Chapter IV
Regional developments and outlook

Developed market economies

The developed market economies have finally exited their deepest recession since the 1930s, but the current situation is highly dependent upon policy stimuli and short-term factors, and the medium-term outlook points to subdued rates of growth with significant downside risks.

Unemployment has increased dramatically across the region, posing a number of risks, both short and long term (see figure IV.1). In the short term, the transition to sustained growth will require a durable improvement in private consumption expenditure, which would be jeopardized by continuing high unemployment. In the medium run lies the danger posed by the growing number of persons without a job who could transition from short- to long-term unemployment, a difficult problem in itself, but also a factor generating lower long-run growth potential.

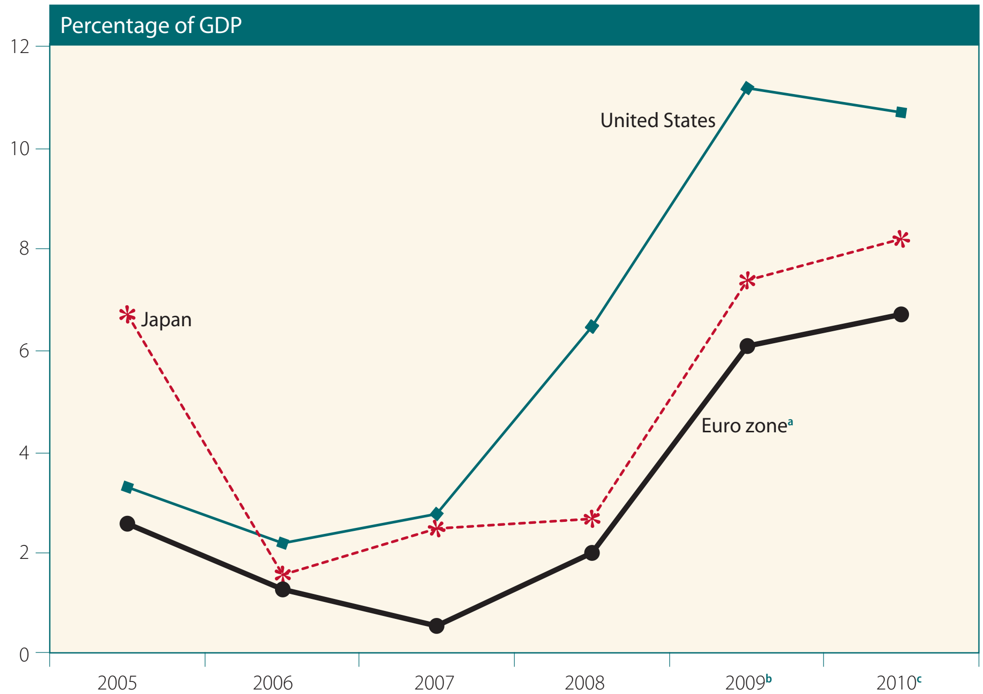
Fiscal and monetary policies have played key roles in stabilizing activity, but the unwinding of these stimuli will be a delicate task. On the fiscal side, government deficits have increased enormously and, given current trajectories, are in many cases not sustainable (see figure IV.2). But premature consolidation would be disastrous, risking a return to recession, as discussed in chapter I. Similarly, monetary policy must withdraw the massive

Figure IV.1
Unemployment in the developed regions, 2006-2010

Sources: Project LINK and UN/DESA, based on data of the Organization for Economic Cooperation and Development (OECD).

a Estimated.
b Forecasts.

Figure IV.2
General government financial deficit, 2005-2010



Source: OECD, *Economic Outlook*, November 2009.
a Excluding Cyprus, Malta and Slovenia.
b Estimated.
c Forecasts.

stimulus provided by unconventional measures and return interest rates to more neutral levels without disturbing the recovery. Some degree of policy coordination may be necessary in this process to mitigate the impact of changing interest-rate differentials on currencies.

North America: growth resumes in the United States but downside risks are high

The economy of the United States of America has moved beyond the trough of its worst recession since the Second World War as, after four quarters of decline, gross domestic product (GDP) resumed growth in the third quarter of 2009; the developments of many high-frequency indicators are consistent with continued growth in the coming quarters. With a slump in the first half of the year, the growth rate for 2009 as a whole is expected to be -2.5 per cent (see annex table A.1). A mild recovery of 2.1 per cent is forecast for 2010, as private consumption is expected to remain weak owing to high unemployment and the need to rebuild the household wealth that was lost during the financial crisis.

The housing market is stabilizing

The recession was mainly caused by the bubble-bust cycle of the housing sector and the associated credit crisis. By the time the housing market reached its trough in May 2009, the level of new home sales had dropped by 74 per cent from its peak in 2006. The Standard and Poor's Case-Shiller Home Price Index for twenty cities declined by 32 per cent in the same period. Builders, in an effort to reduce the supply of new homes, pushed housing starts to a level which was 79 per cent lower than the peak level of 2006, their lowest in history. These factors have triggered a continuous decline in residential investment since 2006. However, in mid-2009, signs of a turnaround emerged in the housing sector, especially in construction activity and housing prices, and further stabilization is expected going forward.

Households are saving more

During the crisis, the reduced value of real estate assets held by households and the simultaneous lower market value for their financial assets significantly reduced the net wealth of households and, as a consequence, the ratio of total debt to financial assets soared (see figure IV.3). In order to rebuild their balance sheets, households adjusted their consumption behaviour in the form of a higher saving ratio. Households also increased their savings as a buffer against income uncertainty following the surge in unemployment. The ratio of personal saving to disposable household income increased from 1.2 per cent for the first quarter of 2008 to 4.9 per cent in the second quarter of 2009.

The predicted stabilization of the housing market is expected to help the recovery of private consumption. However, given the headwinds faced by households, this recovery is expected to be weak, with private consumption contracting in 2009 before increasing by a modest 1.5 per cent in 2010.

Business investment suffered a shock of a magnitude similar to that of residential investment. Capital spending on equipment and software items started to decline from the beginning of 2008, while business spending on construction joined the downturn in the second half of 2008. Credit tightening, falling equity prices and declining corporate profits have all led to a sharp decline in business fixed investment. Although the fall in capital goods orders may have bottomed out in mid-2009, business construction is expected to remain weak for an extended period, dragged down by the general weakness in the economy, the inventory overhang and the difficulty in financing. In summary, fixed capital formation is expected to decline by another 18 per cent in 2009 but will increase by 2.3 per cent in 2010.

High unemployment may be a drag on the recovery

Labour-market conditions have been deteriorating since 2008, with the level of employment on a continuous decline. By the end of 2009, more than eight million people had lost their jobs, pushing the unemployment rate up to more than 10 per cent. Over the same period, average working hours also declined. Going forward, this provides

Figure IV.3

Net worth[a] of assets of United States households and non-profit organizations, fourth quarter of 2003-second quarter of 2009

Source: United States Federal Reserve Board, Flow of Funds Account, available at http://www.federalreserve.gov/releases/z1/.

a Net worth at the end of each quarter, not seasonally adjusted.

firms with the possibility of increasing output without new hiring. Given the relatively weak recovery, employment is not expected to pick up until the latter half of 2010 causing the rate of unemployment to peak by mid-year before it eases back (see annex table A.7).

Headline inflation peaked at 5.6 per cent in July 2008 and has been declining steadily ever since, reaching a low of -2.1 per cent in July 2009; it is estimated to average -0.4 per cent for the year as a whole (see annex table A.4). This swing in inflation mainly reflects the volatility in the prices for energy and certain commodities over the 2008-2009 period. Core inflation has been running just below 2 per cent throughout 2009, decelerating slightly towards the end of the year, and is expected to remain subdued in 2010. Cost pressures, as measured by unit labour costs, are expected to remain weak. The growth rate (year on year) in hourly wages declined from 3.7 per cent in January 2009 to 2.4 per cent in October 2009 and is expected to remain stable in 2010 (close to the rate of core consumer price index (CPI) inflation), while labour productivity growth is expected to increase slightly. Moderate core inflation, coupled with the assumption of another rise in energy and other commodity prices, is likely to keep headline inflation low, at a projected 1.4 per cent on average for 2010.

The external deficit has declined

The external balances of the United States have undergone a significant adjustment over the past few years. After reaching its peak in mid-2006, the trade deficit is estimated to have fallen by more than half in nominal terms by the end of 2009. In volume terms, the growth of imports started to slow down or even turn negative in late 2006 and has fallen by about 14 per cent in 2009. The growth of exports (in volume terms) started to increase in 2007 and reached a rate of 5.4 per cent in 2008. However, the global recession in 2009 led to a collapse in trade, with the exports of the United States falling by 10.4 per cent. In addition, the drop in fuel prices after the summer of 2008 has helped to reduce the import bill by about $80 billion for 2009. The lower trade deficit has also reduced the current-account deficit, but it is expected to increase again in 2010 with the sharp rise in the fiscal deficit and insufficient increase in private savings.

The Federal Reserve is expected to keep interest rates down

On the policy front, the United States Federal Reserve (Fed) is assumed to keep the federal funds rate within the current range of 0.00–0.25 per cent until the third quarter of 2010. It is also assumed that the $700 billion that was authorized for the Troubled Asset Relief Program (TARP) will be fully utilized. Of all the announced elements of TARP, the Public-Private Investment Program (PPIP) is the most recent one to have been put into operation and only part of the amount committed has been allocated as of late 2009. It is assumed that it will be fully implemented and will further relieve the credit constraints encountered by businesses and households.

Public debt will rise to worrisome levels

In February, the Government enacted the American Recovery and Reinvestment Act of 2009 which planned to disburse $787 billion over ten years to provide economic stimulus. Through the Act, the Government aims to provide direct relief to households through tax cuts, expanded unemployment benefits and social welfare provisions. It also envisages increased government expenditure and investment. Nevertheless, this package, together with the cost of bailing out financial institutions and the reduced revenue owing to the recession, has jointly pushed the federal budget deficit to $1.4 trillion for the 2009 fiscal year, equal to 9.9 per cent of GDP. The current government budget is anticipated to post an even higher deficit for the 2010 fiscal year. On the level of State and local governments, reduced revenue has restrained their capability to provide additional stimulus. In some instances, State and local governments even had to cut expenditures and raise taxes.

Risks include the possibility of a resumption of a downward spiral in financial markets, a continuation of the housing slump, a further increase in unemployment rates, and a continuation of the drop in business capital spending. The tremendous increase in government debt, combined with the fact that the Fed is now holding huge amounts of public debt securities, presents another risk that could trigger concerns about the value of the United States dollar, as discussed in chapter I.

Canada's growth was dragged down by the United States economy

After a very weak growth of 0.4 per cent in 2008, the Canadian economy is expected to recover from its decline of 2.6 per cent in 2009 and to expand again by 2.6 per cent in 2010. Since the financial system in Canada was much less exposed to toxic assets and far less leveraged than that of the United States, the banks have been able to navigate the financial crisis without receiving capital injections from the Government. Yet, the extremely close economic ties with the United States have provoked a severe downturn through trade channels. Merchandise exports are more than 75 per cent dependent upon United States markets and fell by about 25 per cent in the first half of 2009 following the economic downturn south of Canada's border. Weak private consumption and fixed investment demand have amplified the downturn originating in the external sector.

In 2010, the Canadian economy is expected to recover, aided by a fiscal stimulus in the form of both tax cuts and higher government expenditure, as well as by the incipient economic recovery in the United States and the turn in the global inventory cycle. The expected recovery of prices for oil and other commodities will also provide some growth impetus as primary products make up an important share of Canadian exports. As employment growth typically lags the growth of production, the unemployment rate will likely stay in the range of between 9.5 and 10 per cent for an extended period.

Developed Asia and the Pacific: high dependency on a global recovery

The economy of Japan is tentatively recuperating from its worst recession in three decades. Since the second quarter of 2009, exports and industrial production have rebounded, leading to an improvement in business sentiment. A mild recovery of 0.9 per cent is expected for 2010, compared with an estimated slump of almost 6 per cent in 2009 (see annex table A.1).

Growth is highly dependent upon export performance

After collapsing by about 40 per cent in late 2008 and early 2009, Japanese exports started to rebound in the second quarter of 2009, but the momentum has moderated recently, reflecting in part the cyclical nature of the global inventory adjustment. Exports will continue to grow in 2010, but only at a moderate pace (see figure IV.4).

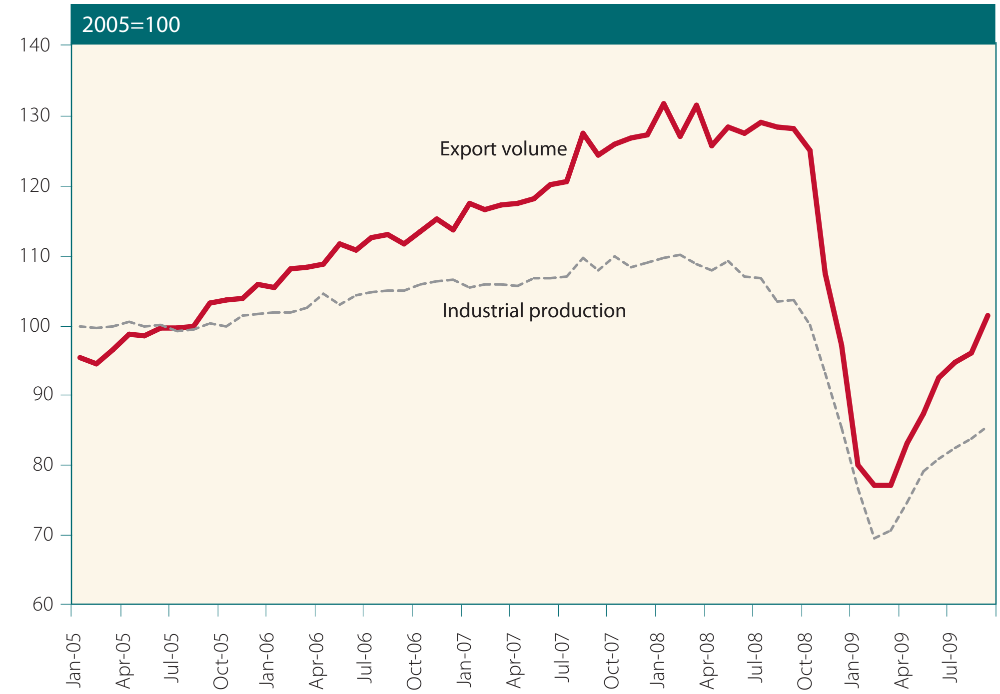
Business investment remains weak but public investment has become an engine of growth

Domestic demand remained weak in the second half of 2009, despite a rebound in industrial production. Business investment continued to decline, although at a moderated pace. Corporate financing conditions have improved, as the premium for corporate bond issuance narrowed and funding for the private sector in general has increased, albeit slowly. However, corporate profits have continued to decline substantially. Given the excess in industrial capacity, business investment is expected to remain weak in the outlook. Public investment, in contrast, has increased, especially public construction, and is expected to remain elevated in the outlook along with the continued implementation of various stimulus measures.

Private consumption is constrained by high unemployment

Demand for durable consumption goods has rebounded, but aggregate private consumption remains weak. A key drag in this respect is the increasingly deteriorating employment situation. In the labour market, the ratio of job offers to applicants

Figure IV.4
Japan's export volume and industrial production, January 2005-September 2009



Source: UN/DESA, based on data from the Bank of Japan and the Japanese Ministry of Economics, Trade and Industry.

has continued to decline. Despite some monthly fluctuations, the unemployment rate is at an historical high of about 5.5 per cent. At the same time, the nominal wage rate is continuing to decline and employee income has decreased significantly. Under these circumstances, private consumption will continue to be severely constrained in the outlook. Deflation continues to characterize economic conditions in general.

No change is expected in monetary policy measures

The Bank of Japan (BoJ) has taken a number of monetary policy measures in three main areas by reducing the policy interest rate, ensuring stability in financial markets and facilitating corporate financing. So far, these measures have improved financial market conditions and have lowered the costs of corporate finance. Given the persistent sizeable output gap and continued weak domestic demand, the BoJ is assumed to maintain the policy interest rate at close to zero and to keep in place the various unconventional expansionary monetary and financial measures taken in response to the crisis, at least until mid-2010.

Public debt is rising to record levels

A series of fiscal stimulus packages have been launched since mid-2008, including additional government spending totalling about 5 per cent of GDP. Despite a change in Government, the stimulus package is expected to be implemented as envisaged in the outlook. The government deficit is estimated to reach about 6.5 per cent of GDP on average during 2009-2010, putting further upward pressure on the already large public debt, which could surpass 200 per cent of GDP, making it among the highest in the world.

Australia is avoiding recession amidst a turbulent global environment, but risks remain

The economy of Australia has managed to avoid falling into a recession amidst the global financial crisis. Aggressive stimulus measures have supported household consumption and business investment, offsetting the severe external shocks. GDP is expected to grow by about 1.3 per cent in 2010, compared with an estimated 0.8 per cent in 2009. Downside risks remain as rising unemployment and depressed asset prices continue to weigh on domestic demand, particularly when the effects of the policy stimuli start to weaken.

In response to the global economic downturn, Australia has adopted drastic monetary and fiscal measures. The Reserve Bank of Australia had reduced interest rates by a total of 425 basis points (bps), but with activity picking up, it raised the policy rate by 50 bps during October and November 2009, thereby becoming the first major developed-country central bank to raise rates in the current cycle. In addition to major tax cuts in its regular budget for 2008/2009, the Australian Government also adopted two fiscal stimulus packages, totalling about 5 per cent of GDP. As a result, the Government budget will be turning from a surplus into a projected deficit of 4.5 per cent of GDP in 2010.

These stimulus measures have supported disposable income, buttressing the growth in private consumption when household net worth fell and unemployment rose. Despite benefiting from low interest rates and tax cuts, business investment is relatively weak amidst reduced profitability due to depressed sales, which is also keeping capacity utilization rates low. Business confidence has strengthened recently, as increased government spending, including outlays on infrastructure projects, is expected to further support domestic demand.

New Zealand is ending its prolonged recession

New Zealand showed positive GDP growth in the second quarter of 2009, for the first time since the end of 2007, ending its most prolonged recession since the 1970s. While net exports made a solid contribution, both household consumption and business investment also increased, driven by record-low interest rates. Consumer and business confidence continued to improve, pointing to a further recovery. GDP is expected to grow by 2 per cent in 2010, recovering from a decline of -1.3 per cent in 2009.

The Reserve Bank of New Zealand has reduced interest rates by 575 basis points in little more than six months, taking them to 2.5 per cent. The Government has so far adopted fiscal stimuli to the tune of 4.3 per cent of GDP.

Declines in international commodity prices, reduced demand for many of New Zealand's manufactured exports and declining numbers of foreign tourists have been accompanied by difficulties experienced by banks in securing offshore funding. As a result, firms have been cutting back in investment and reducing labour demand. The deteriorating employment outlook is weighing on consumer confidence, and households have already been scaling back spending in response to falling housing and financial wealth.

Western Europe: emerging from recession, but the recovery will lack vigour

Western Europe is emerging from its worst recession of the post-war period. Economic activity plummeted in the final quarter of 2008 and continued its descent in the first quarter of 2009 as exports dropped sharply following the severe deceleration in world demand, investment spending collapsed from both the multiple shocks emanating from the financial crisis and the greatly diminished future demand outlook, and firms embarked on a massive round of inventory destocking. The second quarter of the year displayed signs of a stabilization of activity as GDP fell only slightly in most economies and positive growth returned to France and Germany. For the euro area as a whole, growth finally returned in the third quarter, marking the end of five consecutive quarters of decline, but the economies of Spain and the United Kingdom of Great Britain and Northern Ireland continued to contract, albeit at marginal rates.

Leading indicators, such as the European Commission's Economic Sentiment Indicator (ESI), began to signal a possible turning point in March, but for the most part remained well below their historical averages. Industrial production in the euro area turned upwards in May for the first time since the beginning of the crisis but was still 13 per cent below its level of September 2008. In the outlook, growth is expected to strengthen somewhat over the forecast period, but will remain sub par. Given the very strong negative carryover from the end of 2008 and beginning of 2009, GDP for the European Union (EU)-15 will fall sharply, by 4.2 per cent in 2009, and is expected to recover by a mere 0.5 per cent in 2010 (see annex table A.1). The recovery will be led by exports, which will rebound along with global aggregate demand and inventory restocking. Domestic demand will be supported mainly through government policy measures. Activity is expected to moderate in the first half of 2010 as policy stimuli and short-term factors fade, before a more durable pickup sets in during the second half of 2010. Stronger recovery will require further normalization of credit conditions and a pickup in global demand that could induce a resumption of business investment and employment growth. This, in turn, would underpin stronger private consumption demand. Such a rebound would assume that macroeconomic stimulus would not be prematurely abandoned, as discussed in chapter I.

Consumption has declined, but has still been a moderating factor during the downturn

Consumption contracted in most economies in the region in 2009, but despite the dramatic fall in consumer confidence, it was at a much slower pace generally than the decline in GDP, and thus acted as a moderating factor during the downturn.[1] Automatic stabilizers and discretionary government spending, especially the labour-market support programmes and car-scrapping schemes,[2] have bolstered consumption spending. In addition, the fall in real disposable income has been dampened by the sharp decline in inflation coupled with lags in the deterioration in labour-market conditions.[3] Consumption is expected to decline further in 2010, though only to a slight degree. Consumer confidence has risen significantly from its trough at the beginning of 2009 and inflation is expected to remain extremely low. But there are significant headwinds: savings rates will likely stay up as consumers need to rebuild their balance sheets (particularly in countries strongly affected by the housing and financial crises), lending conditions are expected to remain significantly tighter than they were before the crisis, and labour-market conditions are not expected to improve much in 2010.

Investment spending will remain sluggish in the near term

The precipitous decline in investment, close to 11 per cent for the EU-15, was a major driver of the recession and its revival will be key to the sustainability of the recovery. Investment in equipment suffered from a combination of collapsing foreign demand leading to a sharp drawdown in inventories and a decrease in capacity utilization to near record low levels, coupled with the multiple negative impacts from the global financial crisis that increased both the cost and conditions of external financing. Foreign demand has picked up and the inventory cycle is turning. Capacity utilization should therefore begin to rise, but with financing conditions remaining tight, a turnaround in investment is not expected until the second half of 2010. Residential investment was hit by the collapse of the housing

1 The exceptions are Denmark and Spain, while Ireland and the United Kingdom experienced outsized drops (but less than the drop in GDP). These economies were mostly affected by collapsing housing markets and/or financial sectors.

2 Car-scrapping schemes promote the replacement of old, fuel-inefficient cars with new, low-emission ones. The incentive schemes are being implemented or are under consideration in at least nine Western European countries, including all of the major economies. See http://en.wikipedia.org/wiki/Scrappage_program#Approaches_by_country; and Nelson D. Schwartz, "In Europe, 'Cash for Clunkers' Drives Sales", *The New York Times*, 31 March 2009, available at http://www.nytimes.com/2009/04/01/business/global/01refunds.html?_r=1.

3 Wage growth reached its cyclical peak in the third quarter of 2008 and moderated only slightly in the fourth quarter before slowing substantially in the first half of 2009, while employment did not start its decline until the third quarter of 2008.

market and the associated financial crisis and is likely to take considerable time to recover as financing conditions for real estate have experienced the most severe tightening.

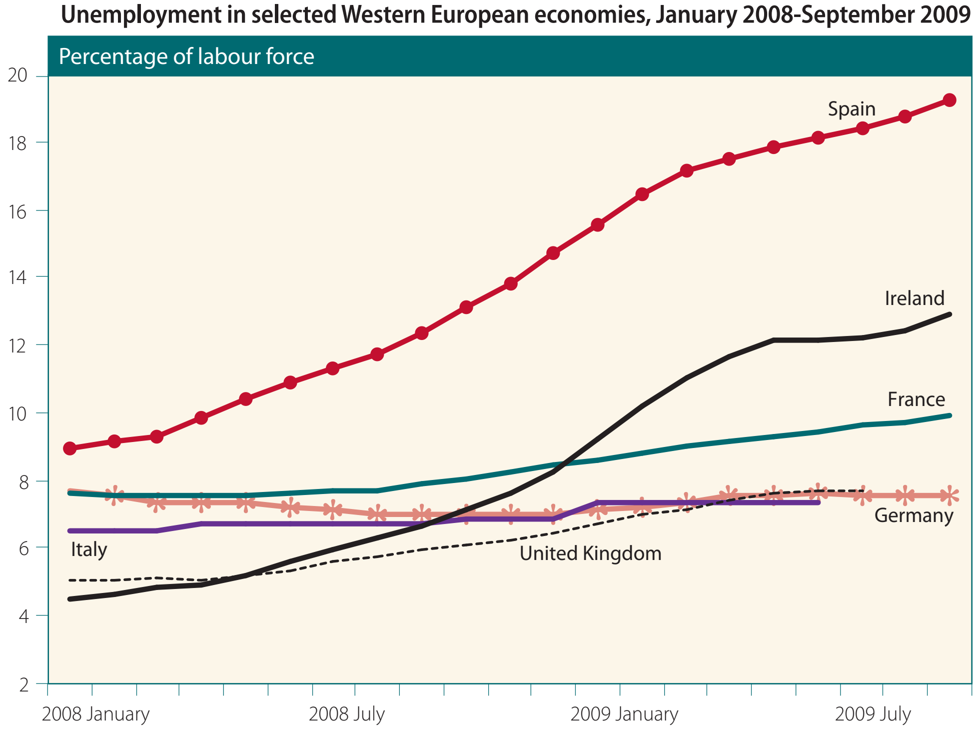
Collapsing exports were a devastating external shock but are now leading the upturn

The other major factor driving the recession was the collapse of exports as world demand plummeted. Some countries were hit particularly hard because of their product specialization and the geographic orientation of their exports. Germany, a major exporter of capital goods, suffered from the steep fall in industrial production in Asia as well as from the decline in import demand from oil-producing countries. Germany's export decline had knock-on effects across Europe. With the rebound in global trade, foreign orders are on the rise again and are supporting output recovery. The revaluation of many regional currencies, however, is dampening the rebound in exports. Imports also collapsed during the downturn, to the extent that in the second quarter of 2009 net export growth actually contributed positively to aggregate demand. Import volumes are expected to register positive growth in 2010 as activity rebounds and is boosted further by the appreciation of European currencies.

Increasing unemployment is a key concern

Average unemployment rates in the euro area have drifted up from 7.2 per cent in March 2008 to 9.7 per cent in September 2009, but employment conditions vary greatly across countries. In Spain, unemployment reached 19.3 per cent in September following an increase of 9 percentage points since March 2008, while Germany registered 7.6 per cent, an increase of only 0.4 per cent (see figure IV.5). This divergence reflects in part differences in the severity and nature of the economic downturn, with the housing market collapse playing a large role in Spain for example, but in part it also reflects differences in labour-market adjustments. In several European countries, the main adjustment was not undertaken through shedding jobs, but rather through labour hoarding by firms, aided in some cases by government policy measures, such as subsidized programmes of shortened

Figure IV.5
Unemployment in selected Western European economies, January 2008-September 2009



Source: OECD Main Economic Indicators.

working hours (the *Kurzarbeitergeld* programme in Germany, for instance). Labour-saving adjustment is readily visible in decreases in the average number of hours worked and declines in productivity. With growth expected to remain anaemic in the outlook, however, such labour-hoarding measures will reach their limits, causing stronger increases in unemployment rates. In the outlook, unemployment is expected to continue to rise in Western Europe through 2010 (see annex table A.7).

Inflation remains extremely low

Headline inflation has fallen from a high of just over 4 per cent in mid-2008 to negative rates from June to October 2009. This is not necessarily indicative of a deflationary environment, but is mostly the result of strong negative base effects caused by last year's high oil prices. These will reverse their impact in the months ahead. The impact of the recession can be more clearly seen in core inflation, which had been close to 2 per cent in the second half of 2008, but which subsequently drifted down to 1.2 per cent in September and October. A widening output gap as demand falls short of supply, coupled with a strengthened exchange rate in some cases, continues to exert downward pressure on prices. As demand recovers, core inflation should begin to rise, but both core and headline inflation are expected to remain well below 2 per cent in the forecast period (see annex table A.4).

Fiscal policy is key to supporting demand

Discretionary fiscal policy and the workings of automatic stabilizers have played major roles in combating the recessionary forces gripping the region. Significant stimulus packages were enacted by many countries under the auspices of the European Economic Recovery Plan.[4] Budgetary positions have worsened significantly not only because of the stimulus measures but also because revenues fell more than usual, as the tax base has been reduced through the decline in real estate and financial wealth and falling corporate profits. Recent estimates from the European Commission put the general government fiscal balance for the euro area at -6.4 per cent of GDP in 2009 compared with -2.0 per cent in 2008, with a further deterioration expected in 2010. The increase in budget deficits, coupled with the numerous financial bailouts, have led to sharply higher debt positions, with the government debt ratio in the euro area rising from 69.3 per cent of GDP in 2008 to an estimated 78.2 per cent in 2009, and continuing to rise in 2010.[5] This sharp rise in indebtedness limits the possibilities for further discretionary stimulus, if needed, and raises questions regarding the timing and degree of future budget consolidations. In the outlook, it is assumed that current policies will be maintained, with no new ones enacted.

Monetary policy has been extremely active and has resorted to unconventional measures

Monetary policy has also been very active. The European Central Bank (ECB) brought rates down from 4.25 per cent in July 2008 to the current 1.00 per cent in May 2009, for a cumulative cut of 325 bps. The Bank of England (BoE), as well as all of the other central banks in the region, has also brought rates down dramatically, in many cases to nearly zero. But policy moved quickly to more unconventional measures, as the scale of the slowdown and its characteristics became apparent. The ECB moved from a variable rate tender with fixed allotment of liquidity to a fixed rate tender with unlimited allotment of liquidity, and subsequently extended the lending maturity to one year. The BoE adopted quantitative easing through the Asset Purchase Facility, whereby it purchased domestic government securities (gilts) in the secondary market as well as high-quality private sector assets, including commercial paper and corporate bonds. These and other types of

4 The European Commission estimates that the total amount of discretionary measures undertaken by euro area member States amounted to 1.3 per cent of GDP for 2009, with an additional 1.2 per cent expected in 2010. See "European Economic Forecast-Autumn 2009", European Commission Staff Working Document, *European Economy*, vol. 10 (3 November 2009), Brussels, p. 30.

5 Ibid., pp. 30-31.

unconventional policy measures are expected to be gradually withdrawn over the forecast period while interest-rate policy remains on hold until the final quarter of 2010.

Downside risks are prevailing

Downside risks to the forecast remain significant. If labour markets were to deteriorate more substantially before recovery is ensured, consumption could falter, leading to a renewed downturn. Similarly, a premature removal of fiscal stimuli or a tightening of monetary policy could lead to a renewed downturn. Investment may not recover if the record low capacity utilization lingers due to too slow a pace of recovery in demand, or if credit availability continues to be difficult. The labour-market situation poses another risk if the short-term unemployed begin to move into the ranks of the long-term unemployed, a far more intractable problem and one which could reduce potential output. Finally, further appreciation of the euro and other regional currencies against the United States dollar could stall the improvement in exports and lead to a renewed downturn.

The new European Union member States:[6] the crisis is over but the upturn is lagging

The crisis has had a profound impact on the region

The new EU member States were among the hardest hit by the global economic crisis. Their combined GDP contracted by 3.7 per cent in 2009 after more than a decade of strong and continuous growth (see annex table A.1). The economic downturn was driven by collapsing export demand and impaired financial systems resulting from frozen international capital markets and rising non-performing domestic loans. With the exception of Poland, which has less of an export-oriented economy and benefits from a relatively healthy financial sector, all new EU member States saw their GDP declining in 2009. The output declines in the Baltic States were particularly steep, falling by about 15 per cent and sweeping away years of dynamic growth.

Although quarterly economic indicators suggest that by the end of 2009 the situation in most economies will have stabilized, the prospects for 2010 remain uncertain. The recession in the Baltic States is likely to continue and only a marginal rebound is expected in Central Europe. Growth is therefore expected to reach only 1.2 per cent for the region in 2010. A return to a foreign credit-fuelled growth pattern is unlikely in the foreseeable future. Moving forward, these economies will have to rebalance and rely more on domestic savings and export growth.

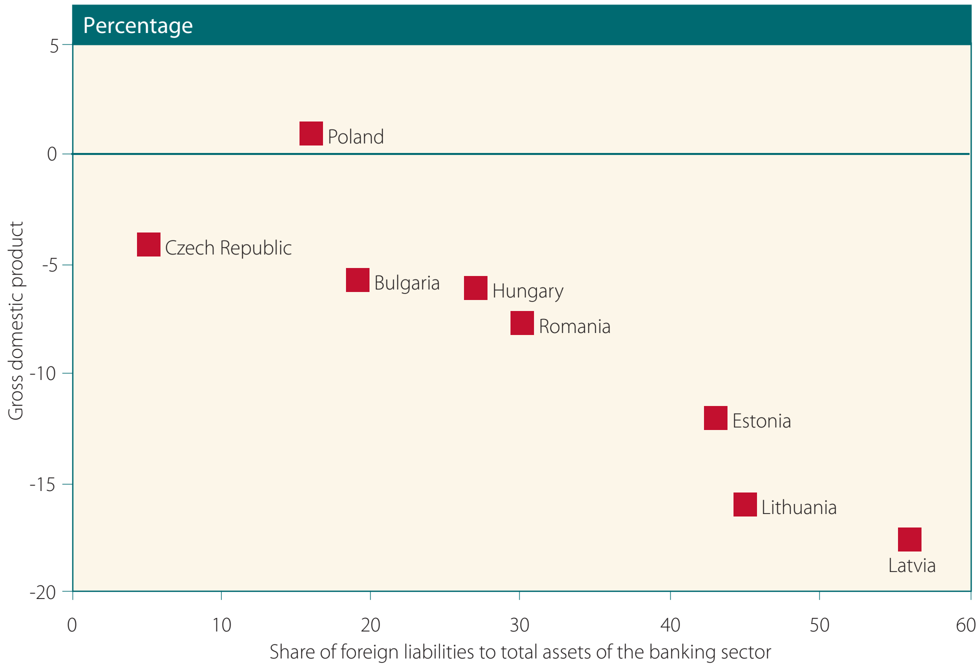
Current-account balances are improving

In the Baltic States, weak domestic demand has substantially reduced imports, resulting in a dramatic turnaround in their current-account balances from double-digit deficits in 2008 (as a share of GDP) to surpluses in 2009. On the one hand, this was due both to significant declines in import demand and to the declining income payments to foreign investors from falling profitability and writeoffs of asset values, and, on the other, to increasing transfers from the EU. In the countries of Central Europe, the current-account deficits as a share of GDP also declined by about 2 percentage points for similar reasons.

The heavy reliance on foreign capital inflows turned from a boon to a source of instability. The banking systems of most new EU member States obtained a large share of funds from foreign parents and international capital markets (see figure IV.6). When global capital markets seized up, the financial systems in these economies were no longer able to finance investment projects or real estate loans or even provide working capital to support normal business activities. In the Baltic States and Bulgaria, economies with currency

6 This subsection mainly refers to the new EU member States in Central and Eastern Europe.

Figure IV.6
External indebtedness of the banking sector, December 2009, and economic performance of selected new EU member States, 2009



Source: The European Central Bank.

boards or fixed exchange-rate regimes and a high proportion of foreign-currency denominated debt, monetary authorities, fearing an adverse impact on debt-servicing obligations and private and public-sector balance sheets, refrained from devaluing their exchange rate in order to adjust external imbalances.

Actions have been taken to prevent a collapse of the financial sector

In response to the crisis, Governments and central banks did implement extraordinary measures, including recapitalizing the banking sectors and nationalizing some financial institutions, increasing deposit insurance, reallocating resources to private credit and negotiating international assistance packages. International assistance, led by the EU and the International Monetary Fund (IMF), played a critical role in stabilizing the region; recipients included Latvia and Hungary in 2008 and Romania in 2009. In addition, Poland negotiated a precautionary Flexible Credit Line facility with the IMF in 2009 to facilitate rolling over its short-term debt.

By the end of 2009, the new EU member States in Central and Eastern Europe were able to return to international capital markets and, as a result of the international assistance packages, the possibility of a systematic meltdown of their financial systems had subsided. Overall credit growth remains subdued, however. In 2010, private consumption will be restrained owing to a combination of factors, including weak consumer confidence, high unemployment, cuts in public sector wages, increased savings as households attempt to consolidate their finances, and increases in the value added tax undertaken to increase budget revenues. Investment, including foreign direct investment (FDI), is likely to remain depressed, undermining the region's productive capacity in the long run. The speed of economic recovery will depend not only on the external environment, but on the flexibility of their internal markets, including the ability of their banking sectors to restore lending.

Fiscal policy options are limited

The Governments in the region have little room for counter-cyclical fiscal spending, especially under the constraints of the Stability and Growth Pact (SGP). Facing serious revenue shortfalls in 2009, the fiscal authorities had to revise budgets repeatedly, cutting expenditures and increasing indirect taxes. This was the case particularly for countries (such as Hungary or Latvia) that received financial assistance from the IMF and the EU, which is conditional on fiscal austerity. Economic stimulus in the region was mostly limited to lowering direct taxes, undertaking efforts to promote exports and FDI and improving absorption of the regular stream of EU funding. In countries of Central Europe, exchange-rate flexibility has permitted a slight depreciation against the euro, which has helped the export sectors remain competitive. In the Baltic States, where the recession is deepest, fiscal policy remains pro-cyclical, as the Governments are committed to the eventual adoption of the euro and must meet strict fiscal criteria. Governments therefore decided on considerable fiscal retrenchment.

Monetary conditions are being loosened, but the effect is still to be seen

Cyprus, Malta, Slovakia and Slovenia have become members of the euro zone and, as a result, have had very low interest rates.[7] Elsewhere, and especially in the Czech Republic, Hungary, Poland and Romania, central banks had to maintain higher interest rates but were able to lower them gradually as their currencies stabilized and inflationary pressures subsided in the second half of 2009. Nevertheless, the banking sectors are facing rising non-performing loans and a cautious private sector will constrain credit growth.

The trend in inflation reversed in 2009

In 2009, inflation subsided among the new EU member Sates as a result of lower food and energy prices and the abrupt weakening of domestic demand. Sluggish labour markets contributed to lower wage pressures, turning core inflation negative in a number of countries. The decline in inflation rates was more pronounced in countries with fixed exchange rates, while periods of currency depreciation in countries with flexible exchange-rate regimes contributed to imported inflation. In 2010, inflation in the region is expected to remain at low, single-digit levels and may stay close to zero in the Baltic States.

The decline in exports and domestic demand, along with other factors, has led to an increase in unemployment in the region, despite active policies to support labour markets. In the Baltic States, unemployment rates increased to about 15 per cent from a low of 4 per cent in 2008. In other countries, the unemployment rate increased by 2-3 percentage points to an average of 10 per cent. Further increases, by a few percentage points, are possible in 2010 and in the longer run may contribute to the rise of structural unemployment in the region.

Economies in transition

Economies in transition have seen divergent performance during the crisis

In 2009, the shock waves of the global economic and financial crisis proliferated throughout the transition economies. While the direct effects of the global financial turmoil struck those countries with relatively higher exposure to international financial markets, a large number of the transition economies experienced strong secondary and indirect negative shocks.

After more than a decade of strong economic growth, aggregate GDP in the transition economies dropped by 6.5 per cent on average in 2009, the decay being much stronger in the Commonwealth of Independent States (CIS) (a decline of 6.7 per cent) than in South-eastern Europe (3.7 per cent). The recession has been deepest in the larger economies (notably, the Russian Federation and Ukraine). A number of smaller economies managed to avoid slipping into recession during 2009.

7 Slovakia joined the Economic and Monetary Union (EMU) on 1 January 2009.

The divergent outcomes to some extent reflect the heterogeneity of the transition economies in terms of the extent to which their market reform processes have been completed and the degree and nature of their integration into the global economy. Countries with weaker integration into global trade and financial markets have been more insulated from the global economic downturn and financial turmoil. In the outlook, economic recovery also seems to be on its way in the economies in transition, but there are important downside risks related to the overall course of recovery in the global economy.

South-eastern Europe: recession on the back of the slowdown in Western Europe

Most economies are in the midst of a recession

With the exception of Albania, the economies in transition in South-eastern Europe slipped into a recession in 2009. Their combined GDP declined by 3.7 per cent (see annex table A.2) on the back of a strong contraction in external demand (predominantly from the EU), shrinking capital inflows and declining remittances. In Albania, GDP growth remained positive, supported by heavy government spending. The Albanian economy is relatively closed, showing an especially low degree of trade openness. The other economies in South-eastern Europe are more open and their growth is export-oriented. Consequently, they were strongly hit by the crisis through trade channels. In Serbia, manufacturing production dropped by nearly 20 per cent (year on year) in the first half of 2009. Similarly, in Croatia, a steep fall in export demand caused a double-digit drop in manufacturing output. The pace of the downturn decelerated in the second half of 2009 in these and other countries of the subregion. A return to positive GDP growth rates is expected in 2010.

Current-account deficits have narrowed

The downturn has triggered sharp reductions in trade and current-account deficits throughout South-eastern Europe. These deficits mirror dwindling FDI and other capital inflows. The main adjustment has been undertaken through a steep decline in imports, as merchandise exports, tourism revenues, remittances and other transfers have all dropped considerably. The contraction of import demand was linked to falling consumer and investor confidence and the decline in economic activity. FDI inflows are not likely to recover to previous heights any time soon and, consequently, a further narrowing of current-account deficits is expected in 2010.

Inflation is low, but unemployment is expected to stay high

Cost-push and demand-pull inflationary pressures in South-eastern Europe have subsided since the second half of 2008. Given the weak global demand, imported inflation has also been low, if not negative. As a result, inflation rates have remained low in 2009 and are expected to stay subdued in 2010 (see annex table A.5). Unemployment rates were already high before the crisis and have been pushed up further during 2009 (see annex table A.8). The rise in unemployment has lagged behind the drop in output, however, as enterprises were slow to dismiss labour. Such lags are expected to affect unemployment during the recovery as well, and jobless rates are expected to continue to rise in 2010.

The crisis has triggered emergency policy responses

The recession has led to a severe drop in government revenue, thus affecting budget execution. Most countries have been forced to adopt emergency anti-crisis measures. Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, and Montenegro undertook major budgetary revisions involving a significant downward revision of projected revenues and planned reductions in the public sector wage bill, as well as attempts to redirect public funds to capital investment. Bosnia and Herzegovina and Serbia also had to revert to emergency borrowing from the IMF to maintain macroeconomic stability. Owing to relatively tight fiscal policies in the years preceding the crisis, only a few of the South-eastern European countries were able to afford fiscal stimulus measures (the former Yugoslav Republic of Macedonia, which has a low level of public debt amounting to about 20 per cent of GDP, being a case in point). Despite subsiding inflationary pressures, anti-crisis responses through monetary policies have been relatively limited. The policy space in some of the South-eastern European economies is partly constrained by explicit or implicit currency pegs to the euro. The surge in fiscal deficits and the rise in non-performing loans during the crisis prevented the central banks from significant monetary loosening out of fear that these conditions would fuel inflationary expectations and undermine currency stability. Serbia, which has a flexible exchange rate, is probably the only country in the subregion that facilitated significant monetary easing.

The Commonwealth of Independent States:[8] a severe economic slump

After a sharp contraction in 2009, prospects for recovery remain uncertain

Output declined sharply in the CIS in 2009 owing to multiple shocks. In the Russian Federation, the initial disruption created by the lack of access to international financing was compounded by sharp falls in world commodity prices. The decline of the Russian economy dampened economic performance throughout the CIS. The output decline was steepest in Ukraine, which faced a strongly adverse terms-of-trade shock and severe external financing constraints, and Armenia, where the remittance-fuelled construction boom ended abruptly. Less open economies, which possessed the fiscal space to implement stimulus packages, such as Turkmenistan and Uzbekistan, continued to expand despite the global recession. Turkmenistan did suffer a setback, however, caused by disruptions to the pipeline for gas exports to the Russian Federation. Other economies, such as Kyrgyzstan and Uzbekistan, found a buffer in rising gold prices and gains from renegotiated agreements with the Russian Federation regarding natural gas exports. The CIS economies are expected to recover in 2010, supported by stronger worldwide demand and improved financial conditions. The rebound will be subdued, however, as a consequence of continued fragility of the banking sector and some planned fiscal consolidation. After contracting by 6.7 per cent in 2009, the combined GDP of the CIS is expected to expand by about 1.7 per cent in 2010.

Falling domestic demand drove the contraction

The larger CIS countries suffered double-digit declines in domestic investment. The drop was particularly large in Ukraine. In contrast, continued foreign interest in the exploitation of natural resources kept up investment demand in Kazakhstan and the smaller energy-producing economies. Growth of public consumption contained the fall of domestic demand in the Russian Federation and other countries with the ability to provide fiscal support during the crisis. The construction sectors, which had shown dynamic growth before the crisis, went into decline in all economies, especially the smaller, low-income countries of the CIS. Sharply falling real estate prices, lack of bank lending and falling remittances explain why construction activity suffered disproportionately during the downturn.

8 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.

Current-account trends diverged but overall surplus declined

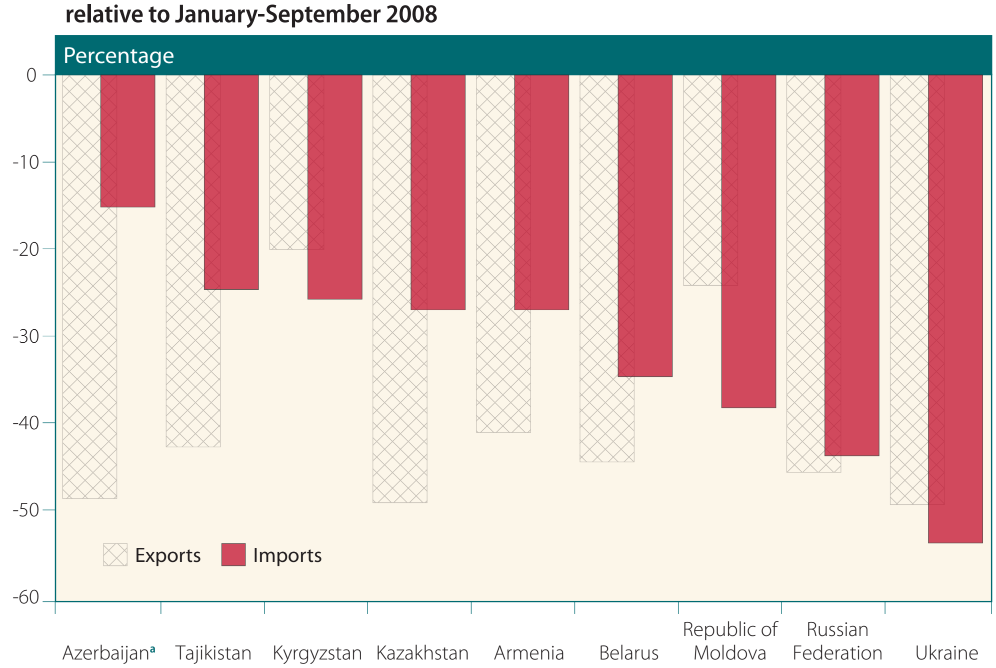
The economic downturn has been accompanied by a sharp fall in both import and export trade volumes (see annex table A.16). The decline in the terms of trade further accentuated the nominal decline in export earnings (see figure IV.7) but the CIS countries were still able, despite considerable narrowing, to post a combined current-account surplus. Ukraine displayed the largest swing, with a small surplus in 2009 as output collapsed and the currency depreciated. The current-account surplus of the Russian Federation fell sharply while the current-account balance in Kazakhstan turned into deficit as lower commodity prices drove exports down and strong FDI and expansive fiscal policies contained the fall of imports. In Belarus, the collapse in demand and prices for oil products reduced exports while the cost of imports was increased by lower energy subsidies. Low-income non-energy exporting countries continued to post large current-account deficits. In Armenia and Tajikistan, the deficit widened further as lower remittances offset the impact of falling imports.

Unemployment is rising

Unemployment rates have increased starkly in most CIS countries as well as in Georgia (see annex table A.8). Unlike during previous episodes of severe economic disruption, wage payment arrears were not the first recourse taken by firms in the Russian Federation in a bid to survive; rather, the adjustment was undertaken through the shedding of workers. Armenia, Moldova and Ukraine also witnessed a significant deterioration in labour-market indicators. Moreover, the return of migrant workers who had lost their jobs in the Russian Federation caused a further increase in unemployment as well as social tensions in their home countries, especially the low-income CIS countries. In Kazakhstan, employment growth stagnated in 2009, but did not affect the rate of unemployment because of low population growth, government employment programmes and net migratory outflows.

Figure IV.7

Declines in imports and exports (freight on board) in selected countries of the Commonwealth of Independent States, January-September 2009 relative to January-September 2008



Source: UN/DESA, based on data from CIS Interstat Statistical Committee, available at www.cisstats.com.

a First half of 2009 relative to the first half of 2008.

Inflation trends are down but significant differences have emerged

Weak domestic demand and falling energy and food prices have dampened inflation throughout the CIS (see annex table A.5). The pass-through effect has been modest in the Russian Federation and Belarus, however, as a consequence of rigidities in price adjustments. In Ukraine, the rate of inflation remained high as the impact of weaker demand and commodity prices was offset by the sharp exchange-rate devaluation and higher tariffs on utilities agreed upon with the IMF. By contrast, inflation decelerated sharply in the smaller economies of the CIS, as well as in Georgia, where the impact of currency depreciations was weaker.

Monetary policy is supporting financial stability

As commodity prices declined and capital flows reversed, strong downward pressures on exchange rates emerged in a number of countries. While administrative restrictions were introduced to limit foreign-currency demand in Ukraine, the contagion of the devaluation of the Russian rouble in early 2009 also forced exchange-rate adjustments in other CIS countries. During the first half of 2009, after commodity prices had started to rebound and inflation concerns had receded owing to weak domestic demand, monetary policy shifted towards preserving financial stability and supporting economic activity. The space for monetary policy responses remains severely limited as a result of the precarious external situation and, in some countries, the increase in the de facto dollarization of their economies. Increased currency substitution has been a response to the ongoing exchange-rate volatility. As access to foreign financing will continue to be limited in the near future and confidence in the economy stays weak, the concerns of monetary policymakers will need to be focused on the impact of liquidity injections on the exchange rate.

Active fiscal policies seek to offset contractionary forces

Fiscal deficits have increased as tax revenues declined, social spending increased and large amounts of resources were earmarked to rescue the ailing banking sectors of the larger CIS economies. Low-income countries were able to sustain higher spending pressures with the support of the IMF; Tajikistan, for instance, obtained resources through a three-year Poverty Reduction and Growth Facility and Kyrgyzstan was given access to the Exogenous Shocks Facility. In some cases, however, especially Ukraine, external emergency financing was insufficient and had to be complemented by tax increases, thereby limiting the effect of automatic fiscal stabilizers. By contrast, some commodity producers with large fiscal reserves, such as Azerbaijan, Kazakhstan and the Russian Federation, engaged in extensive stimulus packages (see box IV.1). This has played an important role in sustaining economic activity. Although a premature withdrawal of stimulus measures must be avoided, CIS countries will soon face the challenge of adopting and implementing medium-term fiscal consolidation plans and redefining spending priorities.

Prospects are uncertain

Despite the projected recovery in output (an albeit muted one), the CIS economies face major uncertainties in the outlook. A further weakening of commodity prices and continued difficulties in accessing international capital markets could colour economic prospects, particularly for countries with large external financing needs. Bank lending will remain depressed given continued financial fragility. Although energy-rich economies were able to deploy reserves for counter-cyclical measures, their policy space has narrowed in the outlook as significant amounts of reserves have already been spent and as fiscal consolidation will be needed in the medium term. Moreover, in the case of the Russian Federation, substantial financing gaps have already emerged and will pose difficulties in covering projected public spending. Despite the robust economic performance prior to the crisis, the current downturn highlights the risks associated with too heavy a reliance on only a few commodity exports and a low degree of economic diversification.

Box IV.1

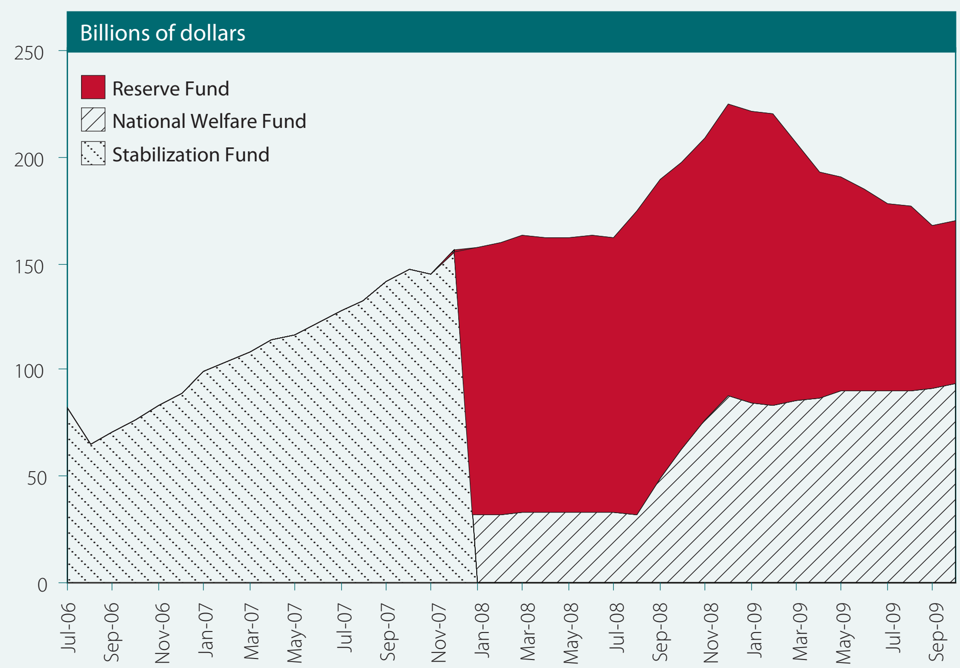
Public finances in resource-dependent economies during the crisis: the case of the Commonwealth of Independent States

Fiscal policy in resource-dependent economies faces specific challenges owing to the fact that public revenues are closely associated with cyclical fluctuations in world commodity markets. This has been the situation in many economies of the Commonwealth of Independent States (CIS) in which commodities still account for a large share of exports. Resource-rich economies can partly address cyclicality by establishing stabilization funds which are replenished during an upturn and can be used to smooth public expenditure during a downturn. The situation is, however, more precarious for resource-dependent economies that are not so richly endowed.

The global economic crisis has had a significant impact on public finances throughout the CIS region, both as a result of the fall in revenues and, in some cases, the increase in counter-cyclical discretionary spending. Countries started the current downturn with very different fiscal positions, and significant fiscal space for anti-crisis measures existed only in oil-producing countries, which had accumulated relatively large reserves in stabilization funds during times of high commodity prices.

The rules determining the accumulation and use of resources differ across countries but, broadly speaking, there has been a convergence towards a model that combines stabilization and saving functions to varying degrees (the offsetting of short-term volatility of hydrocarbon prices and the accumulation of resources on a long-term basis for intergenerational sharing). The reform of the Russian Federation's Stabilization Fund in 2008 explicitly recognized these two roles by splitting the resources into a Reserve Fund and a National Welfare Fund, with holdings reaching 9.7 per cent and 6.2 per cent of gross domestic product (GDP), respectively, by the end of that year (see figure A). In other countries in the region, these different functions are implicit in the rules defining the accumulation and use of resources in a single fund. By the end of 2008, the National Fund of Kazakhstan held assets equivalent to 20.6 per cent of GDP (see figure B), while the resources held at the State Oil

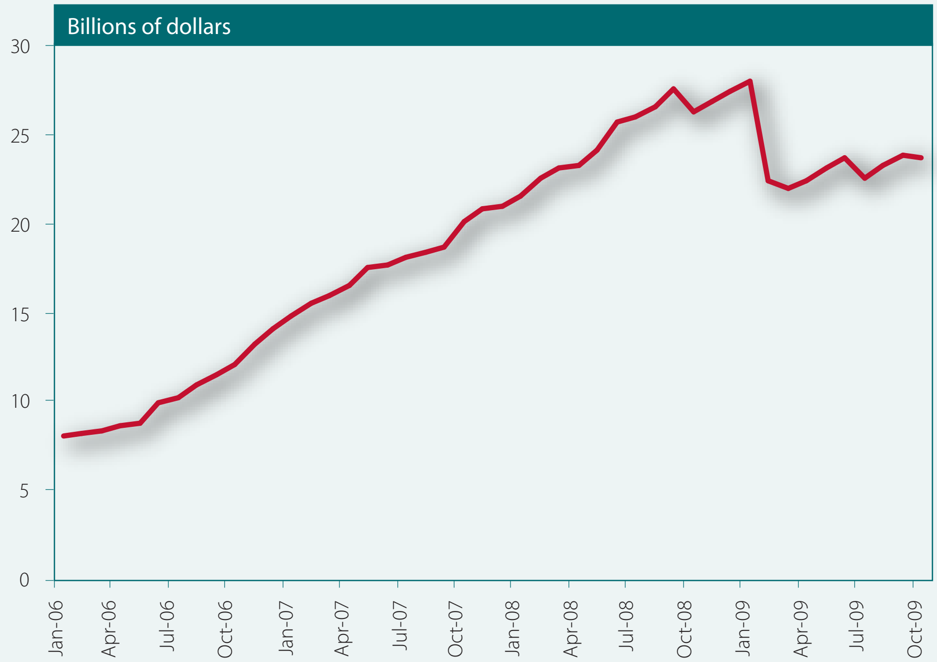
Figure A
Russian Federation: Oil funds assets, July 2006-September 2009



Source: Ministry of Finance of the Russian Federation.

Box IV.1 (cont'd)

Figure B
Kazakhstan: National Fund assets, January 2006-October 2009



Source: National Bank of Kazakhstan.

Fund of Azerbaijan reached 23.6 per cent of GDP. The larger size of the funds in these two countries reflects not only that they were created earlier but also that they had different sources and rules for the accumulation of resources.

During the years of high prices and fast output growth, saving part of the oil and gas receipts reduced overheating pressures and strengthened the capacity of public finances to deal with a possible downturn. However, buoyant oil and gas prices leading to rapid expansion also encouraged capital inflows, which, unlike current revenues, were not sterilized by the oil funds operating in CIS countries. These funds, by design, were effective in dampening appreciating pressures only on exchange rates associated with large current-account surpluses but not those related to capital inflows.

Reluctance to let the exchange rate appreciate fully as a result of large capital inflows created expectations of future appreciation that encouraged further inflows. Despite the support provided by cautious fiscal policies, loose monetary policies contributed to entrenched inflation. The strength of public finances, resulting in sovereign credit-rating upgrades, and the confidence-boosting effect of the oil funds, facilitated borrowing by the private sector in international capital markets. The reliance of the private sector on external financing became a growing source of vulnerability and the initial channel for the transmission of the worldwide financial crisis to Kazakhstan and the Russian Federation.[a]

Considering the existing fiscal space relative to the size of their economies, the counter-cyclical responses adopted by Kazakhstan and the Russian Federation were among the largest in the world. In Kazakhstan, the National Fund provided $10 billion, or 7.4 per cent of 2008 GDP, in 2008-2009 to finance the government's stimulus package. In the Russian Federation, the fiscal measures introduced in 2008 and those announced in 2009 were equivalent to about 7 per cent of GDP. For the first time since 2000, a budget deficit will emerge in both countries in 2009.

The future dynamics of these countries' budget deficits will depend on the evolution of oil prices, the robustness of the economic recovery and the policy decisions regarding maintenance or withdrawal of fiscal stimulus. Given the starting position—the 2009 shortfall of the federal budget

a See *World Economic Situation and Prospects 2009* (United Nations publication, Sales No. E.09.II.C.2), chapter IV, box IV.1, pp. 104-106.

Box IV.1 (cont'd)

deficit in the Russian Federation is projected at about 9 per cent of GDP—budget deficits will persist in the coming years. The necessary financing of these deficits will be a radical departure from the pre-crisis environment, where the Government had practically withdrawn from capital markets. Official projections envisage the depletion of the Russian Reserve Fund by the end of 2010. Net foreign financing in 2010 is initially estimated at $16 billion and similarly large amounts will need to be raised over the subsequent two years.

The projected reliance on foreign capital markets introduces a new source of vulnerability and emphasizes the need to put in place financial and institutional reforms that facilitate the mobilization of domestic resources. In this context, the potential contribution of privatization initiatives may be discussed. The willingness of investors to finance these deficits will depend on the credibility of the plans put forward to return public finances to more sustainable levels. They will need to be anchored in medium-term plans that envisage fiscal consolidation as the situation improves. The current difficulties have, however, unwound progress that has been made in putting in place a formal system of fiscal rules.

Fiscal balances have deteriorated in virtually all CIS economies as a result of lower economic growth, declining trade and falls in the prices of other commodities. Given the absence of fiscal reserves and the difficulties in financing those deficits, many countries have been unable to let automatic fiscal stabilizers work fully and have been forced to cut public expenditures, despite some official financing. In Ukraine, International Monetary Fund (IMF) support envisaged a tightening of fiscal policy, excluding the costs of domestic banking recapitalization. In Belarus, the agreement with the IMF did not leave space for counter-cyclical fiscal stimulus, although it did leave support to the banking sector outside fiscal ceilings. In the poorest countries in the region, the low degree of financial development has spared them from the costs of a banking crisis. However, external official financing represents the only way to offset the sharp falls in fiscal revenues and avoid the need for dramatic compression in expenditure.

Developing economies

Average growth in developing countries slowed considerably from 5.4 per cent in 2008 to 1.9 per cent in 2009, corresponding to only 1 per cent in per capita terms. Overall, developing countries were hit hard through financial and, especially, trade channels, with the magnitude of the impact varying according to openness and export dependence. Countries whose growth depends strongly on exports of energy, minerals and manufactured goods were the most severely affected. By contrast, China and India, whose growth is less export-led, showed resilience, mainly owing to strong fiscal and monetary policy interventions and the large size of their domestic markets. Together with other economies in East Asia, both countries are expected to be drivers of a global recovery. Over the next year, economic activity is expected to gain momentum across all developing regions. Many developing countries in Africa, Western Asia and Latin America and the Caribbean are expected to experience significant turnarounds as demand for oil and minerals strengthen. While average growth for developing countries is forecast to accelerate to 5.3 per cent in 2010, it still remains far below its potential.

Overall, the economic slowdown and the deterioration of labour markets had strong and very likely long-lasting adverse effects on poverty reduction and other development goals. As the global recovery still appears to be fragile and slow, developing countries face major challenges in achieving robust and sustainable growth.

Africa: signs of recovery, but concerns remain

Some signs of recovery are beginning to appear …

There seems to be a growing sentiment in Africa that the worst of the economic and financial crisis has passed as signs of recovery begin to appear. The future of many mineral and oil exporters in the region looks brighter than in early 2009 as the prices and the demand for these commodities rebounded sharply at the end of the first quarter and general economic activities started to resume.

… but the crisis will likely have long-lasting effects on development and poverty reduction

However, economic growth in almost all African countries will remain well below potential. Aggregate growth in Africa is estimated to be 1.6 per cent in 2009, down from an average of about 5.7 per cent during the period 2002-2008. Average GDP per capita for the region contracted by 0.7 per cent in 2009. The richer African countries faced stronger declines in per capita income than low-income countries owing to greater economic linkages with the rest of the world (figure IV.8). As all groups registered a growth of GDP per capita below 3 per cent, which is considered the minimum rate for achieving a meaningful reduction in poverty, 2009 marked an unfortunate reversal and offset part of the hard-earned social and economic gains that had been made in reducing both poverty and the large gap which still separates Africa from its Millennium Development Goals (MDGs). In addition, considerable economic difficulties remain, as seen in the two largest sub-Saharan African economies. In South Africa, manufacturing activities and the labour market remain depressed. In Nigeria, the banking system is experiencing severe distress. More worrisome, hunger levels have soared in the Horn of Africa and in East Africa, owing to prolonged droughts and are exacerbated by increased insecurity in some countries.

Southern Africa registered the strongest contraction, while East and North Africa were more resilient

At the subregional level, Southern Africa contracted by 1.7 per cent in 2009, the worst regional performance on the continent. South Africa recorded its first recession since the collapse of the apartheid regime. This slowdown also spilled over to its neighbours, particularly Lesotho, Swaziland and Namibia. West Africa grew by 2.4 per cent in

Figure IV.8
Growth of per capita GDP in Africa,[a] by income group, 2006-2010

Source: UN/DESA.

a Excluding Seychelles and Swaziland, owing to lack of data.
b Estimated.
c Forecasts.

2009. Nigeria, the second-largest sub-Saharan economy, grew by 1.9 per cent, as declines in the industrial sector and crude oil production were offset by increases in agriculture. Meanwhile, other food exporters of the region proved to be quite resilient as the demand and prices for commodities like cocoa, coffee and bananas remained robust. North Africa, with an average growth of 3.5 per cent in 2009, was also more resilient, owing to robust domestic consumption and excellent harvests in Algeria and Morocco. In Morocco, the unemployment rate even decreased from 9.6 to 8.0 per cent between the first and second quarters of 2009. East Africa recorded the highest subregional growth rate in 2009: owing to the dynamism in Ethiopia and in the five member countries of the East African Community, it expanded by 3.8 per cent. However, the significance of such a positive headline figure appears questionable in view of severe problems in satisfying the basic needs of a large number of those countries' citizens. More specifically, prolonged droughts and variations in rainfall, accentuated in some cases by conflicts and political turmoil, continue to have a devastating impact on a region where more than 20 million people are affected by severe hunger.

Vulnerable employment rates have increased further

Unemployment and underemployment remain a major concern in Africa, especially among women and youth. Moreover, Africa has a very high rate of vulnerable employment,[9] which is expected to rise from 73 to 78 per cent in sub-Saharan Africa and from 37 to 42 per cent in North Africa between 2008 and 2009.

Inflation will decline, except in countries facing a food crisis

Weighted average inflation decreased to 8.1 per cent in 2009 as food and oil prices declined from their peak in 2008, although subregional levels remain diverse. In the Communauté financière africaine (CFA) zone, inflation is forecast at approximately 4 per cent in 2009. In North and Southern Africa, it is expected to be about 6 and 8 per cent, respectively, while it is likely to remain at about 15 per cent in East Africa. In the outlook, as prices are expected either to decline slightly further or to remain stable at their October 2009 level, inflation is forecast to be about 6 per cent in 2010. However, food prices will likely soar in many East African countries as the food crisis affecting their populations intensifies.

While most financial systems were not adversely affected, the Nigerian banking system is experiencing severe distress

Many of Africa's biggest central banks have reduced their main interest rates by between 3 and 5 percentage points since the last quarter of 2008. While most African countries' financial systems have not been adversely affected by the crisis, the Central Bank of Nigeria injected $2.6 billion into five troubled banks in August 2009 before injecting an additional $1.3 billion into four other banks at the beginning of October.

Fiscal balances have deteriorated in 2009, forcing several oil exporters to revise their budgets downwards

Due to prudent management of public finances during periods of robust growth, many African countries entered the current crisis in a better fiscal position than in past crises. Some countries, such as Egypt, Mauritius, Nigeria and South Africa, embarked on fiscal stimulus packages, primarily in infrastructure. Nevertheless, the economic crisis has strained budgets in the region. With the exception of Ghana and a few other countries, almost all African countries experienced a deterioration of their fiscal balances in 2009. In oil-importing middle-income countries (MICs), this decline can be mainly explained by increased government expenditure, while in most of the energy-exporting MICs, the main factor was the decline in government revenues. The crisis also forced most of the major oil exporters to switch from fiscal surplus to deficit this year. While most of their Governments entered the crisis in strong budget positions after the prices of their exports skyrocketed in 2008, some of these countries, such as Angola, Chad and Nigeria, revised their budgets downwards for 2009 after oil prices fell below $40 per barrel (pb). Nevertheless, near-term prospects look brighter as oil prices have rebounded to $70-$80 pb, and this may be reflected in the upcoming budgets.

9 Vulnerable employment as defined by the International Labour Office is calculated as the ratio between the sum of own-account and contributing family workers to total employment.

African trade and current accounts switched into deficit as oil revenues dropped

Regarding trade, aggregate exports declined faster than imports owing to the sharp drop in the prices of oil and minerals. Hence, the aggregate African trade and current-account balances, which are mainly determined by the price of oil, switched into deficit in 2009 and will probably remain so in 2010. However, this aggregate picture contrasts dramatically with some country-specific situations. For instance, South Africa's trade balance moved into surplus in the second quarter of 2009 following a sharp decline in its volume of merchandise imports.

FDI is likely to decline as projects have been interrupted

Preliminary data suggest that FDI flows to Africa declined in 2009, following five years of uninterrupted growth. Natural-resource producers, which attract a large share of the region's inflows, suffered particularly as some projects were interrupted. Rwanda, whose FDI went up sharply during the first half of 2009, constitutes one of the few exceptions.

All African currencies depreciated by an average of 10 per cent compared with 2008

In comparing the average monthly levels for African currencies between January and September 2009 with the 2008 average, all African currencies had depreciated vis-à-vis the dollar as that currency had recorded a significant rebound in the second half of 2008 and early 2009 owing to flight-to-safety effects (see chapter I). While the average depreciation had been about 10 per cent up until September 2009, the currencies of the Democratic Republic of the Congo, Ghana, Seychelles and Zambia had depreciated by more than 30 per cent.

African growth continues to rely heavily on agriculture and commodity exports, but progress has been made in improving governance

The global economic crisis and adverse weather shocks have undoubtedly complicated efforts to restructure those African economies that continue to rely heavily on agriculture and commodity exports. However, while significant threats to political stability persist in several countries, modest progress has been observed in terms of improvements in economic governance and public sector management.[10] This progress may have helped some African countries to mitigate the worst social and economic consequences of the global crisis. Moreover, several African countries have continued to implement long-term reforms to improve their business environment and investment climate, despite the challenges presented by the crisis.

Although Africa's future looks bright, growth will remain below potential over the next few years

While African countries have taken a number of initiatives to lessen the impact of the economic downturn, their recovery will mainly depend on the revival of the global economy. Moreover, many African countries are expected to remain below their growth potential during the next few years, as the economic crisis will have long-lasting effects. As global demand recovers, Africa is projected to grow by 4.3 per cent in 2010. In addition, African countries are expected to benefit from plans to boost domestic demand and from a gradual recovery in FDI and other private flows.

However, numerous downside risks to economic growth remain. A key structural element relates to the continued high dependence of most African economies on primary commodity exports, which are subject to strong fluctuations in demand and prices. Other downside risks include the possibility of prolonged global recession, failure of donors to meet aid commitments, fragility of domestic financial sectors, limited access to foreign borrowing, erratic weather conditions and political instability in some countries. To mitigate these risks, Africa needs to make greater efforts, with the help of donors and international financial institutions, to implement long-term reforms and strategies in order to reduce vulnerability to external shocks, improve mechanisms of transparent and effective public administration, strengthen private sector development and promote investment, employment generation and poverty reduction.

10 Economic Commission for Africa, *African Governance Report II,* Oxford University Press, Oxford, United Kingdom, 2009.

East Asia: leading the global recovery

East Asia has rebounded after experiencing a sharp economic slowdown

The East Asian economies rebounded in the course of 2009 after suffering severe downturns in the aftermath of the Lehman Brothers bankruptcy, when exports, industrial production and domestic investment weakened sharply. Driven by a strong performance of China's economy, average regional growth in 2009 is estimated at 4.1 per cent, down from 6.2 per cent in 2008 (see annex table A.3). Economic activity in East Asia is expected to gain further momentum in 2010 as exports and private sector demand continue to recover, with average growth forecast at 6.7 per cent.

Expansionary monetary and fiscal policies are driving the recovery

In many East Asian economies, strongly expanding government expenditures on consumption and investment drove the recovery. At the same time, aggressive monetary easing and fiscal policy measures, such as tax rebates and the extension of credit lines to households and firms, supported private sector demand. Since the second quarter of 2009, export sectors have recovered gradually as demand for manufactured goods stabilized, trade finance improved and inventories were built up. Overall, growth disparities within the region were wider in 2009 than in previous years although most countries benefited from strong macroeconomic fundamentals at the onset of the crisis. Viet Nam and the region's less export-dependent economies of China and Indonesia showed remarkable resilience on the back of buoyant domestic demand, which had been spurred by rapid credit growth and sizeable fiscal stimulus measures. In fact, much of East Asia's growth in 2009 is accounted for by China, where GDP expanded by 8.1 per cent compared to 9.0 per cent in 2008. In 2010, growth in China is forecast to accelerate to 8.8 per cent as economic policies remain expansionary. The smaller, heavily export-dependent economies of the region were much harder hit by the global recession, with rapidly falling exports triggering severe declines in investment. Several of these economies, for instance Hong Kong Special Administrative Region (SAR) of China and Singapore will experience full-year contractions of GDP in 2009. However, they did rebound strongly in the course of the year and are likely to benefit the most from the expected recovery of global demand and trade activity in 2010.

Government measures have helped stabilize labour markets

Across East Asia, labour markets started to improve in the second half of 2009 after deteriorating markedly at the beginning of the year, when the manufacturing industries in the region suffered dramatic contractions. Government measures, such as direct wage subsidies, tax reductions, easier access to credit and higher infrastructure spending, played a key role in alleviating an emerging employment crisis. In 2010, labour markets are expected to see further modest improvements owing to the recovery of export industries and continued government stimulus in support of domestic demand. In the heavily export-dependent economies, unemployment rates are now much higher than in recent years. In Taiwan Province of China, for instance, the unemployment rate reached 6.1 per cent in August 2009, the highest level since record-keeping began in 1978. In some of the more populous countries of the region, including China, Indonesia and the Philippines, the impact of the current crisis on unemployment levels has been relatively muted. However, since in many countries, labour surveys are conducted only infrequently and underemployment is often not adequately recorded, the actual employment situation may be weaker than suggested by officially reported data. Several countries, for instance Indonesia and Thailand, registered an increase in informal and vulnerable employment as weak social protection systems and widespread poverty have forced people to take whatever work is available.

Inflationary pressures remain low, mainly owing to excess capacities

Average consumer price inflation in East Asia declined from 6.0 per cent in 2008 to 0.6 per cent in 2009 owing to weaker domestic demand, significant excess production capacity and, most importantly, lower oil and commodity prices in world markets. Several economies, including China, Taiwan Province of China and Thailand, experienced deflationary pressures. However, these pressures started to ease in the third quarter as the base effect of the surge in energy and commodity prices in 2008 began to wane and economic activity across the region recovered. Inflation is expected to rise mildly in the course of 2010, mainly as a result of shrinking output gaps and higher global commodity prices. Nonetheless, in most countries, inflation will likely remain low during 2010, except in Viet Nam, where pressures are expected to be high.

Monetary policy will remain accommodative in 2010, though some central banks may start raising interest rates

Central banks across the region eased monetary policy aggressively between October 2008 and April 2009 to increase credit flows, support domestic liquidity and stimulate demand. During the rest of 2009, interest rates were kept at record lows in most countries as inflationary pressures continued to be subdued. The easing of liquidity stimulated credit expansion and domestic spending: for instance, domestic credit in China, Indonesia and Malaysia continued to record double-digit growth in 2009, fuelling concerns of asset bubbles. The People's Bank of China started to implement measures to rein in liquidity and bank lending, while thus far refraining from interest-rate hikes. In general, monetary authorities are expected to maintain an accommodative policy stance until a sustained recovery is ensured or inflationary pressures increase considerably. An early and decisive tightening of monetary policy is also complicated by the fact that it would likely fuel the appreciation of the domestic currency against the currencies of major trading partners, thus weakening the domestic export sector. Nevertheless, some East Asian central banks are expected to start raising interest rates from their current lows in the first half of 2010.

Some Governments will gradually remove the extraordinary stimulus measures

Most East Asian Governments responded to the sharp economic slowdown in the second half of 2008 by announcing large fiscal stimulus packages with a view to strengthening domestic demand, supporting the business sector and mitigating the impact of the crisis on the vulnerable and the poor. Overall, discretionary support during the course of 2009 has been stronger than in most other regions as East Asian economies benefited from healthy fiscal positions at the onset of the crisis. In addition, automatic stabilizers, such as welfare payments and unemployment insurance are relatively weak. In 2010, fiscal policy will remain expansionary overall, but many Governments will start to remove some of the extraordinary stimulus measures put in place in 2009 and will gradually move towards a more neutral policy stance. In China, the Government indicated that it would continue to implement its proactive fiscal policy. The increase in government spending led to a marked deterioration of fiscal balances in 2009. Nonetheless, budget deficits remained relatively moderate in most countries, ranging from 2.5 per cent to 5 per cent of GDP. Malaysia and Viet Nam have been outliers, registering deficits of more than 8 per cent, adding to concerns about fiscal sustainability.

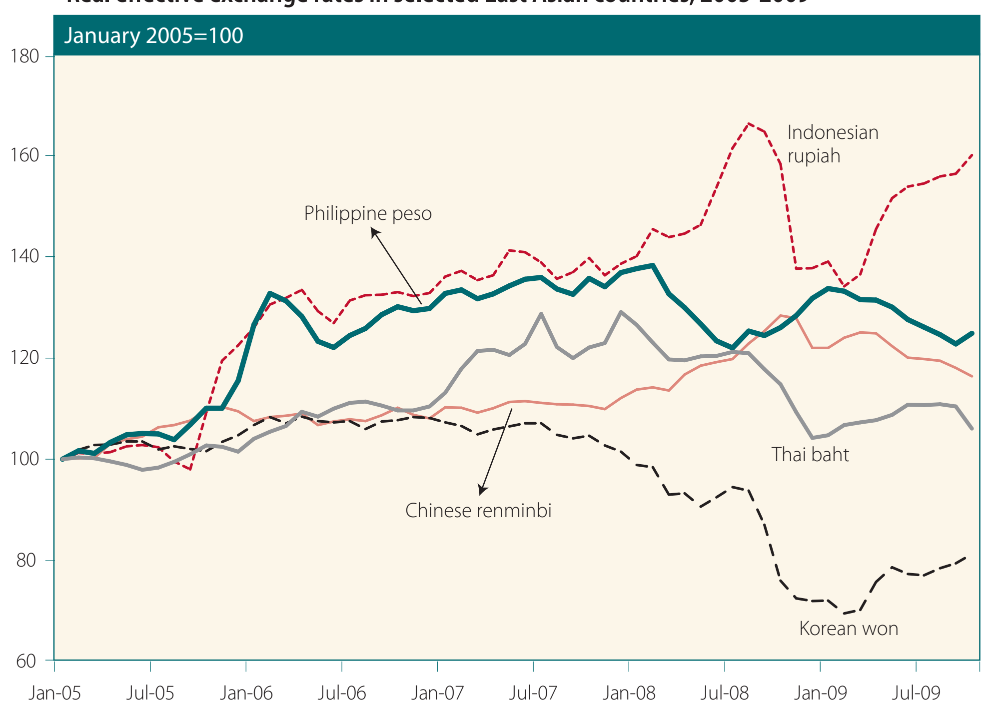
Exports have started to recover after contracting sharply in early 2009

The current crisis has illustrated the dependence of many East Asian economies on exports as their engine of growth. In the final months of 2008 and at the beginning of 2009, East Asia's merchandise exports and imports declined precipitously as the impact of lower final demand from developed economies was compounded by the high import content of the region's manufactured exports. Since the second quarter of 2009, exports and imports recovered gradually owing to improved trade finance, restocking of inventories and stabilizing final demand for manufactured goods. In most East Asian economies, the decline in export earnings in 2009 was more than offset by reduced import bills, resulting in improved trade balances, most notably in Indonesia, the Republic of Korea and Thailand. The main exception is China, whose trade and current-account surpluses shrank markedly—a trend that seems unlikely to continue in 2010. Import bills will rise considerably in 2010 as domestic demand recovers and international energy prices move up. Trade surpluses may therefore start to narrow in many countries despite growth in export earnings. In several East Asian economies, particularly in the Republic of Korea, export sectors benefited from significant real depreciations of the national currencies in 2008 and early 2009 (see figure IV.9). However, since then, some currencies, such as the Indonesian rupiah, have appreciated markedly as a result of massive capital inflows, raising concerns among policymakers (see also box IV.2). Meanwhile, China faces mounting international pressure to allow the renminbi to appreciate and contribute more significantly to a global rebalancing.

The timing of the monetary and fiscal exit strategies poses a key policy challenge

While the overall outlook for East Asia is favourable, the region faces several major policy challenges and downside risks, including a premature exit or sharp reversal of the expansionary monetary and fiscal policy measures that were put in place over the past year. In some countries, continued large capital inflows, combined with strong domestic credit growth and sharply higher international commodity prices, might fuel asset bubbles and increase inflationary pressures. Central banks may therefore see the need to tighten monetary policy more aggressively than currently anticipated, thus hampering the fragile economic recovery. Besides, a possible escalation of the influenza A (H1N1) pandemic may undermine consumer confidence and harm the tourism sector, which is important for several East Asian economies.

Figure IV.9
Real effective exchange rates in selected East Asian countries, 2005-2009



Source: UN/DESA, based on data from JPMorgan.
Note: An increase in the value indicates a real effective appreciation of the currency (see annex table A.13 for details).

Box IV.2

Progress in monetary and financial cooperation in Asia and the Pacific

The global financial and economic crisis has again directed the attention of policymakers to the lack of financial tools and policies available at the regional level over and above those in the hands of national governments. While most countries had built up sufficient reserves to protect their balance of payments, other countries, most notably Pakistan and Sri Lanka, were severely impacted by capital outflows and did not have recourse to regional sources of assistance.

So far, the potential for monetary and financial cooperation in the region has only been marginally tapped. A pressing policy gap for the region, which has been highlighted by the recent crisis, is the lack of mechanisms for coordinating exchange-rate policies. Such mechanisms could be particularly important during the economic recovery phase as pressure on countries to maintain exchange-rate competitiveness increases. The Asian Clearing Union, which was established in 1974 at the initiative of the Economic and Social Commission for Asia and the Pacific (ESCAP), remains limited to the clearing of settlements and does not deal with exchange-rate stability for intraregional trade. The development of an Asian bond market, another regional initiative, could also be accelerated. At present, it remains at the preparatory stage, with discussions among Governments relating to issues such as regulation and harmonization. Integration and credibility of regional bonds could be encouraged through the issuance of debt denominated in Asian Currency Units or a similar basket of currencies.

The current crisis presents the region with a window of opportunity to press forward with a truly effective regional crisis-response fund. Such a window also opened immediately after the 1997 crisis but the relatively rapid return to economic growth resulted in a loss of policy urgency.

As agreed at the Fifteenth Summit of the Association of Southeast Asian Nations (ASEAN) held in Hua Hin, Thailand, from 23 to 25 October 2009, the ASEAN Plus Three Chiang Mai Initiative reserve pool—known as the Chiang Mai Initiative Multilateralization (CMIM)—will be implemented by the end of 2009. The agreement paves the way for the conversion of the existing system of bilateral swap agreements between ASEAN Plus Three countries, amounting to $80 billion, to a multilateral pool of $120 billion. Eighty per cent of the new funds will be provided by the Plus Three countries, China, Japan and the Republic of Korea. Japan will contribute $38.4 billion to the pool (it has also extended $60 billion worth of yen-denominated swap facilities separately), as will China (including Hong Kong Special Administrative Region (SAR) of China), while the Republic of Korea will contribute $19.2 billion. Within ASEAN, the contributions of member economies will be made primarily by Indonesia, Malaysia, Thailand, Singapore (each contributing $4.76 billion) and the Philippines ($3.68 billion). The reserve pool could evolve into a truly effective first line of defence in situations of balance-of-payments difficulties or banking sector pressures. However, it appears at present that the same restrictive conditions attached to the Chiang Mai Initiative remain in place, most importantly the fact that only 20 per cent of borrowing is unrestricted, while 80 per cent is tied to IMF conditionality.

Many other issues still need to be resolved before this agreement can fulfil its function as a defence mechanism in the event of a balance-of-payments crisis. For the agreement to become a first line of defence during a crisis, its geographical coverage, size and functions will need to be expanded. To be effective in preventing systemic crises, a regional crisis fund should attempt to include as many systemically important countries in the region as possible. The quantum of resources placed in the fund should be sufficient for it to act as the lender of first resort in the event of macroeconomic difficulties. Within its remit, the fund should also ideally include support to domestic financial sectors by Governments, in addition to balance-of-payments support, similar to the lending provided by the IMF to countries in difficulty. Critically, for the fund to be operational, an institutional structure must be set up and would include revising the relationship with the IMF. The fund would require a physical infrastructure with a well-qualified and independent secretariat that would engage in monitoring economies prior to and during crises as well as in designing and monitoring the terms associated with lending to regional Governments.

South Asia: resilience to the global crisis

South Asia has shown considerable resilience in the face of the global crisis

The global economic crisis adversely affected South Asia through weakening export demand and reduced capital inflows, but the slowdown in growth has been less severe than in other developing regions. Average growth decelerated moderately from 6.5 per cent in 2008 to 4.7 per cent in 2009. Overall, South Asian economies showed considerable resilience as domestic demand was supported by strong remittance inflows, lower inflationary pressures, accommodative monetary policies and sizeable fiscal stimulus measures. In 2010, regional growth is expected to pick up, to 5.5 per cent, as exports recover and domestic demand remains strong (see annex table A.3).

Robust growth, particularly in India, is supported by increased public spending

India continues to lead the growth momentum of the region and its economy expanded by 5.9 per cent in 2009, down from 7.3 per cent in 2008. Growth was underpinned by a large increase in public expenditures. Private consumption and investment also continued to expand—although at a lower pace than in previous years—owing to tax cuts and the easing of credit delivery to specific economic sectors. In 2010, growth is forecast to accelerate to 6.5 per cent on the back of stronger private consumption and investment and a moderate recovery of exports. The long-term growth prospects of the Indian economy remain promising given the high rates of domestic savings and investment and the improved macroeconomic policy environment.

Pakistan and Sri Lanka have received support from the IMF after suffering from large budgetary and external imbalances, which had resulted in a sharp deceleration of economic growth. However, Pakistan's outlook continues to be fragile owing to the volatile security situation and the ongoing violence, even though a slight recovery is projected in 2010. The prospects for Sri Lanka's economy, by contrast, have improved as the 25-year-long civil war ended in May 2009. In Bangladesh and Nepal, economic activity has so far been only mildly impacted by the global crisis. In both countries, private consumption has remained buoyant on the back of robust growth in workers' remittances and strong agricultural output. The Islamic Republic of Iran experienced a sharp economic slowdown since mid-2008 owing to lower oil prices and declining oil production, but a moderate recovery is expected in 2010.

Export-oriented industries saw significant job losses in 2009

Labour markets in South Asia continue to be characterized by a large informal sector and a heavy dependence on agriculture. While the impact of the economic crisis on official unemployment rates has been less pronounced than in other developing regions, labour-market pressures have intensified over the past year. Recent surveys in India and Sri Lanka show that the economic slowdown adversely affected employment levels, particularly in export-oriented industries, as well as the quality of employment. In India, the textile sector saw large job losses in 2009 as it suffered from weaker demand in developed economies and price cuts by Bangladeshi competitors. By contrast, employment levels in Indian firms catering to the domestic market have been largely unaffected by the slowdown. Moreover, the 2006 National Rural Employment Guarantee Act (NREGA), by which adults living in rural areas are guaranteed at least 100 days of wage employment per year, helped to mitigate the effect of slowing output growth. In Sri Lanka, unemployment increased to 6.2 per cent in the second quarter of 2009, up from 5.3 per cent a year ago, while the labour force participation rate declined to its lowest level in over a decade.

Food price inflation remains elevated despite lower commodity prices

Inflation in most South Asian countries slowed in 2009 owing to the drop in commodity prices and the softening of aggregate demand pressures. Regional average inflation declined from its decade high of 12.6 per cent in 2008 to 10.9 per cent in 2009. However, in India, the Islamic Republic of Iran, Nepal and Pakistan, inflation—

particularly food price inflation—has remained persistently high due to a variety of factors, including large nominal exchange-rate depreciations, the reduction of fuel and other subsidies, the upward revision of minimum support prices for agricultural crops, as well as poor harvests owing to late monsoon rains in 2009. Unless international oil and commodity prices rise more quickly than expected in 2010, inflation is likely to slow in most countries, the regional average being forecast at 9.8 per cent.

Most central banks are expected to maintain their accommodative monetary policy stance

Most South Asian central banks eased monetary policy in 2009, following a long period of monetary tightening in the region. Reduced inflationary pressures allowed for interest-rate cuts and other accommodative measures in order to provide greater liquidity to financial institutions and stimulate domestic economic activity. Most importantly, the monetary authorities tried to ensure adequate credit flows to productive sectors by directly influencing credit supplies. An example is the agricultural-cum-rural credit policy and programme in Bangladesh. The quick and aggressive moves by the Reserve Bank of India (RBI) helped to stabilize the financial sector and cushion the impact of the global crisis on the domestic economy. Other central banks eased monetary policy more slowly as inflationary concerns persisted. In the near term, most central banks are expected to maintain their accommodative policy stance as growth remains below potential and inflation continues to decline. However, the RBI is expected to tighten monetary policy in the course of 2010 as the focus is expected to shift gradually towards addressing inflationary fears.

Expansionary fiscal policies have led to sizeable budget deficits

Faced with challenging global conditions and slowing domestic economies, most South Asian Governments pursued expansionary fiscal policies in 2009, which resulted in further increasing budget deficits. Bangladesh, India and Sri Lanka implemented fiscal stimulus packages that included, for instance, special support for the sectors that were most severely affected by the crisis, additional spending on infrastructure and social programmes and—in the case of India—sizeable tax cuts. While fiscal expenditures increased significantly, revenue growth weakened over the past year. Therefore, most economies experienced sharply deteriorating fiscal balances in 2009, with deficits in Bangladesh, India and Sri Lanka ranging from 6 to 9 per cent of GDP. Several Governments, most notably that of India, are expected to wind down the stimulus measures in 2010 with a view to reducing the budget deficits.

Current-account balances have improved despite sharply lower export revenues

Despite a drop in export revenues, trade and current-account balances improved in all South Asian economies in 2009 except in the Islamic Republic of Iran. Exports sectors were hard hit as demand from developed countries declined sharply, particularly for manufactured goods. The Islamic Republic of Iran, India and Pakistan registered the most severe contractions, with annual export earnings falling by more than 17 per cent. However, exports started to recover in several South Asian economies in the second half of 2009—a trend that is likely to continue in 2010. The decline in global energy and food prices, combined with the slowdown in domestic demand, led to sharply lower import bills, while remittance inflows continued to increase substantially. Current-account deficits narrowed markedly as a share of GDP in India, Pakistan and Sri Lanka. Bangladesh is expected to report a larger surplus than in 2008. Meanwhile, pressures on the domestic currencies of India, Pakistan and Sri Lanka eased in the course of 2009 following sharp depreciations earlier.

Slowing remittance inflows and higher inflation may harm domestic demand

In the near term, a sharper-than-expected slowdown in remittance inflows, renewed weakness in exports and lower agricultural output may drag economic growth in South Asian countries. Most economies continue to be highly vulnerable to weather conditions owing to insufficient irrigation and extensive subsistence farming. Lower agricultural output, combined with a marked rise in energy prices, may also push up inflation, which has remained elevated in several countries. This may constrain household spending, one of the drivers of growth in recent years. In the medium term, considerable risks are associated with the high fiscal deficits of many countries.

Western Asia: improving global conditions will underpin a return to positive growth

Economic sentiment has improved from pessimism to cautious optimism

With the world economy starting to see a recovery from recession through the second and third quarters of 2009, the economic sentiment in Western Asia has improved from pessimism to cautious optimism. As the region comprises the major crude oil exporters, the strong recovery of prices for crude oil to about $80 per barrel has contributed to the optimistic projection for 2010. Nevertheless, Western Asia is estimated to experience an economic contraction by 1.0 per cent in 2009, down from a positive growth rate of 4.6 per cent in 2008 (see annex table A.3). The regional contraction is mainly driven by those economies characterized by a stronger international economic linkage with the United States and Europe. A fall in external demand and lower fund inflows from developed countries, especially in terms of private foreign capital, contributed to lower net exports and a slowdown in investment projects. However, as in the case of Saudi Arabia, for example, resilient domestic demand, backed not least by fiscal stimulus measures, helped to prevent an even sharper fall in economic growth. In 2010, the region is forecast to experience a rebound in economic growth to 3.6 per cent, underpinned by a solid performance of the oil-exporting economies in the light of higher oil prices.

Trade surpluses will increase again with rebounding oil prices

External demand conditions, which in many respects led the region into the downturn, will also determine the extent and speed of the recovery. Oil exporters will benefit from the recovery in oil prices from their trough at the end of 2008, which was driven by more optimistic expectations regarding global growth and its effect on oil demand, by the fall in the value of the dollar and, at least in part, by a significant production cut by the Organization of the Petroleum Exporting Countries (OPEC) that became effective at the beginning of 2009. In Saudi Arabia, for example, after a sharp contraction by more than 50 per cent in 2009 compared with the previous year, the trade surplus will move up again by about 37 per cent to $103 billion in 2010. At the same time, non-oil exporters have been suffering from a sharp drop in global demand across virtually all product groups. However, with imports having contracted even more severely, countries such as Israel and Turkey will experience narrowing trade deficits in 2009. They are, however, expected to widen again in 2010 following the stabilization of domestic demand and higher import bills.

Fiscal stimulus is upholding domestic demand

Meanwhile, domestic demand conditions varied widely among the countries in the region. Private consumption has suffered from generally weaker consumer sentiment in the course of the crisis. At the same time, personal disposable incomes are also under pressure from rising unemployment. In Turkey, government stimulus measures have helped to avoid a sharp contraction in private consumption. Similarly, Kuwait, Saudi Arabia and the United Arab Emirates are expected to experience continued growth in domestic demand in 2009, despite the contraction in real GDP and thanks to expansionary fiscal policies.

Inflation has been decreasing, but is forecast to pick up moderately in 2010

Consumer price inflation peaked in the second half of 2008. As a general trend, the rate of consumer price inflation has been declining since then in several countries in view of weaker demand and lower commodity prices. In this context, in the oil-exporting economies, the lower oil price has removed upward price pressures both on the supply and the demand sides, as lower revenues have curtailed overall demand. The decline in inflation has been particularly pronounced in Qatar, with the estimated consumer price inflation declining from 15.0 per cent in 2008 to -1.4 per cent in 2009 owing to lower commodity prices and a considerably weaker housing market. A similar scenario has been playing out in the United Arab Emirates, with inflation dropping from 12.3 per cent in 2008 to 1.5 per cent in 2009. In 2010, inflation is forecast to pick up moderately owing to the impact of the decline in the value of the dollar in those economies with a currency peg and low base effects.

While widespread reverse migration from the Gulf Cooperation Council countries has not occurred so far, unemployment is rising elsewhere

The once-feared reverse mass migration of expatriate workers from the member countries of the Gulf Cooperation Council (GCC)[11] did not take place (see box IV.3) as the labour markets showed resilience. However, labour markets remained weaker in other parts of the region. For example, the unemployment rate of Jordan rose to 14.0 per cent in the third quarter of 2009, from 12.0 per cent in the same period of the previous year, while Turkey's unemployment rate increased to 12.8 per cent in July 2009, compared with 9.9 per cent in July 2008.

Box IV.3

The early impact of the financial crisis on expatriate workers in the Gulf Cooperation Council countries

At the onset of the current global financial crisis, one of the major economic and social concerns in the Western Asia region, besides the abrupt plunge in crude oil prices, was the state of expatriate workers in the region's major oil-exporting countries, namely the member States of the Gulf Cooperation Council (GCC).[a] Despite active efforts to promote employment of national citizens in the private sector, the GCC member countries have remained dependent upon expatriate workers, implying a significant influx of foreign workers during the economic boom. This led to a pronounced expansion in the foreign workforce of the GCC countries, with the share of foreign nationals in the total population reaching 49 per cent in Bahrain (2007), 69 per cent in Kuwait (2008), 29 per cent in Oman (2007), 27 per cent in Saudi Arabia (2008) and 81 per cent in the United Arab Emirates (2008), and the share of foreign nationals 15 years of age and older reaching 89 per cent in Qatar (2006). As the global financial crisis initially had a particular impact on the region's core activities in the private sector, namely finance and construction, there had been fears of massive job losses and an exodus of expatriate workers from the GCC countries, leading to possible severe repercussions for both the host countries and the labour-exporting countries in the Arab and Asia regions.

However, up to the third quarter of 2009, there has been no sign of a large-scale exodus of expatriate workers. A case in point is Lebanon, which is significantly dependent upon employment opportunities in the GCC member countries as well as workers' remittances from these countries, and where no appreciable number of returning expatriates has been reported. The picture is similar for other major labour-exporting countries for which data are available. For example, workers' remittances from the GCC member countries to Pakistan have been increasing and remittances to the Philippines were stable until the second quarter of 2009. Meanwhile, remittances to Egypt decreased in the first quarter of 2009, but showed a recovery in the second quarter (see figure). Assuming that informal remittance flows are correlated to the officially recorded flows by central banks, these data suggest that outflows of workers' remittances from the GCC member countries have remained fairly stable despite the financial crisis.

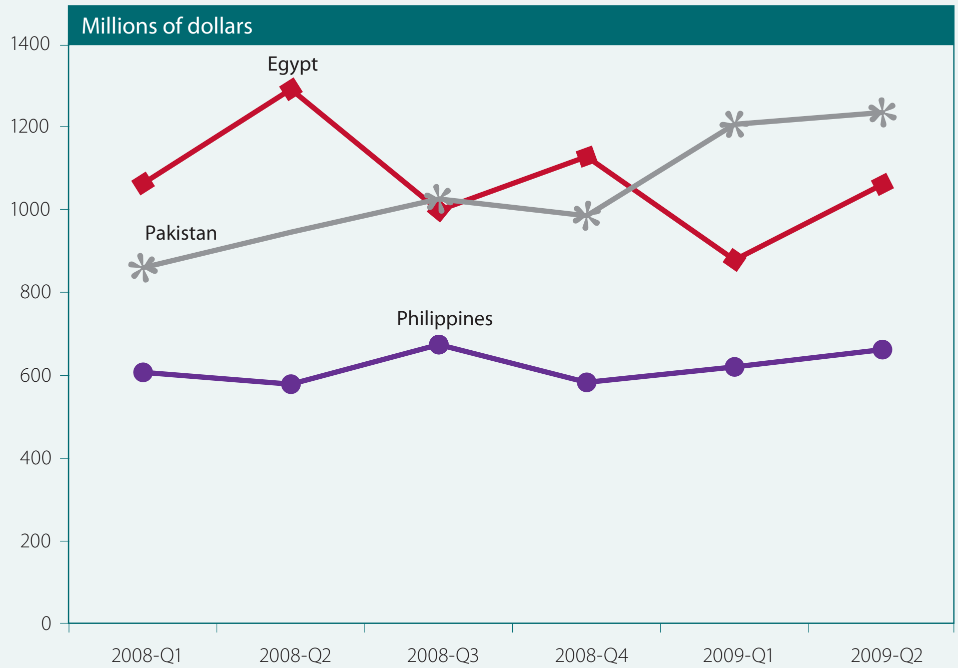
The GCC countries manage the hiring and firing of expatriate workers under a sponsorship system, whereby a transfer of expatriate workers from one employer to another is restricted. Once laid off and losing the sponsoring employer, an expatriate worker mostly must leave the host country. The system's influence is reflected in official unemployment figures. In 2008, the unemployment rate

a The Gulf Cooperation Council comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

11 Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

Box IV.3 (cont'd)

Workers' remittances from the Gulf Cooperation Council countries, first quarter 2008-second quarter 2009



Sources: Central Bank of Egypt, State Bank of Pakistan and Bangko Sentral ng Pilipinas.

for nationals in Saudi Arabia stood at 9.8 per cent, while that for foreigners stood at 0.4 per cent. In the United Arab Emirates, the unemployment rate for the national workforce was 13.8 per cent, whereas that for foreigners was 2.6 per cent. The GCC countries have been actively engaged in labour-market reforms in recent years. Although the job security of nationals became an urgent policy challenge only when economies slowed, reforms regarding the employment of expatriate workers have been ongoing. Bahrain, Kuwait, Qatar and Saudi Arabia had all taken measures to reform the sponsorship system by the third quarter of 2009. In particular, in May, Bahrain decided to allow expatriate workers to shift jobs without the sponsor's permission. This was the first significant relaxation of the sponsorship system in the GCC member countries. The decision was enforced in August, and, in the same month, Kuwait followed Bahrain's lead.

There are four possible explanations for the relatively stable employment situation of expatriate workers in the GCC member countries. First, despite a possible contraction of GDP in major crude oil-exporting countries, domestic demand continued to expand moderately on the back of active fiscal measures that lessened the impact on the employment situation (all GCC countries had committed to an active fiscal policy for the year 2009). Second, employers might be expecting an imminent upturn in economic activity and so maintained their pool of expatriate workers to avoid possible high costs of new recruitment in the future. In fact, in the debate on sponsorship system reform, those against relaxing the rule of employee transfers cited higher recruitment costs as a major concern. Third, within the GCC countries, expatriate workers are relocating to areas less affected by the financial crisis. For example, the remittance data of the State Bank of Pakistan in 2009 shows an increase of remittances from Abu Dhabi and a decrease from Dubai. Anecdotal evidence also shows a move of expatriate workers to Qatar and Saudi Arabia. Fourth, flexible wage adjustments may take place to the mutual benefit of employers and employees. This argument is supported by the absence of any second-round effects of the inflation in 2007-2008, and the rapid decline in consumer inflation rates in 2009.

Investment flows have recovered and have also become more selective

International and intraregional investment flows have taken on a more selective nature in the wake of the crisis, not least due to increased risk aversion. At the height of the crisis, the drying-up of international credit markets and the sharp contraction in crude oil prices severely curtailed investment levels. However, the normalization in credit markets and the recovery in oil prices have also revived investment flows, although there is a stronger risk awareness attached to them. In addition, government stimulus measures have also helped to underpin investment levels.

Exchange rates have been resilient

Exchange rates in the region stayed stable as of the end of the third quarter of 2009, with the new Israeli shekel and the Turkish lira showing a slight appreciation against the dollar for 2009. Signs of fragility have been observed in Yemen, whose national currency has gradually depreciated against the dollar. Despite a positive decision at the GCC summit in December 2008, the goal of creating a GCC currency union in January 2010 has been facing further challenges as the United Arab Emirates has opted not to participate in the currency union from its inception.

Monetary policy is likely to tighten later in 2010

A series of reductions in policy interest rates have been observed in the region since October 2008, together with the reduction in commercial banks' reserve requirements and the provision of extra liquidity facilities. Owing to falling general price levels, the region's monetary authorities are expected to maintain a supportive stance focused on stabilizing economic growth, although this room for manoeuvre will diminish more noticeably in the second half of 2010 in view of the expected rise in inflation. With Israel having already seen the first hike in its policy interest rate in the light of inflation that is running slightly above the policymakers' target range, more economies are expected to follow suit in 2010.

Fiscal balances are facing a multitude of pressures

Fiscal policies remain dominant in stimulating economic activity in many economies in the region. However, fiscal balances are being squeezed from different directions. In the oil-exporting countries, revenue will be lower in 2009 compared to 2008 owing to lower average oil prices, while non-oil-exporting countries in the region will see lower tax revenue as a result of weaker domestic demand. On the expenditure side, while lower average oil prices in 2009 will reduce subsidies on domestic energy prices, this fiscal gain is expected to be outweighed by increased spending in an effort to create jobs and, in the case of the oil-exporting countries, to diversify the structure of their economies. Taken as a whole, supportive fiscal policies will generate sizeable budget deficits in virtually all economies in the region. This will include even more extreme swings in fiscal positions, such as in Saudi Arabia, which is forecast to see a fall in its budget balance from a surplus of 33.0 per cent of GDP in 2008 to a deficit of 9.0 per cent in 2009. However, oil exporters will be in the relatively more comfortable position of being able to sustain deficit spending measures by drawing on the fiscal reserves that they have accumulated since 2002.

Risks include a sharper correction in oil prices and unexpected fiscal austerity measures

The fragility in crude oil prices represents the main downside risk in Western Asia. Crude oil prices are an indicator not only for the oil-exporting countries' income and wealth, but they also constitute an important determinant of economic sentiment that influences forward-looking economic behaviour in the majority of countries in the region. In this respect, an unexpected sharp fall in oil prices could again set off a more severe contraction in economic activity in the region. In addition, unexpected fiscal austerity measures could dent domestic demand, subjecting the economic recovery in the region to renewed uncertainty.

Latin America and the Caribbean: policy stimulus and rebounding commodity prices improve the outlook for 2010

After five consecutive years of GDP growth above 4 per cent, Latin America and the Caribbean contracted by 2.1 per cent in 2009, as growth across the region fell sharply in the first half of the year. Mexico, whose economy contracted by 9.2 per cent in the first semester, and Central American countries are among the economies expected to register the lowest growth figures this year. In 2010, the regional economy, which has already presented signs of recovery in the third quarter of 2009, is forecast to return to positive growth of 3.4 per cent (see annex table A.3).

A rebound in the second half of 2009 is expected to be followed by a recovery in 2010

Latin American and Caribbean economies suffered primarily from a decrease in external demand and low commodity prices for their exports. In addition, a rapid contraction of private consumption and investment aggravated the economic outlook for 2009. The contraction of private consumption was exacerbated by a sharp reduction in migrants' remittances to Mexico, Central America and the Caribbean, where double-digit falls were registered between the second quarter of 2008 and the second quarter of 2009.

In several countries, active counter-cyclical policies, including a significant increase in government consumption, prevented more severe contractions. By the third quarter of 2009, economic activity had stopped falling in most countries, consumer confidence had improved, and signs of recovery had emerged. In 2010, the region as a whole is expected to recover, owing mainly to the rebound of commodity prices and higher external demand.

The pace of recovery is expected to vary across the region. In South America, the recovery will be faster, led by Brazil and sustained by the expansion of domestic consumption and the improvement of external demand, in particular from China. According to the United Nations baseline forecast, the Brazilian economy is expected to grow by 4.5 per cent in 2010. In contrast, the recovery in Mexico and the Central American and Caribbean countries depends on a better performance of the United States economy. Mexico's economy is forecast to grow by 3.0 per cent in 2010, recovering from a decline of 7 per cent in 2009.

Unemployment rates are stabilizing, but poverty is expected to increase

In the first half of 2009, there were massive job losses, especially in manufacturing sectors. This pushed up both unemployment rates and informal sector employment. About 2.5 million more urban workers became unemployed in the region in 2009, pushing up total urban unemployment to 18.4 million. Fiscal stimulus measures have prevented greater employment losses. Increasing unemployment rates started to decelerate in the second quarter of 2009. The average unemployment rate for the region is expected to increase to 8.5 per cent in 2009, up from 7.5 per cent in 2008. The rate would have been much higher, had the participation rate not declined as much as it did in the first half of 2009. Despite a projected economic recovery in the region, unemployment rates are expected to remain at their elevated levels in 2010.

Rising unemployment poses serious risks to economic recovery. In addition, the shrinking formal job sector has pushed many more people into low productivity informal sector jobs and into poverty, so that the deeper social impact of the economic crisis may not become more evident until 2010. In several countries, this could pose an additional challenge for public spending, as greater pressures could be exerted on Governments to increase compensatory social transfers.

Inflation pressures have eased

In most Latin American and Caribbean countries, inflationary pressures eased in 2009. Average inflation is estimated to reach 6.2 per cent in 2009, down from 7.8 per cent in 2008. The deceleration of inflation was more pronounced in Chile, Colombia, Ecuador and Peru. Two factors explain the reduction in inflationary pressures. First, higher unemployment and lower domestic demand have reduced pressure on domestic prices. Second, falling commodity prices reduced cost-push pressures, especially in countries that are net importers of food and energy. These factors were of less importance in the Bolivarian Republic of Venezuela where inflation rates have continued to be high, at about 30 per cent, driven by higher taxes and a shortage of essential products. In 2010, despite higher oil prices, inflation is expected to remain subdued as domestic demand growth will be limited in most countries and exchange rates are expected to strengthen along with the weakening of the United States dollar.

Interest rates are expected to remain low

Central banks, in particular those in Brazil, Chile, Mexico and Peru, started to ease monetary policy aggressively in the last quarter of 2008 in response to emerging liquidity shortages. In addition, several central banks, in particular those of Argentina and Brazil, lowered the legal reserve requirements in order to prevent a liquidity crisis. The Central Bank of Brazil also opened several lines of credit to banks and specific sectors of the economy, and, in July 2009, the supply of bank credit in Brazil was already 20 per cent higher than in June 2008. In the course of 2009, risk premiums on lending to emerging market economies fell and many Latin American countries regained access to international capital markets and managed to issue new sovereign and corporate bonds.

Interest rates are expected to remain low in 2010, at least until the recovery is perceived to be more solid and as long as inflation rates remain stable. If growth turns out to be weaker than expected and inflationary pressures stay low, several central banks may consider a further easing of monetary policies.

There is limited room for additional counter-cyclical fiscal policies

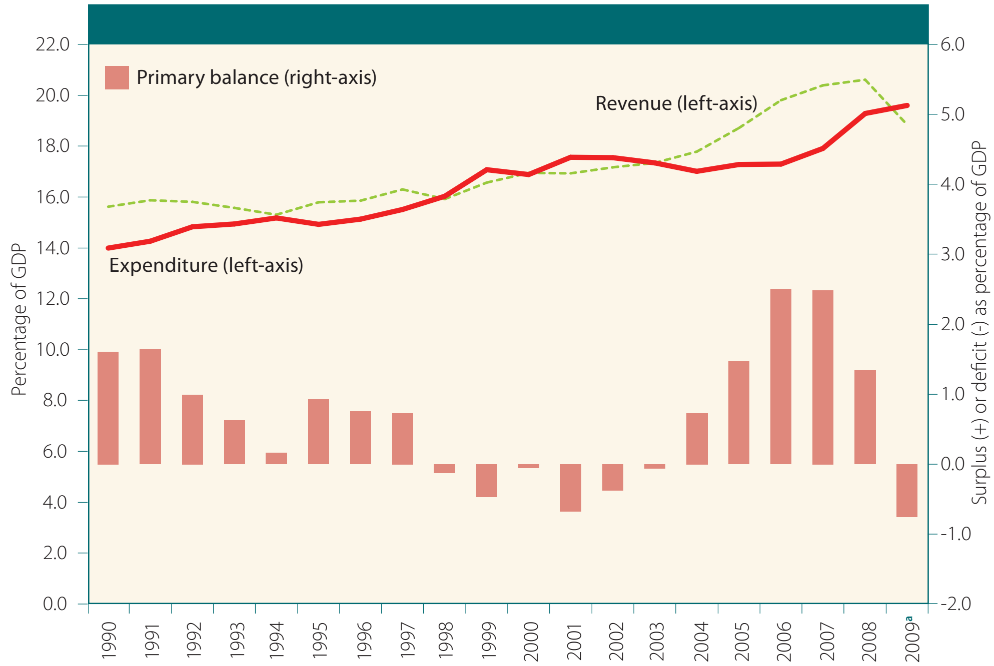
In many countries, Governments actively implemented counter-cyclical fiscal policies. This was the case in particular in countries (such as Brazil, Chile, Panama and Peru) that had been able to sustain fiscal surpluses in previous years and that had accumulated ample foreign-exchange reserves. Enhanced social programmes made up an important part of the fiscal stimulus packages in some countries. In Brazil, these programmes played an important role in mitigating the impact of the financial crisis on private consumption. Tax breaks further stimulated domestic demand in Brazil and already helped move the economy out of its recession in the second quarter of 2009.

The space for additional counter-cyclical measures in 2010 is limited in many countries, in particular in countries whose public spending largely depends on oil-export revenues. In the case of Mexico, the challenge is particularly great, since an accelerating fall in oil output is not expected to be compensated by high prices, as in previous years. For Latin America and the Caribbean as a whole, public revenues are expected to fall by about 1.8 percentage points of GDP, leading to a primary deficit of 0.9 per cent of GDP in 2009 (see figure IV.10). Mexico's Government had to cut spending in 2009 even before the economy reached bottom, as oil revenues had dropped significantly in the first half of the year. Caribbean economies also face limited room for counter-cyclical policies because of falling government revenues and already high levels of public indebtedness (see box IV.4). Therefore, several countries, in particular Caribbean and Central American countries, will need access to external resources from international financial institutions to finance their public policies in the context of a slow economic recovery and higher unemployment and poverty levels.

The region will sustain a small current-account deficit in 2009

The aggregate current-account balance is estimated to record a small deficit in 2009, showing little change compared with that in 2008. Countries that had recorded large trade surpluses in previous years, such as the Bolivarian Republic of Venezuela, saw strong decreases in export earnings, but import demand in the region contracted strongly

Figure IV.10
Revenue, expenditure and primary balances of central Governments in Latin America and the Caribbean, 1990-2009



Source: Economic Commission for Latin America and the Caribbean (ECLAC).
a Estimated.

Box IV.4

Challenges for exchange-rate management in the English-speaking Caribbean countries and Suriname

Most of the countries in the English-speaking Caribbean and Suriname have fixed or quasi-fixed nominal exchange-rate regimes, which have become a valuable instrument for anchoring expectations and reducing inflation. During 2008, as shown in the figure below, some of these regimes have faced challenges in keeping their real exchange rates competitive, as is evident from the significant and sustained appreciation of their currencies against the United States dollar.

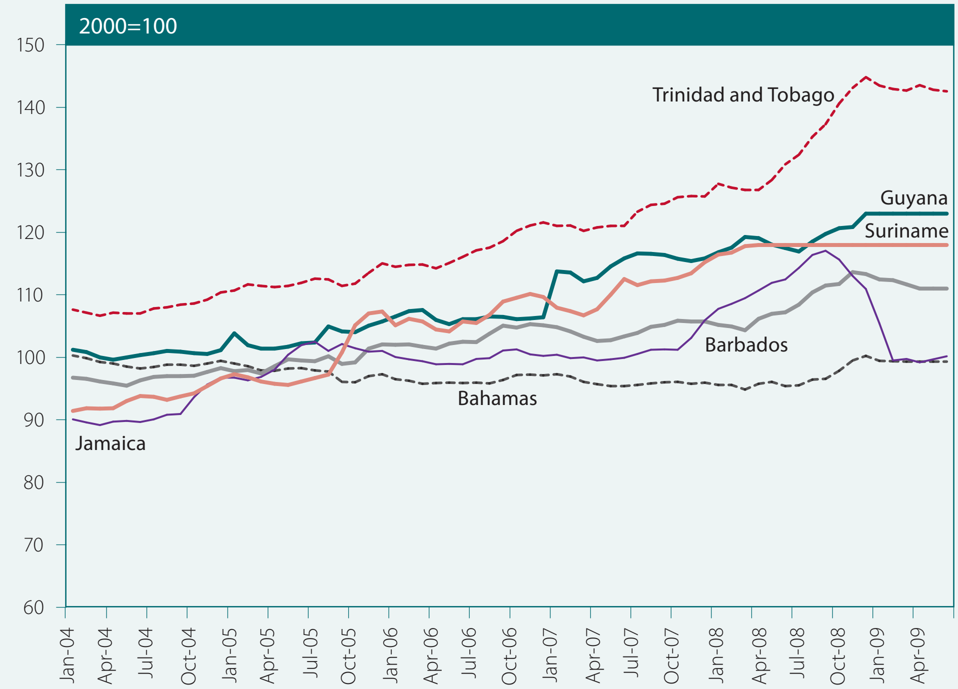
As a consequence of the financial crisis, inflationary pressures started to subside in all English-speaking Caribbean countries, leading to a progressive narrowing of the inflation differentials with the United States and limiting further appreciation of their real exchange rates. Unlike other countries in the region, Jamaica operates a managed floating exchange-rate regime. As a consequence, its currency experienced a marked depreciation of 16.9 per cent in real terms against the dollar between September 2008 and June 2009.

The stabilization of real exchange rates has helped stem further losses of export competitiveness which had affected the tourism sectors in particular. Yet, balance-of-payments problems emerged during the crisis as capital inflows dried up and remittance earnings fell. In Jamaica, for instance, both private capital inflows and remittances fell sharply, the latter falling by 13 per cent in July 2009 compared with July 2008. The fact that several of these countries are reporting large current-account deficits, high levels of public debt and low international reserves makes them more vulnerable to the drying up of financial inflows.

As a consequence of the crisis, several Caribbean countries, including the Dominican Republic, Guyana, Saint Lucia and Saint Vincent and the Grenadines, are facing severe balance-of-payments problems and a policy dilemma in managing their exchange rates. An eventual devaluation

Box IV.4 (cont'd)

Bilateral real exchange rates versus the dollar, selected countries, 2004-2009



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

would make imports more expensive and exports more competitive, which could help reduce the current-account deficit. However, given that several of these countries have high import dependence, the potential benefits from changing the parity are unlikely to be significant. In addition, the short- to medium-term costs of such an adjustment would be much higher debt-servicing obligations (in terms of national currency), and this in turn would push up government deficits and costs to firms with sizeable foreign debts. Moreover, the exchange-rate peg has offered a strong anchor for price expectations, which have contributed to financial deepening and economic development in the region.

In the case of countries with abundant natural resources, such as Suriname and Trinidad and Tobago, which in recent years have posted surpluses on both the fiscal and external accounts and have accumulated vast international reserves, the situation is less dramatic. They have thus been better placed to sustain their quasi-fixed exchange-rate regimes. By contrast, Barbados, Belize, Guyana and several countries of the Eastern Caribbean Currency Union (ECCU) are dependent upon accessing external financing in order to maintain their fixed exchange rates. Jamaica, which has already received external financing from multilateral financial institutions but needs more funding, has started negotiations with the International Monetary Fund for emergency financing to cover debt-service payments on the country's large public debt and avoid a severe exchange-rate crisis.

with the decline in domestic demand. South American countries saw a significant deterioration in their terms of trade owing to the correction in international commodity prices. Central American countries and other net energy importers, in contrast, saw their trade deficits narrow, as the relative price of their imports decreased substantially. In 2010, an expected global economic recovery and higher commodity prices will help increase export volumes and prices, improving the regional trade balance and current accounts.

The inflow of remittances also fell markedly in the region since the beginning of 2009, putting pressure on the current transfers account. These flows are not expected to increase in 2010, as labour markets in developed economies will take time to recover. By contrast, foreign direct investment flows to the region have already started to pick up, in particular to Brazil. The region's stock of international reserves is growing again, after falling 9.9 per cent between September 2008 and February 2009. This is particularly the case for Brazil, which had already rebuilt its international reserves in July 2009, achieving a new record of $209 billion.

After concerns of national currency depreciation in late 2008 in some economies, the weakening of the dollar is now a major concern for several South American countries, as their currencies appreciated in nominal terms. This reflects improved expectations and credit conditions, as well as increased concerns about the long-term value of the United States dollar. In contrast, Mexico and some Central American countries continued to register nominal depreciations of their currencies.

Downside risks to the forecast remain

A weaker-than-expected global recovery would limit demand for exports from the region, which is still highly dependent upon commodity prices and demand from the United States, in particular for manufactured products. On the domestic side, if labour-market conditions continue to deteriorate, they would affect consumer confidence and domestic demand, limiting a quick economic recovery in 2010. As fiscal positions have deteriorated significantly, many countries in the region face limited room for additional counter-cyclical policies which remain crucial to sustaining the economic recovery and alleviating social costs.