ECONOMIC AND SOCIAL COUNCIL HIGH-LEVEL SEGMENT

Global Policy Dialogue

"World Economic Situation and Prospects 2011"

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Global macroeconomic trends

The world economy continues to recover from the global economic crisis, but the pace remains uneven across countries.

Output growth is feeble in many developed economies. At the present pace of output growth, it would take another four or five years before employment is back at pre-crisis levels in developed countries. Despite some progress in rebuilding balance sheets in the financial sector, the banking sectors of the major developed countries still look vulnerable to multiple risks from continued weak housing markets, sovereign debt stress, and continued overall economic weakness. In addition, fiscal policies are shifting towards austerity in response to heightened concerns about the sustainability of public debt levels, but weakening growth prospects in the short run.

Developing countries and economies in transition, in contrast, have contributed significantly to the post-crisis expansion of the world economy. The strong recovery continues to be led by the large emerging economies in Asia and Latin America, particularly China, India and Brazil. However, also in these economies the growth outlook is challenged by rising inflation, emerging domestic asset price bubbles, rapid capital inflows and related upward pressure on their exchange rates.

New headwinds have also emerged in 2011. The earthquake, tsunami and nuclear crisis in Japan also shook world financial markets and have led to disruption in important global supply chains. While these effects on the global economy may be shortlived, uncertainties remain, particularly those associated with the leakage of radioactivity at a Japanese nuclear power plant.

Primary commodity prices have surged during the first four months of 2011; much more forcefully than anticipated in WESP 2011. The surge was driven in part by the political unrest in Western Asia and North Africa, which – inter alia – led to a disruption to oil production in the Libyan Arab Jamahiriya.

Food prices also soared in early 2011. Nonetheless, prices of major grains, such as rice and wheat, are still substantially below their peaks of 2008. Global food demand has remained strong, especially in developing countries, but also demand for biofuel feedstock increased along with higher oil prices. Food supply growth fell short, being affected by a number of weather-related shocks. A weaker United States dollar bolstered the upward trend in world market prices.

Worldwide, the higher energy and food prices have pushed up headline inflation. In most economies, however, core inflation, which excludes food and energy prices, has so far remained low, although it has been creeping up somewhat.

The labour market situation has generally improved, but continues to be a reason for concern. Unemployment rates in developed economies have fallen in an increasing number of countries, with output recovery translating to jobs creation with a considerable time lag. Employment levels generally have returned to above pre-crisis levels in developing countries, especially to East Asia. Aggregate numbers mask the major employment challenges which many countries are still facing. In West Asia, for example, employment opportunities for young workers continue to be dire and this has been a factor in the recent political uprisings.

World trade of goods and services expanded by almost 12 per cent in 2010, more than previously estimated, representing a strong rebound after the steep decline by 11 per cent in 2009. By the end of 2010, the volume of world merchandise exports had fully recovered to the pre-crisis peak, although it remained markedly below its long-term trend. In the outlook, growth of world trade is expected to moderate to around 7 per cent in 2011 and 2012.

Net private capital inflows to emerging economies continued to recover from their precipitous decline during the global financial crisis of 2008-2009. In the outlook for the rest of 2011 and 2012, higher output growth and rates of return will continue to attract more capital flows to emerging economies. The ratio of capital inflows to GDP of these economies stands at about 4 per cent, only about half of its peak level.

At the same time, the increase in capital flows to emerging markets has varied implications and several countries are not benefiting from capital inflows. While attracted by good economic performance, policy makers in emerging markets have become increasingly concerned with uneven impact of large capital inflows in the form of appreciating currencies and inflation of asset bubbles. In response, Governments of many emerging economies are intervening in their currency markets and are trying to dampen capital flow volatility through a variety of capital control measures.

The dollar has continued its downward trend against other major currencies (figure 2). Despite the lingering risks associated with the sovereign debt levels in some European economies, the euro appreciated against the dollar in the first quarter of 2011, partly buttressed by the expectation of faster monetary tightening in the euro area. This trend is expected to continue until late 2011, when the United States Federal Reserve (Fed) may raise its interest rates. The dollar/euro exchange rate is assumed to be 1.38 in 2011 and 1.28 in 2012. The yen has fluctuated around a high of about 82 yen/dollar since late 2010, but the earthquake in March triggered extraordinary volatility for the exchange rate until a joint intervention of the Finance ministers of the Group of Seven (G7) mitigated the situation.

Risks and uncertainties

Fiscal austerity and sovereign debt stress in developed economies

Major concerns remain over the still rising trend in public indebtedness in developed economies. The average public debt ratio for developed economies has already surpassed 100 per cent of GDP in 2011. Such concerns have already triggered further downgrading of the sovereign debt ratings of several developed economies, including Greece, Ireland, Japan, Portugal and Spain. As indicated, one rating agency recently also presented a negative outlook for the debt burden of the United States.

In response to these concerns and in attempts to anchor expectations of low long-term interest rates, many developed economies have already committed to fiscal consolidation.

If the commitment to fiscal consolidation is not credible enough to bring public debt down, interest rates in financial markets may increase anyway, heightening the risk of default. On the other hand, if austerity measures are too drastic and come too soon given the stage of the recovery, economic growth and employment could suffer and the still fragile banking sector could weaken further.

Financial sectors in developed economies remain vulnerable

Given the large-scale government bailout programmes over the past two years, risks in the private financial sector, particularly the banking sector, have been transferred to the public sector. Nevertheless, the banking sector in major developed economies remains vulnerable, which also exposes their economic recovery to a significant downside risk. For example, many banks in Europe will face increasing pressure to ensure funding for the rollover of their debts in the second quarter of 2011. The increased interdependence between the balance sheets of banks and Governments exacerbates the risks regarding sovereign debt as well as the vulnerability of the banking system. In the United States, a protracted slide in housing prices and a large number of foreclosures continue to put pressure on the broader financial system.

Risks associated with a further surge in commodity prices

In the baseline outlook, the prices of oil and other primary commodities will moderate in the second half of 2011 and 2012. However, the risk lies in an aggravation of the supply shocks, for example stemming from the situation in Western Asia and North Africa. This would push commodity prices even higher and reduce global economic growth compared to the baseline forecast.

Global imbalances and the risk of a collapse of the dollar

The global imbalances narrowed as a result of the collapse in world trade and the aggregate demand compression. With the recovery they have started to widen again, albeit moderately. In the near-term outlook, the global imbalances should not be expected to return to the levels observed prior to the global financial crisis. However, even if the global imbalances do not edge up significantly in the near term, the underlying adjustment in stocks of international asset and liability positions would continue to move in a risky direction. The most recent wave of the dollar devaluation has also been driven by other factors, including interest rate differentials between the United States and other economies, and the growing concern about the sustainability of the public debt of the United States, 50 per cent of which is being held by foreigners. Measured by the exchange rate index of the dollar vis-à-vis a basket of other major currencies, the dollar has reached the lowest level since the 1970s. The depreciation of the dollar against the currencies of many emerging economies has also been significant. As a result, further (expected) loss of the book value of the massive foreign reserve holdings could trigger a confidence crisis in the reserve currency, which would put the entire global financial system at risk.

Policy challenges

Dealing with these risks and uncertainties poses serious policy challenges to Governments and international organizations across the globe. Macroeconomic policies in most developed countries have shifted during 2010 and early 2011 towards a combination of monetary accommodation and fiscal austerity, while many developing countries have shifted to monetary tightening accompanied with relatively accommodative fiscal stances. In the outlook for the rest of 2011 and for 2012, more and more countries are expected to further unwind both monetary and fiscal support measures. Challenges differ across countries, warranting different policy stances, but as indicated present national policy stances are far from satisfactory to address the risks to the global economy and may well exacerbate these.

In order to make the global economic recovery more robust, balanced and sustainable, the five policy directions discussed at some length in the *World Economic Situation and Prospects 2011* still apply.

First, developed countries in particular should be cautious not to embark prematurely in fiscal austerity policies given the still fragile state of the recovery and prevailing high levels of unemployment. Several still possess ample fiscal space for additional stimulus in the short run. For many developing countries the challenge is to avoid that rising food and commodity prices and exchange rate appreciation caused by surging capital inflows will not erode growth and lead their economies into another boom-bust cycle.

Second, at the same time, fiscal policy needs to be redesigned to strengthen its impact on employment and aid in the transition towards promoting structural change for more sustainable economic growth over the medium and long run.

Third, find greater synergy between fiscal and monetary stimulus, while counteracting damaging international spillover effects in the form of increased currency tensions and volatile short-term capital flows. This will require stronger bilateral and multilateral surveillance, including through more thorough assessment of spillover effects and systemic risks. The G-20 and the International Monetary and Financial Committee of the IMF have made efforts, but accelerated progress needs to be made to come to an operational framework.

Fourth, related to the previous point, find ways to make macroeconomic policy coordination among major economies more credible and effective. In this regard, the G-20 framework for strong, balanced and sustainable global growth is a sound initiative, but efforts are needed to make it more specific and operational. Having clear and verifiable targets for desired policy outcomes would help make parties accountable, while the possible loss of reputation through non-compliance would be an incentive to live up to policy agreements.

Last, ensure that sufficient resources are made available to developing countries, especially those possessing limited fiscal space and facing large development needs. These resources will be needed, in particular, to accelerate progress towards the achievement of the MDGs and for investments in sustainable and resilient growth, especially for the LDCs. 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.

Suggested key questions:

1. **What are the effective measures, at both international and national levels, to stabilize volatility in the international prices of oil and foods, to enhance food security and energy security for developing countries, particularly, for the poor?**
2. **What are the systematic and effective approaches to the management of cross country capital flows, which could allow receipt countries, particularly developing countries to achieve the benefits of foreign capital flows while at the same time to minimize the instability associated with the flows? What are the prospects for discussing a global financial transaction tax?**
3. **Given the diverging needs in individual countries for different macroeconomic policy stance according to their stage of the economic recovery from the global financial crisis, how to improve the international policy coordination and build greater resilience? How should the nations overcome the obstacles to a successful outcome of the Doha Round?**
4. **How should the United Nations be more involved in the debate on the reform of the international financial system and global economic governance?**
5. **What are the ways to advance the sustainable development agenda, especially in light of the 2012 United Nations Conference on Sustainable Development (UNCSD) focusing on building green economies and creating an institutional framework for sustainable development?**