Chapter 1
Global economic outlook

Prospects for the world economy in 2013-2014

Risk of a synchronized global downturn

The world economy continues to struggle with post-crisis adjustments

Four years after the eruption of the global financial crisis, the world economy is still struggling to recover. During 2012, global economic growth has weakened further. A growing number of developed economies have fallen into a double-dip recession. Those in severe sovereign debt distress moved even deeper into recession, caught in the downward spiralling dynamics from high unemployment, weak aggregate demand compounded by fiscal austerity, high public debt burdens, and financial sector fragility. Growth in the major developing countries and economies in transition has also decelerated notably, reflecting both external vulnerabilities and domestic challenges. Most low-income countries have held up relatively well so far, but now face intensified adverse spillover effects from the slowdown in both developed and major middle-income countries. The prospects for the next two years continue to be challenging, fraught with major uncertainties and risks slanted towards the downside.

Conditioned on a set of assumptions in the United Nations baseline forecast (box I.1), growth of world gross product (WGP) is expected to reach 2.2 per cent in 2012 and is forecast to remain well below potential at 2.4 per cent in 2013 and 3.2 per cent in 2014 (table I.1 and figure I.1). At this moderate pace, many economies will continue to operate below potential and will not recover the jobs lost during the Great Recession.

The global slowdown will put additional strains on developing countries

The slowdown is synchronized across countries of different levels of development (figure I.2). For many developing countries, the global slowdown will imply a much slower pace of poverty reduction and narrowing of fiscal space for investments in education, health, basic sanitation and other critical areas needed for accelerating the progress to achieve the Millennium Development Goals (MDGs). This holds true in particular for the least developed countries (LDCs); they remain highly vulnerable to commodity price shocks and are receiving less external financing as official development assistance (ODA) declines in the face of greater fiscal austerity in donor countries (see below). Conditions vary greatly across LDCs, however. At one end of the spectrum, countries that went through political turmoil and transition, like Sudan and Yemen, experienced major economic adversity during 2010 and 2011, while strong growth performances continued in Bangladesh and a fair number of African LDCs (box I.2).

Weakness in developed economies underpins the global slowdown

Weaknesses in the major developed economies are at the root of continued global economic woes. Most of them, but particularly those in Europe, are dragged into a downward spiral as high unemployment, continued deleveraging by firms and households, continued banking fragility, heightened sovereign risks, fiscal tightening, and slower growth viciously feed into one another (figure I.3a).

Several European economies are already in recession. In Germany, output has also slowed significantly, while France's economy is stagnating. A number of new

Table I.1
Growth of world output, 2006-2014

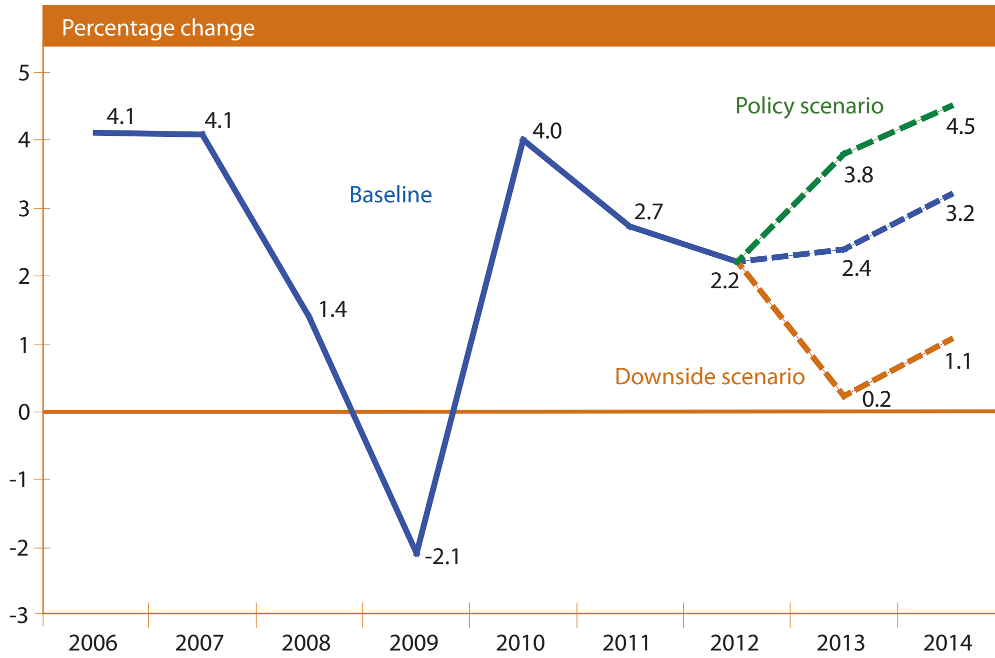
Annual percentage change

	2006-2009[a]	2010	2011[b]	2012[c]	2013[c]	2014[c]	Change from June 2012 forecast[d] 2012	2013
World	**1.1**	**4.0**	**2.7**	**2.2**	**2.4**	**3.2**	**-0.3**	**-0.7**
Developed economies	-0.4	2.6	1.4	1.1	1.1	2.0	-0.1	-0.7
United States of America	-0.5	2.4	1.8	2.1	1.7	2.7	0.0	-0.6
Japan	-1.5	4.5	-0.7	1.5	0.6	0.8	-0.2	-1.5
European Union	-0.3	2.1	1.5	-0.3	0.6	1.7	-0.3	-0.6
EU-15	-0.5	2.1	1.4	-0.4	0.5	1.6	-0.3	-0.6
New EU members	2.1	2.3	3.1	1.2	2.0	2.9	-0.5	-0.8
Euro area	-0.4	2.1	1.5	-0.5	0.3	1.4	-0.2	-0.6
Other European countries	0.9	1.9	1.7	1.7	1.5	1.9	0.6	0.2
Other developed countries	1.2	2.8	2.4	2.3	2.0	3.0	0.0	-0.6
Economies in transition	2.2	4.4	4.5	3.5	3.6	4.2	-0.5	-0.6
South-Eastern Europe	1.6	0.4	1.1	-0.6	1.2	2.6	-1.2	-0.6
Commonwealth of Independent States and Georgia	2.2	4.8	4.8	3.8	3.8	4.4	-0.5	-0.6
Russian Federation	1.7	4.3	4.3	3.7	3.6	4.2	-0.7	-0.8
Developing economies	5.2	7.7	5.7	4.7	5.1	5.6	-0.6	-0.7
Africa	4.7	4.7	1.1	5.0	4.8	5.1	0.8	0.0
North Africa	4.2	4.1	-6.0	7.5	4.4	4.9	3.1	0.0
Sub-Saharan Africa	5.0	5.0	4.5	3.9	5.0	5.2	-0.2	0.0
Nigeria	6.6	7.8	7.4	6.4	6.8	7.2	0.1	0.0
South Africa	2.5	2.9	3.1	2.5	3.1	3.8	-0.3	-0.4
Others	6.3	5.5	4.4	3.9	5.5	5.3	-0.3	0.1
East and South Asia	7.1	9.0	6.8	5.5	6.0	6.3	-0.8	-0.8
East Asia	7.2	9.2	7.1	5.8	6.2	6.5	-0.7	-0.7
China	11.0	10.3	9.2	7.7	7.9	8.0	-0.6	-0.6
South Asia	6.4	8.3	5.8	4.4	5.0	5.7	-1.2	-1.1
India	7.3	9.6	6.9	5.5	6.1	6.5	-1.2	-1.1
Western Asia	2.3	6.7	6.7	3.3	3.3	4.1	-0.7	-1.1
Latin America and the Caribbean	2.5	6.0	4.3	3.1	3.9	4.4	-0.5	-0.3
South America	3.9	6.5	4.5	2.7	4.0	4.4	-0.9	-0.4
Brazil	3.6	7.5	2.7	1.3	4.0	4.4	-2.0	-0.5
Mexico and Central America	-0.1	5.4	4.0	4.0	3.9	4.6	0.6	0.0
Mexico	-0.6	5.5	3.9	3.9	3.8	4.6	0.5	-0.1
Caribbean	3.6	3.5	2.7	2.9	3.7	3.8	-0.4	-0.3
By level of development								
High-income countries	-0.2	2.9	1.6	1.2	1.3	2.2		
Upper middle income countries	5.3	7.4	5.8	5.1	5.4	5.8		
Lower middle income countries	5.8	7.4	5.6	4.4	5.5	6.0		
Low-income countries	5.9	6.6	6.0	5.7	5.9	5.9		
Least developed countries	7.2	5.8	3.7	3.7	5.7	5.5	-0.4	0.0
Memorandum items								
World trade[e]	-0.3	13.3	7.0	3.3	4.3	4.9	-0.8	-1.2
World output growth with PPP-based weights	2.3	5.0	3.7	3.0	3.3	4.0	-0.4	-0.7

Source: UN/DESA.

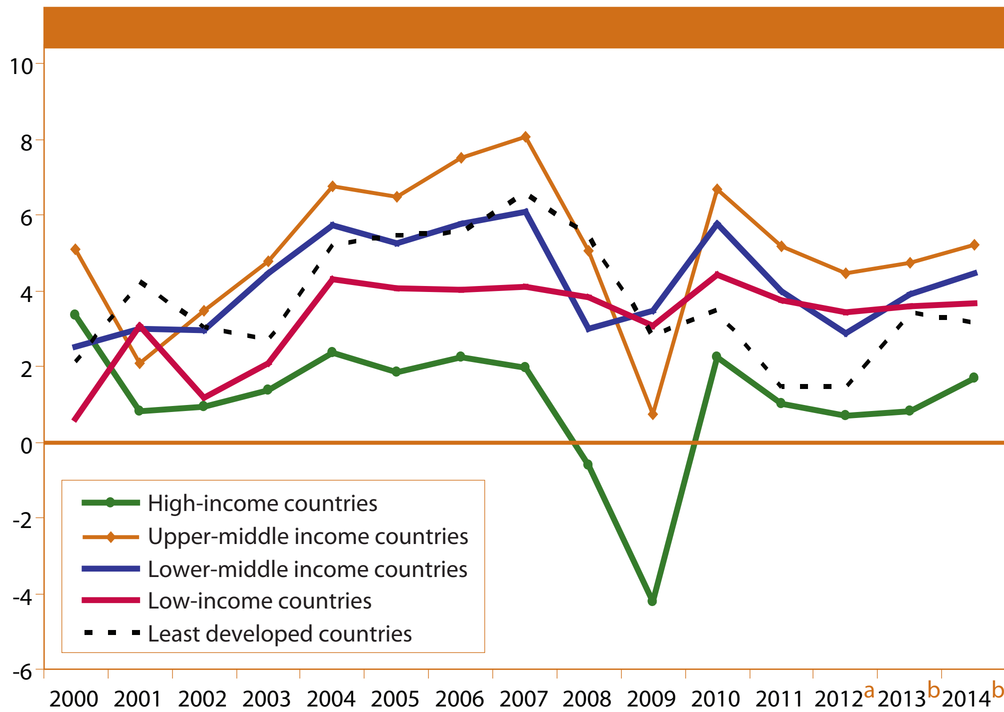
a Average percentage change.
b Actual or most recent estimates.
c Forecast, based in part on Project LINK and baseline projections of the UN/DESA World Economic Forecasting Model.
d See United Nations, *World Economic Situation and Prospects as of mid-2012* (E/2012/72).
e Includes goods and services.

Figure I.1
Growth of world gross product, 2006-2014[a]



Source: UN/DESA.
a Growth rate for 2012 is partially estimated. Estimates for 2013 and 2014 are forecasts. See "Uncertainties and risks" section for a discussion of the downside scenario and box I.3 for a discussion of the policy scenario.

Figure I.2
Growth of GDP per capita by level of development, 2000-2014



Source: UN/DESA.
a Estimates.
b United Nations forecasts.

Box I.1

Major assumptions for the baseline forecast

The forecast presented in the text is based on estimates calculated using the United Nations World Economic Forecasting Model (WEFM) and is informed by country-specific economic outlooks provided by participants in Project LINK, a network of institutions and researchers supported by the Department of Economic and Social Affairs of the United Nations. The provisional individual country forecasts submitted by country experts are adjusted based on harmonized global assumptions and the imposition of global consistency rules (especially for trade flows, measured in both volume and value) set by the WEFM. The main global assumptions are discussed below and form the core of the baseline forecast—the scenario that is assigned the highest probability of occurrence. Alternative scenarios are presented in the sections on "Uncertainties and risks" and "Policy challenges". Those scenarios are normally assigned lower probability than the baseline forecast.

Monetary policy

The Federal Reserve of the United States (Fed) is assumed to keep the federal funds interest rate at the current low level of between 0.00 and 0.25 per cent until mid-2015. It is assumed that the Fed will purchase agency mortgage-backed securities at a pace of $40 billion per month until the end of 2014, and will also continue its programme to extend the average maturity of its securities holdings through the end of 2012, as well as reinvest principal payments from its holdings of agency debt and agency mortgage-backed securities. The European Central Bank (ECB) is assumed to cut the minimum bid and marginal lending facility rates by another 25 basis points, leaving the deposit rate at 0 per cent. It is also assumed that the ECB will start to implement the announced new policy initiative, Outright Monetary Transactions (OMT), to purchase the government bonds of Spain and a few selected members of the euro area. The Bank of Japan (BoJ) will keep the policy interest rate at the current level (0.0-0.1 per cent) and implement the Asset Purchase Program, with a ceiling of ¥91 trillion, as announced. With regard to major emerging economies, the People's Bank of China (PBC) is expected to reduce reserve requirement rates twice in 2013 and reduce interest rates one more time in the same period.

Fiscal policy

In the United States, it is assumed that the 2 per cent payroll tax cut and emergency unemployment insurance benefits are extended for 2013, to be phased out gradually over several years. It is also assumed that the automatic spending cuts now scheduled to begin in January 2013 will be delayed, giving more time for the new Congress and president to produce a package of spending cuts and tax increases effective in 2014. The Bush tax cuts are assumed to be extended for 2013-2014. As a result, real federal government spending on goods and services will fall about 3.0 per cent in 2013 and 2014, after a fall of about 2.5 per cent in the previous two years.

In the euro area, fiscal policy is assumed to be focused on reducing fiscal imbalances. The majority of countries remain subject to the Excessive Deficit Procedure (EDP) under which they must submit plans to bring their fiscal deficits close to balance within a specified time frame. Typically, a minimum correction of 0.5 per cent per annum is expected, and the time frames range from 2012 to 2014. The time periods for achieving these targets will be extended in the most difficult cases. It is also assumed that in the event that tensions increase in sovereign debt markets, affected euro area countries will seek assistance from the rescue fund, thus activating the new OMT programme of the ECB. It is assumed that this will allow increases in bond yields to be contained and that the policy conditionality attached to the use of OMT finance will not entail additional fiscal austerity; rather, Governments requesting funds will be pressed to fully implement already announced fiscal consolidation measures.

In Japan, the newly ratified bill to increase the consumption tax rate from its current level of 5 per cent to 8 per cent by April 2014 and to 10 per cent by October 2015 will be implemented. Real government expenditure, including investment, is assumed to decline by a small proportion in 2013-2014, mainly owing to phasing out of reconstruction spending.

In China, the Government is assumed to maintain a proactive fiscal policy stance, with an increase in public investment spending on infrastructure in 2013.

Box I.1 (cont'd)

Exchange rates among major currencies

It is assumed that during the forecasting period of 2013-2014, the euro will fluctuate about $1.28 per euro. The Japanese yen is assumed to average about ¥80 per United States dollar, and the renminbi will average CNY6.23 per United States dollar.

Oil prices

Oil prices (Brent) are assumed to average about $105 per barrel (pb) in 2013-2014, compared to $110 pb in 2012.

policy initiatives were taken by the euro area authorities in 2012, including the Outright Monetary Transactions (OMT) programme and steps towards greater fiscal integration and coordinated financial supervision and regulation. These measures address some of the deficiencies in the original design of the Economic and Monetary Union (EMU). Significant as they may be, however, these measures are still being counteracted by other policy stances, fiscal austerity in particular, and are not sufficient to break economies out of the vicious circle and restore output and employment growth in the short run (figure I.3b). In the baseline outlook for the euro area, GDP is expected to grow by only 0.3 per cent in 2013 and 1.4 per cent in 2014, a feeble recovery from a decline of 0.5 per cent in 2012. Because of the dynamics of the vicious circle, the risk for a much worse scenario remains high. Economic growth in the new European Union (EU) members also decelerated during 2012, with some, including the Czech Republic, Hungary and Slovenia, falling back into recession. Worsening external conditions are compounded by fiscal austerity measures, aggravating short-term growth prospects. In the outlook, GDP growth in these economies is expected to remain subdued at 2.0 per cent in 2013 and 2.9 per cent in 2014, but risks are high for a much worse performance if the situation in the euro area deteriorates further.

Growth in the United States will slow, with significant downside risks

The United States economy weakened notably during 2012, and growth prospects for 2013 and 2014 remain sluggish. On the up side, the beleaguered housing sector is showing some nascent signs of recovery. Further support is expected from the new round of quantitative easing (QE) recently launched by the United States Federal Reserve (Fed) whereby monetary authorities will continue to purchase mortgage-backed securities until the employment situation improves substantially. On the down side, the lingering uncertainties about the fiscal stance continue to restrain growth of business investment. External demand is also expected to remain weak. In the baseline outlook, gross domestic product (GDP) growth in the United States is forecast to decelerate to 1.7 per cent in 2013 from an already anaemic pace of 2.1 per cent in 2012. Risks remain high for a much bleaker scenario, emanating from the "fiscal cliff" which would entail a drop in aggregate demand of as much as 4 per cent of GDP during 2013 and 2014 (see "Uncertainties and risks" section). Adding to the already sombre scenario are anticipated spillover effects from possible intensification of the euro area crisis, a "hard landing" of the Chinese economy and greater weakening of other major developing economies.

The need for fiscal consolidation will reduce growth in Japan

Economic growth in Japan in 2012 was up from a year ago, mainly driven by reconstruction works and recovery from the earthquake-related disasters of 2011. The Government also took measures to stimulate private consumption. Exports faced strong headwinds from the slowdown in global demand and appreciation of the yen. In the outlook,

Box I.2

Prospects for the least developed countries

The economies of the least developed countries (LDCs) are expected to rebound in 2013. GDP growth is projected to average 5.7 per cent in 2013, up from 3.7 per cent in 2012. However, most of the rebound is expected to come from improvements in economic conditions in Yemen and Sudan, following notable contractions of both economies in the face of political instability during 2010 and 2011.

In per capita terms, GDP growth for LDCs is expected to accelerate from 1.3 per cent in 2012 to 3.3 per cent in 2013. While an improvement, at this rate welfare progress will remain well below the pace of 5.0 per cent per annum experienced during much of the 2000s, prior to the world economic and financial crisis.

Economic performance varies greatly among LDCs, however. Numerous oil exporters such as Angola and Guinea will benefit from continued solid oil prices, propelling GDP growth to more than 7 per cent and 4 per cent, respectively, in 2013. LDCs with a predominant agricultural sector have seen volatile economic conditions. In Gambia, for example, where agriculture provides about one third of total output, poor crop conditions caused GDP to contract by 1.0 per cent in 2012. Much better harvests are expected to propel GDP growth to 6.2 per cent. Such sharp swings in the overall economic performance create multiple problems for policymakers. The inherent uncertainty not only complicates the planning and design of economic policies, especially those of a longer-term nature, but it also threatens the implementation of existing policy plans owing to sudden dramatic changes in economic parameters. In addition, unforeseen crises create needs—in the form of short-term assistance to farmers, for example—which divert scarce financial and institutional resources away from more structurally oriented policy areas. On the other hand, Ethiopia's robust growth of the past few years is expected to come down slightly but remain strong, partly owing to its programme of developing the agricultural sector.

A number of LDCs have also seen solid investment and consumption, supported by sustained inflows of worker remittances. This applies, for example, to Bangladesh, whose growth rate will continue to exceed 6.0 per cent in 2013 and 2014 despite a marked slowdown in external demand. Growth of remittance inflows to Bangladesh picked up to about 20 per cent year on year in the second half of 2012, following a strong rise in overseas employment earlier in the year.

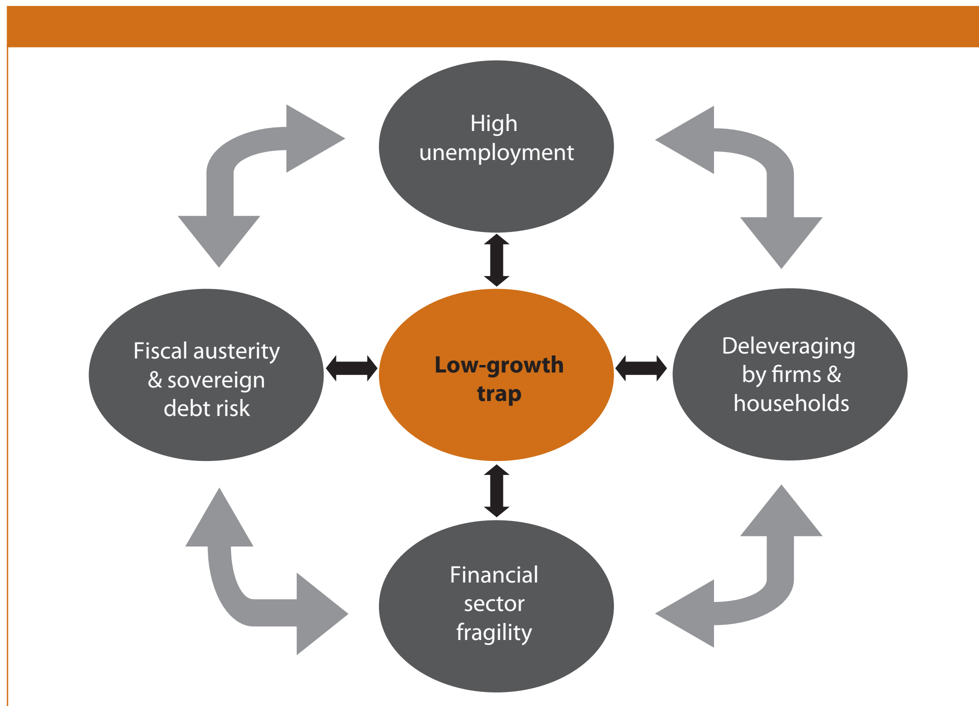
The outlook for LDCs entails several downside risks. A more pronounced deterioration in the global economic environment would negatively affect primary commodity exporters through falling terms of trade, while others may be affected by falling worker remittances. Falling aid flows are expected to limit external financing options for LDCs in the outlook.

Japan's economy is expected to slow given the phasing out of private consumption incentives combined with a new measure increasing taxes on consumption, anticipated reductions in pension benefits, and government spending cuts. These measures responded to concerns about the extremely high level of public indebtedness. The impact of the greater fiscal austerity will be mitigated by reconstruction investments, which will continue but at a slower pace. GDP is forecast to grow at 0.6 per cent in 2013 and 0.8 per cent in 2014, down from 1.5 per cent in 2012.

Spillover effects from developed countries and domestic issues dampen growth in developing countries

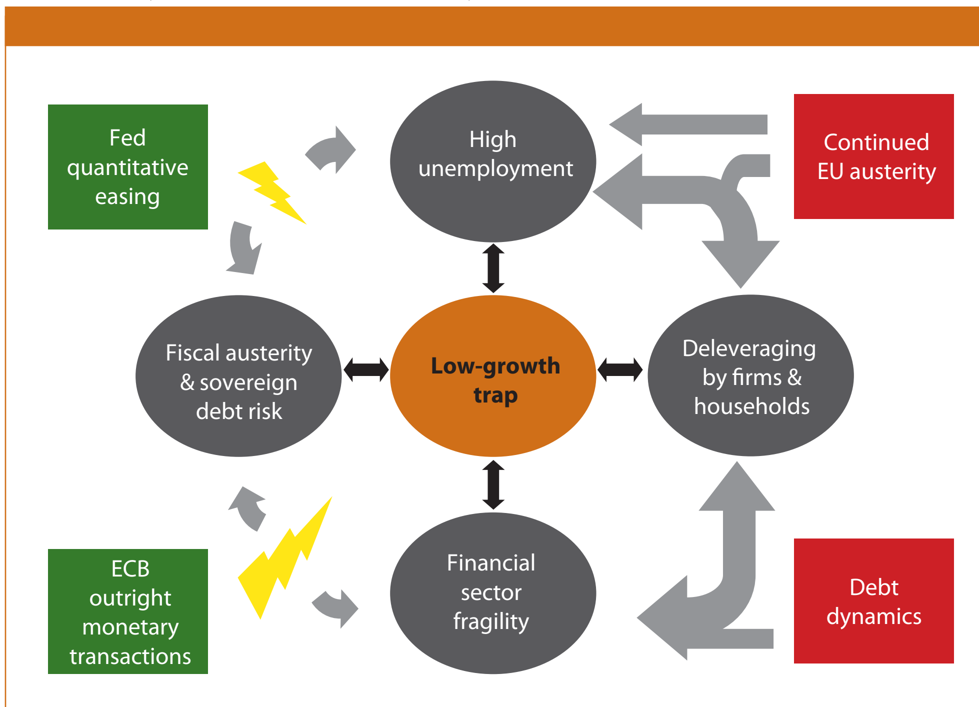
The economic woes of the developed countries are spilling over to developing countries and economies in transition through weaker demand for their exports and heightened volatility in capital flows and commodity prices. Their problems are also home-grown, however; growth in investment spending has slowed significantly, presaging a continued deceleration of future output growth if not counteracted by additional policy

Figure I.3a
The vicious cycle of developed economies



Source: UN/DESA.

Figure I.3b
Feeble policy efforts to break the vicious cycle



Source: UN/DESA.

measures. Several of the major developing economies that have seen fast growth in recent decades are starting to face structural bottlenecks, including financing constraints faced by local governments regarding investment projects in some sectors of the economy, and overinvestment leading to excess production capacity in others, as in the case of China (see "Uncertainties and risks" section).

On average, economies in Africa are forecast to see a slight moderation in output growth in 2013 to 4.8 per cent, down from 5.0 per cent in 2012. Major factors underpinning this continued growth trajectory include the strong performance of oil-exporting countries, continued fiscal spending in infrastructure projects, and expanding economic ties with Asian economies. However, Africa remains plagued by numerous challenges, including armed conflicts in various parts of the region. Growth of income per capita will continue, but at a pace considered insufficient to achieve substantial poverty reduction. Infrastructure shortfalls are among the major obstacles to more dynamic economic development in most economies of the region.

The economies in developing Asia have weakened considerably during 2012 as the region's growth engines, China and India, both shifted into lower gear. While a significant deceleration in exports has been a key factor for the slowdown, the effects of policy tightening in the previous two years also linger. Domestic investment has softened markedly. Both China and India face a number of structural challenges hampering growth (see below). India's space for more policy stimulus seems limited. China and other countries in the region possess greater space for additional stimulus, but thus far have refrained from using it. In the outlook, growth for East Asia is forecast to pick up mildly to 6.2 per cent in 2013, from 5.8 per cent estimated for 2012. GDP growth in South Asia is expected to average 5.0 per cent in 2013, up from 4.4 per cent of 2012, but still well below potential.

Contrasting trends are found in Western Asia. Most oil-exporting countries experienced robust growth supported by record-high oil revenues and government spending. By contrast, economic activity weakened in oil-importing countries, burdened by higher import bills, declining external demand and shrinking policy space. As a result, oil-exporting and oil-importing economies are facing a dual track growth outlook. Meanwhile, social unrest and political instability, notably in the Syrian Arab Republic, continue to elevate the risk assessment for the entire region. On average, GDP growth in the region is expected to decelerate to 3.3 per cent in 2012 and 2013, from 6.7 per cent in 2011.

GDP growth in Latin America and the Caribbean decelerated notably during 2012, led by weaker export demand. In the outlook, subject to the risks of a further downturn, the baseline projection is for a return to moderate economic growth rates, led by stronger economic performance in Brazil. For the region as whole, GDP growth is forecast to average 3.9 per cent in the baseline for 2013, compared to 3.1 per cent in 2012.

Among economies in transition, growth in the economies of the Commonwealth of Independent States (CIS) has continued in 2012, although it moderated in the second half of the year. Firm commodity prices, especially those of oil and natural gas, held up growth among energy-exporting economies, including Kazakhstan and the Russian Federation. In contrast, growth in the Republic of Moldova and Ukraine was adversely affected by the economic crisis in the euro area. The economies of small energy-importing countries in the CIS were supported by private remittances. In the outlook, GDP for the CIS is expected to grow by 3.8 per cent in 2013, the same as in 2012. The prospects for most transition economies in South-Eastern Europe in the short run remain challenging, owing to their close ties with the euro area through trade and finance. In these economies,

GDP growth is expected to average 1.2 per cent in 2013, a mild rebound from the recession of 2012 when economies in the subregion shrank by 0.6 per cent.

Lower greenhouse gas emissions, but far cry from "low-carbon" growth

Helped by weaker global economic growth, greenhouse gases (GHGs) emitted by the Annex I countries to the Kyoto Protocol are estimated to have fallen by about 2 per cent per year during 2011-2012 (see annex table A.22). This reverses the 3 per cent increase in GHG emissions by these countries in 2010. Emissions fell by 6 per cent in 2009 along with the fallout in GDP growth associated with the Great Recession. With the more recent decline, GHG emission reductions among Annex I countries are back on the long-run downward trend. Given the further moderation in global economic growth, emissions by these countries are expected to decline further during 2013-2014.[1] As a group, Annex I countries have already achieved the target of the Kyoto Protocol to reduce emissions by at least 5 per cent from 1990 levels during the 2008-2012 commitment period. Several important individual countries, however, such as the United States and Canada, are still to meet their own national targets. At the same time, GHG emissions in many developing countries are increasing at a rapid pace, such that globally, emissions continue to climb.

The world remains far from achieving its target for CO_2 equivalent concentrations

In all, the world is far from being on track to reduce emissions to the extent considered necessary for keeping carbon dioxide (CO_2) equivalent concentrations to less than 450 parts per million (consistent with the target of stabilizing global warming at a 2°C temperature increase, or less, from pre-industrial levels).[2] To avoid exceeding this limit, GHG emissions would need to drop by 80 per cent by mid-century. Given current trends and even with the extension of the Kyoto Protocol, this is an unachievable target. "Greener" growth pathways need to be created now, and despite large investment costs, they would also provide opportunities for more robust short-term recovery and global rebalancing (see "Policy challenges" and chapter II on the environmental costs of expanding trade through global value chains).

Job crisis continues

Unemployment remains high in developed economies

Unemployment remains elevated in many developed economies, with the situation in Europe being the most challenging. A double-dip recession in several European economies has taken a heavy toll on labour markets. The unemployment rate continued to climb to a record high in the euro area during 2012, up by more than one percentage point from one year ago. Conditions are worse in Spain and Greece, where more than a quarter of the working population is without a job and more than half of the youth is unemployed. Only a few economies

1 Projections are based on past trends in GDP growth and GHG emissions, accounting implicitly for the effects over time of policies aimed at decoupling (see notes to annex table A.22 for a description of the methodology). As far as the longer-term trends are concerned, the impact of more recent energy policy changes may not be adequately reflected.

2 A recent study by PricewaterhouseCoopers notes that "since 2000, the rate of decarbonisation has averaged 0.8% globally, a fraction of the required reduction. From 2010 to 2011, global carbon intensity continued this trend, falling by just 0.7%. Because of this slow start, global carbon intensity now needs to be cut by an average of 5.1% a year from now to 2050…. This rate of reduction has not been achieved in any of the past 50 years". (See PricewaterhouseCoopers LLP, "Too late for two degrees? Low carbon economy index 2012", November 2012, pp. 2-3, available from http://preview.thenewsmarket.com/Previews/PWC/DocumentAssets/261179_v2.pdf).

in the region, such as Austria, Germany, Luxembourg and the Netherlands, register low unemployment rates of about 5 per cent. Unemployment rates in Central and Eastern Europe also edged up slightly in 2012, partly resulting from fiscal austerity. Japan's unemployment rate retreated to below 5 per cent. In the United States, the unemployment rate stayed above 8 per cent for the most part of 2012, but dropped to just below that level from September onwards. However, the labour participation rate is at a record low, while the shares of long-term unemployment reached historic highs of 40.6 per cent (jobless for 6 months or longer) and 31.4 per cent (one year or longer). Long-term unemployment is also severe in the EU and Japan, where four of each ten of the unemployed have been without a job for more than one year. For the group of developed countries as a whole, the incidence of long-term unemployment (over one year) stood at more than 35 per cent by July 2012, affecting about 17 million workers. Such a prolonged duration of unemployment tends to have significant, long-lasting detrimental impacts on both the individuals who have lost their jobs and on the economy as a whole. The skills of unemployed workers deteriorate commensurate with the duration of their unemployment, most likely leading to lower earnings for those individuals who are eventually able to find new jobs. At the aggregate level, the higher the proportion of workers trapped in protracted unemployment, the greater the adverse impact on the productivity of the economy in the medium to long run.

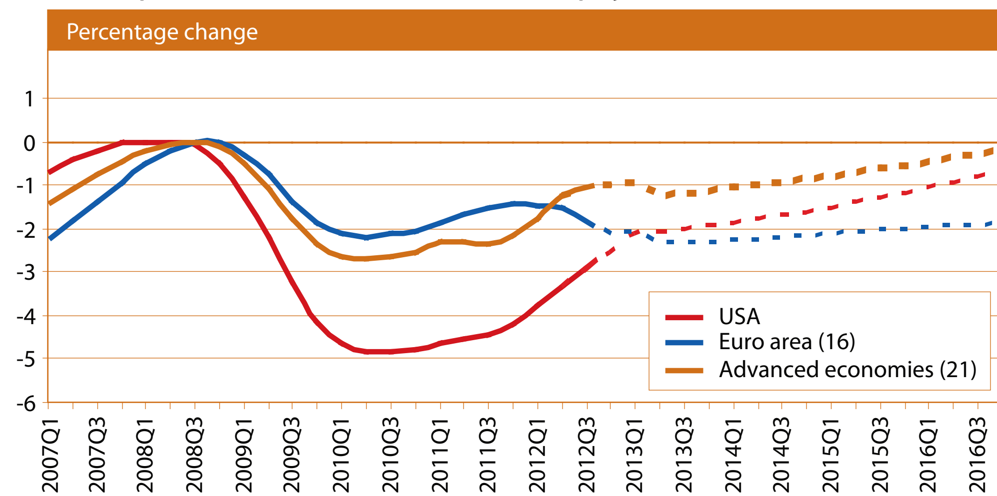
Adequate job creation should be a key policy priority in developed economies. If economic growth stays as anaemic in developed countries as projected in the baseline forecast, employment rates will not return to pre-crisis levels until far beyond 2016 (figure I.4).

The employment situation varies across developing countries

The employment situation varies significantly across developing countries, but

Figure I.4

Post-recession employment recovery in the United States, euro area and developed economies, 2007 (Q1)-2011 (Q2) and projections for 2012 (Q3)-2016 (Q4)



Source: UN/DESA, based on data from ILO and IMF.

Note: The chart shows percentage changes of total employment (as a moving average) with respect to pre-recession peaks. Projections (dashed lines) are based on estimates of the output elasticity of employment (Okun's law), following a similar methodology to that of ILO, *World of Work Report 2011* (Geneva).

the common challenges are to improve the quality of employment and reduce vulnerable employment as well as confront structural unemployment issues such as high youth unemployment and gender disparities in employment—all of which are key social and economic concerns in many developing countries.

Among developing countries, the unemployment rates in most economies in

East Asia and Latin America have already retreated to, or dropped below, levels seen prior to the global financial crisis. The growth moderation in late 2011 and 2012 has so far not led to a discernible rise in the unemployment rate in these two regions—a positive sign, with the caveat that a rise in the unemployment rate would usually lag in an economic downturn. If the growth slowdown continues, the unemployment rate could be expected to increase significantly. In Africa, despite relatively strong GDP growth, the employment situation remains a major problem across the region, both in terms of the level of employment and the quality of jobs that are generated. Labour conflicts also constitute a major downside risk to the economic performance of the region. Gender disparity in employment remains acute in Africa as well as in South Asia. Women are facing unemployment rates at least double those of men in some African countries, and the female labour force participation rate in India and Pakistan is much lower than that of males. Social unrest in North Africa and West Asia has been caused in part by high unemployment, especially among youth. The related disruptions in economic activity, in turn, have further pushed up unemployment rates in some countries. Among economies in transition, the unemployment rate in the Russian Federation declined to a record low of 5.2 per cent in August 2012, partly as a result of increased public spending, but also because of a shrinking active population. Notable job creation has also been recorded in Kazakhstan, but the unemployment rate has increased in Ukraine as a result of tighter fiscal policy and weaker external sector.

Inflation receding worldwide, but still a concern in some developing countries

Inflation remains subdued in most developed economies...

Inflation rates remain subdued in most developed economies. Continuing large output gaps and downward pressure on wages in many countries are keeping inflationary expectations low. Inflation in the United States moderated over 2012, down to about 2 per cent from 3.1 per cent in 2011. A further moderation in headline inflation is expected in the outlook for 2013. In the euro area, headline inflation, as measured by the Harmonized Index of Consumer Prices (HICP), continues to be above the central bank's target of 2 per cent. Core inflation, which does not include price changes in volatile items such as energy, food, alcohol and tobacco, has been much lower at around 1.5 per cent, with no evidence of upward pressures. In the outlook, inflation is expected to drift down slowly. Inflation in the new EU members is also expected to lessen. Deflation continues to prevail in Japan, although the central bank has raised its inflation target to boost inflation expectations.

...and is receding in most developing countries, although still high in some

Inflation receded in a majority of developing countries during 2012, but remains stubbornly high in some. In the outlook, higher oil prices and some country-specific supply-side constraints may continue to put upward pressure on inflation in developing countries in 2013 and into 2014. In Africa, while inflation moderated in many economies, the rate of inflation is still above 10 per cent in Angola, Nigeria and elsewhere. Inflation is expected to remain subdued in most of East Asia, but is still a concern for most countries in South Asia where inflation rates were, on average, over 11 per cent in 2012 and are forecast to remain above or near 10 per cent in 2013 and 2014. Inflation remains low in most economies in West Asia, though it is still high (above 10 per cent) in Yemen and very high (30 per cent) in the Syrian Arab Republic. The inflation rate in Latin America and the Caribbean is expected to stay at about 6 per cent.

Outlook for global commodity and financial markets

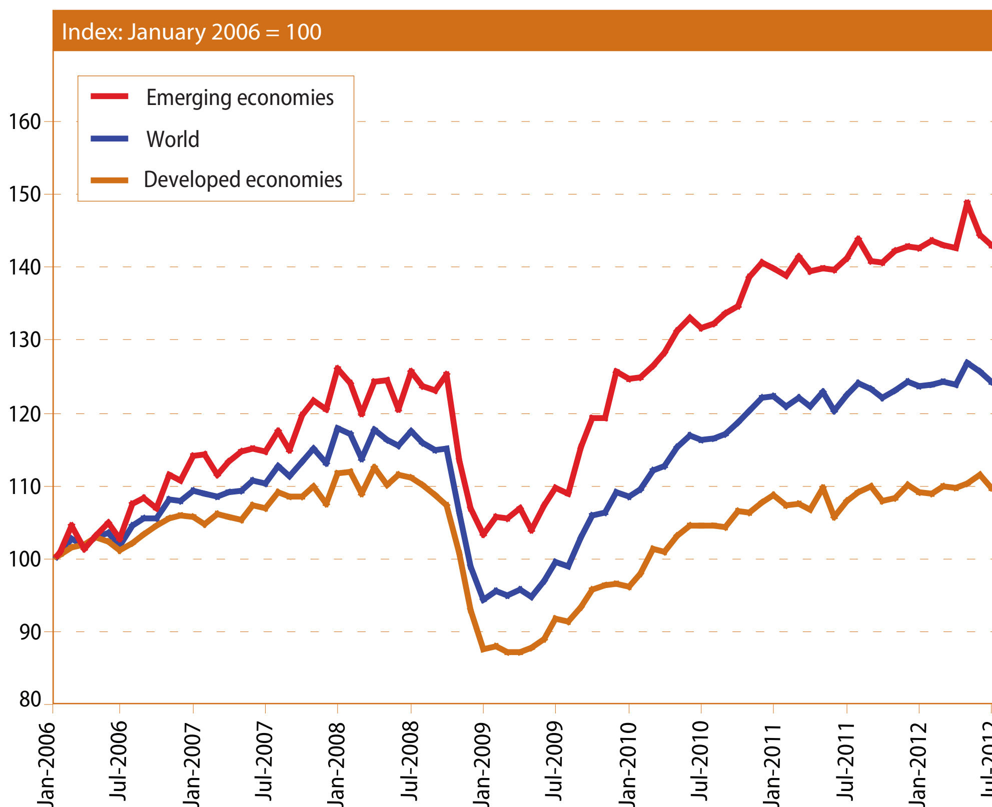
World trade slowed notably during 2012, along with weaker global output. The sovereign debt crisis and economic recession in the euro area and continued financial deleveraging in most developed economies affected capital flows to emerging markets and other developing countries, adding to uncertainty about economic prospects and enhancing market volatility. These factors, combined with spillover effects of expansionary monetary policies in developed economies, have also fueled volatility in primary commodity prices and exchange rates. Global imbalances, characterized by large savings surpluses in some economies and deficits in others, have narrowed markedly in the aftermath of the global financial crisis. However, the rebalancing has hardly been a benign process, having resulted mainly from demand deflation and weaker trade flows.

Sharp slowdown of world trade

Declining import demand in Europe dampened world trade growth in 2012

After plunging by more than 10 per cent in the Great Recession of 2009, world trade rebounded strongly in 2010. Since 2011, the recovery of the volume of world exports has lost momentum (figure I.5). Growth of world trade decelerated sharply during 2012, mainly owing to declining import demand in Europe, as the region entered into its second recession in three years, and anaemic aggregate demand in the United States and Japan. Developing countries and economies in transition have seen demand for their exports weaken as a result.

Figure I.5
World merchandise exports volume, January 2006-August 2012



Source: CPB Netherlands Bureau for Economic Policy Analysis, rebased by UN/DESA.

The monthly trade data of different regions and countries showed a clear sequence of the weakening demand that originated in the euro area transmitting to the rest of the world. Import demand in Greece, Italy, Portugal and Spain started to decline in late 2011 and fell further during 2012, but the weakness in trade activity has spread further to the rest of Europe as well, including France and Germany. In tandem, imports of the United States and Japan also slowed significantly in the second half of 2012. East Asian economies that trade significantly with the major developed countries have experienced commensurate declines in exports. For example, the Republic of Korea, and Taiwan Province of China registered considerable drops in exports during 2012. China's exports also decelerated notably. Further down the global value chain, energy and other primary-exporting economies have seen demand for their exports weaken as well. Brazil and the Russian Federation, for instance, all registered export declines in varying degrees in the second half of 2012. Lower export earnings, compounded by domestic demand constraints have also pushed down GDP growth in many developing countries and economies in transition during 2012. This has led to flagging import demand from these economies, further slowing trade of developed countries.

At the same time, a rise in international protectionism, albeit modest, and the protracted impasse in the world multilateral trade negotiations, have also adversely affected international trade flows.[3] In the outlook for 2013 and 2014, the continued weak global growth outlook and heightened uncertainties lead to expectations that world trade will continue to expand at a rather tepid pace of 4.3 per cent in volume terms in 2013 and 4.9 per cent in 2014, compared to 3.3 per cent in 2012 and 6.8 per cent during 2005-2008.

Oil prices soften but risk premium remains

Oil prices fluctuated in 2012, with weaker demand offsetting geopolitical risks

The price of oil fluctuated during 2012 (figure I.6); weaker global demand tended to push prices down, while heightened geopolitical risks in several oil-producing countries put upward pressure on prices. Global oil demand decelerated somewhat to 0.9 per cent in 2012. Global supply was affected by sanctions imposed by the EU and the United States on Syrian and Iranian oil exports. This was compensated to a large extent, however, by the preventive increase in oil production in Saudi Arabia, the resumption of production in Libya and higher-than-expected output in North America, Latin America and the Russian Federation. Yet, spare capacity dropped to 2.8 million barrels per day (mbd), down from an average of about 4 mbd during 2006-2011.

In the outlook, world oil demand is expected to remain subdued during 2013 and 2014. Supply is expected to further expand in several oil-producing areas, including North America, the Russian Federation and Brazil, partially offset by declines in the North Sea and Central Asia. Saudi Arabia is expected to lower production, thereby increasing spare capacity. Continued geopolitical tensions in the Middle East will likely continue to put a risk premium on prices, however. As a result, Brent oil prices are forecast to decline somewhat and fluctuate around $105 per barrel (pb) in 2013-2014, down from an average of $110 pb in 2012.

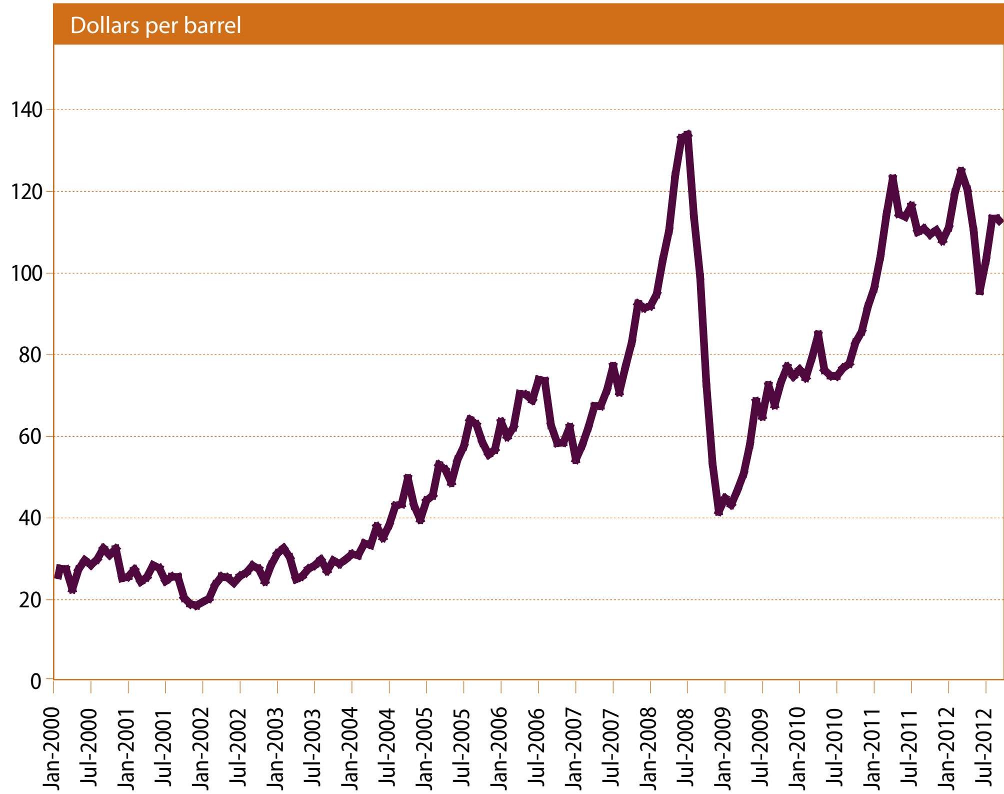
Rising food prices

Food prices increased to a record high, but will moderate in 2013

Despite slowing global demand, food prices jumped to a record high in July 2012 (figure I.7). Global cereal production in 2012 is expected to fall by 2.7 per cent from previous

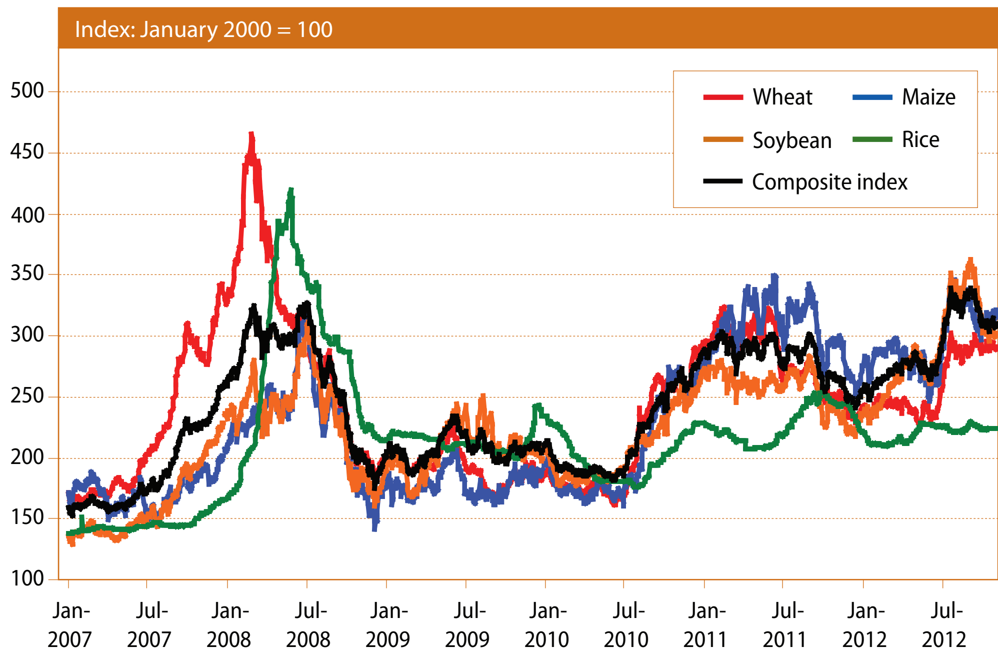
3 See *MDG Gap Task Force Report 2012: The Global Partnership for Development—Making Rhetoric a Reality* (United Nations publication, Sales No. E.12.I.5).

Figure I.6
Brent oil price, January 2000-October 2012



Source: UN/DESA.

Figure I.7
Daily grain prices, January 2007-October 2012



Source: International Grains Council.

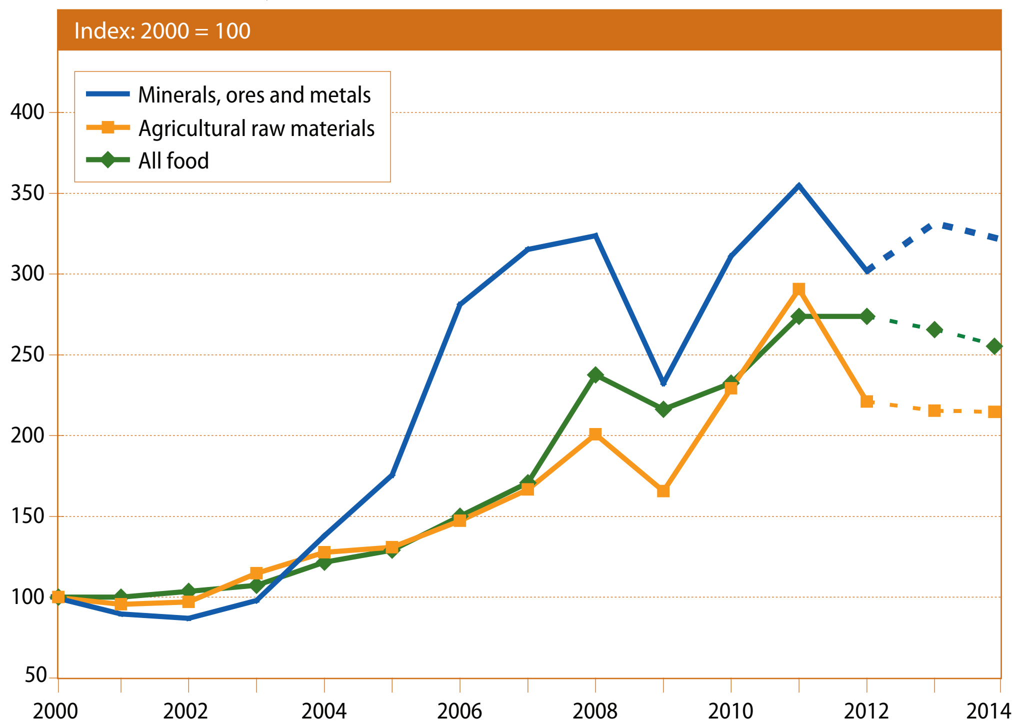
year's record crop. The overall decrease reflects a 5.5 per cent reduction in wheat, and a 2.5 per cent decline in coarse grains, while the global rice crop is seen to grow by 0.7 per cent above last season's record. Severe droughts and poor weather this year in the United States, the Russian Federation, Ukraine and Kazakhstan have been the main cause of the reduced maize and wheat crops. According to the Food and Agricultural Organization (FAO), the decline would also reduce the world cereal stock-to-use ratio from 22.6 per cent in 2012 to 20.6 per cent in 2013, which compares with the low of 19.2 per cent registered in 2007-2008.[4] The situation is not yet considered a threat to global food security, however. In the outlook, food prices will likely moderate somewhat with slowing global demand. However, given that markets are very tight, even relatively minor supply shocks may easily cause new price spikes.

Softening non-food commodity prices

Metal and ore prices will remain weak as a result of subdued demand

The prices of non-oil, non-food commodities started to decline in the second quarter of 2012 as a result of the slowdown in global demand (figure I.8). The appreciation of the United States dollar has also contributed to the weakness in the prices of non-food commodities, as these prices are dollar-denominated. Prices of base metals and ores continued their downward trend until mid-2012, before rebounding somewhat towards the end of the year, mainly influenced by financial factors (see chapter II). Global demand remained weak, while new mining projects implemented over the past decade have increased global supply.

Figure I.8
Non-oil commodity prices, 2000-2014



Source: UN/DESA.

4 Food and Agricultural Organization of the United Nations, "World cereal production in 2012 down 2.7 percent from the 2011 record", FAO Cereal Supply and Demand Brief, 8 November 2012, available from http://www.fao.org/worldfoodsituation/wfs-home/csdb/en/.

The prices of metals and ores are likely to remain weak, as global demand is not expected to pick up quickly during 2013. Market conditions are likely to remain volatile, however. New rounds of monetary easing by major developed economies in a context of continued financial fragility, for instance, would likely induce more speculative financial flows into commodity markets, thereby keeping prices up and bringing more volatility into the market.

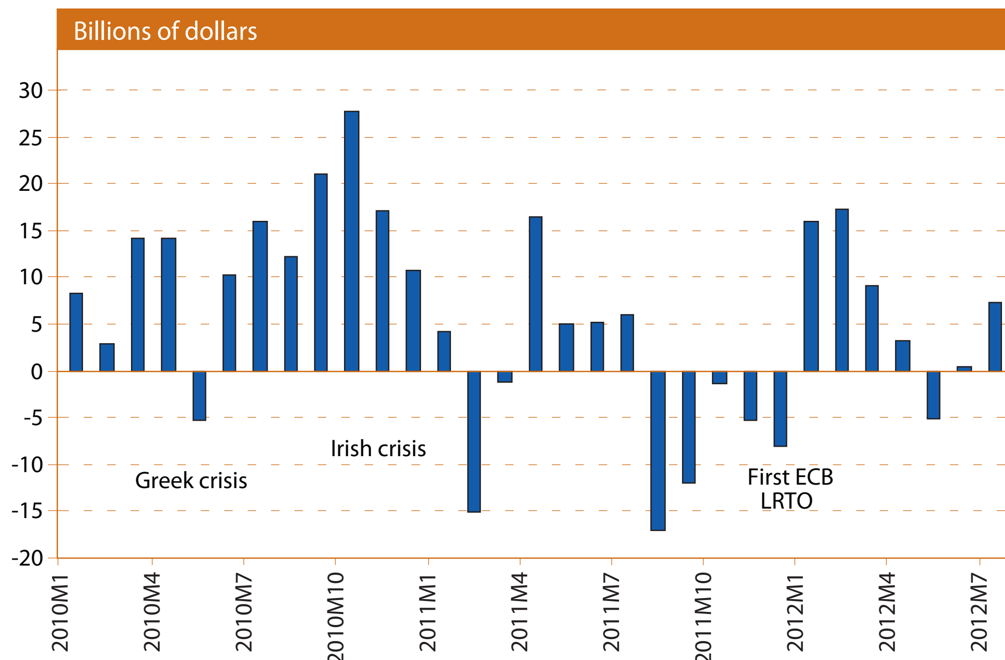
Continued volatility of capital flows to emerging markets

Emerging markets will continue to experience volatile capital flows

Global financial vulnerabilities remain unabatedly high. Bank lending has remained sluggish across developed economies. Financial conditions are likely to remain very fragile over the near term because of the time it will take to implement a solution to the euro area crisis and the shadow being cast over the recovery of the United States economy by the fiscal cliff. Most emerging markets are likely to continue experiencing volatile capital flows as they have over the past few years, strongly influenced by fragility in financial markets and QE policies in developed countries (figure I.9).

For the year 2012, net private capital inflows to emerging markets—that is, selected developing countries and economies in transition—are estimated to reach about $1 trillion, down by about 10 per cent from the previous year.[5] Next to ongoing deleveraging in developed countries, domestic factors specific to emerging market economies added to the downward pressure on net capital inflows in the first half of 2012. Slower growth in China and a few other Asian economies has lowered exchange-rate adjusted rate-of-return expectations of international investors. In North Africa and the Middle East, uncertainties

Figure I.9
Net capital flows to emerging markets



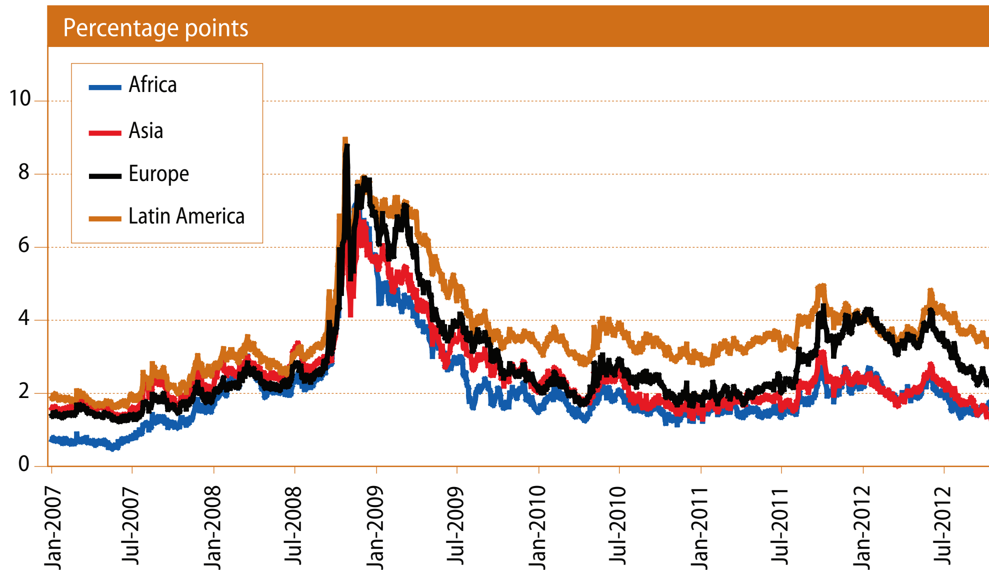
Source: IMF, WEO database, October 2012.

5 Institute of International Finance, "Capital flows to emerging market economies", IIF Research Note, 13 October 2012. Data referring to private capital flows in this section cover about 30 emerging market economies and discuss net capital inflows separate from net outflows. In this sense the data differ from those presented in chapter III, which cover all developing and transition economies and apply the "net net flow" concept, that is net inflows less net outflows.

remain in the wake of political transformations and, in some cases, ongoing conflicts, creating an adverse environment for stronger capital inflows. Several Latin American countries, such as Brazil, have introduced more rigorous capital account regulation to limit short-term capital inflows and mitigate capital-flow and exchange-rate volatility.

The costs of external borrowing financing increased for developing countries and economies in transition when the crisis in the euro area escalated in mid-2012, but have since decreased and remain low in general (figure I.10).

Figure I.10
Daily yield spreads on emerging market bonds, January 2007-October 2012



Source: JPMorgan Chase.

Net private capital inflows to emerging markets are not expected to increase by much on average in 2013, although volatility in markets would persist. New rounds of monetary easing announced by the central banks of developed countries are expected to provide some stabilizing impact on financial markets, which may help reduce risk aversion among investors. In view of the interest rate and growth differentials, investors are expected to retain interests in developing countries. At the same time, however, the continued need for deleveraging the bank system in developed countries keeps the risk of capital reversals high for emerging markets. Furthermore, uncertainties surround future growth prospects for some large developing economies (see "Uncertainties and risks" section), which could temper appetite for foreign investments in emerging markets.

Capital inflows continue to be accompanied by large scale capital outflows from emerging markets

Volatile capital inflows continue to be accompanied by large-scale capital outflows from emerging markets. Emerging market economies invested $1.3 trillion abroad in 2012, mostly associated with further increases in foreign exchange reserve holdings. Even though the degree of reserve accumulation was slightly less than in 2011, it signals continued concerns in emerging and developing country economies regarding world commodity and capital market volatility. While providing buffers against shocks and policy space to mitigate exchange-rate volatility, the massive reserve accumulation is also further weakening global demand.[6]

6 See, for example, the discussion in *World Economic and Social Survey 2010: Retooling Global Development* (United Nations publication, Sales No. E.10.II.C.1), chap V.

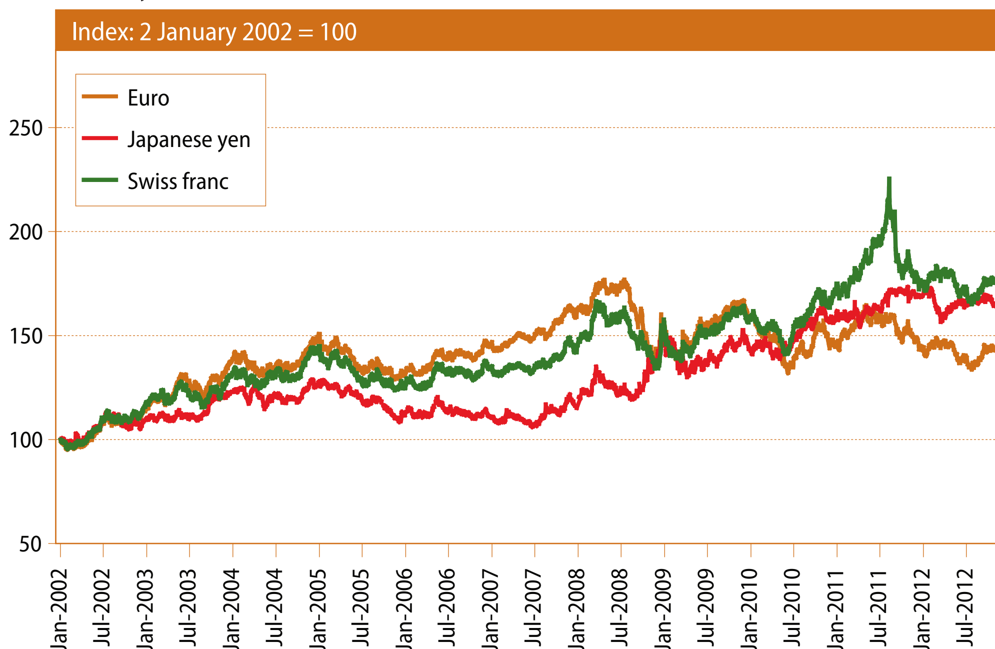
Net ODA flows from member countries of the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) reached $133.5 billion in 2011, up from $128.5 billion in 2010. In real terms, however, this represented a fall of 3 per cent, widening the delivery gap in meeting internationally agreed aid targets to $167 billion.[7] Preliminary results from the OECD survey of donors' forward spending plans indicate that Country Programmable Aid (CPA)—a core subset of aid that includes programmes and projects, which have predicted trends in total aid—is expected to increase by about 6 per cent in 2012, mainly on account of expected increases in outflows of soft loans from multilateral agencies that had benefited from earlier fund replenishments. However, CPA is expected to stagnate from 2013 to 2015, reflecting the delayed impact of the global economic crisis on donor country fiscal budgets.

Continued exchange-rate volatility

Exchange rates between major currencies remained relatively calm in response to QE measures

A large depreciation of the euro vis-à-vis other major currencies was the defining trend in global foreign exchange markets for the first half of 2012 (figure I.11), driven by the escalation of the debt crisis in the euro area. The euro rebounded somewhat in the second half of the year after the European authorities announced some new initiatives, including the OMT programme. The exchange rates between major currencies remained relatively calm in response to announcements of the OMT and further QE by the European Central Bank (ECB) and the Fed. In the outlook, given announced monetary policies in major developed economies and their generally weak growth prospects, it is difficult to ascertain a clear trend in the exchange rates among the major currencies.

Figure I.11
Exchange rates of major currencies vis-à-vis the United States dollar, January 2002-October 2012



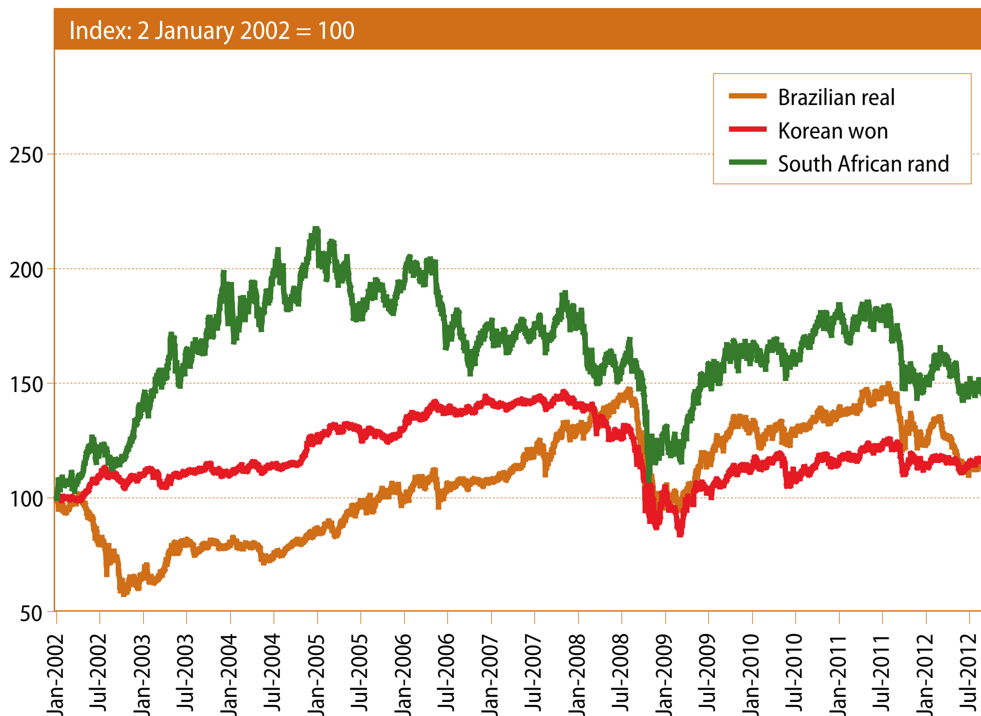
Source: UN/DESA, based on data from JPMorgan Chase.

7 *MDG Gap Task Force Report 2012*, op. cit.

After a precipitous fall in late 2011, the first half of 2012 saw currencies in most developing countries and the economies in transition depreciating further against the United States dollar (figure I.12). This trend was driven by two main factors: the reduction in capital inflows to these countries and the weaker growth prospects for these economies. Since mid-2012, the exchange rates of most of these currencies have stabilized, and some of them started to rebound after the launches of the new QE in major developed countries. In the outlook, continued implementation of the open-ended QE in major developed countries will likely increase the volatility in the exchange rates of the currencies of developing countries and the economies in transition.

Figure I.12

Exchange rates of selected developing country currencies vis-à-vis the United States dollar, January 2002-October 2012



Source: UN/DESA, based on data from JPMorgan Chase.

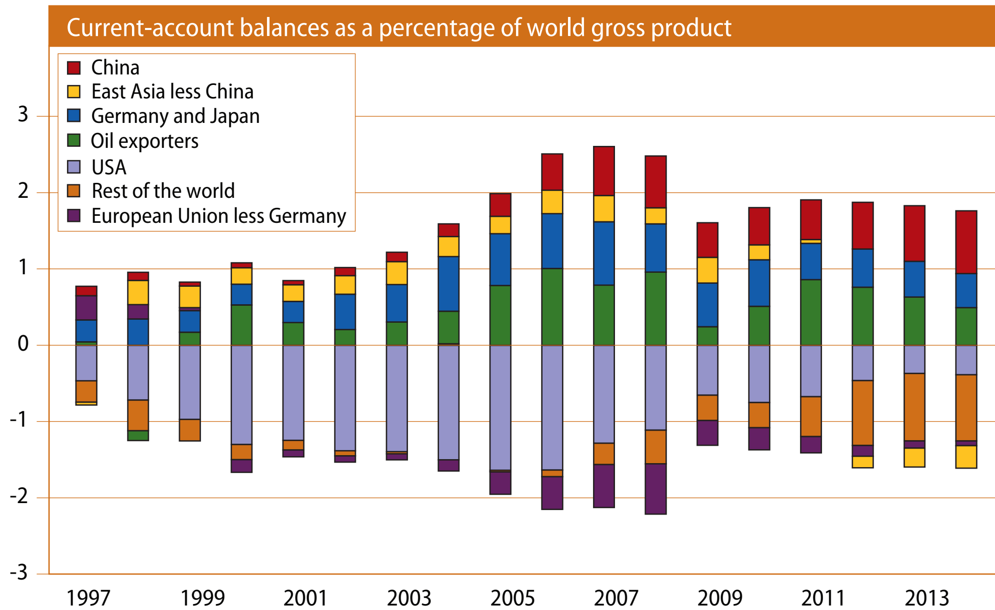
No benign global rebalancing

External imbalances have fallen as a result of overall weakness in global demand

Global imbalances, which refers to the current-account imbalances across major economies, have narrowed significantly in the aftermath of the global crisis. Even if widening slightly during 2012, they remain much smaller than in the years leading up to the crisis (figure I.13). Unfortunately, this trend cannot be seen as a sign of greater global financial stability and more balanced growth. External imbalances have fallen as a result of overall weakness in global demand and the synchronized downturn in international trade rather than through more structural shifts in savings rates and demand patterns.

The United States remained the largest deficit economy, with an estimated external deficit of about $467 billion (3.1 per cent of GDP) in 2012, down substantially

Figure I.13
Global imbalances, 1997-2014



Source: IMF World Economic Outlook database, October 2012 for historical data, and Project LINK for the 2012-2014 forecasts.

from the peak of $800 billion (6 per cent of GDP) registered in 2006. In mirror image, the external surpluses in China, Germany, Japan and a group of fuel-exporting countries have narrowed, albeit to varying degrees. China recorded an estimated surplus of slightly over 2 per cent of GDP in 2012, a sharp decline from a high of 10 per cent of GDP in 2007. Japan is expected to register a surplus of 4 per cent of GDP in 2012, also a significant reduction from its peak level of 5.0 per cent of GDP reached in 2007. While Germany's surplus declined only slightly, remaining above 5 per cent of GDP, the current account for the euro area as a whole turned from a deficit into a surplus of 1 per cent of GDP. Large surpluses relative to GDP are still present in oil-exporting countries, reaching 20 per cent of GDP or more in some of those in Western Asia.

The larger part of the adjustment reflects demand deflation in the global economy. In the United States, following several years of rebounding exports, both export and import demand weakened markedly in 2012. The corresponding narrowing of the saving-investment gap reflects a small decline in the savings rate and significant moderation in investment demand. The household saving rate, which increased from about 2.0 per cent of disposable household income before the financial crisis to about 5.0 per cent in the past few years, has started to fall again to about 3.8 per cent. The investment rate fell from 19.2 per cent in 2007 to 16.4 per cent of GDP in 2012. The government budget deficit dropped from 10.1 per cent of GDP in 2011 to 8.7 per cent in 2012, mainly as a result of further cuts in government spending, not increased government revenue. In the outlook, a further narrowing of the current-account deficit is expected in the United States in 2013 as a result of weakness caused by similar adjustments.

The decline in the external surplus of China was driven by a drop in export growth

In the surplus countries, the decline in the external surplus of China has mainly been driven by a significant drop in the growth of its exports caused by the weaker global economy, rather than a strengthening of imports pushed by domestic rebalancing. Both exports and imports in China decelerated substantially in 2012, even as China's

exchange-rate policy has become more flexible. The Government has stepped up measures aiming to boost household consumption and rebalance the structure of the economy towards greater reliance on domestic demand, but thus far this has not resulted in any visible increase in the share consumption in GDP. The corresponding narrowing of the saving-investment ratio in China came mainly from a notable slowdown in the growth of investment, rather than a reduction in saving brought on by increased consumption.

In Japan, the narrowing of its external surplus has, to some extent, reflected the strengthening of its domestic demand—including increased imports of oil related to reconstruction in the aftermath of the devastating earthquake—but also a significant slowdown in exports.

The surpluses in oil-exporting countries are of quite a different nature as these countries will need to share the wealth generated by the endowment of oil with future generations through a continued accumulation of surpluses in the foreseeable future. Yet, some studies warn of a slowdown in oil exports for the Russian Federation in the medium run.[8]

In the euro area, the current-account deficits of member States in the periphery fell dramatically as a result of fiscal austerity and the severe contraction of private investment and consumption demand. Smaller current-account deficits were accompanied by large financial outflows triggered by panic in the banking sector of debt-distressed countries of the euro area. This reflects a stark reversal of the European economic integration process of past decades, when capital flowed from the core members to the peripheral members. In Germany, room remains for policies to stimulate more domestic demand so as to further narrow its external surplus.

Persistent global imbalances have induced wide imbalances in net asset and liability positions

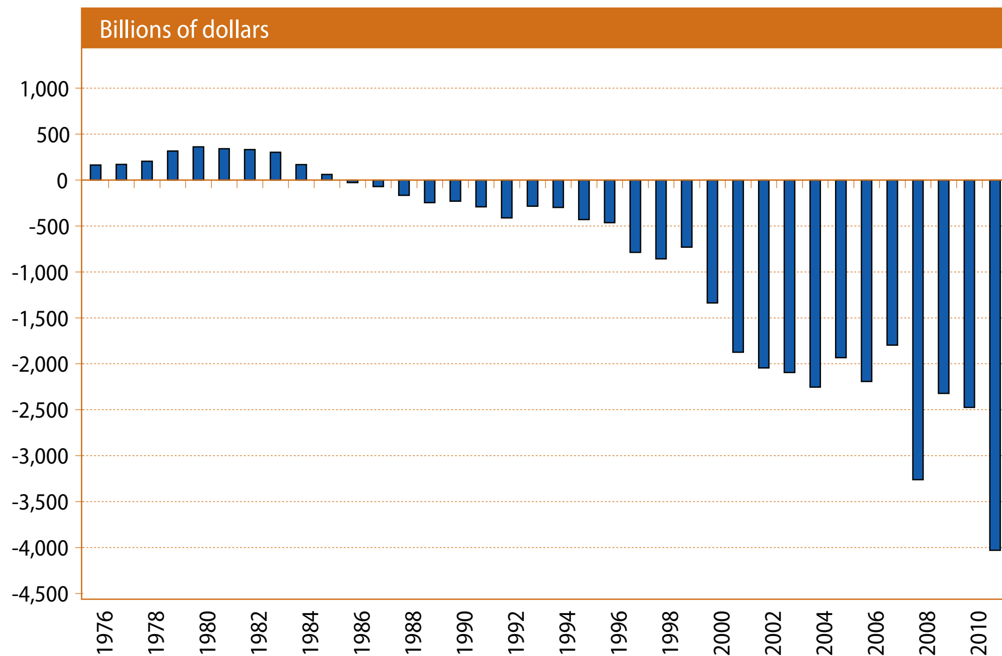
Global imbalances persist, inducing wide imbalances in net asset and liability positions. The latest data show that the net external liability position of the United States widened to a record $4 trillion (more than 25 per cent of GDP) in 2011, a significant increase from $2.5 trillion in the previous year (figure I.14). The foreign assets owned by the United States totalled about $21 trillion by the end of 2011, while assets in the United States owned by the rest of the world totalled about $25 trillion.[9] Given the trends in global financial markets in 2012 and the current-account deficit trends discussed above, the net external liability position of the United States is estimated to have increased further during 2012.

Given current trends, the global imbalances are not expected to widen by a margin significant enough in the coming two years as to become an imminent threat to the stability of the global economy. However, the large net liability position of the United States poses a continued risk to the medium-term stability of exchange rates among major currencies, as investors and monetary authorities holding large dollar-reserve holdings may fear a strong depreciation of the dollar over time and which would accelerate such a process in possible disorderly fashion. Should the global economy fall into another recession, the imbalances could narrow further through demand deflation. It would thus seem

8 See Ernst & Young, "The future of Russian oil exploration: Beyond 2025", available from http://www.ey.com/Publication/vwLUAssets/Perspectives-of-Oil-and-Gas-explorations-2011-EN/$FILE/Perspectives-of-Oil-and-Gas-explorations-2011-EN.pdf.

9 The United States acquisitions of foreign assets increased by about $484 billion during the year, but valuation adjustments lowered the value of foreign assets owned by the United States by $702 billion, mostly from decreases in prices of foreign stocks. On the other hand, foreign acquisitions of the assets in the United States increased by about $1 trillion, and valuation adjustments raised the value of foreign-owned assets in the United States by $353 billion, mostly from price increases of the United States Treasury bonds. In short, the large increase in the net external liability position of the United States during 2011 mainly reflected a substantial change in the valuation of the assets and liability, with net flows accounting for a smaller part.

Figure I.14
Net international investment position in the United States



Source: UN/DESA, based on United States Bureau of Economic Analysis data.
Note: Data for 2009 and 2010 has been revised; data for 2011 is preliminary.

that international policy coordination should not have the rebalancing of current-account positions as its primary focus in the short term, but rather should give priority to concerted efforts to reinvigorate the global recovery, job creation and greater policy coherence to break out of the vicious circles.

Uncertainties and risks

The baseline outlook presented above is subject to major uncertainties and risks, mostly on the downside. The economic crisis in the euro area could continue to worsen and become more disruptive. The United States could fail to avert a fiscal cliff. The slowdown in a number of large developing countries, including China, could well deteriorate further, potentially ending in a "hard landing". Geopolitical tensions in West Asia and elsewhere in the world might spiral out of control. Given dangerously low stock-use ratios of basic grains, world food prices may easily spike with any significant weather shock and take a toll on the more vulnerable and poorest countries in the world. The discussion in this section focuses on the likelihood of the occurrence of the first three of these risks and what impact there would be on the global economy should they materialize.

Risk of a deeper crisis in the euro area

The euro area crisis continues to be the biggest threat to global growth

The crisis in the euro area continues to loom as the largest threat to global growth. The economies in the euro area have been suffering from entanglement in a number of vicious circles. The dangerous dynamics between sovereign debt distress and banking sector fragility are deteriorating the balance sheets of both Governments and commercial banks. The fiscal

austerity responses are exacerbating the economic downturn, inspiring self-defeating efforts at fiscal consolidation and pushing up debt ratios, thereby triggering further budget cuts.

As a result, the region has already fallen into another recession three years after the global Great Recession of 2009, with unemployment rates rising to record highs since the debut of the euro. The situation in Greece remains particularly dire, despite the fact that fears of an imminent exit from the monetary union have eased and Greek government bond yields have subsequently retreated from their peaks following the debt restructuring in early 2012. GDP continues to plunge, however, even after having already fallen by nearly 20 per cent since 2007. Unless the troika of the EU, the ECB and the IMF relax the terms of conditionality on the target and the time span of Greek fiscal adjustment, and also provide more support, the economy will be unable to extricate itself from the present crisis any time soon.

The focus of attention shifted towards Spain in mid-2012. Spain is the fourth largest economy of the euro area, with a GDP twice the size of Greece, Ireland and Portugal combined. The country's borrowing costs surged when the Government asked for international financing to recapitalize the banks in early June 2012. Yields on 10-year sovereign bonds peaked at 7.6 per cent in late July, surpassing the level Greece, Ireland and Portugal faced when they were forced to ask for international assistance to address debt distress. Financial market contagion spread to Italy, which also has seen significant increases in sovereign borrowing costs.

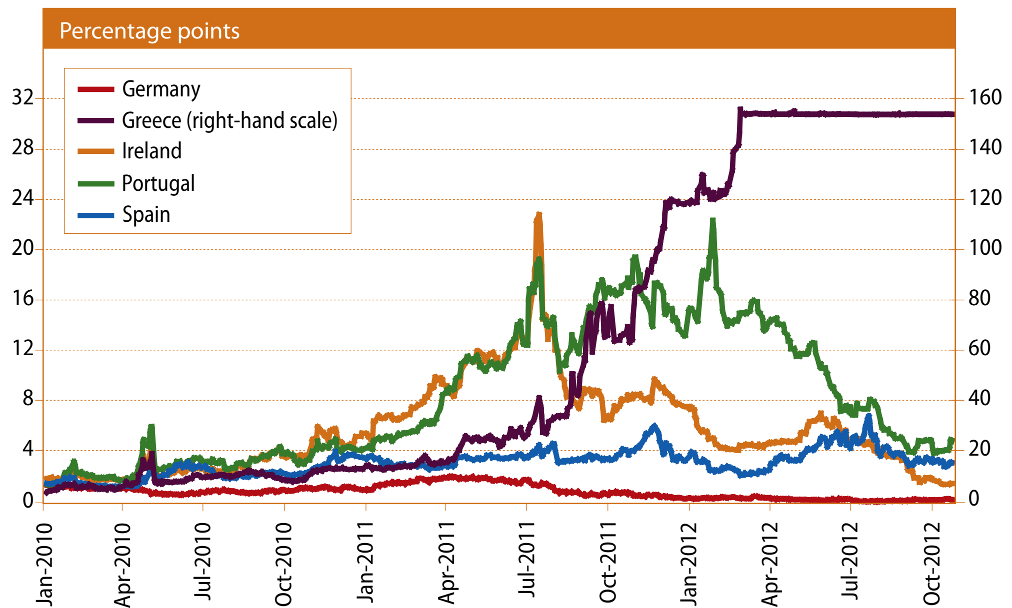
These developments posed heightened systemic risks for the monetary union. In response, the ECB announced a new OMT programme in September through which it can make potentially unlimited purchases of sovereign bonds with a maturity of three years or shorter issued by selected debt-distressed countries. The OMT programme aims to reduce borrowing costs for these countries. However, the ECB can only purchase bonds under the OMT programme if countries have applied for international assistance via both the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), which comes with policy conditionality attached.

After the announcement, sovereign yields of Spain and a few other countries retreated substantially (figure I.15). In late September, Spanish authorities presented a budget that aims to cut the projected 2013 deficit by €40 billion ($51.4 billion). Government spending is to be cut by 8.9 per cent, while public infrastructure spending is to drop from 1.3 per cent to 0.89 per cent of GDP, among other austerity measures. A recent bank stress test showed a capital shortfall of €59.3 billion for Spanish banks. It will be feasible to repair this with the €100 billion in European aid the Spanish Government has already requested for recapitalization of its banks.

The OMT programme of the ECB could significantly reduce debt refinancing costs, but uncertainties remain

The OMT programme initiated by the ECB, if implemented as planned, potentially could significantly reduce debt refinancing costs for Spain and debt-distressed euro area countries. Uncertainties remain, however, on a number of issues unfolding in the future. For example, the agreement made earlier by euro area leaders to directly recapitalize Spanish banks without increasing the country's sovereign debt was considered to be a key initiative to effectively short-circuit the vicious feedback between sovereign debt and bank fragility. Subsequently, however, some euro area member countries have voiced a somewhat different interpretation in that the direct bank recapitalization would work only for banks getting into trouble in the future, not for those being rescued under the current programme for Spain. If this interpretation would hold in practice, Spain's government deficit would be much higher than originally projected and could trigger severe additional fiscal adjustment.

Figure I.15
Yields on two-year government bonds of selected euro area countries, January 2010-October 2012



Source: JPMorgan Chase.

Question remains as to whether Spain actually needs such deep budget cuts. In contrast with Greece, some analysts argue that Spain's woes started in the private sector as the housing bubble burst, drastically reducing government tax revenue and prompting a rescue of banks. Before that, the Government had relatively low debt levels and a modest deficit. From this perspective, fiscal austerity would not address the root cause of the problem in Spain, but only exacerbate the economic downturn and cause more unemployment.

The announced policy initiatives seem to be insufficient to break the downward spiral

In any case, even if the policy initiatives announced to date are implemented as planned, they seem to be insufficient to break the downward spiral many euro area members face in the short run and inadequate to boost a solid growth in the medium run. Given all the uncertainties and risks, a number of researchers have already studied the scenarios and economic ramifications of the possible exit of some euro area members.[10] The pessimistic scenario, discussed further below, does not assume any break-up of the euro area or the exit of any of its members, however. The real implications of such an event are extremely difficult to gauge because of the large amount of financial market uncertainty that would arise and the complex, but as yet unknown, set of institutional rearrangements that would result.

Instead, the downside scenario presented below looks at possibility of a much deeper recession in the euro area than delineated in the baseline. The further downturn

10 Global Insight estimates that an exit of Greece would come with substantial international spillover effects. It estimates that the simulated output loss for the United States could be as much as 2.5 per cent, pushing the economy into recession in 2013. (See IHS Global Insight, "US Executive Summary", November 2012). Oxford Economics ("Central banks take out additional insurance", Global Scenario Service, September 2012) estimates that an exit of Greece in the third quarter of 2013 would lower euro area GDP by 3.5 per cent and WGP would drop 1.3 per cent below the baseline for 2014. In a fuller euro area break-up with Greece, Portugal, Ireland, Spain, Italy, and Cyprus exiting in the first quarter of 2014, Oxford Economics estimates output losses could be as high as 10 per cent and those for the world as a whole would also be commensurately higher.

could be caused by a delayed implementation of the OMT programme and other support measures for those members in need. Delays could occur through political difficulties in reaching agreement between the countries in need of assistance and the troika of EU, ECB and IMF, and/or much larger detrimental effects of the fiscal austerity programmes and more difficulties in structural adjustments than anticipated in the baseline forecast.[11]

Uncertainties about the "fiscal cliff" in the United States

The United States may see major changes in government spending and tax policy at the end of 2012

Unless Congress can reach an agreement to avert it, the United States will face a sharp change in its government spending and tax policy at the end of 2012. Because of the potentially severe implications, it has been coined the "fiscal cliff". The tax cuts endorsed during the Administration of George W. Bush worth $280 billion per year (often referred to as the "Bush tax cuts"), the 2 percentage point payroll tax reduction worth $125 billion, and the emergency unemployment compensation worth $40 billion introduced during the first term of the Obama Administration, were all designed to expire at the end of 2012. More specifically, the expiration of the Bush tax cuts would imply an increase in income tax rates across all income levels by about 5 percentage points in 2013. Among the other changes associated with the expiration of Bush tax cuts are the phasing out of the reduction in the Federal Child Tax Credit and an increase in the maximum tax rate for long-term capital gains by about 5 percentage points. The expiration of the 2-percentage-point reduction in employee payroll taxes would imply a decline in aggregate disposable income by about $125 billion. Moreover, the expiration of emergency unemployment compensation, which was first passed into law in 2008 and has been extended in the past four years, would imply a reduction in consumption spending by about $40 billion.[12] On the expenditure side, automatic budget cuts will be activated, cutting expenditure by $98 billion.[13] Together these actions amount to a downward adjustment in aggregate demand of no less than 4 per cent of GDP.

The risk was still clear and present in the immediate aftermath of the November 6 presidential and congressional elections in the United States. In the worst case, political gridlock would prevent Congress from reaching any agreement, leading to a full-scale drop in government spending by about $98 billion and substantial hikes in taxes amounting to $450 billion in 2013. It is reasonable to assume that after realizing the costs to the economy, policymakers will feel compelled to reach an agreement on reinstating those tax reduction measures and on ceasing the automatic spending cuts in the second half of 2013.

11 More specifically, the scenario of a deeper euro crisis presented in table I.2 below assumes further fiscal tightening in the debt-distressed countries and no use of the OMT programme. As a result, bond yields and borrowing costs increase, while consumer and business confidence drop further, affecting private consumption and investment demand.

12 For more details, see JPMorgan Chase Bank NA, "The US fiscal cliff: an update and a downgrade", Economic Research Note, 18 October 2012, available from https://mm.jpmorgan.com/EmailPubServlet?h=c7s2j110&doc=GPS-965096-0.pdf; and Joseph Brusuelas, "Fiscal cliff", Bloomberg Brief, 25 September 2012, available from http://www.bloombergbriefs.com/files/2012-9-25-Fiscal-Cliff-Special-Issue.pdf.

13 These automatic cuts are specified in the Budget Control Act which was adopted as a result of the failure of the Joint Select Committee on Deficit Reduction (the so-called "Supercommittee") to reach an agreement in 2011 as to how to bring the budget deficit down to sustainable levels over the next ten years.

A hard landing of some large developing economies

Growth slowed noticeably during 2012 in a number of large developing economies, such as Brazil, China and India, which all enjoyed a long period of rapid growth prior to the global financial crisis and managed to recover quickly at a robust pace in 2010. For example, growth in Brazil dropped from a peak of 7.5 per cent in 2010 to an estimated 1.3 per cent in 2012; in China, from 10.4 per cent to 7.7 per cent; and in India, from 8.9 per cent to 5.5 per cent.

Given the uncertainties about their external demand and various domestic growth challenges, risks of further and larger-than-expected declines in the growth of these economies are not trivial. In this section, China is used as an example to illustrate such risks and their implications for these economies and for the rest of the world.

China has seen a slowdown in exports and investment

China's exports continued to slow during 2012, owing to weak demand in major developed economies. For 2012 as whole, real exports for China may register growth of about 5-6 per cent, compared to an average growth of about 20 per cent in the past 10 years. Meanwhile, growth in investment, which contributed to more than 50 per cent of GDP growth in the past decades, has been decelerating. Growth in nominal fixed investment has declined from 25 per cent a year ago to 20 per cent currently. As fixed investment accounts for almost 50 per cent of GDP, this deceleration alone will reduce GDP growth by 2.5 percentage points. Compared with 2009, when China's exports dropped by more than 10 per cent, it appears that the present deceleration in GDP growth comes mainly on account of domestic demand.

The slowdown in investment growth in China has been driven primarily by two factors. First, the Government has adopted policies to control the risk of asset price bubbles in the housing sector, including requirements for larger down payments and limits on the number of housing units people can buy. Real estate investment, which accounts for about 25 per cent of total fixed investment, increased by 15 per cent in the first half of 2012, but the pace of growth was down from 33 per cent recorded a year ago. Acquisition of land for home construction has been declining at an annualized pace of about 20 per cent since the beginning of 2012. Because this is a key source of revenue for local governments in China, their fiscal space has been heavily reduced. Slower real estate investment growth also has considerable damaging effects on supplying industries.

Second, the central Government has become more cautious about fiscal stimulus. Most of the 2009-2010 large-scale fiscal stimulus package, costing about 4 trillion yuan, was used for infrastructure investment and formed an important driver of economic growth in those years. However, after it was phased out in 2011, increasing concerns have been expressed in China over unintended side effects created by the stimulus and vast excess production capacity emerging in some industrial sectors. The Government seems set to put more effort into restructuring the economy, rather than trying to create more aggregate demand stimulus. This is based on the assumption that a rebalancing of the economy through an increase in the share of household consumption in GDP could compensate for a decline in the investment rate and a slowdown in exports. It assumes that with such rebalancing the economy could still grow at a robust pace of 7.5 per cent (which is the official growth target for 2012). However, thus far it has proven difficult to boost consumption in the short run and, moreover, industrial restructuring and future GDP growth would require making substantial new investments today.

Furthermore, local governments have been facing financing constraints in the implementation of new projects. Fixed investment projects managed by local governments account for more than 90 per cent of total fixed investment in value terms. The financing

constraints have emerged because of less revenue from land sales and lack of bank lending as the banks await positive signals from the central Government.

Because of these factors, there are substantial risks for much lower GDP growth in China. The downside scenario presented below assumes a slowdown in growth to about 5 per cent per year, particularly if fixed investment growth decelerates further, subtracting another 5-10 percentage points per year in 2013-2014. Other assumptions for this alternative scenario for the Chinese economy include the central Government maintaining the tightening measures in the housing sector and no fiscal stimulus.

In the downside scenario, it is assumed that growth in China would slow to about 5 per cent

Risk of a double-dip global recession

Table I.2 summarizes the global economic consequences of the three scenarios discussed above, based on simulations using the United Nations World Economic Forecasting Model.

The euro crisis scenario focuses on the relatively high risk of deeper fiscal cuts in the debt-distressed countries. For reasons mentioned above, the much worse case, but, for now, less likely scenario of a break-up of the monetary union is not considered here. More specifically, in this first scenario, Greece, Italy, Portugal and Spain are expected to take further austerity measures in 2013, with deeper cuts than assumed in the baseline. As a result, the estimated output losses in these economies would be between 1 and 2 percentage points in 2013. The deeper recession is assumed to spread to other economies through trade channels and, more importantly, through greater financial uncertainty as confidence in the euro and prospects for recovery erodes further. As a result, the economy of the euro area would shrink by 0.9 per cent compared with the baseline forecast for 2013, thus further deepening the euro area recession that set in throughout 2012. During 2013-2015, the cumulative output loss for the euro area as a whole would amount to 3.3 per cent. The further weakening in the euro area would spill over to the rest of the world and the cumulative loss of global output would amount to 1.1 percentage points. The other developed economies, such as the United States and Japan, would all suffer notable losses. The deepening of the euro crisis would cost developing countries about 0.5 per cent of GDP on average.

A deepening of the euro crisis would cause a loss of global output of more than 9 per cent

In the fiscal cliff scenario, world economic growth would slow to 1.2 per cent in 2013, compared to 2.4 per cent in the baseline. The cumulative output loss between 2013 and 2015 would be 2.5 percentage points. The United States economy would enter into recession and Japan and the EU would also be severely affected, with output losses of about 2 percentage points during 2013-2015. Mexico and Central America would be hardest hit among developing countries, losing about 3.0 percentage points owing to close economic ties with the United States. East Asian economies would see cumulative output losses of about 1.6 percentage points.

The fiscal cliff would have an even larger impact

A hard landing of the Chinese economy, with GDP growth slowing to 5 per cent in 2013, would also have a visible impact on the world economy. China accounts for about 8 per cent of WGP and 10 per cent of world trade. Compared with the baseline forecast, a 3 percentage point deceleration in the pace of growth of the Chinese economy would cause a cumulative global output loss of 1.5 percentage points during 2013-2015.

A hard landing of the Chinese economy would also have a visible impact on the world economy

Given its close economic ties with China, Japan would be most affected, suffering a GDP loss of 1.6 percentage points. GDP of the United States and the EU would drop by 0.7 and 0.6 percentage points, respectively, over 2013-2015 compared with the baseline. Much of their output losses would be caused by lower exports of capital goods to China.

Table I.2
Downside scenarios for the world economy[a]

Percentage deviation from baseline GDP level

	Output loss (-)											
	Deeper euro area crisis			*United States fiscal cliff*			*Hardlanding in China*			*Three scenarios combined*		
	2013	*2014*	*2015*	*2013*	*2014*	*2015*	*2013*	*2014*	*2015*	*2013*	*2014*	*2015*
World	**-0.3**	**-0.7**	**-1.1**	**-1.2**	**-2.1**	**-2.5**	**-0.4**	**-1.0**	**-1.5**	**-2.2**	**-4.3**	**-5.9**
Developed economies	-0.4	-0.9	-1.5	-1.7	-2.7	-3.2	-0.1	-0.4	-0.8	-2.5	-4.7	-6.4
United States of America	-0.1	-0.4	-0.8	-3.8	-5.2	-5.3	-0.1	-0.3	-0.7	-4.1	-6.3	-7.3
Japan	-0.2	-0.4	-0.6	-0.6	-1.2	-2.1	-0.4	-0.9	-1.6	-1.7	-3.5	-5.8
European Union	-0.7	-1.8	-2.7	-0.5	-1.2	-1.9	-0.1	-0.3	-0.6	-1.6	-4.1	-6.5
EU-15	-0.7	-1.8	-2.8	-0.5	-1.2	-2.0	-0.1	-0.3	-0.6	-1.6	-4.2	-6.7
New EU members	-0.6	-1.1	-1.3	-0.2	-0.6	-1.1	-0.1	-0.3	-0.6	-1.4	-2.8	-3.7
Euro area	-0.9	-2.1	-3.3	-0.5	-1.2	-1.8	-0.1	-0.3	-0.6	-1.7	-4.6	-7.3
Other European countries	-0.4	-0.9	-1.2	-0.2	-0.8	-1.4	-0.1	-0.3	-0.7	-1.1	-2.8	-4.2
Other developed economies	-0.1	-0.2	-0.3	-0.6	-1.3	-1.7	-0.1	-0.3	-0.7	-0.8	-2.0	-3.0
Economies in transition	-0.3	-0.5	-0.6	-0.2	-0.5	-0.7	-0.1	-0.3	-0.6	-0.9	-1.8	-2.4
South-Eastern Europe	-0.5	-0.8	-0.9	-0.1	-0.4	-0.7	0.0	-0.2	-0.3	-1.1	-1.9	-2.4
Commonwealth of Independent States and Georgia	-0.3	-0.5	-0.6	-0.2	-0.5	-0.8	-0.1	-0.4	-0.7	-0.9	-1.8	-2.4
Russian Federation	-0.3	-0.5	-0.6	-0.2	-0.5	-0.8	-0.1	-0.4	-0.7	-0.8	-1.8	-2.4
Developing economies	-0.2	-0.3	-0.5	-0.3	-0.9	-1.3	-1.1	-2.3	-3.0	-1.7	-3.7	-5.1
Africa	-0.5	-0.5	-0.6	-0.6	-1.0	-1.0	-0.4	-0.8	-1.1	-1.8	-2.5	-2.9
North Africa	-0.9	-0.8	-0.9	-0.9	-1.2	-1.1	-0.2	-0.4	-0.7	-2.7	-2.9	-3.1
Sub-Saharan Africa	-0.3	-0.3	-0.4	-0.5	-0.9	-0.9	-0.5	-0.9	-1.3	-1.5	-2.3	-2.8
Nigeria	-0.4	-0.5	-0.7	-1.1	-1.8	-1.7	-0.1	-0.4	-0.7	-1.8	-3.0	-3.5
South Africa	-0.3	-0.2	-0.3	-0.3	-0.5	-0.5	-1.1	-1.8	-2.3	-1.9	-2.6	-3.2
Others	-0.3	-0.3	-0.4	-0.4	-0.7	-0.8	-0.2	-0.6	-0.9	-1.1	-1.8	-2.3
East and South Asia	-0.1	-0.3	-0.5	-0.3	-0.9	-1.4	-1.6	-3.3	-4.2	-2.2	-4.8	-6.4
East Asia	-0.2	-0.4	-0.6	-0.3	-1.0	-1.6	-2.0	-3.9	-4.9	-2.6	-5.6	-7.4
China	-0.2	-0.4	-0.7	-0.4	-1.1	-1.8	-3.0	-5.7	-6.8	-3.7	-7.6	-9.6
South Asia	-0.1	-0.2	-0.3	-0.1	-0.4	-0.5	-0.3	-0.8	-1.5	-0.6	-1.5	-2.5
India	-0.1	-0.2	-0.2	-0.1	-0.4	-0.5	-0.1	-0.3	-0.5	-0.4	-0.9	-1.4
Western Asia	-0.1	-0.2	-0.3	-0.2	-0.5	-0.7	-0.1	-0.3	-0.6	-0.6	-1.2	-1.9
Latin America and the Caribbean	-0.2	-0.3	-0.4	-0.5	-1.2	-1.7	-0.4	-0.9	-1.5	-1.0	-2.5	-3.7
South America	-0.1	-0.2	-0.3	-0.2	-0.6	-0.9	-0.4	-1.0	-1.6	-0.8	-2.0	-3.1
Brazil	-0.1	-0.2	-0.3	-0.1	-0.4	-0.7	-0.4	-1.1	-1.7	-0.8	-1.9	-2.9
Mexico and Central America	-0.3	-0.4	-0.6	-1.0	-2.6	-3.2	-0.5	-0.9	-1.4	-1.4	-3.7	-5.2
Mexico	-0.3	-0.4	-0.6	-1.0	-2.7	-3.4	-0.5	-1.0	-1.5	-1.4	-3.9	-5.5
Caribbean	-0.1	-0.2	-0.4	-0.5	-1.2	-1.6	0.0	-0.1	-0.3	-0.7	-1.7	-2.5
Least developed countries	-0.2	-0.3	-0.4	-0.3	-0.6	-0.8	-0.2	-0.5	-0.7	-0.8	-1.6	-2.1

Source: UN/DESA.

a See section on "Uncertainties and risks" for assumptions for these scenarios.

Developing Asia would also feel the consequences through trade channels, especially as it experiences decreased demand for intermediate products in the context of global value chains (see chapter II for further discussion). Economies in Latin America, Africa and Western Asia would be most impacted by lower demand for primary commodities, losing about 1 per cent of their aggregate income.

It is difficult to ascertain the probability of these three risks materializing simultaneously. However, considering the magnitude of the global consequences of each of these events separately, if these events were to occur at the same time, thereby reinforcing each other, the global economy would fall into another Great Recession.

Policy challenges

Current macroeconomic policy stances

Most developed countries have adopted a combination of fiscal austerity and expansionary monetary policies

Weakening economic growth and policy uncertainties cast a shadow over the global economic outlook. As indicated, most developed countries have adopted a combination of fiscal austerity and expansionary monetary policies, aiming to reduce public debt and lower debt refinancing costs in order to break away from the vicious dynamics between sovereign debt and banking sector fragility. These policy measures were expected to calm financial markets and restore consumer and investor confidence. Supported by structural reforms of entitlement programmes, labour markets and business regulation, the improved environment is expected to help restore economic growth and reduce unemployment. However, reducing debt stocks is proving to be much more challenging than policymakers expected. Public debt rollover requirements remain very high and continue to expose fiscal balances to the whims of financial markets. Helped by the QE policies of central banks, borrowing costs have been contained and are elevated only for a subset of debt-distressed euro area countries. While the QE programmes have helped lower long-term interest rates, their impact on economic growth will be rather limited at this stage of the recovery.

An additional problem is that fiscal consolidation efforts of most developed countries rely more on spending retrenchment than improving revenue collection. The former tends to be more detrimental to economic growth in the short run, particularly when the economy is in a downward cycle.[14] In many developed countries, public investment is being cut more severely than any other item, which may also prove costly to medium-term growth. In most cases, spending cuts also involve entitlement reforms, which immediately weaken automatic stabilizers in the short run by curtailing pension benefits, shortening the length of unemployment benefit schemes and/or shifting more of the burden of healthcare costs to households. Moreover, the fiscal austerity measures have been found to induce greater inequality in the short run.[15] The impact tends to be stronger when unemployment effects are higher, when there is no compensation for the cost of entitlement reform to lower- and middle-income groups, and when revenue increases are pursued through increases in sales or value-added tax rates. Rising inequality by itself tends to weaken the recovery, as lower-income groups tend to have higher spending pro-

14 See *World Economic Situation and Prospects 2012* (United Nations publication, Sales No. E.12.II.C.2), box I.3.

15 International Monetary Fund, *Fiscal Monitor: Taking stock—A progress report on fiscal adjustment* (Washington, D.C., October 2012).

pensities. The distributional impact of spending and revenue measures thus should be a concern to macroeconomic policymakers. In short, downside risks for developed countries remain extremely high, because the present policy stances are, on balance, not supportive of growth and job creation, and thus fail to definitively break out of the vicious circle.

Most developing countries and economies in transition have relatively stronger fiscal positions. Some have opted to put fiscal consolidation on hold in the face of global economic weakening. Fiscal deficits may rise in most low-income countries that have slowing government revenue from commodity exports and the growing weight of food and energy subsidies. Concerns are also mounting in developing countries about the possible adverse effects of QE on the financial and macroeconomic stability of their economies through increased volatility in international prices of commodities, capital flows and exchange rates. Such concerns underlie the further accumulation of reserves and justify maintaining capital controls. Facing a slowdown in growth and inflation, central banks in many developing countries and economies in transition have eased monetary policy during 2012. In the outlook, further monetary easing will be likely in many of these countries, except for those with persistently high inflation, such as South Asia and Africa.

The need for more forceful and concerted actions

Given the looming uncertainties and downside risks discussed in the previous section, current policy stances seem to fall well short of what is needed to prevent the global economy from slipping into another recession. More forceful and concerted actions should be considered.

Policy uncertainties should be addressed immediately and a different approach must be taken

First, the policy uncertainties associated with the three key risks discussed in the downward scenario need to be addressed immediately through shifts in approach and greater consideration of international spillover effects of national policies. In the euro area, the piecemeal approach to dealing with the debt crises of individual countries of the past two years should be replaced by a more comprehensive and integrated approach, so as to address the systemic crisis of the monetary union and mitigate the key risks for the stability of the global economy. While individual countries may still need to confront issues in their domestic economic structures and institutions, crucial collective efforts are needed to close the institutional gaps and mend the pervasive deficiencies of the EMU, including through laying solid foundations for fiscal and banking unions. Although important steps in this direction are being taken or considered, the present state of affairs requires much swifter and more forceful action. Only when concrete actions are taken that will restore confidence in the union can other more technical policy measures be put in place to deal with such issues as how to resolve debt overhang and how to break the linkage between sovereign risk and bank fragility. Policymakers in the United States should prevent a sudden and severe contraction in fiscal policy—the so-called fiscal cliff—and overcome the political gridlock that was still present at the end of 2012. As holds for the EU, the global ramifications of failing to do so should be considered. It is only feasible to work out the current debt problems over the long run, and a fiscal consolidation plan will be credible only when rooted in an explicit strategy of economic growth and jobs creation. The major developing countries facing the risk of hard landings of their economies should engage in stronger countercyclical policy stances aligned with measures to address structural problems over the medium term. China, for instance, possesses ample policy space for a much stronger push to rebalance its economy towards domestic demand, including through increased government spending on public services such as health care, education and

social security—all of which will help lower precautionary household savings and increase consumption, thus reducing dependence on external demand.

Fiscal policy should become more countercyclical, more supportive of jobs creation and more equitable

Second, more specifically, fiscal policy should become more countercyclical, more supportive of jobs creation and more equitable. The present focus on fiscal consolidation in the short run, especially among developed countries, has proven to be counterproductive and to cause more protracted debt adjustment. The focus needs to shift in a number of different directions:

- As a starting point, a first priority of fiscal adjustment should be to provide more direct support to output and employment growth by boosting aggregate demand and, at the same time, spread out plans for achieving fiscal sustainability over the medium-to-long term. Introducing cyclically adjusted or structural budget targets will allow for keeping a countercyclical stance while aiming for fiscal sustainability over the medium term.
- Fiscal multipliers tend to be more forceful during a downturn, but can be strengthened further by shifting budget priorities to growth-enhancing spending, undoing cuts in public investment and expanding subsidies on hiring (which may be targeted towards new labour entrants and the long unemployed) as well as enhancing public work programmes and employment schemes. On the tax side, reducing taxes on labour and changing tax codes to reduce labour income tax wedges for youth, women, and older workers are options that provide short-term boosts to employment as well as labour supply.
- The distributional consequences of fiscal policies should be duly considered, not only for equity reasons, but also because of their implications for growth and employment generation. As indicated, rising inequality tends to have a dampening effect on aggregate demand and hence on economic growth. Shifting spending priorities to enhance employment effects will help avoid such an outcome, as much as would maintaining an adequate degree of progressivity in taxation and access to social benefits. Many middle- and low-income countries may wish to reconsider across-the-board subsidies on food and fuel; these tend to come with a heavy fiscal cost, while the benefits may accrue most to higher-income groups. Better targeting would provide more effective income protection to the poor at potentially much lower fiscal cost.
- Economic recovery can be strengthened in the short and longer run by promoting green growth through fiscal incentives and investments in infrastructure and new technologies. Lessons can be learned from several developing countries, such as the Republic of Korea, which have successfully provided economic stimulus through green infrastructure investment and energy-saving incentives. This has been found to generate strong employment effects, suggesting that investing in green growth can be a win-win solution. Moreover, these measures are imperative to substantially accelerating reductions in greenhouse gas emissions—an essential step in combating climate change. Developing countries also stand to gain, provided they obtain technological and financial support to adopt the still higher-cost clean energy technologies without jeopardizing economic development prospects.

Global financial market instability needs to be attacked at its root causes

Third, global financial market instability needs to be attacked at its roots. This challenge is twofold. First, greater synergy must be found between monetary and fiscal stimulus. Continuation of expansionary monetary policies among developed countries

will be needed, but negative spillover effects into capital-flow and exchange-rate volatility must be contained. This will require reaching agreement at the international level on the magnitude, speed and timing of QE policies within a broader framework of targets to redress the global imbalances. The second part of the challenge is to accelerate regulatory reforms of the financial sector. This will be essential in order to avoid the systemic risks and excessive risk-taking that have led to the low-growth trap and financial fragility in developed countries and high capital flow volatility for developing countries. Steps have been proposed in some national jurisdictions, but implementation is lagging behind. Moreover, insufficient coordination between national bodies appears to result in a regulatory patchwork. Global financial stability is unlikely to be achieved in the absence of a comprehensive, binding and internationally coordinated framework. This is needed to limit regulatory arbitrage, which includes shifting high-risk activities from more to less strictly regulated environments. Among other measures, such a framework should include strict limits on positions that financial investors can take in commodity futures and derivatives markets—measures that may also help stem volatility in capital flows and commodity prices.

Sufficient resources need to be made available to developing countries

Fourth, sufficient resources must be 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. Fiscal austerity among donor countries has also affected aid budgets, as seen in the decline of ODA in real terms in 2011. Further declines may be expected in the outlook. 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. In this regard, internationally agreed taxes (such as airline levies, currency transaction taxes or carbon taxes), along with the possibility of leveraging idle special drawing rights (SDRs) for development finance could be considered, as suggested in a recent United Nations report.[16]

A jobs creation and green growth-oriented agenda as outlined above is compatible with medium-term reduction of public debt ratios and benign global rebalancing, as shown in a scenario of internationally concerted policies simulated using the United Nations Global Policy Model (GPM).[17] With continued existing policies, but assuming no major deepening of the euro crisis, growth of WGP would average, at best, about 3 per cent per year on average, far from sufficient to deal with the jobs crisis or bring down public debt ratios. The alternative scenario, based on the agenda outlined above, includes a shift in fiscal policies away from austerity and towards more job creation through, inter alia, more spending on infrastructure; energy efficiency, social programmes and tax and subsidy measures to stimulate private investment projects in these areas; continued expansionary monetary policies aligned with stronger capital account regulation to stem capital flow volatility; and enhanced development assistance to the poorest nations. The GPM simulations show that under such a policy scenario, WGP would grow at an average rate of 4.5 per cent between 2013 and 2017, public debt-to-GDP ratios would stabilize and

16 *World Economic and Social Survey 2012: In Search of New Development Finance* (United Nations publication, Sales No. E.12.II.C.1).

17 The scenario is an update of the ones presented in *World Economic Situation and Prospects 2012*, op. cit., pp. 33-36; and United Nations Economic and Social Council, "World economic situation and prospects as of mid-2012 (E/2012/72).

start falling from 2016 or earlier. Employment levels in major developed countries would gradually increase and return to pre-crises levels in absolute terms by 2014 and by 2017 after accounting for labour force growth. The employment recovery thus would come much sooner than in the baseline, although remaining protracted even with the suggested internationally concerted strategy for growth and jobs. An additional 33 million jobs per year on average would be created in developing and transition economies between 2013 and 2017 (see box I.3).

Box I.3

An internationally coordinated strategy for jobs and growth

An alternative policy scenario based on the recommendations in this chapter has been created using the United Nations Global Policy Model (GPM). The key finding is that such a scenario would avoid a widespread double-dip recession; instead, it would allow for a benign rebalancing of the global economy. Job losses caused by the global financial crisis would see recovery and a shift towards more sustainable fiscal balances and debt levels would begin, setting the global economy on a more sustained (and sustainable) path to growth.

The key differences with the baseline policy assumptions are that:

- Policies, especially those in developed economies, shift away from premature fiscal austerity and towards a more countercyclical stance, thereby supporting aggregate demand in the short run. This is done cautiously, however. Public spending is allowed to grow, but more slowly than GDP. As tax revenues grow in response to overall income growth, budget deficits narrow and debt-to-GDP ratios decline over time.
- In all countries, Governments enhance public spending on social and physical infrastructure and public investment as well as expanding fiscal incentives for private investors promoting "green" growth (including through greater energy efficiency and clean energy generation). This also applies to developing countries where most additional public spending is directed to infrastructure investment, including capacity in sustainable agriculture and renewable energy. Green growth investments are generally perceived to have greater job creation effects than existing "brown" technologies. This is also assumed to be the case in the GPM.
- Industrial policy incentives implemented by developing countries are assumed to be supportive of economic diversification and reduced dependence on commodity exports.
- Central banks and other financial regulators in developed countries further step up action to prevent soaring interest rates on sovereign bonds and accelerate regulatory action that reduces bank fragility and helps commercial lending to grow again.
- The policy scenario further assumes that these national policies are part of an internationally concerted strategy. Policy coordination would ensure that there is sufficient aggregate fiscal stimulus in the short run, while differentiating stimulus across countries in accordance with available fiscal and other macroeconomic policy space (based on initial levels of indebtedness, sovereign borrowing costs and size of external surplus). Furthermore, it is assumed that monetary policy action is better coordinated internationally to prevent the strategy underlying the alternative scenario from being disrupted by excessive exchange-rate and capital flow volatility. Through concerted efforts, developing countries (low-income countries, in particular), are provided with adequate access to official development assistance and other external financing to complement domestic resources for financing new investments in infrastructure and sustainable energy and agriculture.

Box I.3 (cont'd)

Under these assumptions, growth of world gross product would accelerate to about 4.5 per cent per year, with both developed and developing economies accelerating output growth by between 1 and 2 percentage points compared with the baseline (see figures A and B). Shortly after the new policies are in place, the jobs deficit caused by the global financial crisis of 2008-2009 would start to close, especially in the developed countries. Employment levels in major developed countries would gradually increase and return to pre-crisis levels in absolute terms by 2014, and by 2017 after accounting for labour force growth. The employment recovery would thus come much sooner than in the baseline, although it would remain protracted, even with the suggested internationally concerted strategy for growth and jobs. An additional 33 million jobs per year on average would be created in developing and transition economies between 2013 and 2017.

The simulation also shows that more rapid recovery of growth and employment helps to stabilize public debts. After an initial increase, government deficits would quickly decrease, stabilizing public debt ratios in the medium term and reducing them thereafter (see Appendix table). As countries with an external surplus apply more fiscal stimulus, private investment and consumption would increase, leading to higher imports and a reduction of global current account imbalances. With investments targeting higher energy efficiency and production of renewable energy, world energy prices would stabilize on lower levels over the medium run. Meanwhile, investment in sustainable agricultural production would allow meeting a growing demand for food and stabilize world food prices.

Source: UN/DESA Global Policy Model (http://www.un.org/esa/policy/publications/ungpm.html).

Figure A: **Employment levels of selected countries or country groups**

Index: 2008=100

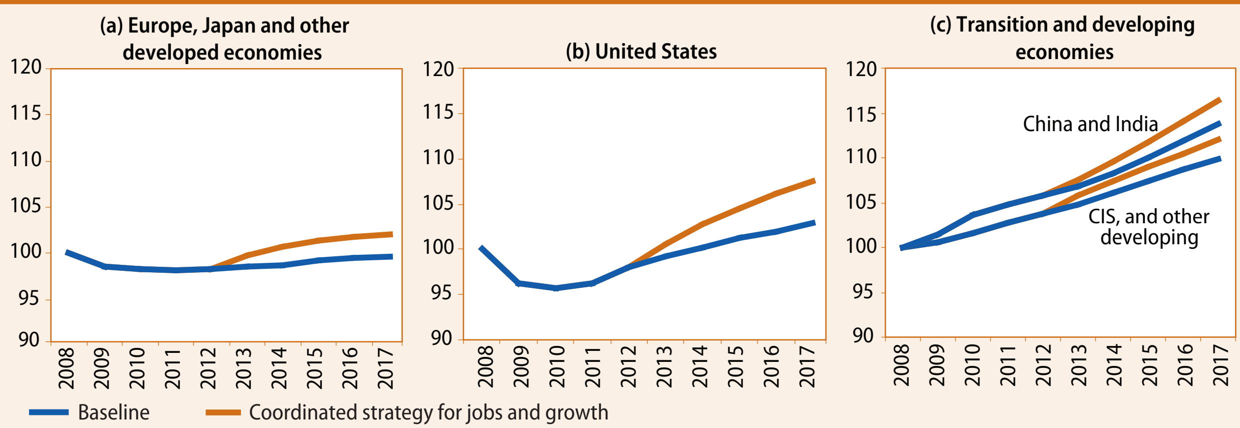
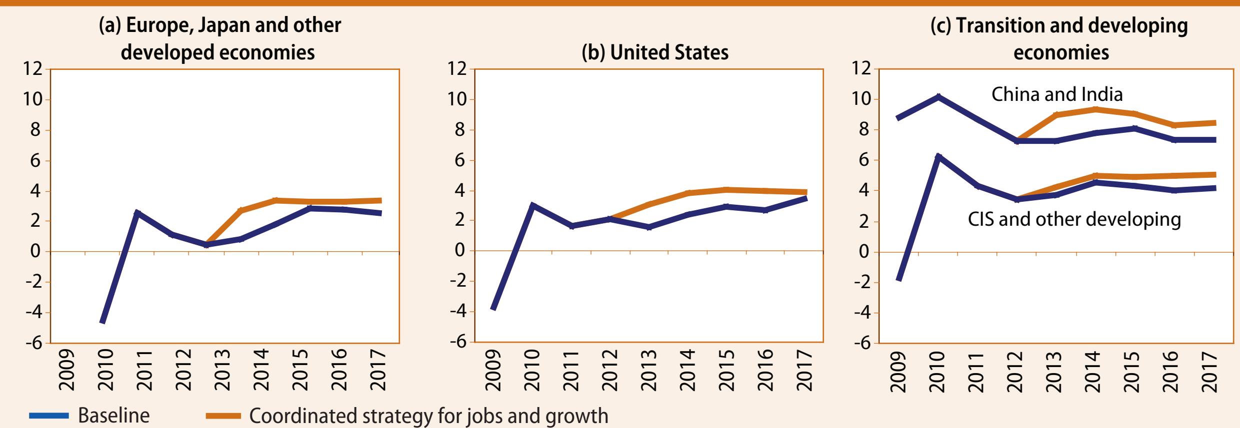


Figure B: **GDP growth rates of selected countries or country groups**

Percentage



Appendix

An internationally coordinated strategy for jobs and growth, 2012-2017

	2012	*2013*	*2014*	*2015*	*2016*	*2017*
GDP Growth (percentage)						
United States	2.1	3.1	3.8	4.0	4.0	3.9
Europe	-0.2	2.9	3.8	3.7	3.6	3.7
Japan and other developed countries	2.0	2.4	2.5	2.5	2.6	2.7
China and India	7.3	9.0	9.3	9.0	8.3	8.5
CIS and Western Asia (major oil exporters)	3.7	3.3	3.6	3.5	3.7	3.8
Other developing countries	3.3	4.7	5.6	5.5	5.5	5.6
Employment created above the baseline (millions)						
United States	0.0	2.1	3.8	5.0	6.3	5.7
Europe	0.0	3.0	4.9	5.1	5.2	4.8
Japan and other developed countries	0.0	1.1	1.7	2.0	2.4	2.6
China and India	0.0	11.3	15.0	18.3	21.7	10.8
CIS and Western Asia (major oil exporters)	0.0	2.3	3.9	5.4	6.8	6.5
Other developing countries	0.0	7.9	13.2	17.7	21.7	2.5
Growth of government spending (constant prices, percentage per annum)						
United States	-2.4	-0.7	2.1	4.2	4.2	3.5
Europe	-1.6	1.6	1.6	0.7	0.9	1.6
Japan and other developed countries	0.9	1.7	2.2	-0.6	2.6	2.9
China and India	8.5	9.0	8.9	8.9	8.9	8.9
CIS and Western Asia (major oil exporters)	4.0	4.9	4.8	4.7	4.7	4.6
Other developing countries	4.8	6.8	6.8	6.8	6.7	6.7
Growth of private investment (constant prices, percentage per annum)						
United States	5.2	11.2	11.6	10.5	10.0	6.3
Europe	-0.7	4.0	7.2	6.4	5.8	6.8
Japan and other developed countries	2.6	4.6	3.3	3.1	3.4	2.8
China and India	5.3	8.6	8.1	7.6	5.6	5.4
CIS and Western Asia (major oil exporters)	8.5	3.5	3.2	1.8	3.9	3.8
Other developing countries	4.7	5.0	6.4	6.9	7.6	7.8
Net government financial surplus (percentage of GDP)						
United States	-11.0	-8.5	-6.9	-6.0	-5.4	-4.9
Europe	-7.2	-6.0	-4.9	-3.8	-2.9	-2.3
Japan and other developed countries	-7.9	-7.1	-6.6	-5.5	-5.3	-5.1
China and India	-3.3	-2.5	-1.8	-1.3	-1.2	-1.2
CIS and Western Asia (major oil exporters)	0.1	-0.1	-0.2	-0.1	-0.1	-0.1
Other developing countries	-3.1	-2.4	-1.7	-1.3	-1.0	-0.8
Net private sector financial surplus (percentage of GDP)						
United States	8.5	5.7	3.8	2.5	1.6	0.8
Europe	8.3	7.5	6.6	5.5	4.6	3.9
Japan and other developed countries	7.1	6.5	6.3	5.7	5.7	6.0
China and India	4.0	2.8	2.2	1.9	2.3	2.5
CIS and Western Asia (major oil exporters)	5.4	4.8	3.9	3.5	2.9	2.6
Other developing countries	2.4	2.0	1.5	1.3	1.1	1.0

Appendix (cont'd)

	2012	*2013*	*2014*	*2015*	*2016*	*2017*
Current account deficit (percentage of GDP)						
United States	-2.6	-2.9	-3.1	-3.5	-3.9	-4.1
Europe	1.1	1.5	1.7	1.7	1.7	1.7
Japan and other developed countries	-0.8	-0.6	-0.2	0.1	0.5	0.8
China and India	0.6	0.3	0.4	0.6	1.1	1.4
CIS and Western Asia (major oil exporters)	5.4	4.8	3.7	3.4	2.8	2.4
Other developing countries	-0.7	-0.4	-0.2	0.0	0.1	0.2
Government debt (percentage of GDP)						
United States	76.4	75.9	73.6	70.6	67.0	63.1
Europe	74.5	73.6	72.1	70.5	67.4	64.9
Japan and other developed countries	138.3	136.0	133.0	129.7	127.0	125.1
China and India	23.8	22.5	20.1	18.0	17.3	16.9
CIS and Western Asia (major oil exporters)	40.5	42.8	45.5	47.4	49.1	50.2
Other developing countries	36.6	36.6	36.3	36.0	35.9	35.9
***Memo*:**						
Growth of Gross World Product at market rate (percentage)	2.3	3.8	4.5	4.5	4.5	4.6
Growth of Gross World Product at ppp rate (percentage)	3.1	4.6	5.2	5.2	5.1	5.2
Global creation of employment above baseline (millions)	0.0	27.8	42.6	53.6	64.1	32.9
Average employment creation in developing countries above baseline (millions)	0.0	21.5	32.2	41.4	50.3	19.8
Growth of exports of good and services (percentage)	3.2	5.9	5.6	6.0	5.0	5.0
Real world price of energy (index)	1.4	1.5	1.4	1.5	1.5	1.5
Real world price of food & primary commodities (index)	1.2	1.2	1.3	1.3	1.4	1.4
Real world price of manufactures (index)	1.0	1.0	1.0	1.0	1.0	1.0

Source: UN/DESA Global Policy Model, available from http://www.un.org/en/development/desa/policy/publications/un_gpm.shtml.