly. GDP growth will likely decelerate in many economies in the second half of 2010, as the effects of both the upward inventory adjustment and fiscal stimuli fade. The fiscal impetus to GDP growth is expected to turn from positive to negative in many developed countries due to fiscal consolidation in the coming quarters, although monetary policy in these economies is likely to remain accommodative.

G-20 agreed to ensure a full return of growth with quality jobs

G-20 leaders at the Toronto Summit agreed on the next steps to take to ensure a full return to growth with quality jobs, to reform and strengthen financial system and to create strong, sustainable and balanced global growth. Recognizing the need to follow through on delivering existing stimulus plans, they also highlighted the need for G-20 countries to put in place properly phased and growth-friendly plans to deliver fiscal sustainability tailored to national circumstances.

In addition, G-20 leaders also agreed to put development issues on the agenda for the next Seoul Summit, as narrowing the development gap and reducing poverty are imperative for ensuring a more robust and resilient global economy for all. Since the UN has been taking the lead in the promotion of development for all, this initiative could provide a further opportunity to enhance cooperation between the UN and the G20.

Developed economies

United States and Canada: signs of a slowdown in economic expansion

In the first quarter of 2010, GDP growth in the United States was revised down to 2.7 per cent from an earlier estimate of 3 per cent, which is much slower than the 5.6 per cent reached in the previous quarter. This deceleration was mainly caused by the reduced pace of export expansion and inventory re-stocking, which was partially offset by an increase in the consumption of durable goods.

Recent indicators have painted a mixed picture for the second quarter. The end of the tax incentive for home buyers in April had a significant effect on the housing sector. Construction of new homes declined notably, while the number of new home sales dropped to a record-low monthly level in May. In addition, the job market remained weak. In contrast, the manufacturing sector continued to recover, supported by inventory re-stocking, the recovery in the fixed investment in equipments, and, to a lesser extent, consumption of durables goods.

Canada also faces the possibility for a slowdown in GDP growth after a growth of 6.1 per cent in the first quarter of 2010. The monthly level of GDP was flat in April, compared with that of March. Housing activity and vehicle sales have also been weak in recent months. Nevertheless, the employment has kept on rising for five consecutive months.

Western Europe and the EU: the recovery continues, but without much vigour

Preliminary estimates for GDP in the first quarter of 2010 showed that all economies in the region, except Greece and Norway, displayed positive growth—the euro area grew by 0.2 per cent quarter over quarter. Growth continued to be supported by changes in inventories, government consumption and exports, but held back by private consumption and fixed investment: private domestic demand has yet to recover.

Short-term indicators continued to improve though at a diminished pace. Industrial Production continued to increase in April, driven by the manufacturing rebound but remained 13.3 per cent below its peak of February 2008. The construction sector has recovered from its sharp decline of the winter months but is still on a downward trend, while retail sales continue to hover close to their post recession low point. Unemployment continued to rise, to 10.1 per cent in the euro area in April, but the period dramatically increasing unemployment seems to have ended. Looking ahead, the European Commission's Economic Sentiment Indicator remains close to its long run average, presaging a continuing recovery, but the indicator is well below its previous cyclical peak.

The new EU member States: divergent economic trends and fiscal retrenchment

Many economies in the new EU contracted in the first quarter of 2010, with GDP falling 3.6 per cent in Bulgaria, 2 per cent in Estonia, 6 per cent in Latvia, 2.8 per cent in Lithuania, 2.7 per cent in Romania, and 1.1 per cent in Slovenia.

Poland and Slovakia, however, registered relatively strong economic growth in the first quarter of 2010, at rates[1] of 3.0 and 4.8 per cent respectively. These growth rates are considered to be buoyant, even after factoring in the weak base in 2009, although the sustainability of strong growth remains uncertain in both countries. On a quarterly basis, seasonally and working-day adjusted GDP increased by 0.9 per cent in Hungary and by 0.3 per cent in Latvia, which has technically exited recession. Moreover, the Latvian labour market has shown signs of improvement for the first time since the onset of the crisis.

Fiscal consolidation, primarily through cuts in public spending, has been set as a priority for the new EU countries. While the fiscal retrenchment in Hungary has been proceeding somewhat smoothly, this has not been the case for Romania, where the Constitutional Court blocked the Government's plan to cut pensions. In response, the Romanian Government decided to increase the VAT rate in order to meet the 6.8 per cent budget deficit target for 2010 to secure disbursement of IMF funds under its standby arrangement.

Developed Asia and Pacific: Japan's new fiscal strategy

The Government of Japan announced a new fiscal strategy, targeting a reduction of the primary deficit from 8 per cent to 4 per cent of GDP, by fiscal year 2015. The strategy also targets a reversal of debt to GDP ratio in and after 2021, which is now about 160 per cent and rising steadily. The fiscal measures include: no increases in the amount of new bond issuance in the next fiscal year, to be followed by reductions in subsequent years; increases in tax revenue through reform of taxes on income, corporate earnings, consumption, and assets; and a cap on total expenditure, excluding debt service, for the next three years. However, a recent government study indicated that meeting these targets will be difficult.

The latest data showed that real exports of Japan continued to recover in May, 2010, although the index of real exports is still 9 per cent below the peak of 2008. Exports to the United States and Europe remained relatively solid, but those to Emerging Asia, including China, have slowed down. Meanwhile, deflation continued in Japan.

Economies in transition

CIS: the recovery continues to strengthen in the three largest economies of the CIS

Industrial output increased by 10.4 per cent in the Russian Federation in the first four months of 2010, and by 12.6 per cent in Ukraine and 11.9 per cent in Kazakhstan in the first five months of the year. Exports expanded by 60 per cent in the Russian Federation, 23.6 per cent in Ukraine, and 66 per cent in Kazakhstan in the first quarter. Recent data point to increasingly

1 The growth in this Note is defined as year on year, unless otherwise specified.

confident consumer demand in the Russian Federation, where retail trade increased 4.2 per cent in the period up to April, while imports grew 29.3 per cent, partly driven by a gradual decline in the unemployment rate from the beginning of 2010. To further stimulate demand, the Central Bank of Russia cut its refinancing rate by 25 basis points to 7.75 per cent in early June. In the Ukraine, however, domestic demand remains weak, with retail trade increasing by only 1.1 per cent in the period up to April.

A dispute over outstanding debts for past deliveries led to a temporary reduction of gas exports from Russia to Belarus in June. The dispute had a knock-on effect in Europe as Belarus temporarily cut transit flows of gas. Meanwhile, the security situation in Kyrgyzstan deteriorated following the ousting of the president in April. Several hundred people were killed during ethnic rioting in the southern part of the country and many thousands sought refuge in neighbouring Uzbekistan. The situation has since calmed and the constitutional referendum proceeded, as planned, on June 27.

South-Eastern Europe: less need for IMF funds in Serbia

The GDP of Croatia declined by 2.5 per cent in the first quarter of 2010, compared to the already weak economic situation of a year ago. Although exports boosted industrial production somewhat at the beginning of 2010, virtually all sectors of the economy shrank in April, underlining the fragility of the recovery. The labour market, however, modestly improved, with the unemployment rate declining from 18.4 per cent in March, to 17.9 per cent in April.

The GDP of Serbia increased by 1.0 per cent in the first quarter of the year, with strong contribution from net exports. The country has officially come out of the recession as a result of the rebound in many important industrial sectors, including manufacturing, steel and transport equipment. Given the modest recovery in FDI, Serbia may need to draw only part of the fourth instalment of its IMF standby loan.

The attempts to introduce fiscal austerity measures throughout the region, including frozen or reduced wages and increased wage arrears, have prompted public opposition, which may delay the delivery of the pledged international assistance.

Developing economies

Africa: the recovery has not produced employment growth

African economies continued to benefit from rising exports and generally buoyant commodity prices, experiencing a notable acceleration in economic activity on the continent. For instance, economic growth in Botswana, the world's biggest diamond producer, surged 36.4 percent in the first quarter of 2010 from a year ago mainly due to increased production by the diamond mines, which were temporarily closed in early 2009.

Growth in South Africa accelerated at a brisk annualised rate of 4.6 per cent in the first quarter of 2010. The strength was widespread among major economic sectors, with manufacturing playing a strong role alongside mining and commerce. Capacity utilisation nevertheless remained at low levels. In addition, the recovery in economic activity had not yet been accompanied by rising employment, and the unemployment rate in the first quarter of 2010 rose further to 25.2 per cent.

In Egypt, foreign portfolio investments surged as economic activity revived. In addition, remittances climbed 7.3 per cent, owing to stronger activity in Western Asian countries. However, foreign direct investment slid by17.3 per cent in the nine months prior to March, 2010.

East Asia: China resumed greater flexibility in its exchange rate, while other countries introduced measures to manage speculative capital inflows

The recovery of East Asia's economies remained strong, as exports and industrial production continue to expand rapidly. The region's sharp rebound over the past year triggered a large amount of short-term capital inflows, some of speculative nature. In several countries, most notably Malaysia and the Republic of Korea, this resulted in strong currency appreciation. In others, such as China and Hong Kong Administrative Region of China, the inflows fuelled property price inflation. A number of countries, including Indonesia, the Republic of Korea and Taiwan Province of China introduced measures to manage the short-term capital inflows and encourage long-term inflows, while minimizing disruption in currency markets. The Central Bank of Indonesia announced the issuance of longer-term debt and imposed a one-month holding period for central bank debt. The Central Bank of the Republic of Korea introduced new rules to limit local and foreign banks' foreign exchange forward positions. Meanwhile, the People's Bank of China announced that it would resume the basket exchange rate regime, which was adopted in 2005 but has been suspended since mid-2008, allowing for a more flexible exchange rate of renminbi. The appreciation of reminbi will however be very mild as the authorities remain concerned about the possible shock to the domestic financial system, as well as to the export sector. The move by the People's Bank of China followed a sharp widening of the trade surplus in May 2010 as exports rose by 48.5 per cent.

South Asia: recovery gains strength as exports and industrial output grow

South Asia's economic recovery has gained further strength over the past few months, and the medium-term growth prospects for most countries in the region are favourable. In India, growth of GDP accelerated to 8.6 per cent in the first quarter of 2010, driven by strong domestic demand and a rebound in exports and industrial output. The Central Bank indicated that it would tighten monetary policy in a calibrated manner, balancing the need to tackle double-digit inflation and the need to shield the economy from external risks, such as Europe's debt woes. In Sri Lanka, economic activity expanded by 7.1 per cent in the first quarter of 2010 as all sectors – agriculture, industry and services – benefited from the end of the civil war and the gradual recovery in global demand. Pakistan's economy has also shown signs of recovery: according to preliminary estimates, gross domestic product has grown by 4.1 per cent in the year to June 2010, up from just 1.2 per cent in the previous year. In the budget for the fiscal year 2010/11, Pakistan's Government announced a series of austerity measures, which include both public expenditure cuts and tax increases. While the defence budget is expected to increase by 17 per cent, health spending is cut by almost 30 per cent. Debt servicing and military spending will account for 45.5 per cent of total expenditure.

Western Asia: continued expansion accompanied by some signs of higher inflation

The region continued to show signs of solid economic expansion. In Turkey, for example, industrial production increased by 17.0 per cent in April. While this gain was driven by all major product categories, the relatively low base stemming from the sharp decline in industrial production during the peak of the global economic crisis also played a major role. Inflation rates in the region remain largely in relatively moderate territory, although some signs of an uptick have emerged in a number of countries. In the United Arab Emirates, for example, consumer prices increased by 0.9 per cent in May, the biggest jump in a year, which is attributable in large part to higher food prices. Saudi-Arabia also saw its inflation rate jump to a 12-month high of 5.4 per cent in May in light of higher rental and food prices.

Latin America: robust economic growth confirms rapid recovery across the region

GDP growths in the region were particularly strong during the first quarter of 2010, with the three major economies registering GDP growth of 9.6 per cent, 6.8 per cent, and 4.3 per cent in Brazil, Argentina, and Mexico respectively. The driving factors of these rapid economic recoveries were, however, quite different. In Brazil, for instance, economic growth was driven by a rapid domestic demand recovery and accompanied by significant job creation in the formal sector. In addition, industrial production registered its fastest pace in the past 20 years in March, at almost 20 per cent, while imports outpaced exports during the first quarter of 2010. By contrast, economic growth in Mexico was led by a recovering external demand from the United States, especially in the automotive sector. The main problem remains domestic demand, as real wages have fallen and consumer credit has contracted. In addition, unemployment figures in Mexico rose in April, as job creation was unable to catch up with increases in the labour force. An exception to the general improving economic environment in the region is Venezuela, whose economy contracted by 5.8 per cent during the first quarter of 2010. Shortages of food also caused soaring inflation in Venezuela: price of food and beverage rose by 21 per cent in the first five months of 2010.

Least developed countries: increased government spending planned in several LDCs and debt relief in Liberia

Government spending in several least developed countries is expected to rise in the 2010/11 budget (fiscal year starting July), driven partly by increased spending in infrastructure. In Rwanda, for instance, the overall budget is expected to increase by 9 per cent, while the development components, such as roads and electrification, are expected to increase by about 20 per cent. In Ethiopia, the corresponding figures are expected to be 20 and 23 per cent, respectively. In Tanzania, budget spending should rise 16.8 per cent, even though support from donors is expected to decline by 36 per cent as compared to the former fiscal year. The budget deficit in these three countries is expected to range from 2.4 to 4 per cent of GDP. In Bangladesh, total public expenditure is estimated to be 17 per cent higher than the revised allocation for the previous fiscal year, while the budget deficit is expected to increase from 4.5 per cent to 5 per cent of GDP.

The IMF and the World Bank have decided to support a $4.6 billion debt relief scheme for Liberia. One third of this amount is to be delivered by multilateral creditors, and the remainder by bilateral and commercial creditors.■