

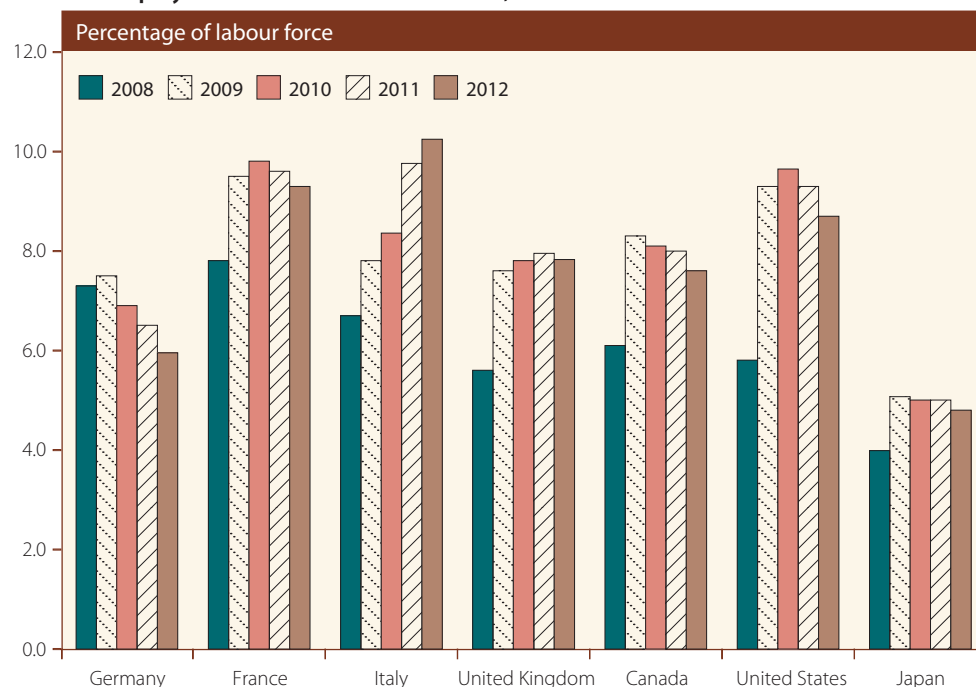
Chapter IV

Regional developments and outlook

Developed market economies

Developed market economies recovered from recession during 2010, posting generally strong growth in the first half of the year. The recovery has slowed since, however, as global trade has decelerated, fiscal stimuli are replaced by austerity-based fiscal consolidation, and inventory restocking is coming to an end. Trade and industrial production have rebounded, but levels of both remain below their previous cyclical peaks and will take some time to reach them, given the deceleration in activity under way. Tentative signs of a recovery maturing to where consumption and investment spending take the leading roles has been seen in some instances. But domestic demand growth generally remains sluggish and is expected to be slow in recovery: balance sheets of firms and consumers are still not repaired, bank lending conditions remain tight, capacity utilization—while improved—remains low, and unemployment is still very high (see figure IV.1). A new push for fiscal stimuli is unlikely and, in fact, many developed countries have already taken steps towards drastic budgetary retrenchment. Monetary policy remains highly accommodative, but may not provide much of a boost to output and employment growth, and may exacerbate tensions in foreign-exchange markets, as discussed in chapter I. The value of the United States dollar has seen wide swings against other major currencies during 2010.

Figure IV.1
Unemployment rates^a in the G7 countries, 2008–2012



Source: UN/DESA and Project LINK, based on data from the OECD Main Economic Indicators.

^a Standardized unemployment rates (see OECD, *Standardized Unemployment Rates: Sources and Methods* (Paris, 1985)).

North America: decelerating recovery

Weakening growth in the United States

Economic growth resumed in the third quarter of 2009 in the United States of America. Initially, the speed of the expansion was comparable to that observed during previous recoveries. However, by mid-2010, the rate of growth of gross domestic product (GDP) had decelerated to about 2 per cent (annualized rate), with other indicators also pointing to more subdued growth in the rest of the year. The GDP growth rate is estimated to be 2.6 per cent in 2010, decelerating to 2.2 per cent in 2011 as inventory restocking as a driver of recovery is coming to an end and fiscal stimuli are waning. Private consumption and investment demand may pick up gradually, allowing for the projected acceleration of GDP growth to 2.8 per cent in 2012 (see annex table A.1).

Consumption and investment have yet to make an impact

During 2009 and 2010, inventory restocking contributed about 60 per cent to total growth. Rebounding consumer demand started to contribute only later on in the recovery. Government consumption and investment demand have only marginally contributed to growth over the past two years. While certainly helping to prevent a steeper downturn, the impact of federal Government stimulus measures has been diluted by spending cuts and tax increases at state and local levels made necessary by the tremendous drops in revenues stemming from the recession. Investment in residential and business construction has been too weak to support output growth, and in the early stages of the recovery, still detracted from it. Only business investment in equipment and software has shown solid growth. The collapse in import demand mitigated the decline in GDP during the height of the recession, but net exports have weakened aggregate demand during the recovery as imports have increased faster than exports.

Unemployment remains high

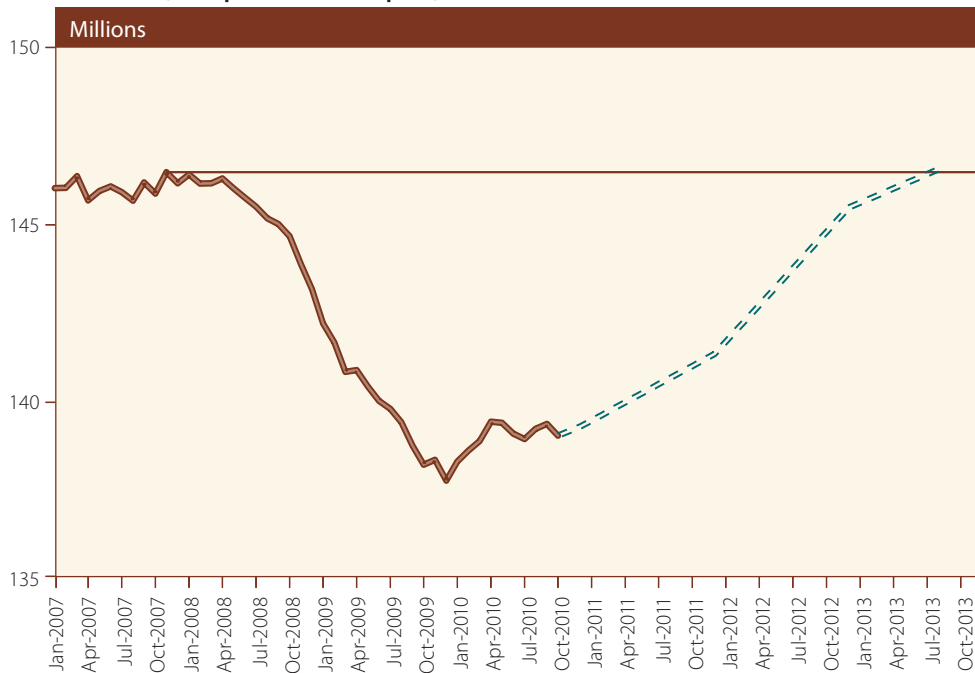
Unemployment rates did not come down during 2010. Household survey data show that civilian employment had dropped by almost 6 percentage points when it reached its trough in late 2009. During 2010, job growth remained anaemic, total employment was still about 5 percentage points below its previous peak level, and the unemployment rate remained high, reaching 9.5 per cent at the end of 2010. Compared with previous recessions, labour market recovery is significantly slower. At the rate of output growth of the United Nations baseline forecast, it will take another three years to bring employment back to its pre-crisis level of early 2008 (figure IV.2). The unemployment rate is expected to decline only modestly to 9.3 per cent in 2011 and to 8.7 per cent in 2012 (see annex table A.7)

The grave employment situation is expected to restrain consumption expenditure in the near term. It is already restraining labour income growth, but high and persistent unemployment is also causing greater income insecurity among workers and their families, delaying consumption and investment decisions. Furthermore, household wealth, both financial and housing, has been significantly eroded by the crisis, leading households to save more to rebuild their balance sheets. The shift in household behaviour is expected to be long-lasting and, as a result, consumer demand in the United States will remain weak in the coming years.

The housing market remains weak but business investment is improving

The United States housing market did not show much improvement during 2010. The federal first-time homebuyer tax credit programme induced some qualified buyers to advance home purchases, but after its expiration in early 2010, residential housing activity dropped significantly. Given the many structural impediments, the outlook is for a very slow recovery. Business structure investment spending, as a whole, has remained

Figure IV.2
Evolution of United States civilian employment^a during the recession, and possible future path, June 2007–October 2013



Source: UN/DESA, based on data from the United States Bureau of Labor Statistics.

Note: The solid line represents the actual observation up to October 2010; the dashes represent the baseline projection for which the monthly level is a linear interpolation of annual forecasts.

a Monthly seasonally-adjusted level of civilian employment.

anaemic so far, held back by low rates of capacity utilization and weak demand prospects in the near term. Tightened standards for loan applications have also handicapped firms' capacity to make new investments, especially by small and medium businesses. The current financial environment should, in principle, be favourable for investment. Quantitative easing is keeping interest rates at very low levels. A large proportion of rebounding profits are being held by larger corporations as cash. For these firms, the funding costs for investment projects will be very low. In addition, investment in equipment and software has been promising, expanding at double-digit rates since coming out of recession. This trend may continue in the coming years, with fixed investment picking up significantly from its modest pace in 2010, provided that the factors underlying the increased macroeconomic uncertainty and continued financial sector fragility will not worsen and will be addressed. Resolving financial sector fragility will be critical for access to investment finance for small and medium-sized firms.

Both export and import volumes of goods and services are predicted to grow by about 10 and 9 per cent in 2010 and 2011, respectively. Given the net trade deficit in the base year, this means net exports are not expected to contribute positively to GDP growth in either year. The trade deficit will widen only moderately, however, and will not come anywhere near its pre-crisis level.

The economy continues to possess vast slack capacity. Keeping new job hiring to a minimum, firms managed to achieve productivity gains and reduce unit labour costs as production picked up again during the recovery. Prices for commodities and energy are also expected to remain contained. As a result, inflationary pressures will remain low. Consumer prices, especially the core index which excludes energy and food items, are expected to increase only moderately. The baseline outlook predicts a headline inflation rate of 1.4 per cent in both 2010 and 2011 (see annex table A.4).

Inflationary pressures remain weak

Fiscal stimulus is
petering out

The collapse in government revenue and the large fiscal stimulus package have significantly widened fiscal deficits at all levels of government. The federal deficit amounted to about 10.0 per cent and 8.8 per cent of nominal GDP, respectively, in the fiscal years 2009 and 2010. The budget situation of most state and local governments is also of some concern. Without additional federal support, many state and local governments will be forced to make severe budget cuts. Further stimuli are extremely unlikely in the near term, however, given political constraints. At the federal level, execution of the final part of the existing fiscal stimulus package will still have an impact on the economy during 2011, though increased pressures for fiscal consolidation may lead to retrenchments in the same year, or become effective in 2012.

Quantitative easing is
raising concerns

The United States Federal Reserve (Fed) has kept its policy rate at an extremely low level since late 2008 and is expected to continue doing so for “an extended period”. The first round of quantitative easing was terminated in early 2010. After observing the slower-than-expected recovery, the Fed decided in November 2010 to start the second round of quantitative easing by purchasing \$600 billion of longer-term securities over the span of eight months. By doing so, the Fed intends to keep long-term interest rates at a low level. Nevertheless, this action has raised concerns, both domestically and internationally. Domestically, the concern is focused on the implications for future inflation. After the Fed first hinted at the possibility of a second round of quantitative easing in August, expected inflation (measured by the yield differential between inflation-indexed and non-indexed bonds) increased by about 70 basis points within a span of seven weeks between August and the end of October. Internationally, the expressed concern is that low interest rates in the United States are encouraging surges in short-term capital flows and causing exchange-rate instability.

Risks centre on housing
and financial markets

Next to persistent high unemployment, the major risk faced by the United States economy is that a dangerous cycle will develop between the housing and financial sectors. If housing prices continue to decline and force more mortgages into foreclosure, financial institutions are likely to tighten credit supply further, reducing the supply of mortgage loans even more, and reducing the number of potential buyers for foreclosed homes, further pushing down prices. This could cause new shockwaves in the economy. First, it would reinforce low consumer confidence. Second, declining housing prices would encourage more mortgage holders to abandon their homes, weakening financial institutions. Third, it would reduce the value of mortgage-backed securities (MBS) and further weaken the financial health of holders of this type of assets. Given the international distribution of MBS, this may trigger demand for a higher risk premium for United States securities by foreign investors.

Canada: continued recovery despite weakening export demand

The Canadian economy exited from recession in the second half of 2009. However, after a few quarters of solid growth, economic expansion decelerated. GDP growth is estimated to be 2.9 per cent in 2010 and to slow to 2.5 per cent in 2011.

Domestic demand continues to be the main driver of growth. Given relatively healthy balance sheets, Canadian households have been able to keep up consumption at the rate of growth of disposable income. Private consumption is expected to continue to grow steadily in 2010 and 2011. Residential investment demand increased strongly until the middle of 2010. Many home buyers advanced purchases in order to avoid the higher

cost of new housing imposed by new tax rules introduced in some provinces. Housing investment has cooled down since then. Investment in machinery and equipment and non-residential construction will remain strong, partially due to a change in the tax law which provides incentives in the form of higher capital cost allowance, lower corporate income tax and the elimination of corporate capital tax.

Weaker export demand was a major cause of the slowdown in 2008 and 2009. The recession in the United States could be quickly transmitted to the Canadian economy given the latter's high dependence on markets in its bigger neighbour. The slower-than-usual recovery in the United States and the appreciation of the Canadian dollar vis-à-vis the United States dollar will adversely affect net export growth in 2011 and 2012 and keep Canada's external balance in deficit.

During 2010, most jobs lost during the recession were recovered. In the third quarter of 2010, the level of employment had returned to its peak of 2008. Nonetheless, continuous growth of the labour force has kept the rate of unemployment at 8.1 per cent, on average, during 2010. This is 2 percentage points above the unemployment rate of 2008. Employment growth is expected to barely keep up with labour force growth, so no significant drop in the unemployment rate is expected in 2011.

Developed Asia and the Pacific: diverging outlook

Tenacious deflation in Japan

Japan's economy showed strong recovery in early 2010. GDP grew by nearly 5 per cent in the first quarter. However, the recovery has been faltering since, with output growth decelerating to less than 2 per cent in the following quarters. For the year as a whole, GDP is estimated to have grown by only 2.7 per cent, a sub-par rebound after the deep recession of 2009 when the economy contracted by 5 per cent. In the outlook, growth is to slow further to 1.1 per cent for 2011 and 1.4 per cent in 2012 (see annex table A.1). Weak domestic demand, particularly the phasing-out of the public investment programmes that formed part of the early fiscal stimulus, will impede output growth. Export growth has also weakened as a result of slowing world trade and yen appreciation. A new stimulus package was announced in September 2010 to prevent the economy from sliding into a double-dip recession. The size of the stimulus seems to be too small, however, to make up for the drop in aggregate demand growth. Persistent deflation and the already high and growing public debt are posing additional policy challenges.

Exports remain the key driver for output growth in Japan. After falling at an annualized rate of 50 per cent during the global downturn at the end of 2008 and early 2009, Japan's exports rebounded in line with the global recovery and stronger import demand in China in the first half of 2010. In the second half of 2010, export growth decelerated to below 20 per cent, and is expected to decelerate further to about 10 per cent in 2011.

Domestic demand has recovered only slowly. Public investment started to decline in the second half of 2010. Fixed investment by businesses has recovered gradually, financed by rising corporate profits. Excess production capacity is still considerable, however, and will restrain new capital spending in the near term. Private consumption has picked up slightly thanks to fiscal stimulus measures, but further strengthening is limited, as the employment and income situations for most Japanese households remain challenging.

The main growth engine, exports, is sputtering

Labour market conditions are weak and deflation remains persistent

The unemployment rate rose to an all-time high of 5.7 per cent in 2009 and did not come down by much during 2010, remaining above 5 per cent. The average pay of workers, which had declined since 2008, started to show some improvement in late 2010. Deflation persists in Japan. It has characterized much of the last two decades. Since 2009, all price indices have been falling even more sharply and deflationary conditions are expected to persist during 2011 and 2012.

The Bank of Japan is maintaining unconventional policy measures

The Bank of Japan has implemented various monetary policy measures, including reductions in the policy interest rate, measures to ensure stability in financial markets and measures to facilitate corporate financing. Facing tenacious deflation, further measures have been taken to inject more liquidity into the economy through the purchase of corporate debt and long-term government bonds. In September 2010, the yen reached a 15-year high vis-à-vis the dollar, leading the Bank of Japan to intervene in the foreign-exchange market in order to stave off further appreciation. The policy interest rate was already very low at 0.1 per cent, but the Bank of Japan cut it further to zero. As with deflation, the real interest rates are still positive and nominal rates cannot be cut further, so the Bank of Japan has engaged in further quantitative easing. In the outlook, monetary policy is expected to maintain its current extremely accommodative stance until late 2011. If economic activity picks up in 2012, policy interest rates are likely to be gradually increased and quantitative easing phased out.

The new fiscal stimulus package may fall short of what is needed

A series of fiscal stimulus packages have been launched since mid-2008. Some of the stimulus was rolled back in the 2010 budget with the reduction in public investment, but direct support to households, on the other hand, was increased. In late 2010, the Government announced a new stimulus package of ¥915 billion in additional public spending. Expectations are that this will boost GDP by about 0.3 per cent, create 200,000 jobs and encourage consumer and business spending. The boost to GDP growth is, however, much less than the deceleration in aggregate demand observed in the second half of 2010. Japan's budget deficit was over 6 per cent of GDP in 2010 and public debt increased to about 200 per cent of GDP. Corporate and household savings have matched the budget deficit, however, limiting the sovereign debt risk so far, and Japan continues to be a net exporter of capital to the rest of the world.

Australia's economy showing resilience

Strong domestic demand is driving GDP growth in Australia

Australia is the only developed economy that avoided recession during 2008-2009. Buttressed by stimulus measures, the growth of domestic demand has been exceptionally strong since late 2009, particularly private investment in the booming mining sector. The rise in the prices of Australia's commodity exports, together with the rebound in export volumes, particularly to emerging economies, pushed the trade balance to its largest surplus as a share of GDP since the 1970s. Growth has slowed somewhat since mid-2010, but the economy is still estimated to have grown by 3.3 per cent for the year as a whole. In the outlook, public demand is expected to detract from GDP growth as stimulus projects are gradually completed, but private consumption should continue to grow along with jobs. GDP is forecast to grow at 3.7 per cent in 2011. The Reserve Bank of Australia has been raising interest rates since 2009, but no further increases in the policy interest rate are expected in 2011 and 2012.

New Zealand recovering from a prolonged recession

New Zealand has been recovering at a moderate pace from a prolonged recession. While net exports have made a solid contribution to growth, household consumption and business investment have also increased, driven in part by low interest rates. Consumer and business confidence continues to improve, but credit conditions remain tight and businesses continue to deleverage their balance sheets. As a result, domestic demand growth is expected to be mild in the outlook. The damage from the earthquake in Canterbury in September 2010 is estimated to have slowed quarterly GDP by about 0.3 per cent, but the post-quake reconstruction is expected to boost the economy. GDP is estimated to have increased by 2.7 per cent in 2010 and is forecast to grow by 2.4 per cent in 2011 and 3.0 per cent in 2012.

Developed Europe: cautious recovery

Western Europe: slow growth of domestic demand

Economic activity picked up strongly in Western Europe during the first half of 2010, through an export-driven industrial rebound, fiscal support measures of varying intensities and inventory restocking. Output growth slowed in the second half of 2010, however, with the weakening rebound in global trade, the turn in the inventory cycle, the gradual withdrawal of fiscal stimuli and, in some countries, the shift to fiscal austerity. This pattern was reinforced by large swings in the values of the euro and other currencies of the region, which depreciated strongly against the United States dollar in the first half of the year, but subsequently rose in the second half. This lower pace of growth is expected to continue into 2011 as more countries push for deep fiscal cuts. Given the strong carry-over from the first half of the year and continued moderate activity, GDP growth for the EU-15 is estimated to be 1.7 per cent in 2010, slowing to 1.5 in 2011. Growth is expected to pick up slightly in 2012, to 1.9 per cent, as domestic demand strengthens.

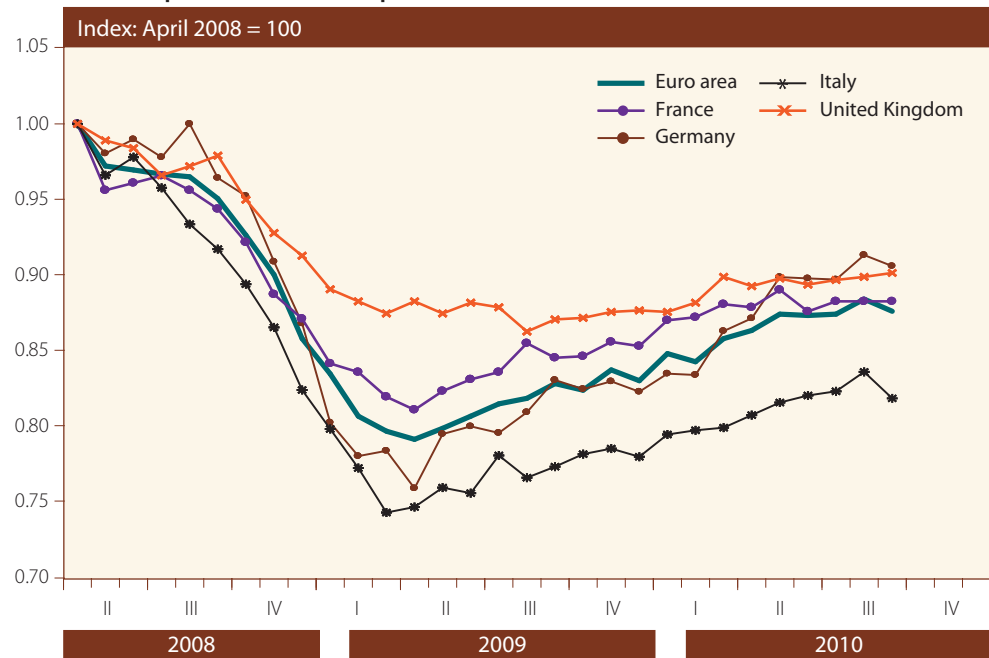
While growth has recovered, it is not robust. The recovery in 2010 masks a number of important weaknesses. Industrial production, for example, remains 12 per cent below its peak of April 2008, indicating that, in terms of levels, recovery is far from complete (see figure IV.3). Unemployment rates remain high in many countries (and exceptionally high in some, like Spain). More ominously, the recovery is taking place at different speeds. At one end are the countries (led by Germany) showing a relatively strong rebound, whose economic activity expanded by 3.4 per cent in 2010 and who were able to take full advantage of the improvement in global trade. At the other end of the spectrum are the countries entrenched in fiscal crises, such as Greece, Ireland, Portugal and Spain, which will either remain in recession or see minimal recovery at best.

Private consumption expenditure acted as a stabilizing factor during the downturn in many European countries, thanks to measures to mitigate the rise in unemployment and the broad coverage of social security. However, it has yet to assume a more prominent role in leading the recovery, held back by high rates of unemployment in most countries and subdued wage growth. In the outlook, consumption expenditure is expected to improve gradually for the majority of countries in the region, but without much vigour: labour markets are stabilizing and are expected to improve slowly, savings rates have retreated from their highs during the financial crisis, and inflation is expected to remain low. Financing conditions remain more challenging than before the crisis, but bank lending to

Export growth and fiscal stimulus have driven the recovery

Consumption continues to support GDP growth but is anything but vibrant

Figure IV.3
Industrial production in the euro area and selected Western European economies,
second quarter 2008-fourth quarter 2010



Source: OECD Main Economic Indicators.

the household sector has been increasing slowly. The situation is far worse in countries with severe fiscal consolidation programmes. In Greece, for example, consumption expenditure is expected to continue to decline through 2012.

Investment could be nearing a turning point

The precipitous decline in investment in both equipment and housing was a major driver of the recession, and evidence for a turnaround is sparse, with the second quarter seeing the first positive investment growth for the euro area since the recession. Going forward, with the exception of the countries undergoing severe fiscal consolidation programs, investment is expected to pick up gradually, registering positive, but low, rates of growth in 2011 and 2012. Capacity utilization has moved up significantly since its record low in the third quarter of 2009. Industrial new orders continue to improve, as have business profits. One major obstacle to a more significant rebound is that external financing conditions remain tight. The cost of external finance is low, but banks continue to tighten credit standards, and although this appears to have reached a nadir, conditions are significantly tighter than before the recession. This may not be a constraint in the near term as loans to the non-financial sector typically lag the pick-up in economic activity during a recovery, with firms relying more on internal financing. As the recovery progresses, however, any persisting major weaknesses in the banking sector could then bring further recovery to a halt. So far, however, loans to non-financial corporations have continued to decline, but at a slower pace, which could suggest that a turning point is near.

High unemployment remains worrisome, although conditions differ across countries

The rate of unemployment in the euro area drifted up from 7.2 per cent in March of 2008 to 10.1 per cent in September of 2010, but most of the increase took place in 2009—since September of that year, the jobless rate has risen by only 0.3 percentage points. The picture differs widely across countries, however, with rates of unemployment reaching 20.0 per cent in the case of Spain, 14.1 per cent in Ireland and 10.0 per cent in France, while in Germany, the rise in unemployment has been largely contained and is

currently 6.7 per cent of the workforce. The modest increases in 2010 could indicate that labour markets are approaching a turning point. Germany has turned the corner already, as the unemployment rate has fallen by a full percentage point since its peak in 2009. The decline has been more modest in other European countries. In Greece and Spain, however, unemployment rates are still increasing and the situation is likely to worsen with the prolongation of the recession and the severe fiscal austerity. The divergence in labour market outcomes is explained by differences in the speed of recovery, labour market policies and economic structure. In Spain, for instance, much of the initial increase in unemployment was caused by the collapse of the construction sector after a long real estate boom. It will take years for employment to rebound, requiring both a reorientation of the sources of growth in the economy and a resolution to the present mismatch in demand and supply for skills. Italy is another case where skills mismatches, coupled with a weak growth outlook, are expected to lead to increasing rates of unemployment. In the outlook for the euro area, unemployment is anticipated to have peaked in 2010, coming down only gradually over the forecast horizon, held back by low levels of growth and the transitional costs of structural economic change in some cases.

Headline inflation, as measured by the Harmonised Index of Consumer Prices (HICP), increased slightly with the rebound in global commodity prices in the first half of 2010 and the currency depreciation, which pushed up import prices. Core inflation—which abstracts from energy, food, alcohol and tobacco, in an attempt to measure underlying inflationary pressures—bottomed at 0.8 per cent in May and has ticked up since, but there is no evidence that inflation is either accelerating or decelerating. Continued weak labour market conditions mean that wage growth will remain slow and, with rising productivity, unit labour costs will remain contained. Output gaps remain large and are expected to narrow only slowly during 2011-2012. World market prices for commodities are projected to increase only slightly on average and, hence, will only have a limited impact on consumer prices. Consequently, headline inflation is expected to remain below 2 per cent.

Fiscal policy and the workings of automatic stabilizers played a major role in softening the impact of the global downturn on most European economies. It has come, however, at the cost of large increases in fiscal deficits and public debt. Across the region, policy stances are shifting towards tightening budgets. The budget deficit in the euro area rose from 2.0 per cent of GDP in 2008 to 6.2 per cent in 2009, while the debt-to-GDP ratio rose from 69.3 per cent to 78.7 per cent. Both ratios are estimated to have increased further in 2010. In some countries, however, including Greece, Ireland, Portugal and Spain, the fiscal situation deteriorated to such an extent that the cost of borrowing surged, with marked increases in sovereign bond spreads vis-à-vis the German Bund rate. Spreads hit record levels in some cases after downgrades of investment ratings by credit rating agencies. In the first half of 2010, Greece faced a sovereign debt crisis which could only be quelled with the announcement of a massive European financial stabilization fund worth €720 billion, consisting of government-backed loan guarantees and bilateral loans provided by euro area members; an expansion of the existing balance of payments facility (involving all European Union (EU) members); and money provided by the International Monetary Fund (IMF). Nonetheless, at the end of 2010, concerns remained over the capacity of Greece to bring down its public debt, while Ireland and Portugal continued to suffer imminent debt distress, spurring calls for an international bail out.

Towards the end of the year, another crisis erupted. After weeks of resisting assistance from the EU, and amidst tremendous pressure in the financial markets, Ireland finally requested, and was granted, emergency finance to deal with the huge increase in its

There are no signs of inflationary pressures

Fiscal policy is transitioning to consolidation, spurred by the sovereign debt crisis

deficit, which had resulted from bailing out its insolvent banking system. This assistance totals up to €85 billion and consists of a mix of EU and IMF sources, made conditional upon Ireland's adopting further austerity measures as part of its planned four-year fiscal adjustment and structural reform programme. But markets have so far reacted sceptically. Sovereign bond spreads for Ireland, Greece, Portugal and Spain continue to be elevated, and there is evidence of further contagion—spreads for Italy and Belgium have increased since the onset of this phase of the crisis, and the euro has again weakened against the United States dollar. Pressure for fiscal consolidation remains high.

More generally, all members of the euro area, with the exception of Finland and Luxembourg, are required to consolidate their budgets, as their deficits exceed the 3 per cent of GDP limit enshrined in the Stability and Growth Pact (SGP). Fiscal retrenchment in most countries is scheduled to start in 2011, and it will take from two to four years to bring deficits to below the ceiling. The countries facing deeper fiscal crises, however, were already forced into drastic fiscal austerity in 2010 and the degree of retrenchment ahead is considerable. The Greek Government, for example, aims to reduce its deficit by more than 10 percentage points of GDP by 2014.

Unconventional measures of monetary easing are being phased out gradually

Monetary policy continues to rely on unconventional measures. In the early stage of the crisis, central banks aggressively cut their main policy rates. The European Central Bank (ECB) cut its main policy interest rate from 4.25 per cent in July 2008 to 1.00 per cent in May 2009, and has maintained that rate since. The Bank of England, as well as all other central banks in Europe, also brought rates down drastically. After reducing interest rates, central banks moved to less conventional measures. The ECB targeted mostly money markets. It modified and extended its refinancing operations by moving from a variable-rate tender with fixed allotment to a fixed-rate tender with unlimited allotment of liquidity, and then extended lending maturities up to one year. Other policies included: ample provision of foreign currency liquidity; purchases of covered bonds; expansion of the list of eligible assets for use as collateral; lowering of the credit rating standards for accepted collateral. The Bank of England adopted quantitative easing through the Asset Purchase Facility, allowing it to purchase securities (gilts) issued by the British Government in the secondary market as well as high-quality private sector assets, including commercial paper and corporate bonds. The ECB subsequently added quantitative easing to its policies, purchasing sovereign bonds of the constituent economies of the euro area. Some of these measures have already been phased out, but others will only be withdrawn gradually during 2011-2012. It is expected that policy interest rates will be kept low during 2011, with very gradual tightening beginning in 2012.

Risks are skewed to the downside, led by fiscal concerns

Risks to the forecast are slanted to the downside. The impact of the fiscal austerity under way or planned could risk a renewed economic downturn. Sovereign debt distress for some countries could cause renewed financial market turbulence. Problems for Governments to repay or refinance their debts would also cause problems for banks holding the debt. Without a concerted EU response, it could affect confidence in the euro, as the affected economies are part of the common currency area. There is a risk for further appreciation of the euro and other regional currencies, given the forces in play that are weakening the United States dollar. Exchange-rate appreciation would erode export competitiveness and thus weaken a key driver of growth in the region. If remaining financial fragility is not addressed, bank lending could remain constrained, hampering the rebound in investment, while consumption spending would falter if labour market conditions are too slow to improve. On the upside, export growth may strengthen if growth in emerging market economies remains robust, and investment expenditure could be stronger if bank-lending conditions were to ease sooner than expected.

The new EU member States:¹ a cautious export-led recovery

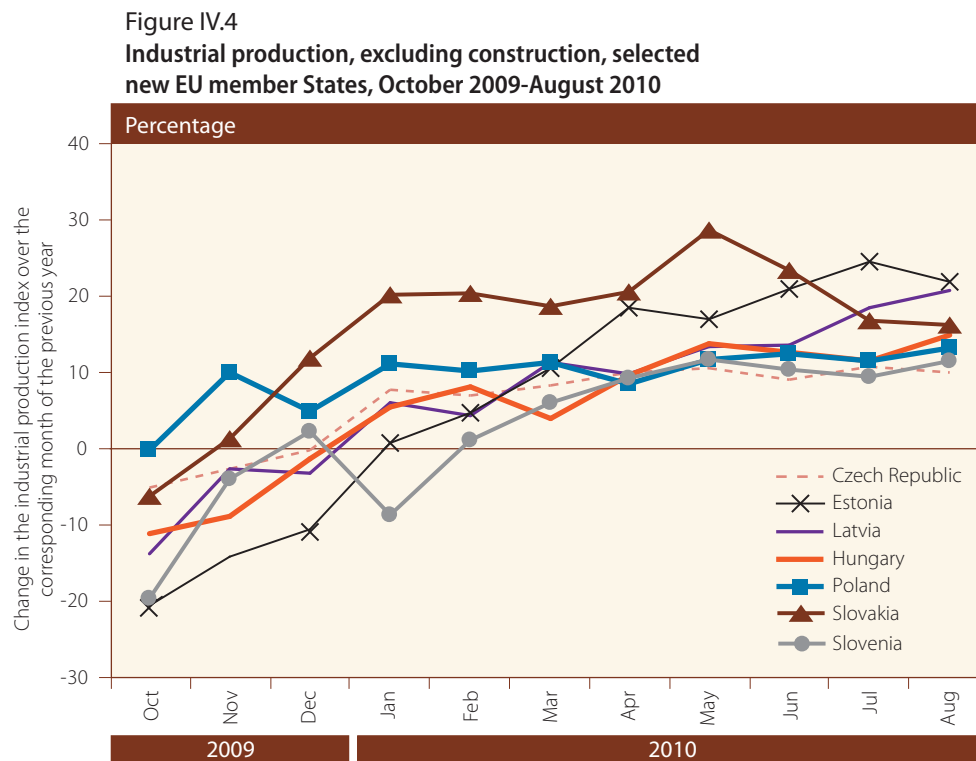
Following the sharp economic downturn of 2009, the new EU member States in Eastern Europe saw a modest recovery in 2010. The recovery was mainly driven by rebounding exports, supported by stronger external demand. In the case of the Baltic States, export growth was stimulated further by the decline in nominal wages, reducing labour costs and enhancing competitiveness. Inventory restocking was also important, especially in the first half of the year. Private consumption and investment demand, by contrast, either stagnated or contracted further, being restrained by lower nominal and/or real wages, high unemployment, fiscal austerity measures, higher indirect taxes and tight credit. Low capacity utilization rates deterred both domestic and foreign investment, undermining the region's long-run growth prospects.

The recovery remains fragile in most economies. Only Poland and Slovakia exhibited solid economic performance in 2010, with output increasing at more than 3.5 per cent. Elsewhere, the upturn was feeble, while in Latvia, Lithuania and Romania, economic contraction continued. On average, GDP of the new EU member States increased by 1.9 per cent in 2010, having shrunk by 3.6 per cent in 2009 (see annex table A.1). Growth is expected to strengthen to 3.2 per cent in 2011, as consumption demand gradually recovers, domestic investment and FDI picks up, and absorption of EU funding improves. It will take time, however, before pre-crisis growth rates will be achieved again. To improve long-term competitiveness, further structural reforms are needed.

External conditions for the new EU member States improved in 2010. Import demand, particularly for durable consumer goods and capital and intermediate goods, strengthened in many important trading-partner economies. This supported the rebound in industrial production, including in the automotive industries in Central Europe (see figure IV.4).

Exports help the new EU members out of recession

External conditions improved in 2010



Source: Eurostat.

¹ This section mainly refers to the new EU member States in Central and Eastern Europe.

Access to international capital markets also improved. Parent banks in the EU-15 avoided withdrawing more capital as the financial sectors of the new EU countries stabilized.

The large output gap is containing inflation

Inflation remained low among new EU members in 2010, as their economies operated well below full capacity. Latvia experienced deflation following the demand contraction forced by the fixed exchange-rate regime. Increases in energy prices and indirect taxes pushed up headline inflation in countries with flexible exchange rates, most notably Romania. Although producer prices strengthened in late 2010, a build-up of serious inflationary pressures in these countries during 2011 is highly unlikely. Headline inflation is projected to increase by 1 to 2 percentage points as a consequence of higher world market prices for energy and primary commodities and possible further increases in indirect tax rates.

The space for stronger counter-cyclical measures which could speed up recovery is limited. There is an urgent need for countries to undertake deeper structural reforms to underpin more sustained long-term growth. Better utilization of available EU funds could support such reforms. Budget deficits are large, especially in the economies most affected by the global crisis. In Latvia and Lithuania, fiscal deficits exceeded 8 per cent of GDP in 2010. Given their commitment to the SGP of the EU, all Governments of the new EU member States will be engaging in drastic fiscal retrenchment over the next three or four years in an attempt to bring deficits below the ceiling of 3 per cent of GDP. This includes Estonia, whose deficit is already below 3 per cent of GDP, but nevertheless aims to balance its government budget in the medium term. This will be challenging in most cases and could come at substantial cost to growth in the short run.

Central banks are maintaining low policy rates

The central banks of the new EU member States continued to keep policy rates low during 2010, hoping to encourage private lending and discourage inflows of speculative capital. Monetary authorities in the Czech Republic, Hungary and Romania cut interest rates in successive rounds. In the case of Slovakia and Slovenia, which have become members of the euro area, the very low rates set by the ECB apply. Estonia, in turn, will adopt the euro in January 2011 and is gradually reducing its reserve requirements to those mandated by the ECB. Accommodative policy should continue in 2011, but thus far it has not unleashed much credit because of continued fragility in the banking sectors.

There are mixed trends in labour markets

Unemployment rates remain relatively high in most new EU member States although they seem to have stabilized by mid-2010. In Latvia, the unemployment rate reached 19.7 per cent in 2009, but had declined to 15 per cent in August 2010. Nevertheless, the time during which unemployed workers are without a job has increased. This is all the more worrisome as fiscal stimulus measures that supported job creation are being withdrawn and more public employment is lost through fiscal austerity measures. This will hold back further improvements in labour markets during 2011.

Economies in transition

During 2010, economies in transition recovered visibly from the steep downturn caused by the global crisis. On average, GDP expanded by 3.8 per cent, a significant turnaround, but far short of what it will take to make up for the dramatic setback of 6.7 per cent in 2009. The recovery was primarily a result of more favourable external conditions, which helped the rebound in exports. The impact of the crisis was greater in the Commonwealth of Independent States (CIS) than in the transition economies of South-eastern Europe, with the former contracting by 7.0 per cent in 2009 compared to 3.6 per cent for the latter. The CIS economies benefited from higher commodity prices and GDP growth reached 4.1

per cent in 2010. Economic performance in South-eastern Europe, by contrast, remained lacklustre as weak domestic demand stifled most of the impetus from export growth. GDP expanded by a mere 0.1 per cent in 2010 (see annex table A.2).

In the outlook, GDP growth is expected to remain subdued in 2011, but may accelerate somewhat in 2012. Downside risks emanate in particular from further weakening of the global recovery and fragility in financial sectors, especially in the CIS. Possible renewed financial turmoil over sovereign debt distress in Greece would be potentially harmful to the recovery in South-eastern Europe.

South-eastern Europe: a feeble recovery

Export growth was the main driving force behind an otherwise weak recovery in Bosnia and Herzegovina, Montenegro, Serbia and the former Yugoslav Republic of Macedonia during 2010. Croatia, however, failed to climb out of the recession as continued declines in consumption and investment outweighed export growth. Domestic demand growth led the recovery in Albania. The recovery is expected to provide an impetus for the entire region in 2011, with GDP growth averaging 2.5 per cent on the expectation of continued favourable external conditions and modest revivals in domestic demand.

The weakness in domestic demand acted as a drag on aggregate output in 2010. Importantly, after several years of growth driven by booming domestic demand accompanied by heavy external borrowing and large current-account deficits, export growth was the main factor in whatever economic recovery the countries in the region saw during 2010. However, in order to sustain more dynamic, export-led growth in the future, manufacturing and services sectors will need to be modernized and become more diversified. This will require additional foreign direct investment (FDI) and technological change. To facilitate this, additional structural reforms will be needed to change the business environment.

Consumer inflation remained subdued in most countries of the region, restrained by stagnant real household incomes and tight consumer credit. Inflation is expected to accelerate by 1 percentage point in 2011, as domestic demand gradually picks up. In Serbia, inflation exceeded 5 per cent, reflecting the effect of currency depreciation as well as the one-off effect of a poor harvest on food prices. Inflationary pressures will likely increase in 2011, following the end to the temporary freeze in pensions and public sector wages (see annex table A.5).

As businesses continued to shed workers, unemployment increased in the region in 2010, with the exception of Albania. Unemployment is particularly high in Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia. As the economic recovery is expected to gain some speed in 2011, job creation in the private sector is also expected to improve. Large numbers of workers have now been without a job for a long period of time. This problem is likely to persist in the absence of targeted measures to encourage retraining and hiring in the formal sector (see annex table A.8).

Macroeconomic policies in South-eastern Europe have been characterized by fiscal discipline. Policymakers have given priority to providing businesses with better access to finance and to incentives aiming to attract strategic investors from abroad. In most countries, monetary policy remained accommodative in 2010 and no change in this regard is expected. Only in Serbia has the central bank increased its policy rate to counteract rising inflation, doing so several times in the second half of the year. More generally, boosting credit to the private sector and encouraging lending in domestic currency are key components of the recovery strategy. Invariably, however, this has not been successful. In

A weak recovery is driven by exports

Medium-term prospects depend on structural reforms

Inflation remains subdued

Labour markets have deteriorated further

While fiscal policy is tightening, monetary policy remains accommodative

Current-account deficits
are narrowing

Croatia, for instance, credit supply remains tight despite the lowering of official reserve requirements, and in Montenegro, credit supply fell sharply.

Moderate export growth and weak import demand led to a narrowing of current-account deficits of all economies in the region, except Serbia. All countries secured the external financing needed to cover the deficits. Serbia and Bosnia and Herzegovina needed support from the IMF in order to do so. FDI inflows have remained subdued and are unlikely to reach the high pre-crisis levels in the near term, especially given the adverse impact of the Greek financial crisis on the confidence of prospective investors.

In addition to weakening global demand conditions, downward risks include the high degree of euroization of bank loans, particularly in Serbia, which given prevailing currency mismatches, could lead to large numbers of non-performing loans in the case of a devaluation. The banking sector of the countries in the region will likely also be affected directly from any serious further deterioration in the financial situation in Greece.

The Commonwealth of Independent States:² a muted recovery

The economic recovery
in the CIS faces uncertain
prospects

After a sharp contraction in 2009, output in the CIS bounced back in 2010, driven by the recovery of commodity prices and general improvement in the external environment. The return to economic expansion in the Russian Federation particularly contributed to the renewed dynamism in the region, boosting exports, financial flows and remittances, which remain critical for low-income countries in the region. However, despite these positive influences, recovery remained muted, as continued fragility in the financial sector and uncertain economic prospects constrained domestic demand in the largest economies in the region. Some further strengthening of domestic demand can be expected in 2011, but the external environment remains uncertain and cannot be relied upon as a major source of economic dynamism. After growing by around 4.1 per cent in 2010, aggregate GDP in the region is expected to increase at a similar pace in 2011.

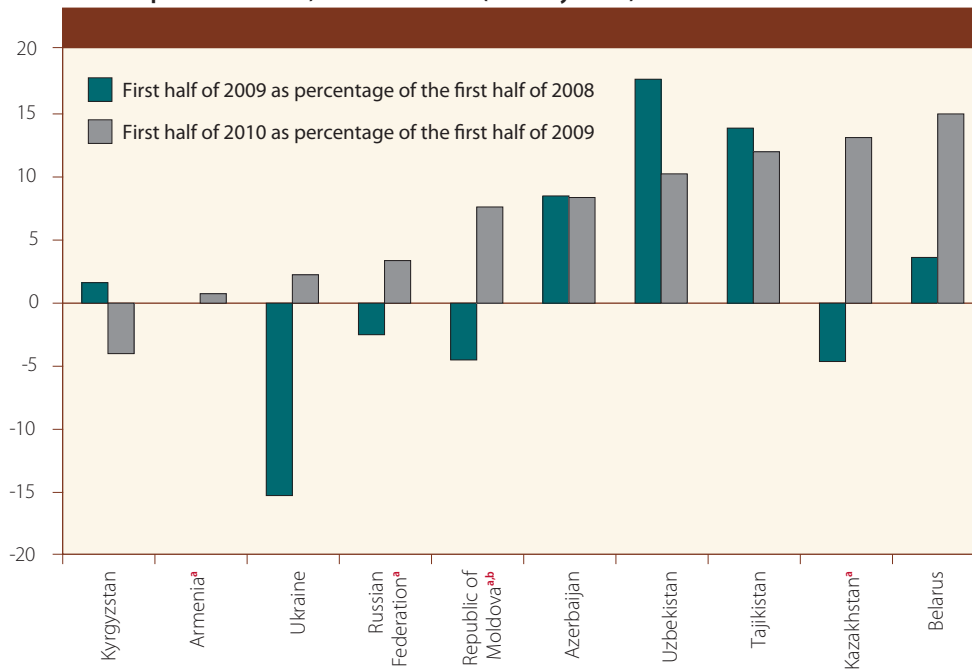
Although domestic
demand is gathering
strength, the region
depends on a favourable
external environment

Domestic demand is gathering strength (see figure IV.5). However, despite improvement in the terms of trade and reduction of unemployment, recovery of domestic demand has been limited and remains dependent upon a favourable external environment. In the Russian Federation, consumer demand benefited from expansionary fiscal policy, which included increases in pensions and public sector wages. Higher remittances have also boosted consumption in small, low-income countries, although adverse weather contributed to depressed agricultural output throughout the region. Exports have increased as the world economy has stabilized, while growth of imports has been constrained by the weakness of the recovery (see annex table A.16). However, unlike in 2009 when net external demand was the main factor sustaining economic activity, domestic demand has played an increasing role in driving economic expansion.

Output recovery was accompanied by an improvement in labour market indicators across the region (see annex table A.8). In the Russian Federation, the return to growth was accompanied by a sharp fall in wage arrears and job creation. In Kazakhstan, the expansion of employment has been the fastest in the region, being particularly remarkable as the country continued to create new jobs during the economic slowdown in 2009. However, performance remains far below potential in most economies. While the fiscal consolidation

² Georgia officially left the Commonwealth of Independent States on 18 August 2009. However, its performance is discussed in the context of this group of countries for reasons of geographic proximity and similarities in economic structure.

Figure IV.5
Comparison of retail turnover in countries of the Commonwealth of Independent States, 2009 and 2010 (January-June)



Source: Based on data from the Interstate Statistical Committee of the CIS.

a Excluding turnover of catering enterprises.

b Trading organizations.

that is expected in 2011 may dampen prospects for employment in the region, credit revival and strengthening domestic demand will provide a positive impulse.

Inflation continued to decline early in 2010 in the CIS, despite the economic rebound, the delayed impact of past devaluations and generally loose monetary policies (see annex table A.5). However, a number of supply shocks put an end to this trend and inflation started to pick up in the second half of 2010 in some countries. Food prices increased sharply as a consequence of adverse weather in the Russian Federation and Ukraine, while border-crossing problems in Central Asia contributed to inflationary pressures. However, weak demand limited the impact of supply-driven inflationary pressures in the region.

Monetary authorities have supported the economic recovery with interest rate cuts in most countries, amidst benign inflation conditions. In some cases, strengthening of national currencies, following the devaluations and exchange-rate volatility observed in 2009, increased the scope for accommodating monetary policies. However, monetary authorities put an end to the easing with the resurgence of inflationary expectations following supply shocks over the summer, stronger economic activity and concerns over the rapid growth of monetary aggregates. Amidst concerns over the fragility of the recovery, interest rates remained unchanged despite accelerating inflation in most countries, with the exception of Armenia and Georgia.

The economic recovery has boosted revenues, particularly in energy-producing countries where there is a direct link between commodity prices and fiscal performance. However, fiscal deficits persist throughout the region. In 2010, the Russian Federation continued to run a fiscal gap for a second year, following a long period of surpluses. Official financing has eased financing constraints and avoided the need to undertake sharper adjustments in other countries, but the fiscal situation remains precarious. A shift towards fiscal retrenchment has already started, dampening GDP growth. However, the increases

After sharp declines, inflationary pressures are re-emerging

Monetary easing is coming to an end, while fiscal tightening has begun

in social expenditures and public sector wages are perceived to be permanent, thereby making fiscal adjustment more challenging as government revenues remain dependent on volatile commodity prices.

The current-account surplus of the region has widened

Higher commodity prices and recovery of export volumes amidst an improved external environment have boosted export earnings. Import growth also accelerated as domestic demand strengthened, particularly in the Russian Federation. While several non-energy exporting countries, such as Armenia, Georgia and Tajikistan, also benefited from rising export prices, their current-account deficits remain large. Overall, the combined current-account surplus of the CIS increased. This was, however, primarily due to significant improvements in the region's terms of trade in 2010.

Fragilities remain, particularly in the financial sector

The return to growth in the region largely reflects the improvement in external circumstances. Overall dynamics in the CIS remain highly dependent upon the economic performance in the Russian Federation. Greater access to external financing also remains critical for many countries in the region. The lack of export diversification makes most CIS economies highly vulnerable to external shocks. Government revenues also remain highly dependent upon revenue from primary commodity exports, making public finances vulnerable to volatility in world market prices. The continued fragility of the financial sector (see box IV.1) remains a policy concern that will need to be addressed to create solid foundations for economic expansion.

Box IV.1

Banking systems and financial risks in the CIS economies

The financial sector was one of the main channels through which the external shocks of the financial crisis were transmitted to the economies of the Commonwealth of Independent States (CIS). In several countries, the banking system came under severe pressure, prompting the need for strong policy responses. In contrast, a low degree of financial development and limited integration into international capital markets provided some protection elsewhere, particularly to the financial sectors of the low-income economies of the region.

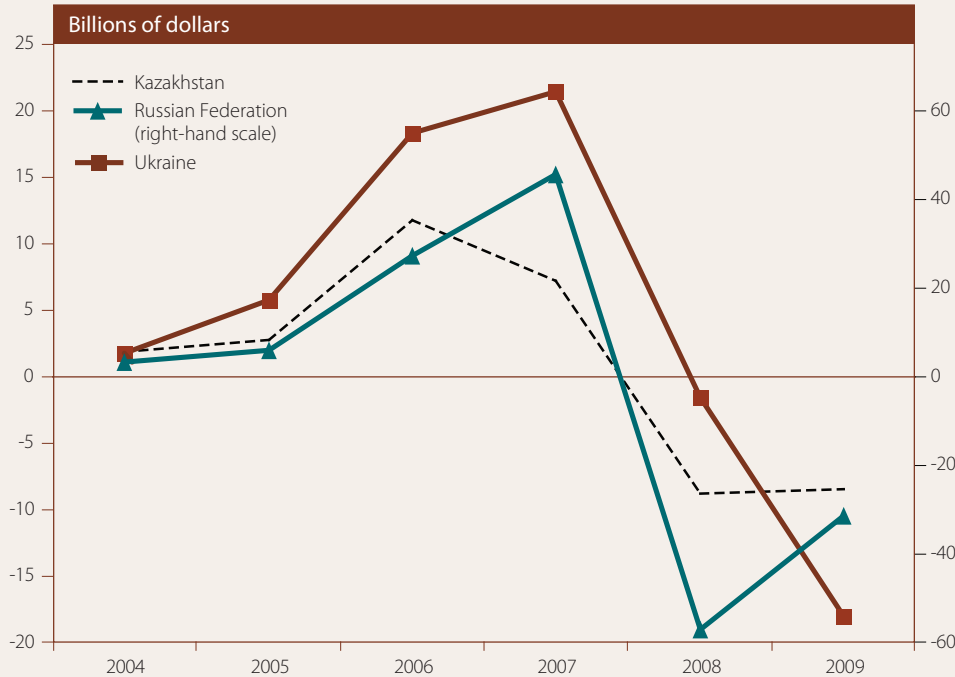
Policy interventions, an improved external environment and the ongoing economic recovery have helped stabilize the overall economic situation in the CIS. However, the banking sector remains fragile due to a combination of funding problems and rising non-performing loans. Despite improved liquidity, this fragility, the need to rebuild balance sheets and weak demand for credit have all contributed to the sluggish growth of credit throughout the region. Among the largest countries, there have been clear signs of improvement only in the Russian Federation.

Rapid credit growth in the pre-crisis period came to an abrupt halt as access to international capital markets dried up (figure A). In Kazakhstan, for instance, annual credit growth exceeded 100 per cent in mid-2007, but was almost flat in the next year. Dependence on external sources of finance, even in countries with current-account surpluses, was a common feature among the largest economies in the region. However, the role of the banking system in intermediating foreign financing has varied from country to country. In Kazakhstan, the crisis started earlier and was more severe owing to the strong reliance of domestic banks on foreign borrowing. In Ukraine, access to international funding was channelled, in part, through foreign-owned banks, which initially represented a source of resilience. While banks' access to external finance was more limited in the Russian Federation, this was not the case for large firms, some of which benefited at times from implicit State guarantees. These firms were, however, directly affected by the turmoil in financial markets. Meanwhile, in the low-income economies, declining remittances deprived banks of a source of liquidity and also reduced borrowers' creditworthiness. Overall, countries that relied to a larger extent on domestic deposits as a source of funding (such as Uzbekistan and Turkmenistan) were relatively sheltered from the effects of the financial crisis.

Looser monetary policy and a temporary relaxation of financial sector regulation helped offset dwindling access to external finance. In energy-exporting countries, sovereign funds

Box IV.1 (cont'd)

Figure A
Banking sector, net capital flows, 2004-2009



Source: Central banks.

were also tapped to provide additional liquidity, while in Ukraine, foreign banks contributed to repairing the balance sheets of their subsidiaries through additional capital contributions. By contrast, in Kazakhstan, where direct foreign equity participation was limited but external debt was substantial, debt restructuring resulted in write-offs of \$11 billion.

The banking sector faces two main challenges

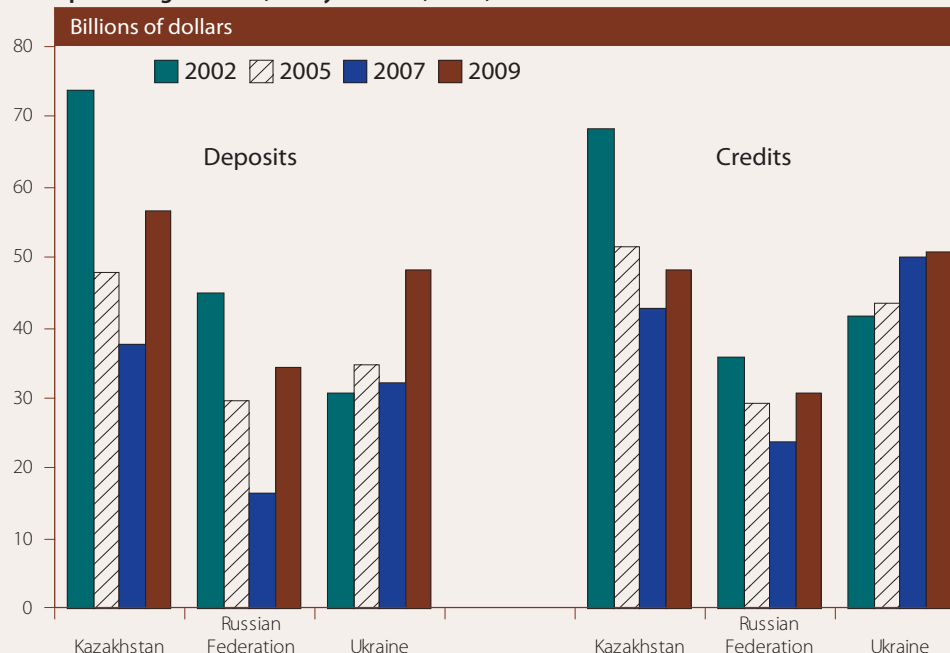
Financial sectors in the region face two key challenges: overcoming remaining fragilities, especially the high shares of non-performing loans (NPLs) and currency mismatches, and how to mobilize more domestic resources now that reliance on foreign borrowing is neither possible nor desirable.

The economic slowdown resulted in a sharp deterioration in the quality of loan portfolios. This has been particularly marked in Kazakhstan, where NPLs are expected to peak at around 30 per cent. In Ukraine, the official estimate of the ratio of NPLs reached almost 12 per cent in August 2010, and is projected to continue to rise. Such high levels of NPLs will require concerted efforts to rehabilitate the financial sector, particularly as the latest stress tests have identified recapitalization needs of around \$5 billion in Ukraine.

Moreover, foreign currency lending and foreign currency deposits remain significant throughout the region, reflecting a mixture of macroeconomic concerns, risk mispricing and pre-crisis access to international funding. In most countries, the share of foreign currency in banking activities declined in the years prior to the crisis as consumer confidence improved and as, in some cases, local currencies appreciated. This was especially the case in those countries that experienced large inflows of foreign currency, such as Kazakhstan and the Russian Federation. Responding to the large capital outflows that occurred in the wake of the crisis, several countries in the region were, however, forced to depreciate their currencies, which in turn contributed to a rise in foreign currency banking activity (figure B). It also intensified the problems of the banking sector in countries such as Ukraine, where most borrowers do not have income sources in foreign currency and—in contrast to banks that raise funding in international capital markets—are unable to hedge against the currency risk by lending in foreign currencies. Consequently, in these countries, credit risk has been replaced by currency risks.

Box IV.1 (cont'd)

Figure B
Foreign currency-denominated deposits and credits as a percentage of total, end-year 2002, 2005, 2007 and 2009



Source: Central banks.

Several countries in the region, including low-income economies in Central Asia, have reacted by introducing regulatory changes, such as higher reserve deposit requirements, in order to reduce external vulnerability in general and foreign currency risk in particular. In Ukraine, foreign currency lending to households has been prohibited outright. Such changes, however, contribute to dampening credit growth in the short term. A deepening of domestic financial markets to reduce external vulnerability may be better as it would reduce foreign-exchange risks structurally and enable greater mobilization of domestic savings through the financial system. While doing so has been a stated policy target in some countries in the region for some time, the recent crisis has provided new impetus to pursue this goal, particularly in Kazakhstan and the Russian Federation.

However, progress in this area is closely linked with the quality of monetary and fiscal institutions. The credibility of macroeconomic policy and the commitment to support growth and stability are necessary to facilitate the deepening of a sound domestic financial system. Given the long-term financing needs of public sectors, the development of well-functioning domestic markets for government securities should be an important ingredient of the financial deepening process. It would further foster the creation of necessary trading infrastructure and facilitate the pricing of corporate bonds. Moreover, better regulation of the activities of institutional investors, such as pension funds, would also support the domestic supply of long-term finance.

Developing economies

Developing economies have been experiencing a robust economic recovery in 2010 with GDP growth averaging 7.1 per cent, up from 2.3 per cent in the previous year. Growth performance has been fairly balanced across regions, with East Asia continuing to post the highest growth rate, averaging 8.8 per cent, followed by South Asia with 7.0 per cent. In both Western Asia and Latin America, the rebound in 2010 followed an economic contraction in 2009. While the revival in global trade has remained a key driver of economic

expansion, economic performance has been fairly broad-based as domestic demand has taken on more significance in underpinning growth with the support of fiscal stimulus measures and accommodative monetary policy stances. In 2011, economic growth is expected to slow down somewhat, but should still reach a solid pace averaging 6.0 per cent. There is a major risk of a further slowdown of growth in developed economies which would weaken global trade. Surging but volatile capital flows pose a further risk to macroeconomic stability in many developing countries. Several have already seen significant currency appreciation, which is, inter alia, undermining export competitiveness.

The economic rebound has helped improve the employment situation, as seen in falling unemployment rates in many countries. In many regions, however, job growth is lagging the rebound, and high levels of vulnerable and informal employment continue to hamper accelerated progress in poverty reduction and achievement of the other Millennium Development Goals (MDGs).

Africa: divergent growth recovery

Africa's rebound from the Great Recession has been faster and stronger than from previous global downturns. GDP growth accelerated to 4.7 per cent on average in 2010, up from 2.3 per cent in 2009 (see annex table A.3). Exports were not the only driver of growth, as was the case in previous cycles. This time, the positive turn in external conditions was supported by domestic factors as well. These included rising public spending on infrastructure, increasing FDI in extractive industries, good harvests and increasing agricultural productivity. Nevertheless, high levels of underemployment and vulnerable employment, as well as continued widespread malnourishment, remain concerns. The continued reliance on a narrow export base and primary production is a hurdle to faster poverty reduction and more broadly shared welfare improvements.

The speed of recovery varies greatly among countries in the region. The rebound among fuel exporters was stronger than in other countries, continuing the trend of the past decade. Yet, a simple distinction in performance between fuel and non-fuel economies is no longer a good basis for explaining divergent performance, because not all output growth in fuel-exporting economies has been on account of expanding activity in the oil sector, as differences in domestic factors also weigh in.

Four patterns can be observed by looking at growth performances before and after the crisis. For this exercise, 3 per cent per capita GDP growth is used to identify fast-growing economies.³ Some economies remained in the same growth category before and after the crisis. A small group of economies managed to accelerate above the 3 per cent threshold between the "pre-crisis" high-growth period of 2004-2007,⁴ and 2010-2011, while others decelerated. Figure IV.6 maps the four patterns of growth performance across the region.

Countries belonging to the first group of *slow-growing economies* are mostly characterized by continued political instability and/or insecurity, with presumed adverse effects on investment and other drivers of growth. In some countries, such conditions were compounded by adverse weather conditions: prolonged droughts in Chad and Niger significantly reduced food production and slowed overall economic activity. In Niger, the

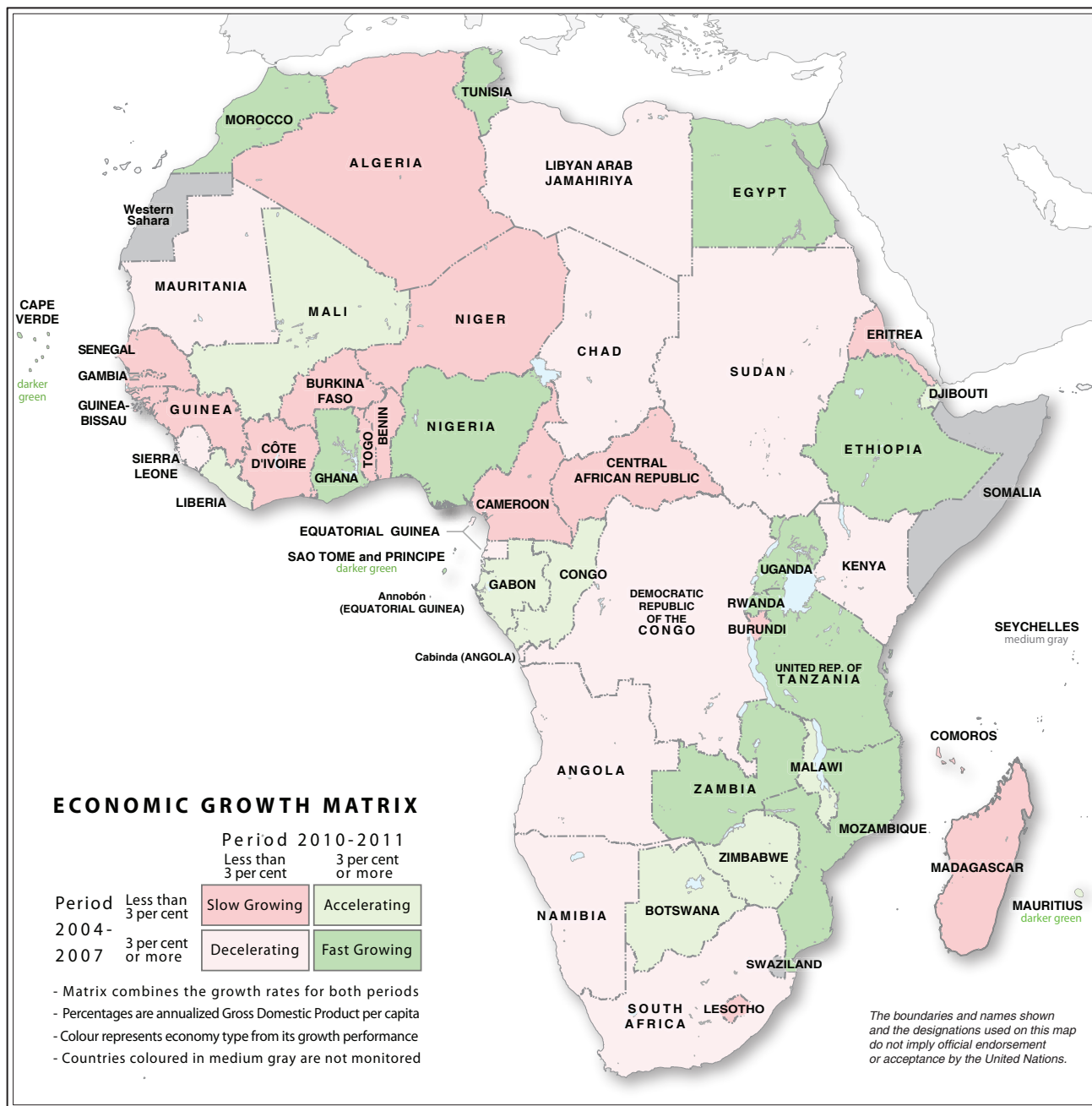
Improved external conditions as well as domestic demand growth have supported economic recovery in Africa

Fuel exporters continue to grow faster, but oil is not the only thing that counts

³ In the African context, a GDP per capita growth rate of 3 per cent is widely seen as the minimum rate of growth to make a dent in poverty rates.

⁴ The comparison focuses on factors of growth across these two periods, thus overlooking the effect of the 2008-2009 crisis, which was, in significant ways, an "external" crisis.

Figure IV.6
Africa growth map



decline in food production outweighed growth in mining output. In contrast, insufficiently widespread structural reforms to diversify and dynamize Algeria's economy pulled its average below 3 per cent in the periods before and after the crisis. Nevertheless, in the medium run, Algeria's massive \$286 billion development plan for 2010-2014 should provide enough impetus to boost GDP per capita above this threshold.

The group of *fast-growing economies*, by contrast, has shown resilience which can be attributed to the robustness of their manufacturing and services sectors, as in Egypt and Uganda; strong expansion of investments in infrastructure and/or of mining activity, as in Ethiopia and the United Republic of Tanzania; agricultural productivity growth, as in Rwanda and Zambia; or a combination of higher oil exports and vibrant domestic activity, as in Nigeria, Africa's most populous country.

Decelerating economies ran out of fortune for different reasons. In Equatorial Guinea, declining oil output and slow growth in the non-oil sector limited economic growth to about 2 per cent, after double-digit economic growth rates for many years before the crisis. In South Africa, depressed demand for manufactures, major labour strikes and subdued domestic demand explain the country's rather weak economic recovery.

Several economies where growth *accelerated* saw significant improvements in external conditions. Botswana took advantage by also implementing strong counter-cyclical fiscal policies. In Mali, new investments in gold mining played an important role. In the Congo and Zimbabwe, political instability abated, spurring expectations of strong growth. As political tensions may linger, the near-term growth projection is surrounded by uncertainty.

Efforts at containing inflationary pressures in the region have not been equally successful. Cost-push effects weakened with lower food prices in 2010. In most parts of East and Southern Africa, improved weather conditions allowed for greater harvests and helped to moderate food prices. In several countries, like Ethiopia, Mozambique and Sierra Leone, however, inflation is expected to remain high—between 10 and 20 per cent—as a result of pass-through effects from exchange-rate devaluation. In South Africa, high unemployment and low capacity utilization rates have offloaded demand pressures on the aggregate price level. Low inflationary pressures in most countries have persuaded central banks to continue policies of monetary easing or, at the minimum, to refrain from monetary tightening. The two central banks in the Communauté financière africaine (CFA) zone, for instance, delayed further monetary easing, after a sequence of interest rate cuts and reserve requirement relaxations. The South African Reserve Bank reduced its repurchase rate by 50 basis points to 6.0 per cent in September 2010 in an attempt to strengthen the economic recovery. The Central Bank of Nigeria, however, engaged in monetary tightening as inflationary pressures mounted and increased the interest rate payable on reserve deposits held with the Central Bank by 225 basis points. Irrespective of the stance, however, the transmission effects of monetary policies into the real sector remain weak in most countries because the lenders are risk averse amidst continued high macroeconomic uncertainty. Lower interest rates have not induced any significant expansion in credits provided to the private sector, despite most banks' being well capitalized.

Fiscal policy remained supportive in the majority of countries, reflecting both Governments' commitments to nurture the recovery as well as ongoing efforts geared towards bridging infrastructural gaps, a key objective of many medium-term development plans. Such expansionary stances contributed to a short-term widening of fiscal deficits. In the aggregate, the fiscal deficit for the region as a whole is estimated to have increased to between 3 and 4 per cent of GDP in 2010, up from about 2 per cent in 2009. A larger budget deficit has prompted some countries to shift focus from short-term demand management to medium-term fiscal sustainability and to tighten fiscal policy stances. This could risk weakening the economic recovery, which would make accomplishing fiscal consolidation a more difficult task.

Inflationary pressures have declined, creating more headroom for expansionary monetary policy

Fiscal policies have supported the recovery

Africa's external balance improved markedly in 2010

The strong recovery of merchandise export revenues helped improve Africa's external accounts markedly in 2010. The rebound was mostly on account of growth in revenue from exports of hydrocarbons and minerals, which comprise approximately four fifths of the total of the region. The rebound has not been strong enough, however, to bring the level of total merchandise exports back to its pre-crisis peak in 2011, especially because demand from advanced economies remains subdued. Africa's import bill has also been growing, albeit at a slower pace. In volume terms, however, imports grew at a faster pace than exports, highlighting Africa's dependence on foreign manufactures.

ODA also increased in 2010 but fell short of targets

Official development assistance (ODA) to the region is estimated to have increased by nearly 4 per cent in 2010 in real terms. Yet, ODA flows continue to fall well short of the targets and commitments made by the international donor community.

Private capital inflows have returned and are increasing

Private capital flows to Africa have been growing steadily with the exception of the short-lived slump in the last part of 2008 and the early months of 2009. FDI rebounded sharply, particularly in the primary sector which is receiving growing interest from Asian and South American companies. Although to a much lesser extent, foreign investments in services and light manufacturing sectors have also increased. Meanwhile, there have been growing cross-border mergers and acquisitions of South African enterprises.

As in other emerging markets, there was also a surge in portfolio inflows during 2010, mainly to the countries with the two largest stock markets in the region, Egypt and South Africa. In Egypt, for instance, private transfers from abroad in the second quarter soared by 235 per cent, to \$4.19 billion. There has also been a surge in short-term, speculative capital flows into South Africa, where the large interest rate differential with developed-country financial markets and exchange-rate appreciation has stimulated the carry trade.

Macroeconomic prospects for 2011 are generally positive. Average GDP growth is forecast to grow by 5.0 per cent in 2011 and 5.1 per cent in 2012, which means that growth of GDP per capita will be 2.7 and 2.8 per cent, respectively, and hence below the 3 per cent threshold. Several factors that supported the recovery in 2010 are expected to support economic development in Africa in the near future, but growth is expected to remain below pre-crisis rates. A possible further slowdown of global growth, caused by the weaknesses in developed economies, poses an important downside risk and would affect both demand for and prices of African exports. Another risk is posed by possible retreats in fiscal stimuli and public investment in infrastructure, as noted earlier.

East Asia: moderate growth, but the outlook is still good

Growth is expected to moderate in 2011 as external demand weakens

East Asia's economies rebounded strongly in 2010, with manufacturing output and exports returning to pre-crisis levels earlier than expected. Driven by rapid growth in China and a rebound in the export-oriented economies, the region's GDP expanded by 8.8 per cent in 2010, up from 4.9 per cent in 2009. Following a very strong recovery in the first two quarters of 2010, growth across the region decelerated in the second half as global conditions weakened and the impact of stimulus measures moderated. This trend is likely to continue in the quarters ahead with GDP forecast to grow, on average, by 7.2 per cent in 2011 and 7.4 per cent in 2012 (see annex table A.3). Given the subdued outlook in developed economies, countries with large and buoyant domestic markets, such as China, Indonesia and Viet Nam, are in a better position to maintain the growth momentum than highly export-oriented economies. Despite the vigorous recovery from the crisis, inflation increased only slowly in most countries, leaving room for central banks to keep monetary

policy accommodative. In 2011 and 2012, Governments and central banks will gradually move towards a neutral policy stance.

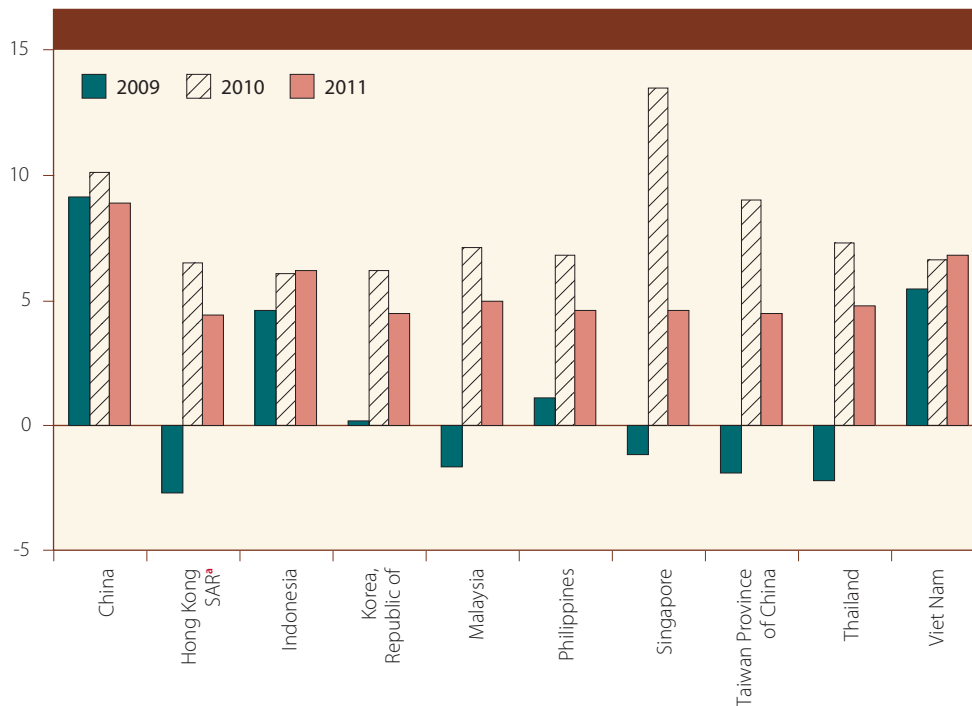
The region's recovery since mid-2009 has increasingly been driven by private sector demand. Loose monetary conditions and a rebound in export demand—partly owing to the restocking of inventories—led to strong growth in business investment, especially in the first half of 2010. Thanks to improved labour market conditions, consumption demand also expanded at a robust pace. Government spending continued to provide significant stimulus in many countries, but contributed less to growth than in 2009. While economic activity expanded at a rapid pace virtually everywhere in East Asia, China and the highly export-oriented economies of Singapore and Taiwan Province of China recorded the fastest growth (see figure IV.7). The Chinese economy grew by 10.1 per cent in 2010 as exports rebounded and domestic demand soared amidst continuing government support. However, the monetary measures taken to slow credit growth, investment spending and property speculation, have also moderated output growth. GDP growth in China is forecast to decelerate to 8.9 per cent in 2011 and 9.0 per cent in 2012.

Labour market conditions in East Asia generally improved in 2010. Strong growth has reduced excess production capacity and boosted employment, especially in manufacturing, construction and services. Unemployment rates have continued to decline and are back to or below pre-crisis levels in most economies. Notably, the employment situation improved considerably in Indonesia and the Philippines, which had faced high unemployment rates. In Indonesia, the unemployment rate dropped to 7.1 per cent in the first quarter of 2010, the lowest level in almost 10 years. The gradual tightening of labour markets, combined with somewhat higher inflation, has led to upward pressure on wages. In most countries, average real wages are estimated to have risen moderately in 2010. China has seen a particularly strong increase in real wages, following significant minimum

Private sector demand has become more important to the recovery

Unemployment is back to pre-crisis levels in most economies

Figure IV.7
GDP growth in selected East Asian economies, 2009-2011



Source: UN/DESA.

^a Special Administrative Region of China.

wage hikes in several provinces. In the outlook, labour market trends in East Asia will likely continue to be favourable. Unemployment and underemployment rates are expected to decline slowly and real wages are forecast to increase further.

Inflation has picked up, but remains well contained

Consumer price inflation in East Asia started to pick up in mid-2009 but has remained well contained in most countries. Average inflation in the region rose from a low of 0.7 per cent in 2009 to 3.2 per cent in 2010 (see annex table A.6). In all economies, except Myanmar, Papua New Guinea and Viet Nam, annual inflation rates are estimated to remain below 5 per cent and inflationary expectations are generally within central banks' target ranges. Most of the increase in consumer price indices over the past year can be attributed to higher food prices, whereas core inflation continues to be low. In China, for example, food prices increased by about 6 per cent during the first three quarters of 2010, well above the increase in the consumer price index of 3 per cent. In most countries, core inflation continued to be mitigated by limited labour cost pressures and stronger currencies. With the slowing of global growth and expected stabilization of world commodity prices, inflation is forecast to accelerate only slightly to about 3 per cent in both 2011 and 2012.

Central banks remain cautious about tightening monetary policy

Central banks across East Asia maintained an accommodative monetary policy stance in 2010 as inflationary pressures remained subdued and uncertainties about global recovery persisted. Despite the economic rebound, authorities have been very cautious about tightening monetary policy, keeping interest rates at or close to the very low levels adopted in 2008 and 2009. In China, Malaysia, the Republic of Korea, Taiwan Province of China and Thailand, policy rates were raised between 25 and 75 basis points. Despite the increases in policy rates and reserve requirements, the People's Bank of China maintained its overall "moderately loose" monetary policy stance. Growth of money supply and credit in China has returned to a more sustainable level in the course of 2010. Authorities also resumed the basket exchange-rate regime, adopted in 2005 but suspended since mid-2008, allowing for a more flexible exchange rate. However, appreciation of the renminbi has so far been very mild as concerns about possible shocks to exports persist. In the outlook, most central banks are expected to tighten monetary conditions slowly. However, in doing so, authorities will remain vigilant to the strength of the recovery in developed economies and the risk of further encouraging capital inflows by increasing the interest rate differential.

Governments are expected to phase out fiscal stimulus

Across East Asia, fiscal policy continued to support growth, especially in the first half of 2010, as stimulus measures adopted earlier were being implemented. This is particularly the case for infrastructure investment, which represents the largest component in most stimulus packages. Government consumption expenditure also expanded at a robust pace in most economies, albeit slower than GDP growth. Like other countries in the region, China continued its proactive fiscal policy in 2010, aiming at faster economic restructuring. Going forward, most Governments are likely to gradually move towards a more neutral fiscal policy stance by phasing out the stimulus. In general, Governments in export-oriented economies such as Malaysia and Singapore may reduce their stimuli earlier than others. Mainly as a result of strong growth, budget deficits as a share of GDP narrowed in most countries in 2010; this trend is likely to continue in 2011 and 2012.

Export growth is expected to slow down markedly in 2011

East Asia's exports rebounded in 2010, driven by a restocking of inventories and rising import demand from China. In many economies, total export earnings were up by more than 25 per cent compared to 2009 despite a slowdown in the second half of the year. The manufacturing sector accounted for most of the growth as demand for machinery and electrical equipment rapidly increased. This lifted the revenues of the export-oriented economies in the region, in particular. Commodity-exporting countries, such as Indonesia and Papua New Guinea, benefited from strong increases in the prices of their main export

goods. Overall, intraregional trade rebounded faster than trade with the United States and European countries. In 2011, export revenues are expected to grow further, although at a much slower pace than in 2010 as demand from developed economies weakens. Owing to higher international commodity prices and strong domestic demand, import spending rose even faster than export revenues in early 2010, thus reducing trade and current surpluses. However, with import demand slowing markedly, trade surpluses have begun to widen again, most notably in China and the Republic of Korea. In value terms, the full-year surplus is therefore expected to increase in most economies in 2011. By contrast, trade surpluses as shares of GDP are likely to continue to decline to levels well below those reached in the years before the global financial crisis (see box IV.2).

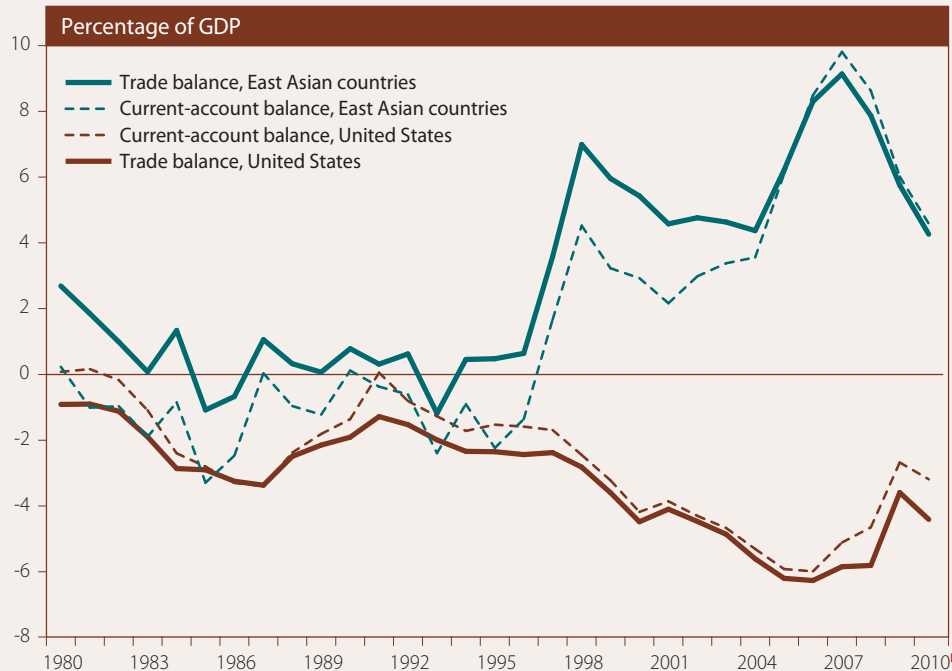
Box IV.2

Addressing global macroeconomic imbalances in East Asia

Prior to the global financial crisis of 2008 and 2009, the world economy was characterized by record large and increasing trade and current-account imbalances among major trading partners. While the United States current-account deficit soared to a record 6.0 per cent of GDP in 2006, the current-account surpluses of four East Asian economies (China, Indonesia, Malaysia and Thailand) reached a peak of 9.8 per cent of their combined GDP in 2007. Although the global financial crisis reduced these imbalances in 2009, they are still large by historical standards (see figure).

In fact, during the period 1996 to 2006, net exports became an important source of economic growth for these four East Asian countries. Net exports increased not only as a share of GDP but also in their contribution to GDP growth: they accounted for 13.0 per cent of China's average growth of 9.3 per cent during this period and for as much as 72.7 per cent of Thailand's average growth of 2.9 per cent.

Trade and current-account balances of selected East Asian countries^a and the United States, 1980-2010



Box IV.2 (cont'd)

Going forward, with the sputtering recovery in developed countries and the implementation of medium-term fiscal consolidation plans in many European countries, global macroeconomic imbalances may continue to decline. But given the high degree of export orientation of East Asian economies, such an adjustment process will have detrimental effects for the region's recovery and growth. Hence, there is an emerging consensus that the region should rely more on its domestic and regional markets to sustain its dynamism, which could contribute to reducing global imbalances. However, in order to design appropriate policies at the national and regional levels, it is necessary to take into account important differences in the nature of the macroeconomic imbalances across countries in the region.

The large surpluses of China, on the one hand, and Indonesia, Malaysia and Thailand, on the other, have different underlying causes. By definition, a current-account surplus reflects an excess of national savings over domestic investment. In the case of China, this results mainly from a very high savings rate. The share of household consumption in GDP dropped steadily over time, from 57 per cent in 1986 to 46.1 per cent in 1996 and to 36.7 per cent in 2006. As a result, the contribution of household consumption to GDP growth was only 30.7 per cent during 1996-2006. By contrast, during the same period, the share of consumption in GDP increased slightly in Indonesia and Malaysia, and remained roughly the same in Thailand. In these three countries, the share of investment in GDP decreased sharply and the contribution of investment to GDP growth was negative. For example, in Malaysia, the share of gross fixed capital formation in GDP declined from 43.6 per cent in 1995 to 20.5 per cent in 2005.

Hence, a "one-size-fits-all" approach will not work when reducing economic imbalances in Asia and the Pacific. First, although China's average growth rate of household consumption increased from 7.7 per cent during 1996-2006 to 10 per cent during 2006-2010, the share of household consumption in GDP is still very low. One reason for this phenomenon lies in precautionary motives for savings associated with the shifting burden of education and health care expenditures from the State to households, as well as uncertainties about State enterprise restructuring in a period of rapid reforms. The unusually high level of savings among younger age groups, in particular, has been attributed to underdeveloped financial markets and the scarcity of mortgage products accessible to younger, urban households.^a Therefore, policy reforms aimed at enhancing the coverage and scope of social protection systems and at fostering inclusive financial development could boost household consumption in China.

Second, given the declines in investment rates in Indonesia, Malaysia and Thailand during 1996-2006, boosting investment should play a major role in any rebalancing towards domestic demand in these countries. However, it is important to keep in mind that the dramatic drops in investment after 1997 partly reflected the end of real estate price bubbles. Thus the investments to be promoted should be carefully considered. In this respect, it has been estimated that the members of the Association of Southeast Asian Nations (ASEAN) needed about \$60 billion per year in infrastructure investment over the period 2006-2015, amounting to roughly five times the average annual level of private sector investment.^b

^a Marcos Chamon and Eswar Prasad, "Why are saving rates of urban households in China rising?", *American Economic Journal: Macroeconomics*, vol. 2, No. 1 (January), pp. 93-130.

^b Biswa Nath Bhattacharya, "Infrastructure development and ASEAN economic integration," ADBI Working Paper Series, No. 138 (Tokyo, Japan: Asian Development Bank Institute, May 2009).

Large and volatile capital inflows pose serious risks for some economies

While East Asia has rebounded strongly from the crisis and is expected to continue on a firm recovery path, there are several downside risks. A key risk is related to the rapid inflows of short-term capital to some economies owing to very low interest rates and abundant liquidity in developed countries. These capital flows lead to exchange-rate pressures, while also increasing the risk of asset price bubbles and of accelerating inflation. In 2010, several East Asian currencies, most notably the Malaysian ringgit and the Thai baht, appreciated significantly against the dollar and the renminbi. Indonesia, the Republic of Korea, Taiwan Province of China and Thailand have put in place capital controls to limit the impact of volatile foreign capital on the exchange rate. Since most East Asian economies rely heavily on external demand, competitive devaluations, combined with other protectionist measures, would be particularly damaging to growth in the region.

South Asia: robust growth momentum

The global economic crisis had only a limited impact on South Asia and economic activity gained further strength in 2010, most notably in India and Sri Lanka. A rebound in private investment and exports, along with a strong industrial expansion and improved agricultural performance, supported the growth momentum. Aggregate GDP expanded by 7.0 per cent in 2010, the second-highest rate of any region after East Asia. Growth is forecast to decelerate slightly in 2011 to 6.9 per cent, before picking up to 7.2 per cent in 2012 (see annex table A.3). Strong inflationary pressures continue to be a major concern for policymakers, however. In several countries, consumer price inflation has remained at double-digit levels, with food prices rising particularly fast. In response, a number of central banks tightened monetary policy in 2010. Governments have started to implement fiscal consolidation plans to reduce the large budget deficits. The combination of tighter monetary and fiscal policy is expected to moderate output growth in 2011.

The strong regional growth masks stark differences among South Asian countries. India continued to lead the region's recovery in 2010, owing to a rapid expansion in gross fixed capital formation, increased government spending and robust growth in private consumption. The manufacturing sector expanded at a fast pace, driven by strong domestic and external demand. Agricultural output was boosted by good monsoon rains. After accelerating to 8.4 per cent in 2010, growth is forecast to moderate to 8.2 per cent in 2011, mainly as a result of tighter monetary and fiscal policies. Sri Lanka's economy is reaping a peace dividend. Following the end of its violent domestic conflict, agricultural output has expanded strongly, domestic trade and transport activities have surged, tourist arrivals have increased and post-conflict reconstruction activities have boosted the investment rate. In contrast to these two economies, the Islamic Republic of Iran, Nepal, Pakistan and, to a lesser extent, Bangladesh are growing at much more subdued paces, owing mostly to country-specific structural factors such as political uncertainties, weak infrastructure and a poor investment climate. Driven by robust private consumption, Bangladesh recorded moderate growth in 2010 despite massive power shortages. Pakistan's recovery was adversely affected by the worst flooding in the country's history, which severely damaged agricultural crops and physical infrastructure. In the Islamic Republic of Iran, economic activity in 2010 was supported by higher oil prices, but it continues to be below potential owing to insufficient investment in the hydrocarbon industry in recent years and slow growth in private consumption.

The recovery in several South Asian economies since mid-2009 has led to some improvements in the labour market. In India, employment in export-oriented industries increased owing to stronger global demand, while in Sri Lanka, the unemployment rate declined markedly. However, most countries continue to face serious employment challenges, including high rates of vulnerable and informal employment, large labour surpluses in rural areas and low productivity in the agricultural sector. In addition, youth unemployment remains a core problem. In Sri Lanka, 18.6 per cent of young men and 24.6 per cent of young women were unemployed in the second quarter of 2010. The employment situation is particularly dire in Pakistan, where more than 5.3 million jobs were lost or affected by the recent flooding.

High inflation remains a key challenge in most countries, with weighted-average regional consumer price inflation standing at 11.0 per cent in 2010 (see figure IV.8). Continued strong inflationary pressures reflect a combination of supply- and demand-side factors, including rapidly rising food prices and growing demand for manufactured goods.

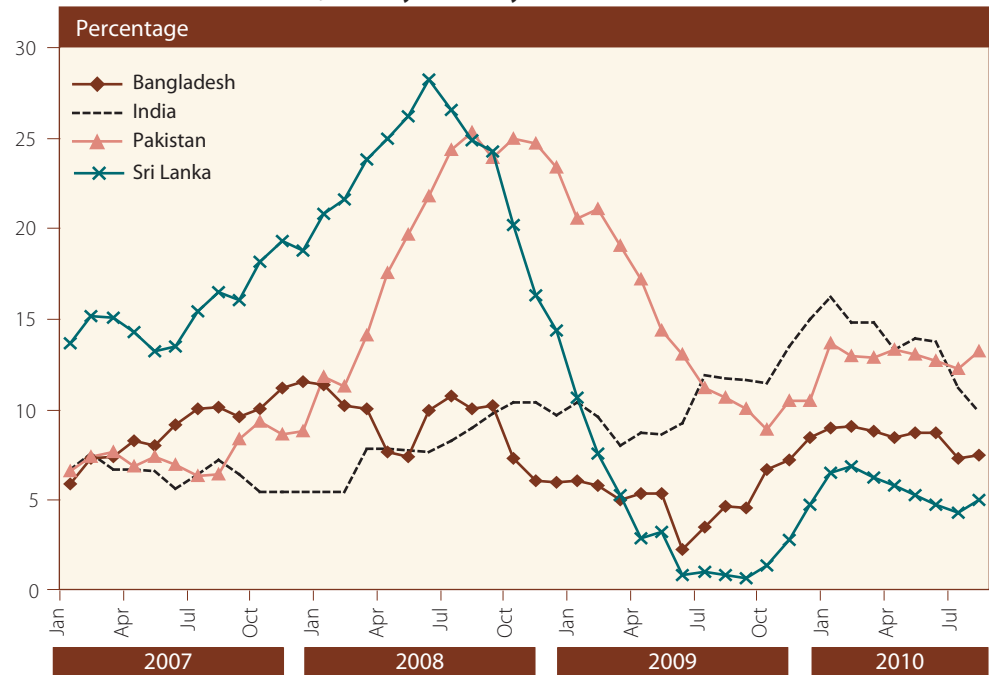
Economic growth gained strength, but inflation remains a concern

India and Sri Lanka enjoy strong growth, driven by rising investment demand

The employment situation remains a key challenge despite some recent improvements

Inflation is expected to decelerate somewhat in 2011 with weaker food prices

Figure IV.8
Year-on-year changes in the consumer price index in selected
South Asian economies, January 2007-July 2010



Source: Official national sources.

Moreover, higher electricity charges and lower fuel subsidies have pushed up the cost of production and transportation of consumer goods and services. In Pakistan, the inflation rate increased sharply in the second half of the year as the flooding destroyed crops and rural infrastructure. In the outlook, inflation is forecast to decline moderately in most countries, averaging 8.7 per cent in 2011 and 7.7 per cent in 2012, as a result of a slower rise in food prices and tighter monetary policies (see annex table A.6).

Given ongoing strong inflationary pressures, several central banks have started to tighten monetary policy. In India, key policy rates were raised six times in 2010, more often than anywhere else. These moves follow sharp policy rate reductions in late 2008 and early 2009, thus largely reflecting a normalization of monetary conditions. In Bangladesh and Pakistan, key policy rates were also increased in the course of 2010. Pakistan's monetary authorities view high inflation and heavy government borrowing as major risks to macroeconomic stability. By contrast, monetary policy was eased in Sri Lanka in the third quarter after inflation declined in the first six months. In the outlook, monetary policy is expected to become tighter, although slowing inflation may give central banks greater room to manoeuvre.

Although budget deficits were already high prior to the global crisis, Governments had little choice but to increase them further as a means of counter-cyclical stabilization policies. The fiscal deficit rose to about 10 per cent of GDP in Sri Lanka and to almost 7 per cent in India. In 2010, Governments in both countries started to implement fiscal consolidation plans, based on a combination of increased tax and non-tax revenues and lower expenditures. Owing to strong economic growth and reduced fuel subsidies, India is in a good position to achieve the target of reducing its deficit to 4.8 per cent of GDP in 2011. Sri Lanka's budget situation benefited from improved security conditions, which facilitated improved tax collection and allowed for a gradual reduction

Central banks have tightened monetary policy to contain inflation

Several Governments have started to implement fiscal consolidation plans

in defence spending. In Bangladesh, however, the fiscal deficit is expected to rise in 2011 as expenditures grow faster than revenues. Pakistan's fiscal deficit increased markedly in the fiscal year 2009/10, missing the IMF target by a wide margin. Given low tax revenues, increased military expenditures, shortfalls in budgetary support from donors and post-flood reconstruction work, the Government will face difficulties in reducing the deficit in the outlook period.

Following a sharp decline in 2009, trade activity has picked up significantly in 2010. Strong demand from East Asia for agricultural commodities and manufacturing goods boosted export revenues. This was particularly the case in India, where export earnings increased by about 25 per cent in 2010. In Bangladesh, the garments sector, which accounts for almost 70 per cent of total merchandise exports, rebounded in the second half of the year as Pakistan and Sri Lanka lost orders. Despite the improved export performance, trade deficits widened in all South Asian countries in 2010, except for the Islamic Republic of Iran. Higher prices for energy products, along with strong domestic demand, caused a significant increase in import bills. The factors causing trade deficits to widen were offset, in part, by increased worker remittances, which continued to grow in 2010, albeit at a slower rate than in recent years. In 2011 and 2012, trade deficits are expected to increase further, although at a more moderate pace than in 2010.

Downside risks for the region's outlook are related to the expected tightening of monetary and fiscal policies amidst relatively weak global conditions. If energy and food prices increase in 2011 and become more volatile, policymakers will find it even more difficult to bring inflation back to target and to consolidate fiscal balances. A more rapid-than-expected tightening could weaken growth and lead to further social unrest in some countries. In Pakistan, a further deterioration of the security situation would hinder the reconstruction of the flood-hit areas and lead to a sharper economic slowdown.

Trade deficits have widened despite a recovery in exports

An increase in energy and food prices could lead to more rapid policy tightening

Western Asia: solid growth after a sharp rebound

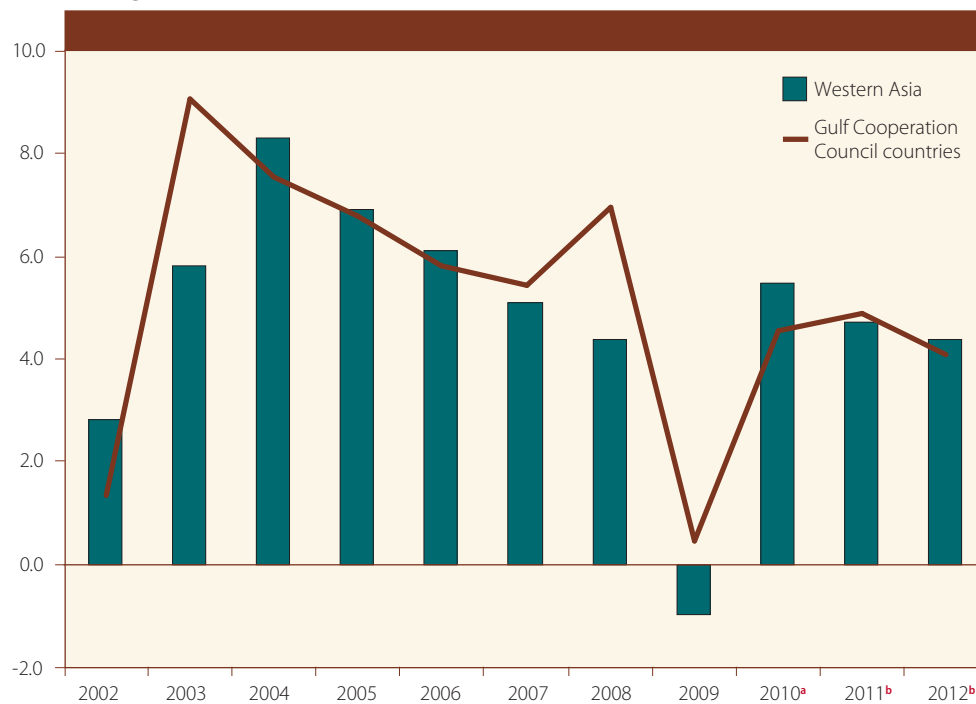
Western Asia's economic prospects have been improving continuously after the pessimism that prevailed during 2008-2009. After a pronounced economic recovery in 2010, the region will see solid economic growth of about 4.5 per cent in both 2011 and 2012, although this remains below the levels reached in the years preceding the global economic crisis (see annex table A.3 and figure IV.9).

The economic performance of fuel exporters mirrors the trajectory of oil prices. After dropping by 37 per cent in 2009, the annual average oil price increased by 28 per cent in 2010 and is expected to fall by 5 per cent in 2011. Against this background, oil exporters will register growth rates in 2011 comparable to those for 2010, although non-oil related engines of growth seem to be becoming more important. In Saudi Arabia, for example, which is the second-largest producer of crude oil after Russia and where oil-related activities represent almost 30 per cent of GDP, both government consumption and public investment have become stronger drivers of growth in an overall fairly balanced economic performance. The picture is similar in the United Arab Emirates, with government spending underpinning robust growth in 2011. However, as a payback to the economic diversification strategy, the services sector, particularly tourism, and the manufacturing sector are also providing significant growth impulses. In Yemen, by contrast, the economy will benefit from increases in its gas production capacity, while water shortage hampers the agricultural sector and political instability casts a shadow over the general economic performance.

Growth is recovering but remains below pre-crisis levels

Higher oil prices are driving growth for the fuel exporters

Figure IV.9
GDP growth in Western Asia, 2002-2012



Source: UN/DESA, based on Project LINK.

^a Partly estimated.

^b Baseline scenario forecasts, based in part on Project LINK.

Private consumption is supporting economic activity for the non-oil exporters

The non-oil exporters are forecast to see continued solid growth rates, with private consumption representing a major pillar of support. This is the case, for example, in Turkey, whose economy contracted by 4.7 per cent in 2009 and where supportive monetary and fiscal policies have been propelling private consumption and investment, leading to a pronounced jump in GDP growth to 7.4 per cent in 2010. The recovery is expected to continue in 2011, but at a more moderate pace of 4.6 per cent. A similar constellation emerges in Israel, where strong private consumption will more than offset the dampening effect from relatively weaker export demand, resulting in growth rates of about 3.0 per cent or higher in both 2011 and 2012. As an example of the positive ripple effects of generally positive regional growth conditions, Lebanon is forecast to register growth of more than 5.0 per cent in 2011 and 2012. One of the main drivers of this performance remains tourism, which has significant positive impacts for construction activity, employment and, thus, available household incomes and private consumption.

Unemployment has stabilized but remains a major challenge

The employment situation generally remains challenging, referring to both open and hidden unemployment as well as underemployment. However, some relatively positive signs have emerged in the aftermath of the peak of the crisis. In Turkey, after a jump to above 14 per cent in 2009, the unemployment rate is expected to fall modestly to below 13 per cent in 2010 and 2011. Likewise, in Israel, after reaching 7.6 per cent in 2009, unemployment will drop below the 7 per cent mark in 2011. The global recovery, not least reflected in the revival of international trade, has been a major factor in this respect.

The inflation picture remains mixed

Since its peak during the second half of 2008, consumer price inflation in the region has slowed down considerably, with the lower level of commodity prices being a major factor. Iraq, Jordan and Qatar experienced deflation in 2009. In the case of Qatar, deflation persisted in 2010. In 2011, all economies in the region are forecast to see positive inflation rates on the back of upward price pressure in the form of gradually increasing

food prices and rising public sector wages, particularly in the Gulf Cooperation Council (GCC) countries. However, second-round effects on inflation from the expected public sector wage increases are expected to be limited.

In line with the inflation outlook, monetary policy in the region will likely vary as well. In Turkey, the central bank is expected to increase its policy interest rate in the first half of 2011 in view of rising price pressures on the back of stronger domestic demand. By contrast, in Israel, where monetary policy tightening has already been in progress since 2009, the central bank is expected to proceed more slowly with any further interest rate hikes in light of a slight drop in inflation to 2.4 per cent in 2011. Other countries such as Jordan, Kuwait and Qatar saw lower policy interest rates in 2010 and are expected to maintain their policy stances in 2011, not least in view of relatively tighter financing conditions in the regional credit market.

In general, Western Asia's Governments remained prudent in their budget planning and implementation. The fiscal stance of GCC countries has remained active in 2010 and is expected to stay in the range of active to neutral in 2011. Overall, fuel exporters will post solid budget surpluses in 2011, although these will be moderately lower than in 2010, reflecting slightly lower oil prices. By contrast, non-fuel exporters will face increasing fiscal policy constraints. Both Jordan and Lebanon, for example, will continue to run budget deficits of about 10 per cent of GDP in 2010 and 2011. Consequently, outstanding public debt and the implied interest payments are significant factors limiting fiscal room to manoeuvre.

External balances in the fuel-exporting countries will continue to show solid surpluses in 2011 in light of the combination of only slightly lower oil prices and largely stable output. In Saudi Arabia, for example, the current-account surplus is forecast to remain at about 10 per cent of GDP in 2011, after more than doubling to about 12 per cent in tandem with recovering oil prices in the immediate aftermath of the global economic crisis in 2010. The general dynamics of global trade also remain relevant for the fuel-exporting economies, as illustrated by the case of Oman. The economy will benefit not only from its oil sector but also from the increasing role of re-exports through its port facilities. The outlier in the region remains Qatar, where major new liquefied natural gas projects will boost exports and lead to a tripling of the trade surplus in 2010 and a further increase by about 65 per cent in 2011.

By contrast, non-fuel exporters saw an increase in trade deficits during the recovery from the crisis, not least due to vigorous domestic demand that outpaced impulses from the main export markets. In 2011, trade balances will register further increases in deficits as the effect of slightly lower oil prices on the import bill is more than offset by strength in domestic demand. This will generally keep current accounts in deficit. In the case of Israel, however, strong exports of business services, including computer software, will continue to ensure a solid current-account surplus.

Sharper volatility and a possible drop in oil prices remain major downside risks for fuel exporters. Economic performance of non-fuel exporters will be directly affected by weaker growth in the major developed economies. For example, almost half of Turkey's exports go to the EU, while about 40 per cent of the exports of Israel go to the United States. Consequently, any renewed economic slowdown in these export markets holds the potential to significantly alter the growth trajectory in the region. At the same time, however, the prospects for the region's major international debtors are fair with respect to achieving balance-sheet adjustments through debt rescheduling.

Monetary policy will also vary depending on the phase of the recovery

Fiscal policies will remain active but will become increasingly subject to constraints

Oil exports drive solid external surpluses in the fuel-exporting countries

Strong domestic demand is pushing trade balances further into deficit for the non-fuel exporters

Oil price volatility and the weakening recovery of developed economies remain major downside risks

Latin America and the Caribbean: strong economic recovery, but diverging across countries

The region will see higher-than-anticipated growth

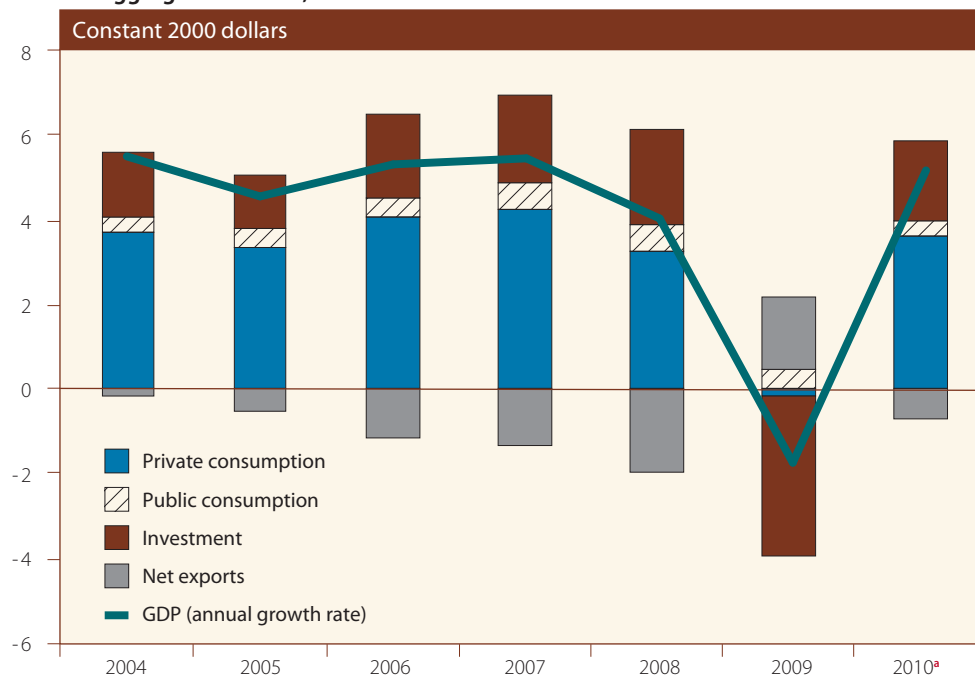
Latin America and the Caribbean saw a stronger-than-expected economic recovery in 2010. GDP of the region as a whole is estimated to have increased by 5.6 per cent in 2010, after contracting by 2.1 per cent in 2009. In 2011 and 2012, economic growth is expected to slow to 4.1 per cent and 4.3 per cent, respectively, but to remain relatively robust by historical standards of the region (see annex table A.3).

The strong rebound has been supported in part by counter-cyclical macroeconomic policies initiated in 2009, which helped restore confidence and strengthened domestic demand through 2010. Private consumption growth was generally strong, stimulated by lower interest rates, higher real wages—as a consequence of sharp reductions in inflation—and targeted social programmes. As a result, in most Latin American countries, the recovery was led by domestic demand. Despite improved external conditions, the contribution of net exports to growth was negative in 2010 (see figure IV.10). Strong domestic demand pushed up import volumes at a rate faster than export growth. In 2011, growth is expected to decelerate as counter-cyclical policies are being phased out and inventory-building will make a smaller contribution to GDP.

South America has seen a strong economic rebound

The recovery has been especially strong among the South American countries, which were more proactive in implementing counter-cyclical macroeconomic policies, but which also saw a strong return of private capital flows and benefited from high demand for and prices of primary commodities (especially, mining and agricultural products). The combination of these factors supported strong growth of domestic demand. During the first half of 2010, Argentina, Brazil, Paraguay and Uruguay posted the highest GDP growth (9.4, 8.9, 11.7 and 9.6 per cent, respectively). The Bolivarian Republic of Venezuela was the main outlier as it saw its economy shrink by 3.5 per cent in the first half of 2010, owing to strong declines in domestic demand and oil production. On average, however,

Figure IV.10
Latin America: GDP growth rate and contribution to growth of components of aggregate demand, 2004-2010



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

^a First trimester.

GDP growth in South America reached an estimated 6.3 per cent of GDP growth in 2010 but is expected to slow to 4.5 per cent in 2011 with the phasing out of stimulus measures and a weakening of global trade growth.

The economic recovery in Mexico, Central America and the Caribbean has been slower, as these countries continue to be highly dependent upon output growth in the United States. Mexico recovered steadily in the first half of 2010, supported mainly by external demand for automobiles produced in the country. The rebound is expected to weaken, however, as recovery of the United States economy is losing its momentum. Domestic demand growth in Mexico and Central America is not strong enough to offset weakening external demand, as consumer confidence remains low and Governments are tightening budgets. The Mexican economy is estimated to have grown by 5.0 per cent in 2010, but GDP growth is projected to slow to 3.4 per cent in 2011. In the Caribbean, despite some improvements in remittances and tourist inflows through 2010, the economic situation is also expected to continue to be particularly challenging in 2011 and 2012.

The strong rebound in output has boosted job creation in several South American countries. This has helped to bring down the average rate of unemployment for the region, which dropped to 7.8 per cent in 2010, down from 8.2 per cent in 2009, but is still above that reached in 2008. The situation is more dramatic in some Caribbean countries, such as Jamaica, where double-digit unemployment is increasing further. Real wages have increased in several countries across the region, particularly in Chile, Costa Rica, El Salvador, Paraguay and Uruguay, as inflation rates dropped significantly from 2008 levels and employment growth put upward pressure on nominal wages.

Inflation rates have been on an upward trend in 2010, but remain low compared with pre-crisis levels. Higher inflation is mainly explained by an increase in commodity prices and the withdrawal of subsidies for energy and food products in Central America and the Caribbean. Inflationary pressures are expected to remain weak in the near term in most countries. The situation is more challenging in Argentina and the Bolivarian Republic of Venezuela, where inflation rates are expected to continue in the double digits.

Current-account deficits are expected to widen somewhat in 2011 and 2012, as a result of weakening export prospects. During 2010, the rebound in global trade and rising commodity prices boosted export revenue, especially for net commodity exporters, including the Bolivarian Republic of Venezuela, Colombia, Ecuador and the Plurinational State of Bolivia. For the region as a whole, the terms of trade are estimated to have improved by about 7 per cent in 2010. Despite gains in the terms of trade, the regional trade surplus observed in 2009 is expected to have eroded in 2010, as import volumes have increased at a faster pace. The current-account deficit is estimated at about 0.5 per cent of regional GDP in 2010 and is expected to widen in 2011 and 2012, reflecting a deterioration of the trade account.

Remittance inflows have recovered modestly, rising by an estimated 5 per cent in 2010, having fallen significantly in 2009, by 12 per cent. As labour markets in Europe and the United States are not expected to improve rapidly, prospects for remittances remain weak for 2011 and the losses in 2009 will not be recovered.

Private capital inflows to Mexico and South America recovered during 2010. FDI inflows are estimated to have increased by 40 to 50 per cent in 2010. This outweighed the increase in the current-account deficit, allowing for further accumulation of foreign-exchange reserves. In addition, risk premia on external borrowing have declined to below pre-crisis levels. Lower borrowing costs and easier access to external financing support the expansion of domestic demand, but also contribute to the exchange-rate appreciation (see box IV.3). Currencies of the region appreciated on average by about 4.5 per cent in 2010. Monetary authorities in several countries have responded by intervening in foreign-exchange markets and introducing stricter controls on short-term capital inflows.

Growth in Mexico, Central America and the Caribbean is highly sensitive to that of the United States

Employment creation has strengthened, but unemployment is above pre-crisis rates

The inflation outlook remains benign

Current-account deficits will widen as export growth weakens

The surge in capital inflows to Latin America contributes to currency appreciations

Box IV.3

Currency appreciation in Latin America and the Caribbean

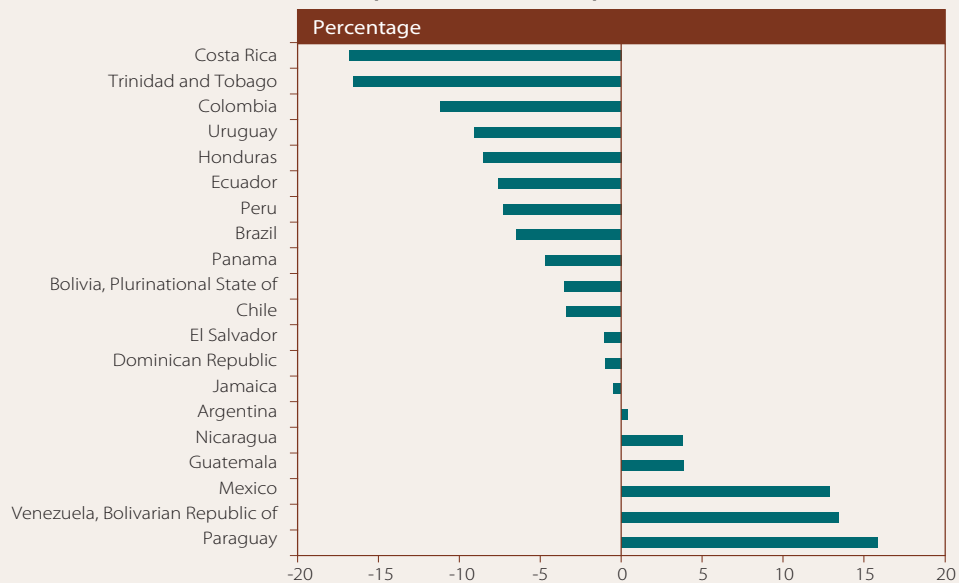
Since the end of the first quarter of 2009, there have been strong and persistent upward pressures on most currencies of the countries in Latin America and the Caribbean (see figure).

Several external and internal factors explain these pressures. First, unprecedented expansionary monetary policy in the United States of America, the euro area and Japan, including aggressive interest rate cuts and quantitative easing measures, has led to low rates of return and excess liquidity in the financial markets of developed economies. Higher rates of return in emerging markets, including those in South America and Mexico, have induced international investors to change their portfolios. The rate of return differential is expected to persist in the near future as developed countries are expected to continue their expansionary monetary policy stance given the weak recovery of their economies, while economic growth in Latin America is forecast to remain relatively strong in 2011. Second, several countries, including Brazil, Chile and Peru, have started to tighten monetary policies during 2010 in efforts to take some air out of emerging asset price bubbles and to limit domestic credit expansion. This has led to a further widening of the interest rate differentials with financial markets in Europe and the United States, providing further stimulus to capital inflows.

The surge in capital inflows has put upward pressure on real exchange rates in the region, thus posing macroeconomic policy challenges. The currency appreciation is eroding the competitiveness of exports and making imports cheaper. With domestic demand staying strong, current-account deficits are set to widen. In the short run, exports of manufactures are likely to be hurt most, being more sensitive to exchange-rate adjustments. The consequences will be felt most in the economies of Mexico and Central America, which rely more heavily on manufacturing exports and face even stronger competition from exports from China in the United States market, particularly as the Chinese currency does not appreciate significantly.

The currency appreciation induced by capital inflows is structurally weakening export capacity. Booming commodity prices helped the strong recovery, especially in the South American economies, but they also reinforced existing export specialization patterns with a heavy reliance on primary exports. The real exchange-rate appreciation will further limit incentives towards greater diversification, which may harm economic growth in the medium term. Primary export specialization makes economies more vulnerable to external shocks as fluctuating exchange rates and interest rates cause high volatility in key domestic prices. This in turn induces greater macroeconomic uncertainty, which tends to affect productive investment and thereby weaken long-term growth and employment generation.

Real effective exchange-rate variables,^a
third quarter 2008 to third quarter 2010



Source: ECLAC, on the basis of official figures.

^a A decline in the real effective exchange rate represents appreciation, while an increase indicates depreciation.

Box IV.3 (cont'd)

Policymakers in the region have responded with measures to stem the volatility of short-term capital inflows and offload pressure on their exchange rates. The central banks of Argentina, Colombia, and, more recently, Brazil and Peru have introduced capital controls. Brazilian authorities, for instance, reintroduced a tax on foreign purchases of domestic equity and bonds, and tripled the rate from 2 per cent to 6 per cent. The monetary authorities in Peru increased reserve requirements on short-term foreign loans. In addition, several central banks are actively intervening in foreign-exchange markets—accumulating more international reserves in the process—in efforts to reduce pressures for further appreciation of their national currencies. By heavily intervening in foreign currency markets, monetary authorities in Argentina were successful in avoiding an appreciation of the peso. In the Bolivarian Republic of Venezuela, the Government introduced a multitiered fixed exchange rate regime and devalued the national currency against the United States dollar—by 21 per cent for certain purchases abroad and by 50 per cent for non-essential products—in January 2010. The devaluation was large enough to more than offset the real appreciation of the bolívar in the period prior to that.

Capital-account regulations and reserve accumulation appear sensible policy responses in the present context, but may not be enough. The measures will need to be supplemented with structural policies to support sustained growth over the medium term and fiscal and/or monetary measures to contain domestic demand that has grown too quickly, spurred by asset price bubbles. In addition, greater coordination at the international level in managing exchange rates, readjusting the global imbalances and improving financial regulation will be needed for a more lasting solution.

On the whole, fiscal revenues in Latin America and the Caribbean increased, on average, by about 1 per cent of GDP in 2010, reflecting the robust economic recovery in South America. This has narrowed the primary deficit and contributed to the reduction of the average fiscal deficit of the region, estimated to have fallen from 2.7 per cent in 2009 to about 2.1 per cent of regional GDP in 2010 (see figure IV.11). However, fiscal conditions vary across the region. Not all countries saw government revenue increase, while most expanded public spending during 2010 to support the recovery. As a result, a number of countries, especially several in Central America and the Caribbean, have limited fiscal space left and face high levels of public indebtedness. Some will need additional external financing to cover expenditure needs. By contrast, most South American countries have sufficient fiscal space left and should be able to continue stimulus as needed to keep the momentum of recovery. This includes Chile, which has large additional expenditure needs in order to continue the post-earthquake reconstruction.

As domestic demand rebounded strongly and fears of overheating economies increased, a number of countries in South America have started to tighten monetary policy. Several central banks, including those of Brazil, Chile and Peru, have increased their policy interest rates and their reserve requirements for banks to stem excessive lending. As the inflation outlook remains benign, central banks are not expected to tighten monetary conditions much further in the near term. In several countries in Central America and the Caribbean, monetary policy is expected to continue to be relatively loose, given limited fiscal space and the need for further stimulus given the outlook for a weak economic recovery in the near term.

Risks to the outlook are associated with both external and domestic factors. External risks are related to a worse-than-anticipated slowdown in developed economies. This could affect commodity prices and export volumes in general. Further appreciation of national currencies against the dollar could also undermine export growth. At the domestic level, fears of domestic asset bubbles or lack of fiscal space could push countries to withdraw their monetary and fiscal stimuli faster than expected, which could be harmful to GDP growth in the near term.

Fiscal balances have strengthened in South America, but fiscal policy space is limited in Central America and the Caribbean

Monetary tightening has started in South America in the light of fears of economic overheating

Downside risks are associated with external and domestic factors

Figure IV.11
Latin America and the Caribbean: government revenue, expenditure and fiscal balances, 2006-2010^a

