Monthly Briefing
World Economic Situation and Prospects
UN/DESA
No. 24 6 October 2010

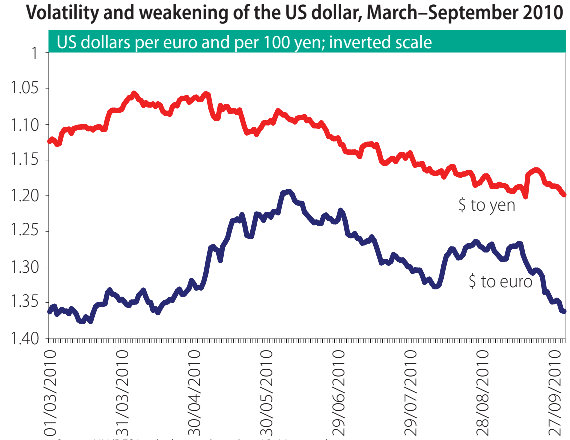
Summary

- Trade tensions and risks of competitive devaluations heighten amidst global economic slowdown and increased turmoil in currency markets
- Sovereign debt stress returns in some European countries
- United Nations summit on MDGs secures more than $40 billion for women's and children's health.

Global issues

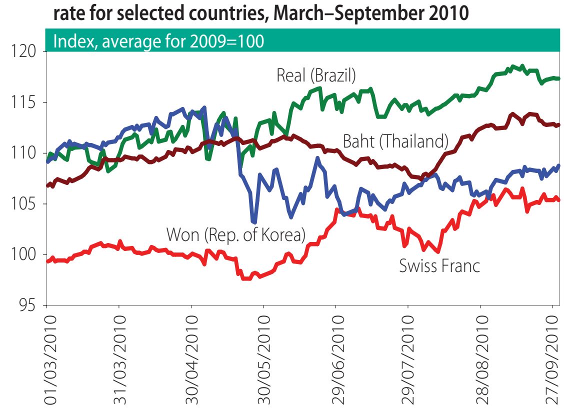
A decelerating global recovery and increased exchange-rate instability among major reserve currencies have given rise to new trade tensions and could well trigger a downward spiral of competitive devaluations. The dollar has been sliding amidst this volatility (see figure 1). Representatives in the United States Congress have recently approved legislation to impose trade sanctions on countries—China in particular—that, in their judgement, artificially hold down the value of their currencies to gain trade advantages. The bill, which has yet to go before the Senate and the President, might face retaliation and trigger a wave of protectionist measures. At the same time, a large number of central banks, including those in Brazil, Japan, the Republic of Korea, Switzerland and Thailand, are intervening with variable success in their respective foreign-exchange markets in attempts to stem further currency appreciation (see figure 2). The European Central Bank (ECB) thus far has refrained from strong intervention in currency markets in order to maintain the competitiveness of European exports. There is a serious risk of a "race to the bottom" that could harm global trade growth, which until now, has been critical to the recovery of the world economy.

Figure 1:
Volatility and weakening of the US dollar, March–September 2010



Source: UN/DESA calculations, based on J.P. Morgan data.

Figure 2:
Effective trade-weighted, multilateral exchange rate for selected countries, March–September 2010

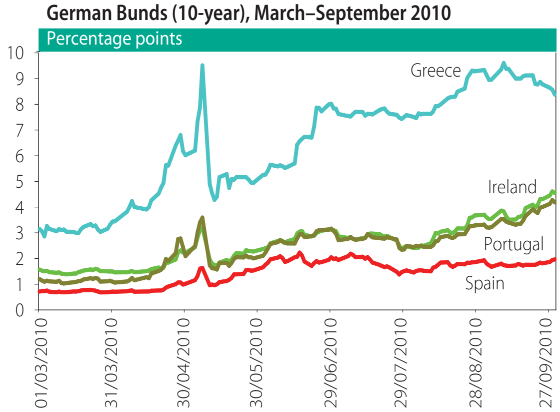


Source: UN/DESA calculations, based on J.P. Morgan data.

After a few months of respite, signs of continued sovereign debt stress re-emerged in several countries in the euro area, particularly in Greece, Ireland and Portugal where a sharp widening of yield spreads have been visible (figure 3). Managing fiscal consolidation has also proved difficult in a number of countries. While Ireland and Spain seem to be on track towards their fiscal targets for the year, there has been some slippage in Greece and Portugal. Yet, in Ireland, budget concerns remain, though mainly over the increasing fiscal burden of the Government's support to banks. Since the announcement of Ireland's financial stability programme last May, support to banks has increased, which will likely push up the country's fiscal deficit to 32 per cent of GDP in 2010. For now, however, there should be no risk of a sovereign debt crisis in the euro zone given the ample liquidity available through the European Stabilisation Mechanism (€60 billion), the European Financial Stability Facility (€440 billion) and the willingness of the ECB to hold up secondary bond markets via debt purchases.

On 12 September, the governing body of the Basel Committee on Banking Supervision decided to increase existing capital requirement ratios, together with the introduction of a global liquidity standard and new capital buffers. The new requirements

Figure 3:
Spreads of selected government bonds over German Bunds (10-year), March–September 2010



Source: UN/DESA calculations, based on J.P. Morgan data.

of "Basel III" will be incrementally implemented from the end of 2011 and should be in full force by 2019. While significant, the measures do not include any safeguards against other threats to international financial stability as they provide no regulatory provisions to stem excessive risk-taking by the "shadow banking" system (investment banks, hedge funds, etc.); neither do they include provisos to address the risks posed by systemically important ("too big to fail") financial institutions.

The recent United Nations summit on the Millennium Development Goals (MDGs) concluded with the adoption of a global action plan to achieve the eight goals by their 2015 target date and the announcement of new commitments, including $40 billion for women's and children's health. The same General Assembly resolution also expressed deep concern that progress made until now falls far short of providing a more enabling environment for developing countries to meet the MDGs through better market access, more generous aid, additional debt resolution and greater facilitation of technology transfers, as detailed in the *MDG Gap Task Force Report 2010: The Global Partnership for Development at a Critical Juncture*.

Developed economies

United States of America and Canada: weakening housing markets

According to the latest, definitive estimates, United States GDP increased at an annualized rate of 1.7 per cent in the second quarter of 2010 compared to the previous quarter, a slight upward revision of 0.1 percentage point compared with the previous estimate. The strong growth of private investment in equipment and software, which reached an annualized rate of 24.8 per cent, together with an accelerating private consumption growth over the last three quarters, brought some respite to an otherwise still rather gloomy situation. The housing market has cooled significantly, after the expiration of the homebuyer tax credit programme. In addition to the decline in transactions, the price for residential homes has started to dwindle again. The weekly initial jobless claims have remained in the range of 450,000 to 500,000 since January and not much improvement in the employment situation is expected in the near future.

The recovery of the Canadian economy shifted into reverse gear. Monthly GDP fell by 0.1 per cent in July, owing to a visibly weaker housing market and a mild contraction of manufacturing output.

Western Europe and the EU-15: a slowing and two-speed recovery

The first full estimates for second quarter GDP growth confirmed that growth in the region was relatively robust, with the economy of the euro area growing by 1.0 per cent quarter on quarter. For the first time since the onset of the recession, private investment spending contributed positively to growth. Moreover, private investment and consumption demand led GDP growth, which could be seen as the first signs of self-propelled recovery. More recent leading economic indicators suggest, however, that the pace of the recovery may be slowing. Industrial production moved sideways in June and July, with new orders falling slightly. The European Commission's Economic Sentiment Indicator continued to increase in September, but the pace of improvement has slowed since July. The recovery in Europe is moving at two speeds. Germany continues to show a strong performance, as does France to a lesser extent. Elsewhere in the region, countries such as Greece, Ireland, Portugal and Spain are experiencing a far slower recovery.

The new EU member States: good export performance, but social unrest over austerity measures

Industrial output continued to expand on the back of strong export demand. The value of Bulgarian exports of goods increased by 29.9 per cent[1] between January and July 2010, and in June recovered to pre-crisis monthly levels. In the Czech Republic, car production increased by over 18 per cent in the first half of 2010. In Lithuania, industrial production increased by 10.9 per cent in August.

Fiscal austerity and high unemployment continue to restrain domestic demand, however. Plans to cut salaries and employment in the public sector have led to protests in the Czech Republic and Romania.

Japan: new policy measures to avoid a relapse into recession

Japan's GDP growth sharply decelerated in the second quarter of 2010 and more recent data also indicate a continued slowing of export growth. Exports increased by 15.8 per cent in August, but declined by 2.3 per cent compared with the level reached in July. The trade surplus fell for the first time in 15 months, to ¥103 billion ($1.2 billion). The slowdown in export growth is explained

1 Growth rates in this Briefing refer to year-on-year estimates, unless otherwise specified.

by the fading of the global recovery compounded by the recent appreciation of the yen. The yen has appreciated by about 10 per cent against the United States dollar in the course of 2010, reaching a 15-year high of ¥79.75 yen per dollar in mid-September. In response, the Bank of Japan intervened in the foreign-exchange market for the first time since 2004. By selling yen and buying dollars without sterilizing the monetary effect, the Bank of Japan is not only trying to prevent the yen from appreciating further but is also injecting more liquidity into the economy, providing new stimulus through so-called quantitative easing. In addition, the Government announced a new stimulus package of ¥915 billion (0.2 per cent of GDP) in public spending in September, through which it hopes to create 200,000 new jobs and encourage consumer and business spending.

Economies in transition

CIS: general slowdown in the largest economies

The economic slowdown observed towards the end of the second quarter of 2010 continued in July and August. Industrial production indices declined in Kazakhstan, the Russian Federation and Ukraine during these months. Nonetheless, taken over the first eight months of 2010, industrial sectors still expanded at double-digit rates compared with the year before. Inflation returned in the Russian Federation as the average price level increased in August for the first time since March 2009, but the spike was mainly due to the impact of the drought and wildfires on food prices, affecting agriculture during July and August. By contrast, inflation continued to decelerate in Ukraine, where the underlying fundamentals of the economy remain weak. The unemployment rate increased to almost 10 per cent in the second quarter of 2010, despite the fact that real output increased by 6 per cent. Problems continue especially in Ukraine's construction sector, as output contracted by almost one fifth in the first half of 2010. In Belarus, in contrast, activity in the construction sector is contributing to improved growth performance (and investment) and the economy is reacting positively to successive cuts in interest rates for refinancing loans.

South-Eastern Europe: diverging recovery

Croatia's second quarter GDP declined by 2.5 per cent. This was mainly caused by a decline in private consumption owing to lower real wages, banks' reluctance to extend consumer credit and lower housing prices, leading to a negative wealth effect and depressed investment. Export growth of 7 per cent could not offset the decline in domestic demand. Serbia's economy, in contrast, showed clear signs of recovery. Second quarter GDP increased by 2 per cent on the back of strong export growth. The IMF completed the fifth review of Serbia's Stand-by agreement in September and cleared the way for disbursement of the next loan instalment of $494 million to the country. The Central Bank of Serbia announced, however, that it will draw only 15 per cent of the full amount, citing the country's favourable balance of payments position.

Developing economies

Africa: economic conditions remain variably favourable

Macroeconomic conditions still look generally favourable in many of Africa's economies, despite the deceleration of the global recovery. On the external side, tourism and remittances have increased sharply, while export prices of primary commodities have held up. In July, tourist arrivals rose 20 per cent in Kenya and 10 per cent in Morocco. Workers remittances to Egypt soared by 235 per cent during the second quarter of 2010. Robust investment, especially in natural resource sectors, continues to boost domestic economic activity in many parts of the continent.

In August, inflation pressures lessened further in many economies, especially in Southern Africa, on the back of falling food prices and appreciating currencies (with the exception of Mozambique (see section on LDC below)). Depressed domestic demand is putting further downward pressure on prices in South Africa, where lower inflation led the Reserve Bank to cut its benchmark interest rate to 6 per cent in early September in an effort to spur output growth.

East Asia: strong growth boosting job creation across East Asia

Strong economic growth in recent quarters has boosted employment across East Asia, especially in the manufacturing and construction sectors. This has led to a marked decline in unemployment. In the Republic of Korea, the unemployment rate dropped to 3.3 per cent in August 2010, compared with 3.7 per cent in August 2009. In the Philippines, one of the countries with the highest level of unemployment in the region, the rate declined from 7.6 per cent in July 2009 to 6.9 per cent in July 2010, while the rate of underemployment fell from 19.8 per cent to 17.9 per cent.

Steady growth of industrial production and retail sales signal that China's economy is still booming, although growth is not as fast as during the first half of 2010, when it expanded by 11.1 per cent. Since the People's Bank of China resumed a more flexible exchange-rate regime in June, the renminbi has appreciated by 2 per cent against the dollar. In recent months, China also seems to have increased the pace of diversification of its foreign exchange reserves. The country's holdings of United States treasury securities have fallen from $940 billion in July 2009 to $847 billion in July 2010, while holdings of Japanese yen and Korean won have increased.

South Asia: accelerated economic growth in India and Sri Lanka

India and Sri Lanka continue to be the most vibrant economies in South Asia. In India, GDP growth accelerated to 8.8 per cent on the back of strong domestic demand. Abundant, but not excessive, monsoon rains helped bolster the agricultural sector, which grew by 2.8 per cent, the fastest pace since early 2009. The manufacturing sector expanded by 12.4 per cent, slightly less than in the previous two quarters. The Reserve Bank of India tightened monetary policy again in September, raising its main policy rate by 50 basis points, to 5 per cent. Inflation remains high although it has decelerated recently. The wholesale price index rose by 8.5 per cent in August, the lowest rate of increase in seven months.

Sri Lanka recorded its strongest growth rate in eight years in the second quarter of 2010. GDP increased by 8.5 per cent. All main economic sectors—agriculture, industry and services—reaped a peace dividend. Tourist earnings were up 61 per cent.

In its largest humanitarian appeal ever, the United Nations has asked the international community for more than $2 billion in aid to flood-ravaged Pakistan. The funds aim to assist 14 million people over the next year and are designated for nearly 500 projects for housing, food, water, sanitation, hygiene and agriculture.

Western Asia: signs of a continued recovery

Turkey's economy grew by 3.7 per cent quarter on quarter in April-June on the back of strong investment activity as well as a solid performance of the external sector. At the same time, inflation rose to 8.3 per cent in August, from 7.6 per cent in July, with a more pronounced increase in food prices being a major driving force in this respect. In Israel, economic growth reached an annualized rate of 4.1 per cent in the first half of the year, underpinned by strong exports and investment. The construction sector showed particular vigour, with the number of new housing starts in the first half of the year increasing by 17.0 per cent over the same period last year. As a reflection of these solid trends, the unemployment rate fell from 7.0 per cent in the first quarter to 6.2 per cent in the second. In the Syrian Arab Republic, monetary authorities reduced interest rates on various forms of deposits in an effort to boost investment activity, not least in order to maintain the momentum of solid economic growth driven in particular by private consumption and government expenditure.

Latin America: strong growth in parts of South America

Economic growth has been particularly strong during the first half of 2010 in Argentina, Brazil, Paraguay and Uruguay, where GDP grew by 9.4, 8.9, 11.7 and 9.6 per cent, respectively. These figures reflect strong increases in exports and investment demand. Accelerating economic growth in combination with the global factors discussed above, has led to an appreciation of Latin American currencies against the United States dollar. The Chilean peso gained the most, appreciating 12 per cent during the third quarter of 2010. In order to temper the appreciation of its currency, Brazil's central bank strongly stepped up dollar purchases this month. Purchases worth $5.9 billion were not enough to stop further appreciation of the real, however. In Argentina, by contrast, the Central Bank has been successful in keeping its currency competitive. The Argentinean peso depreciated in September, extending its decline to 4.1 per cent so far this year. Costa Rica's Government announced it would issue bonds on international markets for the first time since 2004 in order to finance its fiscal deficit which soared by 70 per cent in the first eight months of 2010. Honduras agreed to an IMF loan of $196 million to finance its 2011 budget.

Least developed countries: food riots in Mozambique

In Mozambique, an estimated 13 civilians lost their lives during riots over food and fuel price hikes in early September. The steady depreciation of Mozambique's national currency vis-à-vis the South African rand forced the Government to increase the state-controlled price of bread by about 20 per cent. Mozambique grows only 30 per cent of the wheat it needs and is heavily dependent on imports from South Africa. Only a few days after the protests, however, the Government took measures to undo the price increases.

The IMF has signed agreements with China, France, Japan and the United Kingdom, to secure about $8 billion in new, concessional loan resources for low-income countries (LICs), including most LDCs. This will expand the IMF's capacity to help LICs hit hard by the global economic crisis.

In its new Country Assistance Strategy for 2011-2014, the World Bank increased its low-interest lending to Bangladesh to $6.1 billion, more than double the amount provided during 2006-2009. The new strategy aims to support accelerated, sustainable and inclusive growth, while focusing more, than in the past, on improving governance and reducing corruption.