Monthly Briefing
World Economic Situation and Prospects

No. 35 **UN/DESA** 13 September 2011

Summary

- Heightened uncertainty and downside risks for the world economy caused a selloff in equity markets
- The sovereign debt crisis in the euro zone remains unabated
- The jobs crisis continues

Global issues

Heightened uncertainty triggered precipitous selloffs in global equity markets

Global equity markets underwent synchronized and massive selloffs in August and early September. Equity prices worldwide declined on average by about 20 per cent from their peak levels a month ago (see figure 1). This has been the most severe selloff since the recovery in asset prices starting in early 2009. Prices in commodity, currency and bonds markets showed large fluctuations.

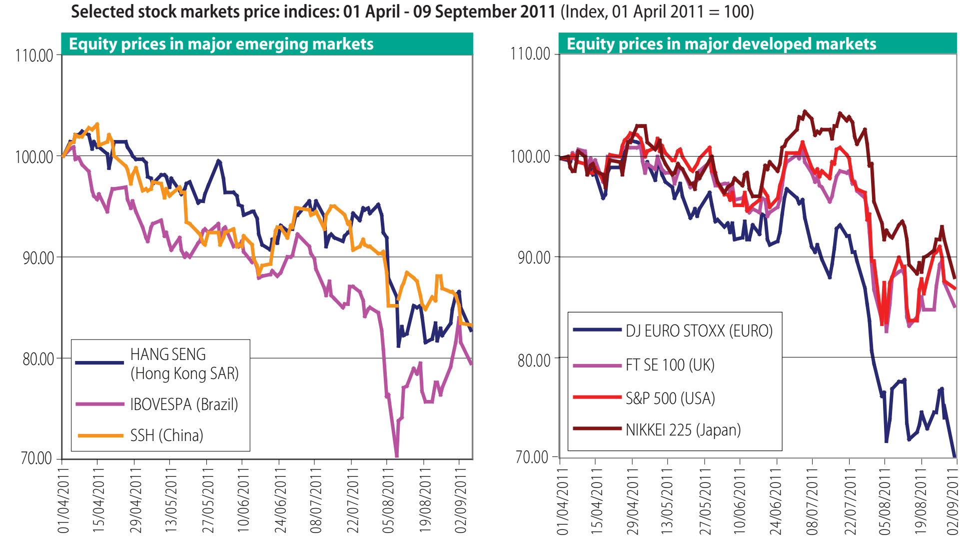
The financial instability has emerged amidst growing fears of a double-dip recession in major developed economies and possible contagion effects of the sovereign debt crises in Europe. During the first half of 2011, economic growth has decelerated substantially in the United States. The economy of the euro zone has come to a virtual standstill, with the larger European economies now also on the brink of a new downturn. Japan has already been mired in a new recession since the end of 2010.

Public debt distress is compounding the continued fragility in the banking sector in many advanced economies. These concerns are further aggravated by a political stalemate about how to cope with those challenges. The synchronized shift towards fiscal austerity as a means of reducing debt burdens is weakening economic activity further and will likely aggravate the fiscal debt problems further down the road.

The sovereign debt crisis in the euro zone remains unabated

The euro area sovereign debt crisis continues to inject turbulence into international financial markets. Worries about the solvency of European banks holding large sums of sovereign debt of debt-ridden countries have increased. In July, euro area Governments reached an agreement to add greater flexibility to the European Financial Stability Facility and empowered it to act preemptively beyond 2013. However, thus far, this has not helped to calm the markets. The measures are considered to be insufficient and their implementation is facing hurdles. The proposals must be voted on by national parliaments and the idea of using tax payer money to bail out other countries' Governments is deeply unpopular in some EU member States. Finland initially pushed for a bilateral agreement

Figure 1:
Selected stock markets price indices: 01 April - 09 September 2011 (Index, 01 April 2011 = 100)



Source: JP Morgan Chase, re-based by UN/DESA with Greece to obtain financial guarantees in exchange for participation in the rescue plan, but eventually had to give up this demand. In Germany, the highest court rejected a challenge to the country's participation in schemes to provide assistance to euro zone nations, but the court also ruled that the Government must seek the approval of parliament before providing future assistance. Meanwhile the European Central Bank has continued its policy of buying bonds of debt-ridden countries to reduce yields.

Elevated unemployment in the aftermath of the financial crisis

According to official statistics, which capture only a fraction of those affected in developing countries, unemployment grew by 17 million people (24 per cent) between 2007 and 2010. In developed economies, the average unemployment rate is about 3 percentage points higher than before the global crisis. At present, they are home to 44 million unemployed compared to 30 million in 2007. In Asia and Latin America, by contrast, unemployment rates have retreated to pre-crisis levels or below.

Youth unemployment has soared in advanced economies, reaching 40 per cent in Spain for workers aged 15-24. The average for the Organisation for Economic Co-operation and Development (OECD) countries is about 19 per cent, more than twice the average for all age groups. In developing economies youth unemployment is worrisome too, with North Africa and Western Asia exhibiting the highest rates. The figure in Algeria is above 40 per cent, while in many sub-Saharan and Latin American countries it is above 20 per cent.

High levels of youth unemployment are detrimental, both in economic and social terms. They erode the economy's human capital base and hence long-term growth prospects. At the individual level, the affected workers face a future of lower lifelong earnings and psychological stress from the lack of economic opportunities. At the collective level, they represent a potential source of social unrest. Indeed, in the areas rife with protests and violence, such as North Africa, Western Asia and some European countries, youth unemployment is extremely high.

Developed economies

United States: job creation on hold

In the United States, statistics released in August revealed the continuing feebleness of the economic recovery. According to a revised estimate, Gross Domestic Product (GDP) grew by 1.0 per cent (quarter on quarter, seasonally adjusted annual rate) from the first to the second quarter. This performance was weaker than previously estimated. Also in August, for the first time in 12 months, the number of payroll workers did not increase and the unemployment rate stayed at 9.1 per cent. At the same time, the average number of working hours and earnings declined from the previous month. Several factors heavily depressed consumers' and business' confidence in the United States economy, including the prolonged negotiation on public debt ceiling and deficit-reduction in late July; the subsequent downgrade by Standard & Poor's of the credit rating for the United States long-term debt; and, equally importantly, the growing awareness of the inadequacy of labour market situation creation and gloomy sales prospects.

Developed Asia and Pacific: Japan's post-quake recovery is weakening

In Japan, the recovery in industrial production from the natural disasters of March 2011 is weakening. Industrial output increased by 0.6 per cent (year on year) in July, a sharp deceleration from the 3.8 per cent gain in June. Manufacturers surveyed by the authorities expect output to fall in September. The weakening in industrial production is partly caused by a continued electricity shortage in the areas of Tokyo and Tohoku, but also reflects a slowdown in global demand. New export orders fell due to subdued external demand and the appreciation of the Japanese yen. Domestic demand continued its recovery in July, as reflected in increased consumer spending and retail sales as well as a surge in new housing construction, but may slow down if external demand and exports continue to falter. Despite these signs of recovery, the economy at large remains in recession.

To cope with the recent yen appreciation, Japan's Ministry of Finance established a new financing facility of $100 billion in August. The facility is to provide seed money in foreign currency to encourage Japanese firms to engage in mergers and acquisitions with foreign firms and in investments securing energy resources abroad. Meanwhile, the Bank of Japan announced an expansion of the Asset Purchase Program (APP), along with ¥4 trillion in currency intervention. If yen appreciation continues, further expansion of the APP is likely.

Europe: stagnating growth

GDP growth in Western Europe slowed sharply in the second quarter of 2011, as global demand decelerated and the euro debt crisis sapped confidence and in some cases forced additional austerity measures. In the euro area, growth was only 0.2 per cent (quarter on quarter) compared to 0.8 per cent in the first quarter. Germany and France which had led the strong performance of the first quarter, decelerated dramatically, with Germany growing by only 0.1 per cent and France registering no growth at all. Among the other major economies of the region, the United Kingdom grew by 0.2 per cent, Italy by 0.3 per cent and Spain by 0.2 per cent. Germany's declining output growth was led by a sharp decline in consumption and a strong rise in imports, while investment and exports continued to provide modest support. In France, falling consumption and flat exports contributed to the slow down in activity. This performance confirms the impression given by the sharp drop in industrial production in June, the continuing decline in business sentiment since February, and the abrupt fall in consumer confidence since July. These developments suggest that the recovery is slowing and likely to remain muted going forward.

The new EU members: slowing growth

As anticipated, most new EU member States reported slower growth for the second quarter of 2011, mirroring the performance of their main export markets in the euro zone, and the majority still yet to regain their pre-crisis output levels. Quarter-on-quarter GDP growth was of only 0.1 per cent in Bulgaria, 0.2 per cent in the Czech Republic, 0.2 per cent in Romania and 0.9 per cent in Slovakia, while the Hungarian economy stagnated. The Baltic States reported stronger indicators, reflecting an ongoing recovery though from a much deeper recession. Except in Poland, where second quarter GDP grew by 1.1 per cent (quarter on quarter), domestic demand is still unable to mitigate the effect of slowing exports. Meanwhile, inflationary pressures, triggered by higher food and oil prices, continued to ease in the new EU countries.

The steady appreciation of the Swiss franc over the last few months has exerted strong pressure on household and business borrowers in Central Europe. Indeed, over 50 per cent of mortgages are denominated in francs in Poland and about 65 per cent of debt held by Hungarian households is in francs. To prevent a possible wave of defaults, the Government of Poland introduced legislation aiding foreign-currency mortgage holders, and the Government of Hungary introduced a payment scheme for foreign-currency mortgages holders at a fixed exchange rate. The Swiss central bank's recent decision to set a fixed limit to the appreciation of the franc compared to the euro should help mitigate current woes for mortgage holders as well.

Economies in Transition

CIS: vulnerability to external shocks

Recent financial developments have had a significant impact on markets in the CIS. In the Russian Federation and in Kazakhstan, the main stock market indices declined by more than 15 per cent in August while in Ukraine, the decline was more than 22 per cent. Greater economic uncertainty and the decline in oil prices also had a negative impact on the Russian rouble, which depreciated by 4.3 per cent against the dollar in August. Meanwhile, trends in consumer prices have diverged among the CIS countries. In the Russian Federation, inflation declined to 9 per cent (year on year) in July, and interest rates were left unchanged for the third month in a row. Rising food costs in Kazakhstan and higher energy and utility prices in Ukraine pushed up inflationary pressures.

Overall, the weaker global environment will negatively impact performance in the region and may trigger monetary authorities to lower interest rates. Authorities in the Russian Federation downgraded their growth forecast along with a lower inflation estimate in August, citing lower-than-expected oil prices as an important factor.

South-eastern Europe: a new IMF loan for Serbia?

The economy of Serbia expanded by 2.2 per cent (year on year) in the second quarter, less then in the previous quarter, as industrial growth slowed. Meanwhile the Government of Serbia started discussions with the IMF on a new precautionary loan to be used if balance-of-payments problems emerge. In Croatia, the appreciation of the Swiss franc created difficulties for many mortgage holders. Like in Hungary, the Government reached an agreement with commercial banks on a programme fixing the exchange rate for payments on home mortgages denominated in Swiss francs.

Developing economies

Africa: worsening food crisis in the Horn of Africa

The severe food crisis in the Horn of Africa continued unabated, with the uncertain security situation in many parts of the sub-region complicating relief efforts, especially in Somalia. In Kenya, the drought has led to food shortages, and rising food prices were one of the main drivers of inflation that continued to rise for the ninth consecutive month in July to 15.5 per cent (year on year) from 14.5 per cent in the previous month. A decline in the value of the Kenyan shilling has driven up the price of imports such as oil. Meanwhile, in Ethiopia, higher food prices continued to drive up inflation, which hit 39 per cent in July. In the United Republic of Tanzania, food prices jumped by 15.9 per cent (year on year) in July and inflation reached 13 per cent (year on year). Without the lowering of the weight of food prices in the overall index, the increase in the headline inflation rate would have been even more pronounced.

East Asia: growth slowdown could signal end to monetary tightening

East Asia's growth momentum has slowed markedly amid renewed recession fears in developed countries. In most economies, the pace of expansion fell in the second quarter of 2011 as weak exports offset robust growth in consumer spending. Output contracted (quarter on quarter, seasonally adjusted) in the export-dependent economies of Hong Kong Special Administrative Region of China, Singapore and Thailand. In the Philippines, economic growth slowed for the fourth consecutive quarter, falling to 3.4 per cent (year on year); private consumption expanded at its fastest pace since the last quarter of 2007, but GDP growth was curbed by weak exports and a sharp drop in construction. Indonesia's economy, by contrast, continued to register strong growth in the second quarter on the back of robust domestic demand, with GDP expanding by 6.5 per cent (year on year).

Recent manufacturing data from the Republic of Korea, Taiwan Province of China and Thailand showed moderate declines, suggesting a further weakening of growth in the third quarter. Less favourable growth prospects and increased global uncertainty have increased pressure on East Asia's central banks to delay further monetary tightening, even as inflation remains elevated. In the Republic of Korea, consumer prices rose by 5.3 per cent (year on year) in August, the fastest pace in three years, driven by sharply higher prices of food and transport.

South Asia: growth in India slowing further

India's economy slowed slightly in the second quarter of 2011 as growth in agricultural output and construction weakened. GDP expanded by 7.7 per cent (year on year), down from 7.8 per cent in the first three months of the year and well below the rapid pace recorded a year ago. On the expenditure side, domestic demand continued to grow at a solid rate despite a significant rise in the cost of borrowing after the Reserve Bank of India hiked interest rates 11 times in less than two years. Private consumption and gross fixed capital formation, the two largest components of GDP, expanded by 6.3 per cent and 7.9 per cent (year on year), respectively. A surge in imports, which increased by 23.6 per cent (year on year), following 10.3 per cent growth in the previous quarter, further dampened domestic output growth.

Sri Lanka's unemployment rate declined to an all-time low of 4.3 per cent in the first quarter of 2011 on the back of ongoing strong growth. However, unemployment is significantly higher among women (6.7 per cent) than men (3.0 per cent). Moreover, youth unemployment represents a major challenge, with almost one in five individuals aged 15 to 24 being out of work.

West Asia: social upheaval extending to Israel

The ongoing unrest in the Syrian Arab Republic is having repercussions in neighbouring countries. Trade with Turkey is limited due to the precarious security situation. In Beirut, through which goods transit on their way to Damascus, port traffic has decreased and tourist arrivals in Lebanon are estimated to have dropped by 20 per cent in the first half of the year. The United States and the European Union have imposed economic sanctions on the Syrian Arab Republic, including a ban on oil imports. In other Arab countries of the region, political protests have been subdued during August.

Israel, however, experienced the largest social protest since its creation. For seven weeks starting in mid-July, the struggling middle class protested against the high cost of living, income disparities and alleged cronyism between politicians and business leaders. The extent to which the success of this popular movement will lead the Government to temper its market-friendly agenda is uncertain.

In Turkey, inflation accelerated to 6.7 per cent (year on year) in August, nearing the upper bound of the central bank's target zone which ranges between 3.5 and 7.5 per cent.

Latin America and the Caribbean: using commodities as a source of revenues

GDP growth in August hovered between 3 and 6 per cent (year on year) across the region's economies. High, albeit volatile, commodity prices continued fuelling large import and fiscal revenues in the mineral-exporting countries. The Government of Peru announced a 3 billion Peruvian Nuevo Sol ($1.1 billion) increase in fiscal revenues from the mining industry in a form yet to be determined, pledging to increase spending on education and health by 25 per cent in 2011. The Governments of Chile and the Plurinational State of Bolivia are considering increasing royalties from the mining industry to fund additional social expenditures.

In Brazil, growing commodity exports kept the currency strong, aggravating concerns about industrial competitiveness. Recent data showing a 1.6 per cent contraction of industrial output in June prompted the introduction of import restrictions and tax breaks for hardest hit industries under the "Bigger Brazil" industrial plan. The central bank cut the official interest rate to 12 per cent in September.

In Argentina, industrial production grew in July by 5.1 per cent (year on year), helped by Brazil's currency appreciation. In the Bolivarian Republic of Venezuela, rising oil prices increased external surplus by almost 100 per cent (year on year) but, according to private sector estimates, GDP fell by 3.2 per cent (quarter on quarter) in the second quarter of 2011.

To subscribe to an electronic copy, please e-mail: wesp@un.org