Monthly Briefing
World Economic Situation and Prospects

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This special issue covers the highlights of the World Economic Situation and Prospects 2012: Update as of Mid-2012, launched on June 7, 2012

Summary

- Growth projections for the global economy revised downward
- The jobs crisis continues
- Euro area debt crisis and rising energy prices are key risks

Global issues

Global growth projected to slow, major risks looming

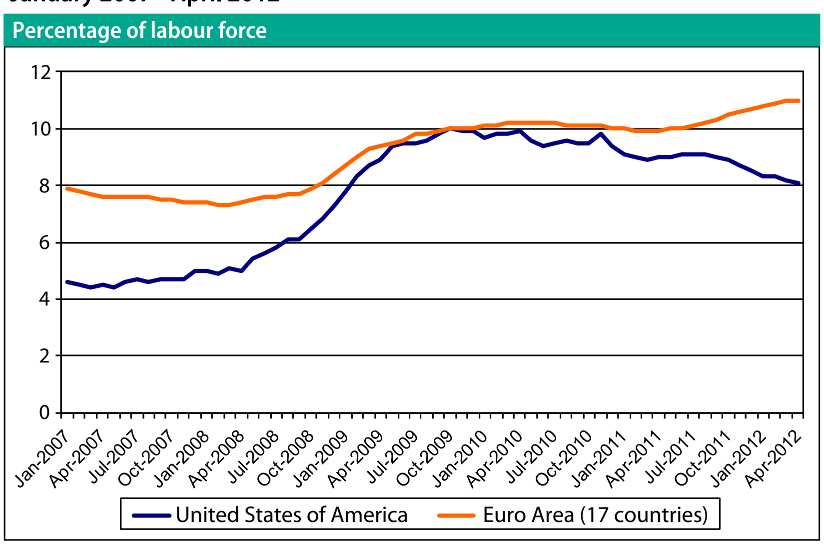
Despite some scattered signs of improvement in recent months, the world economic situation and prospects continue to be challenging. After a marked slowdown in the course of 2011, global economic growth will likely remain tepid in 2012, with most regions expanding at a pace below potential. The World Economic Situation and Prospects 2012: Update as of Mid-2012 (WESP Update per Mid-2012) projects that world gross product (WGP) will grow by 2.5 per cent in 2012 and 3.1 per cent in 2013, following growth of 2.7 per cent in 2011. This constitutes a slight downward revision from the forecasts presented in the World Economic Situation and Prospects (WESP) 2012 in January. Downside risks for further weakening of global economic conditions remain unabatedly high.

Developed economies are still struggling to overcome the economic woes originating from the global financial crisis. This has given rise to sluggish and fragile growth. The outlook for developing economies and economies in transition remains more benign, although notable growth moderation is projected for 2012. World trade growth will slow further to 4.1 per cent in 2012, down from 13.1 per cent in 2010 and 6.6 per cent in 2011.

In the face of subdued growth, the jobs crisis continues, with global unemployment still above its pre-crisis level and unemployment in the euro area rising rapidly (see figure 1). Employment-to-population ratios remain below their 2007 levels in all major economies, except Brazil, China, and Germany. By the end of 2011, an estimated 48 million additional jobs were required for employment ratios to return to pre-crisis levels. Following an upturn in 2011, inflation is forecast to decelerate owing to weakening global demand and gradually moderating food and commodity prices.

The risks to the global outlook are tilted to the downside. The euro area debt crisis remains the biggest threat to the world economy. An escalation of the crisis would likely be associated with severe turmoil in financial markets and a sharp rise in global risk aversion, leading to a contraction of economic activity in developed countries, which would spill over to developing countries and economies in transition. A further sharp rise in global energy prices may also stifle global growth.

Figure 1: Unemployment rates in selected developed countries: January 2007 - April 2012



Source: EUROSTAT and OECD *Main Economic Indicators*

The WESP Update per Mid-2012 includes a number of policy recommendations which would need to be enacted simultaneously to avoid a renewed global downturn, including: reorienting fiscal policies away from premature austerity and towards internationally coordinated efforts to boost growth; coordinating monetary policy to stem exchange rate and capital flow volatility; redesigning fiscal policy to target unemployment and green growth; enforcing stricter and better coordinated regulations of the financial sector; and ensuring that the appropriate resources are made available to developing countries to aid in their efforts to meet the Millennium Development Goals (MDGs).

Below, the regional outlooks are presented with reference to the baseline forecasts of the WESP update which assumes no further escalation of the current crises.

Developed economies

North America: growth improves, but unemployment remains high

Economic activity in the United States of America is expected to grow by 2.1 per cent in 2012 and 2.3 per cent in 2013, a slight upgrade from the previous forecast and above the 1.7 per cent recorded in 2011. In early 2012, job creation exceeded expectations, stock market indices registered some gains, credit conditions eased notably, while also consumer confidence and spending increased markedly. However, the economy is not out of the woods yet. Despite falling labour participation, the unemployment rate remains much higher than it was before the crisis and, since April, job creation has slowed again to below the level needed to absorb the natural increase of the labour force. The number of workers without a job for more than six months continues to increase. Weak employment conditions, along with the continued weak housing market and risk of foreclosures, hold back the recovery in household spending. With the phasing out of fiscal stimulus measures injected during the crisis, Government spending has declined, dragging output growth. The upcoming presidential election creates uncertainties over the fiscal policy outlook, clouding overall economic prospects.

Developed Asia and the Pacific: moderate recovery moving ahead, but falling exports could be a drag on growth

In Japan, gross domestic product (GDP) contracted by 0.7 per cent in 2011. Economic activity is projected to grow by 1.7 per cent in 2012 and 2.1 per cent in 2013. The recovery from the earthquake and tsunami that hit the country in March 2011 was hampered by supply chain disruptions in the fourth quarter caused by the flooding in Thailand, a major supplier of manufactured inputs. In 2012, private consumption growth is expected to remain moderate owing to sluggish growth in wage income. Reconstruction works are expected to spur investment growth. This impulse is being partly offset, however, by cuts in other Government expenditures and a tax increase. The measures have been taken to address the large budget deficit and Japan's outsized public debt. As in 2011, falling net exports will drag GDP growth. In particular, fuel imports will increase further because of the need to substitute energy with the phasing-out of nuclear power generation.

Western Europe: despite some action, crisis still looms and growth falters

The recovery came to a halt at the end of 2011, and with ongoing private-sector deleveraging, a weak and vulnerable banking system, fiscal tightening, slowing external demand, high unemployment, and high oil prices, prospects for growth are bleak. In 2012, GDP is expected to contract by 0.3 per cent, after growing by 1.5 percent in 2011. Only a modest rebound of 0.9 per cent is expected for 2013. The debt crisis is the key restraining factor, acting through increasingly stringent fiscal austerity programs in the crisis-stricken countries, weakening lending capacity of the banking system, and impacting severely on consumer and industrial confidence across the region. In early 2012, several massive ECB policy actions, an agreement by EU heads of state on a new fiscal architecture, and a successful write-down of Greek debt led to some calming of financial markets, but this was short-lived and tensions have re-emerged.

The aggregate picture masks important differences across the region, however. Germany's economy, for example, is expected to grow by 1.0 per cent in 2012, while the crisis-stricken countries will remain mired in recession. For the euro area, average unemployment is expected to increase from 10.2 per cent in 2011 to 11.1 per cent in 2012 and stay high at 11.0 per cent in 2013. Again, significant regional differences are apparent: with high and increasing unemployment in the crisis-affected countries, but more stable (and even declining in some) and significantly lower in other countries.

New EU members: growth slows due to weak export markets and fiscal austerity

The recovery in the economies of the new EU member States in Central and Eastern Europe is expected to slow noticeably in 2012, affected by weakness in their major export markets and by contractionary effects of fiscal austerity policies. Growth of aggregate

GDP is expected to slow from 3 per cent in 2011 to just 1.7 per cent in 2012, before strengthening to 2.8 per cent in 2013. Some countries, such as Hungary, may slip back into recession.

Poland, which has a less export-dependent economy and registered robust growth of 4.3 per cent in 2011, could avoid a sharp slowdown. Domestic demand will not support growth in 2012 owing to fiscal tightening, weak labour markets, private sector indebtedness and stagnating credit flows. Consumer confidence remains fragile as fiscal austerity measures encompass wage and employment reductions in the public sector.

Inflation in the new EU member States, mostly driven by one-off factors such as higher oil and food prices and higher VAT rates, should subside in 2012. The new EU members remain vulnerable to external shocks such as massive deleveraging by the parent EU-15 banks in case of a crisis, as fiscal resources for countercyclical policy responses are scarce.

Economies in Transition

CIS and Georgia: growth slows after a robust expansion in 2011

The economies of the Commonwealth of Independent States (CIS) are expected to see a mild slowdown in the outlook period. Output is projected to expand by 4.3 per cent on average in 2012, compared with 4.7 per cent in 2011. In the outlook for 2012, the economy of the Russian Federation is forecast to expand by about 4 per cent, contingent on oil prices staying at present high levels. However, triggered by uncertainty and negative sentiments among Russian investors, the economy experienced near record level capital outflows in 2011, which have continued into early 2012 and tempered growth prospects. In most other CIS economies, growth is expected to moderate in line with lower commodity prices and tighter fiscal policies. Inflation accelerated in 2011 on the back of higher food and fuel prices, rising wages, and, in some cases, massive foreign exchange inflows. Private consumption will benefit as inflation in the CIS countries is set to moderate in 2012.

South-Eastern Europe: the region is expected to stagnate as the euro area stalls

The transition economies of South-Eastern Europe are expected to stagnate in 2012, growing a mere 0.6 per cent in 2012, with Croatia likely to fall back into recession. Growth is forecast to accelerate to 1.8 per cent in 2013 as domestic demand, especially private investment, strengthens. Growth of manufacturing output and construction activity weakened in late 2011 and early 2012 owing to weaker external demand and a harsh winter. In 2012, against the backdrop of the sluggish EU economy, export growth will likely remain slow, especially given the region's strong trade ties with Greece and Italy. In addition, weak employment conditions, lower public sector wages, fiscal tightening, sluggish credit growth and private sector indebtedness continue to restrain domestic consumption and investment. The planned boost to public investments in infrastructure and energy, financed through EU support and other international resources is expected to provide some counterweight. The region remains dependent on external finance and the large presence of Greek banks in parts of the region entails the risk of capital outflows. An abrupt decline in remittances, triggered by a deeper crisis in the EU, would stifle private consumption.

Developing economies

Africa: growth revised lower, but remains solid

GDP growth in the region is forecast to average 4.2 per cent in 2012 and 4.8 per cent in 2013, a downward revision by 0.7 and 0.3 percentage points, respectively, from the previous forecast. This revision is partly a result of lingering global economic uncertainty, which will weigh on exports and lead to more cautious investment. Public and private investment in the natural resource and infrastructure sectors will continue to grow at a solid pace in a number of countries. However, infrastructural deficits, especially in energy generation and refining capacity, continue to impede acceleration of growth and development in much of the region. Meanwhile, added production capacity, as in Sierra Leone, and relatively buoyant commodity prices are expected to underpin continued solid performance in the resource sectors. However, political instability and uncertainty drag economic growth in countries like Libya and Egypt. The service sector remains strong in many economies, including Nigeria and Ghana, where the telecommunications and construction sectors are expected to continue to show robust growth. Domestic consumption demand has strengthened in many countries in the region as well. While inflation rates are forecast to be moderate, they remain high in much of sub-Saharan Africa. They are still well into the double-digits in Ethiopia, Nigeria, Tanzania, Uganda, and elsewhere, curbing purchasing power and, hence, consumption spending. Important downside risks are associated with greater-than-expected commodity price weakening, and the prospect of renewed droughts leading to the re-emergence of severe food shortages.

East Asia: growth moderates owing to weak developed country demand and Chinese deceleration

Weak demand in developed countries and a slowing Chinese economy are likely to weigh on economic growth in East Asia in the outlook period. After decelerating from 9.2 per cent in 2010 to 7.1 per cent in 2011, average regional growth is expected to slow further to 6.5 per cent in 2012, before picking up slightly to 6.9 per cent in 2013. The growth slowdown reflects weaker import demand in developed countries, increased global uncertainty and the lagged effects of credit tightening in parts of the region, most importantly in China. While the risk of a hard landing of China's economy in the outlook period is low, growth is forecast to slow from 9.2 per cent in 2011 to 8.3 per cent in 2012. Across the region, weaker growth of exports and investment is expected to be partly offset by strong household and Government consumption as fiscal policy becomes slightly more expansionary. Household consumption will be supported by persistently low real interest rates and rising real wages. The region's labour markets are expected to remain fairly robust despite slower employment growth, particularly in the manufacturing sector. A significant decline in consumer price inflation owing to easing food and commodity prices will also contribute positively to real wage growth in 2012.

South Asia: growth slows with divergences across the region

Economic growth in South Asia is projected to moderate to 5.6 per cent in 2012, down from 6.1 per cent in 2011 and well below the 7.1 per cent pace recorded in 2010. In 2013, regional GDP growth is expected to accelerate again to 6.1 per cent. The recent deceleration mainly reflects significantly lower growth in India, where domestic demand, in particular private investment, has weakened on the back of aggressive monetary tightening and a policy standstill. India's economy is forecast to expand by 6.7 per cent in 2012, after growing by 7.1 per cent in 2011. Across the region, consumption and investment activity are negatively impacted by elevated inflation, relatively restrictive macroeconomic policies, and country-specific factors such as security concerns and political uncertainties. Sluggish economic activity in developed economies, combined with weaker growth in East Asia, will lead to a slowdown in export growth. In addition, high oil prices put a strain on fiscal and external balances, while also preventing a more rapid decline in consumer price inflation. GDP growth in 2012 is projected to vary widely across the region, ranging from 0.3 per cent in the Islamic Republic of Iran to 6.9 per cent in Sri Lanka. In Sri Lanka, the unemployment rate remains close to all-time lows. In the Islamic Republic of Iran and Pakistan, in contrast, both unemployment and underemployment are increasing as GDP growth is well below the pace required to absorb the rapidly rising labour force.

Western Asia: growth decelerates with diverging trajectories for oil exporters and importers

Average regional growth is expected to decline from 6.9 per cent in 2011 to 4.0 per cent in 2012 and 4.4 per cent in 2013 as a result of weakening external demand and a moderation of public spending growth following the exceptional measures taken in the wake of the Arab spring. Exceptionally high export and Government revenues allowed oil-exporting countries to increase public spending and boost private consumption as a substitute for domestic political reform. In response to political unrest in 2011, Arab policymakers made unprecedented use of fiscal policy to increase public sector employment and wages as well as access to low-cost housing. This could entail a more permanent rise in public expenditures, resulting in higher structural fiscal deficits. Thus far, however, the measures have not led to an increase in inflationary pressures, which, in fact, dampened throughout in the region, except in Turkey. Oil-importing countries, however, are facing higher import bills in addition to slowing exports; these factors have started to weigh on domestic demand. Consequently, the recent slowdown in Israel and Turkey may extend into the second half of 2012 if economic activity fails to pick up in their main export markets. Furthermore, continued violent clashes have affected economic activity in the Syrian Arab Republic with spill-over effects to neighbouring countries.

Latin America and the Caribbean: Latin American growth slows while the Caribbean sees mild acceleration

Economic growth in Latin America and the Caribbean is expected to slow from 4.3 per cent in 2011 to 3.7 per cent in 2012, before accelerating again to 4.2 per cent in 2013. In many countries, the phasing out of fiscal and monetary stimulus measures has curbed domestic demand growth. Strengthened growth in the United States boosted exports from Mexico and the Caribbean faster than expected in 2011 and is expected to increase tourism and remittances in the coming year. Yet, overall economic growth in Mexico is expected to slow to 3.4 per cent in 2012. The Caribbean economies are expected to see a mild acceleration of GDP growth to 3.3 per cent in the baseline forecast for 2012 and 4.0 per cent in 2013, up from 2.5 per cent in 2011. Scope for additional support through fiscal policy is limited given already high levels of public indebtedness. Economic growth in Brazil is expected to recover gradually in 2012 and 2013 as private investment is supported by monetary loosening and Government spending increases. A fall in industrial production and upward pressure on the real has prompted the Government to strengthen capital account regulation and to implement fiscal measures aimed at supporting industrial activity. A sharp economic slowdown is expected in Argentina in 2012, following a period of fast growth.