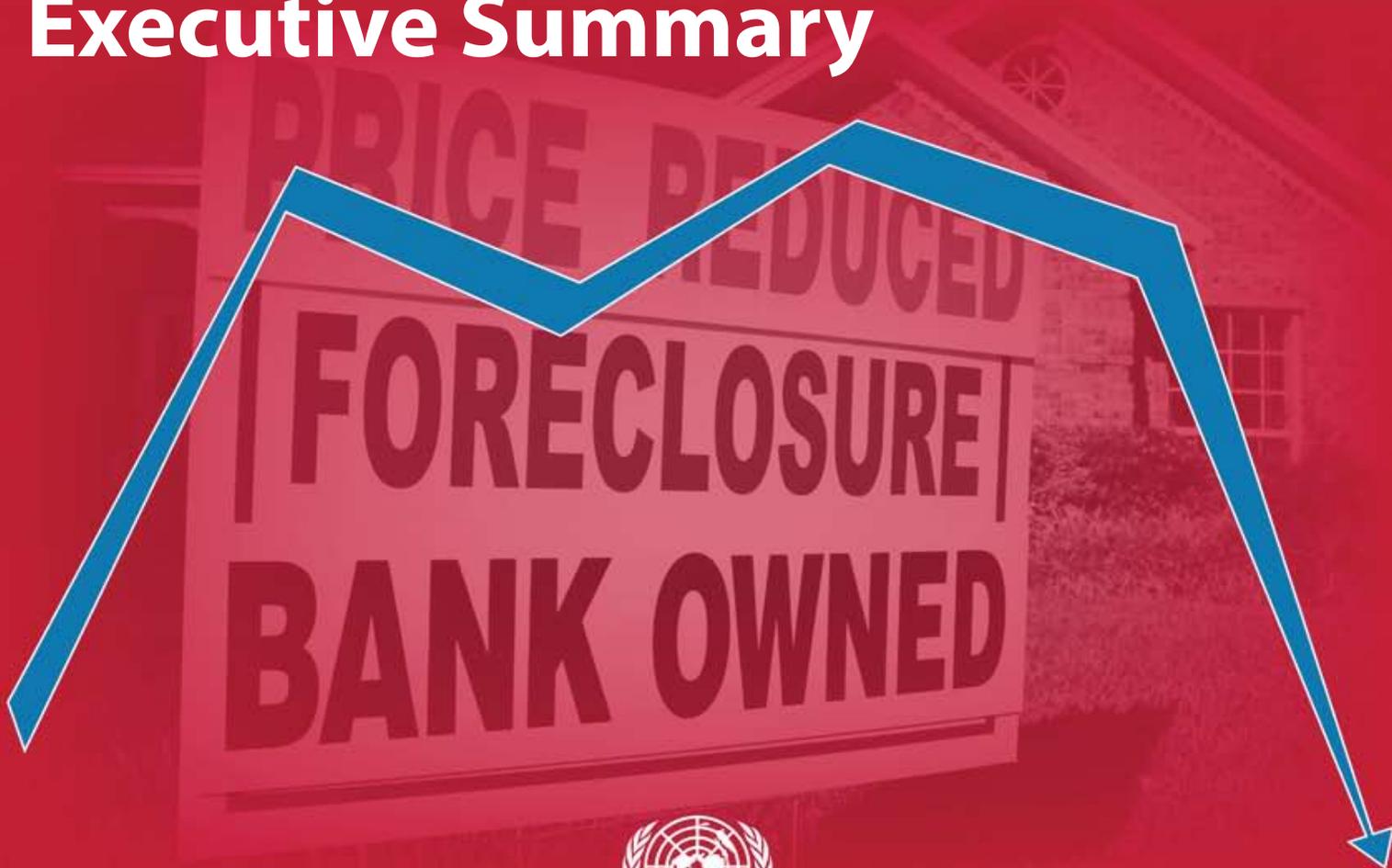


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World Economic Situation and Prospects 2009

Executive Summary



United Nations

Executive Summary

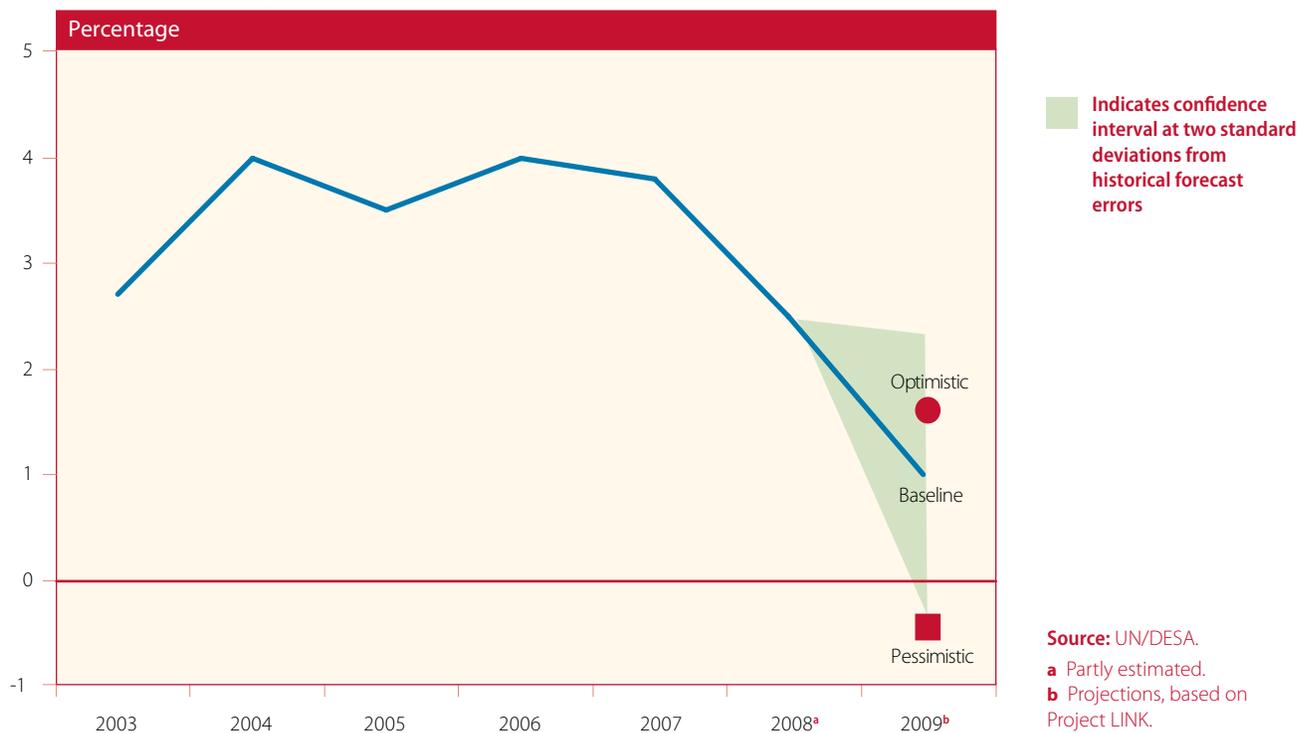
The global outlook

The world economy is entering into a recession

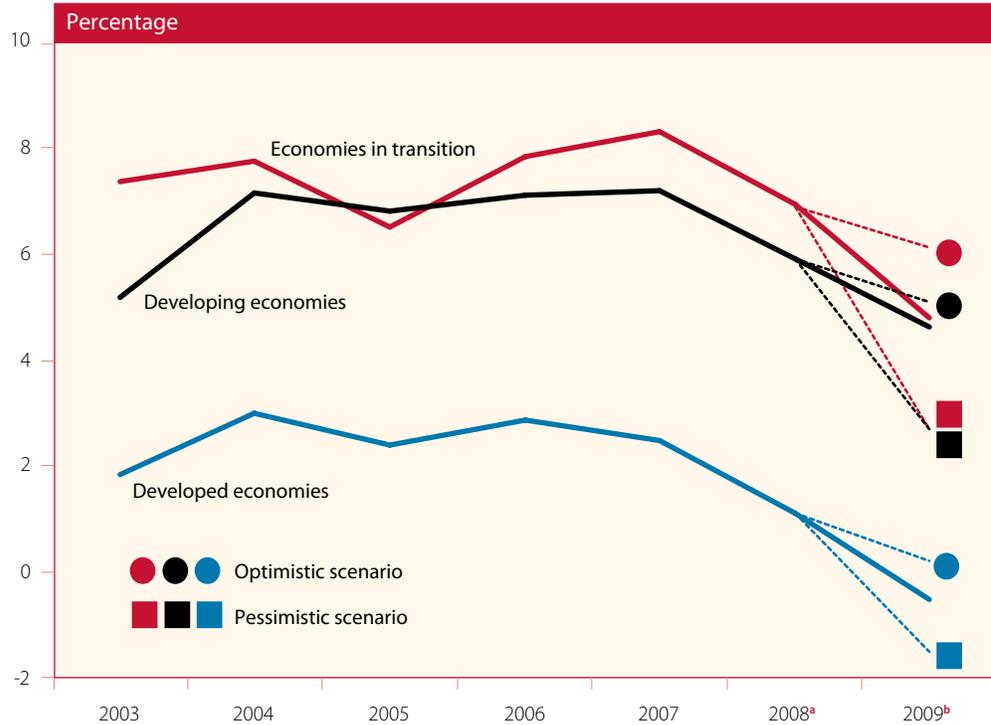
The world economy is mired in the worst financial crisis since the Great Depression. What first appeared as a sub-prime mortgage crack in the United States housing market during the summer of 2007 began widening during 2008 into deeper fissures across the global financial landscape and ended with the collapse of major banking institutions, precipitous falls on stock markets across the world and a credit freeze. These financial shockwaves have now triggered a full-fledged economic crisis, with most advanced countries already in recession and the outlook for emerging and other developing economies deteriorating rapidly, including those with a recent history of strong economic performance.

In the baseline scenario of the United Nations forecast, world gross product is expected to slow to a meagre 1.0 per cent in 2009, a sharp deceleration from the 2.5 per cent growth estimated for 2008 and well below the more robust growth of previous years. At the projected rate of global growth, world income per capita will fall in 2009. Output in developed countries is expected to decline by 0.5 per cent in 2009. Growth in the economies in transition is expected to slow to 4.8 per cent in 2009, down 6.9 per cent in 2008, while output growth in the developing countries would slow from 5.9 per cent in 2008 to 4.6 per cent in 2009.

The world economy could fall into recession in 2009



Synchronized global slowdown, led by a recession in developed countries



Source: UN/DESA.
 a Partly estimated.
 b Forecast.

Given the great uncertainty prevailing today, however, a more pessimistic scenario is entirely possible. If the global credit squeeze is prolonged and confidence in the financial sector is not restored quickly, the developed countries would enter into a deep recession in 2009, with their combined gross domestic product (GDP) falling by 1.5 per cent; economic growth in developing countries would slow to 2.7 per cent, dangerously low in terms of their ability to sustain poverty reduction efforts and maintain social and political stability. In this pessimistic scenario, the size of the global economy would actually decline in 2009—an occurrence not witnessed since the 1930s.

To stave off the risk of a deep and global recession, *World Economic Situation and Prospects (WESP) 2009* recommends the implementation of massive, internationally coordinated fiscal stimulus packages that are coherent and mutually reinforcing and aligned with sustainable development goals. These should be effected in addition to the liquidity and recapitalization measures already undertaken by countries in response to the economic crisis. Under a more optimistic scenario—factoring in an effective fiscal stimulus of between 1.5 and 2 per cent of GDP by the major economies, as well as further interest-rate cuts—*WESP* forecasts that, in 2009, the developed economies could post a 0.2 per cent rate of growth, and growth in the developing world would be slightly over 5 per cent.

Origins of the global financial crisis

The story of a crisis foretold

The intensification of the global financial turmoil in September-October 2008 revealed the systemic nature of the crisis and heightened fears of a complete global financial meltdown. Although the problems originated in the major developed countries, the mounting

financial fragility was closely tied to an unsustainable global growth pattern that had been emerging as far back as the early 2000s, a risk forewarned early on in previous issues of *WESP*. As part of this pattern, growth was driven to an important extent by strong consumer demand in the United States of America, stimulated by easy credit and underpinned by booming house prices as well as very high rates of investment demand and strong export growth in some developing countries, notably China. Growing United States deficits in this period were financed by increasing trade surpluses in China, Japan and other countries that had accumulated large foreign-exchange reserves and were willing to buy dollar-denominated assets.

At the same time, increasing financial deregulation, along with a flurry of new financial instruments and risk-management techniques (mortgage-backed securities, collateralized debt obligations, credit default swaps, and so forth), encouraged a massive accumulation of financial assets supported by growing levels of debt in the household, corporate and public sectors. In some countries, both developed and developing, domestic financial debt has risen four- or fivefold as a share of national income since the early 1980s. This rapid explosion in debt was made possible by the shift from a traditional “buy-and-hold” banking model to a “dynamic-originate-to-sell” trading model (or “securitization”). The leverage ratios of some institutions went up to as high as 30, well above the ceiling of 10 generally imposed on deposit banks. The deleveraging of this financial house of cards now under way has brought down established financial institutions and has led to the rapid evaporation of global liquidity, together threatening the normal operations of the real economy.

Until recently, all parties seemed to benefit from the boom, particularly the major financial players in the rich economies, while the risks were conveniently ignored, despite repeated warnings, such as those highlighted in *WESP*, that mounting household, public sector and financial sector indebtedness in the United States and elsewhere would not be sustainable over time. As strains in the United States mortgage market were transmitted to the wider financial sector, fears of a meltdown escalated and have now spread around the world.

*Policymakers worldwide have taken
unprecedented measures to deal with the crisis ...*

Policymakers initially responded in piecemeal fashion, failing to see the systemic risk or to consider the global ramifications of the turmoil in their entirety. The approach included massive liquidity injections into the financial system and the bailout of some major financial institutions, while accepting the failure of others. As the crisis intensified in September 2008, policymakers shifted to a more comprehensive and internationally improved coordinated form of crisis management. The measures taken have reshaped the previously deregulated financial landscape. Massive public funding has been made available to recapitalize banks, taking partial or full ownership of failed financial institutions and providing blanket government guarantees on bank deposits and other financial assets. Governments in both developed and developing countries have started to put together fiscal and monetary stimulus packages in attempts to prevent the global financial crisis from turning into a worldwide human disaster.

... but it will take a long time for the policies to take effect on the real economy

These policy measures are aimed at restoring confidence and unfreezing credit and money markets by recapitalizing banks with public funds, guaranteeing bank lending and insuring bank deposits. During the fourth quarter of 2008, interbank lending rates retreated somewhat following the start of the large-scale bailout. However, by December 2008, congestion and dysfunction remained in important segments of the credit markets. In any event, it will take time for most of these policy measures to take effect; the restoring of confidence among financial market agents and normalization of credit supplies will take months, if not years, if past crises can be taken as a guide. Furthermore, it typically takes some time before problems in financial markets are felt in the real economy. Consequently, it seems inevitable that the major economies will see significant economic contraction in the immediate outlook and that recovery may not materialize any time soon, even if the bailout and stimulus packages were to succeed. Moreover, the immediate fiscal costs of the emergency measures will be huge, and it is uncertain how much of these can eventually be recovered from market agents or through economic recovery. This poses an additional macroeconomic challenge.

Implications for world trade and finance

Commodity prices have become increasingly volatile ...

The crisis has already had a severe impact on global commodity markets with far-reaching implications for the prospects of the developing world at large. Commodity prices have been highly volatile during 2008. Most prices surged in the first half of 2008, continuing a trend that had begun in 2003. Trends in world market prices reversed sharply from mid-2008, however. Oil prices have plummeted by more than 60 per cent from their peak levels of July to November. The prices of other commodities, including basic grains, also declined significantly. In the outlook, most of these prices are expected to even out further along with the moderation in global demand.

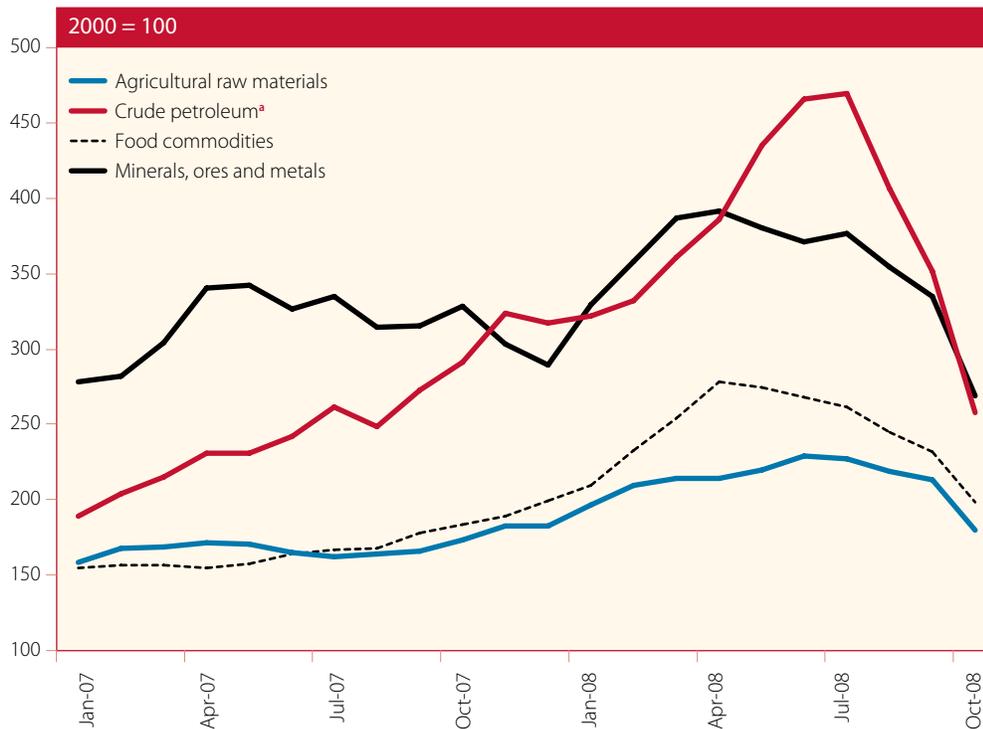
... and prospects for world trade are bleak

Growth of world *trade* decelerated to 4.3 per cent in early 2008, down from 6.4 per cent in 2007, owing mainly to a decline in imports by the United States. United States imports, which account for about 15 per cent of the world total, have registered a decline in every quarter since the fourth quarter of 2007 and dropped as steeply as 7 per cent in the second quarter of 2008. Growth in the volume of world trade had dropped to about 3 per cent by September 2008, to about one third of the rate of growth a year earlier. In the outlook, global trade is expected to weaken further in 2009.

The risk of a pullback of lending to developing countries has heightened

Owing to their limited exposure to the mortgage market derivatives that brought down major banks in the United States and Europe, financial systems in most developing countries initially seemed shielded from any direct impact from the international financial crisis. Growing risks have emerged through other channels, however, as investors have started to pull back resources from emerging market economies and other developing countries

The rise and fall of commodity prices in 2007 and 2008



Source: UNCTAD Commodity Price Statistics database.

^a Average of Brent/Dubai/Texas, equally weighted (dollars per barrel).

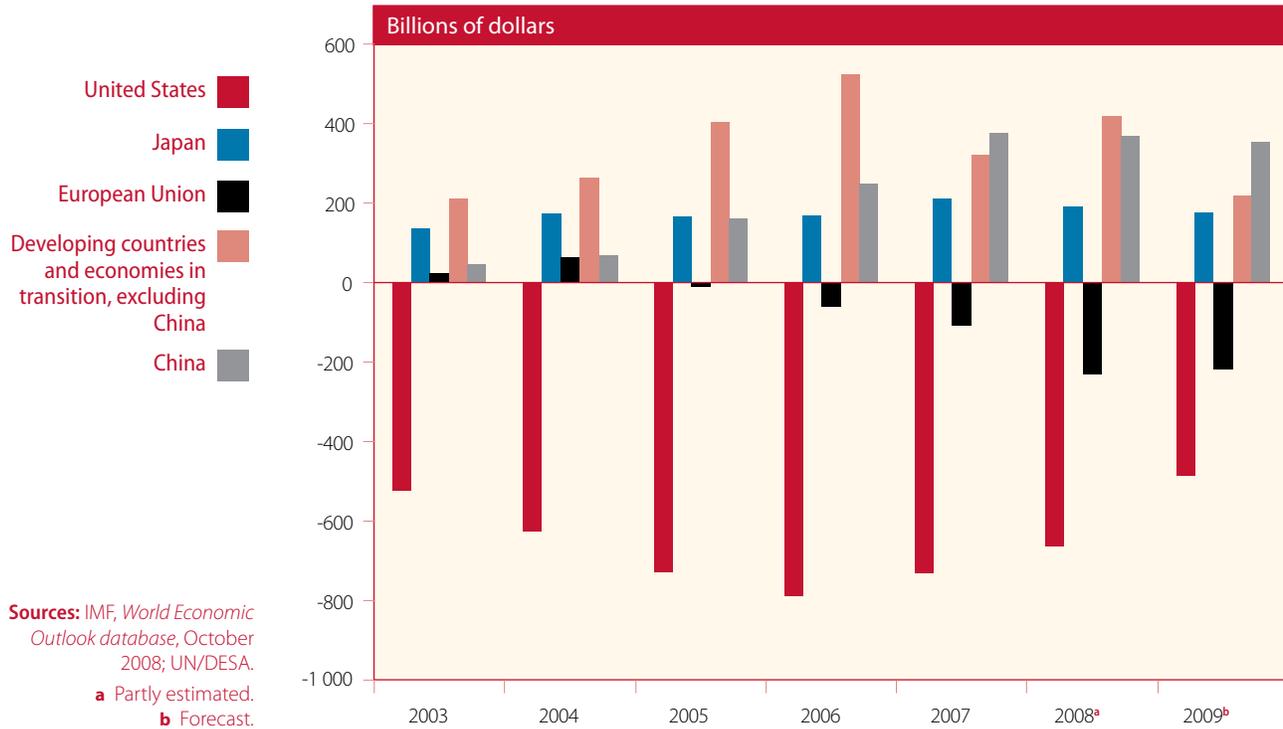
as part of the deleveraging process of financial institutions in the developed countries. External financing costs for emerging market economies surged along with the tightening of the global credit market, as measured by the spreads of the Emerging Markets Bond Index. Unlike in recent years when the spread varied significantly across regions and countries to indicate investor discrimination among country-specific risks, the latest surge has been uniform, suggesting that contagion and aversion to investing in emerging markets has taken hold among investors. Spreads are expected to remain high in 2009, as the strains in global credit markets linger and also as capital flows to emerging market economies are projected to drop further.

Exchange-rate volatility has increased and the risk of a hard landing of the dollar in 2009 remains

Volatility in *foreign-exchange markets* has also increased substantially with the deepening of the global financial crisis. The United States dollar depreciated substantially vis-à-vis other major currencies, particularly the euro, in the first half of 2008, but has since reversed direction even more sharply. For many currencies in developing countries, the earlier trend of appreciation vis-à-vis the dollar has either reversed or slowed. Currencies in a number of developing countries, particularly those that are commodity exporters, have depreciated against the dollar substantially since mid-2008. The heightened risk aversion among international investors has led to a “flight to safety”, as indicated by the lowering of the yield of the short-term United States Treasury bill to almost zero.

However, it is expected that the recent strength of the dollar will be temporary and the risk of a hard landing of the dollar in 2009 or beyond remains. Even though the global imbalances have narrowed somewhat in 2008 and are expected to narrow further in

The global imbalances have narrowed, but still pose a risk for further financial trouble



2009 with the recession in developed countries, the United States external deficit remains significant and its net international liability position continues to increase. The large current-account deficit and perceptions that the United States debt position is approaching unsustainable levels are important factors underlying the trend depreciation of the United States dollar since 2002. The flight to safety into the United States dollar in the wake of the global financial crisis is pushing the external indebtedness of the United States to new heights; this is likely to precipitate a renewed slide of the dollar once the process of deleveraging has ended. Policymakers should recognize the risk of a possible hard landing of the dollar as a potential source of renewed turmoil in financial markets in 2009.

Impact on developing countries

Developed economies are leading the global downturn, but the weakness has rapidly spread to developing countries and the economies in transition, causing a synchronized global downturn in the outlook for 2009.

Among the *economies in transition*, growth of the *Commonwealth of Independent States* (CIS) region is on course for a marked slowdown in 2009, dragged largely by the impact of a global recession and falling commodity prices on the largest economies, such as Kazakhstan, the Russian Federation and Ukraine. A slowdown in business investment, and, to a lesser degree, in household consumption will be felt throughout the region. In *South-eastern Europe*, a further moderation of economic growth is expected.

Among developing countries, growth in *Africa* is expected to decelerate in 2009, as the contagion effects of the global economic slowdown spread throughout the region, leading to weakened export demand, lower commodity prices and a decline in in-

vestment flows to the region. Growth in *East Asia* is expected to decline notably in 2009, as exports see significant deceleration. Some economies in the region will also experience sizeable financial losses as a result of their relatively high exposure to global financial markets. *South Asia* is experiencing an overall slowdown in economic growth from the industrial sector to the service sector. Growth in *Western Asia* is anticipated to slow down significantly in 2009 as export earnings from oil fall sharply, and investment spending across the region is expected to decline. Growth in *Latin America and the Caribbean* is also expected to slow markedly, dragged largely by the fall in commodity prices and global credit constraints.

Significant downturn in all developing regions in 2009

| Annual percentage change | | | | | | | | | |
|---------------------------------|------|------|------|------|------|-------------------|-------------------|----------------------|---------------------|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 ^a | 2009 ^b | | |
| | | | | | | | Baseline scenario | Pessimistic scenario | Optimistic scenario |
| Economies in transition | 7.4 | 7.7 | 6.5 | 7.8 | 8.3 | 6.9 | 4.8 | 2.7 | 6.1 |
| Developing economies | 5.2 | 7.1 | 6.8 | 7.1 | 7.2 | 5.9 | 4.6 | 2.7 | 5.1 |
| Africa | 4.9 | 5.9 | 5.7 | 5.7 | 6.0 | 5.1 | 4.1 | 0.1 | 4.7 |
| East Asia | 6.9 | 8.0 | 7.7 | 8.6 | 9.0 | 6.9 | 5.9 | 4.6 | 6.4 |
| South Asia | 6.9 | 6.7 | 9.5 | 6.9 | 7.9 | 7.0 | 6.4 | 4.0 | 6.6 |
| Western Asia | 4.9 | 8.2 | 6.8 | 5.9 | 4.7 | 4.9 | 2.7 | 1.6 | 3.3 |
| Latin America and the Caribbean | 1.8 | 5.9 | 4.6 | 5.5 | 5.5 | 4.3 | 2.3 | -0.2 | 2.7 |

Source: UN/DESA.

^a Partly estimated.

^b Forecasts, based on Project LINK.

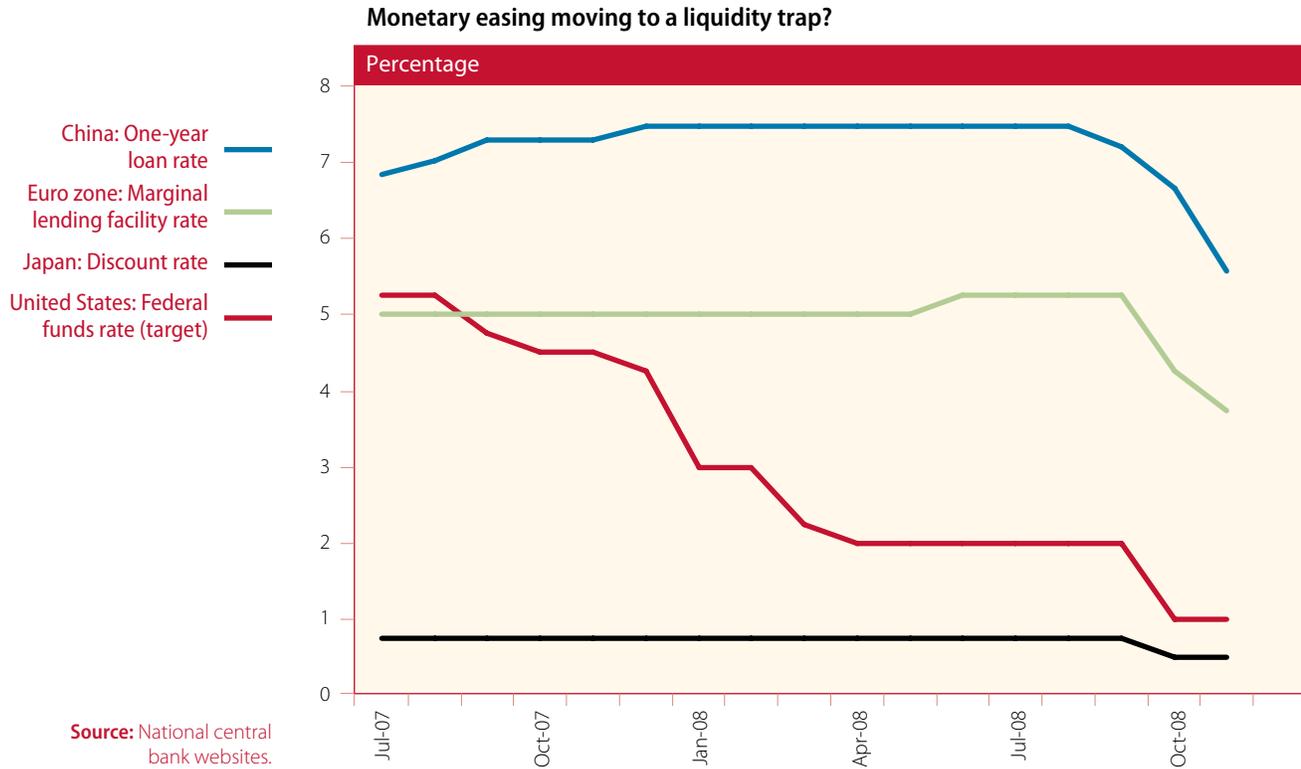
The crisis will present a setback for the fight against poverty

Coming on the heels of the food and energy security crises, the global financial crisis will most likely substantially set back progress towards poverty reduction and the Millennium Development Goals. The tightening of access to credit and weaker growth will cut into public revenues and limit the ability of developing country Governments to make the necessary investments to meet education, health and other human development goals. Unless adequate social safety nets are in place, the poor will no doubt be hit the hardest. An estimated 125 million people in developing countries were already driven into extreme poverty because of the surge in global food prices since 2006. Lessons from earlier major financial crises point to the importance of safeguarding (public) investment in infrastructure and social development so as to avoid major setbacks in human development and allow a recovery towards high-quality economic growth in the medium term.

Immediate policy challenges

Policymakers initially underestimated the crisis

Policymakers worldwide initially underestimated the depth and breadth of the current financial crisis. As a result, policy actions by and large fell behind the curve and, in the early stages, policy stances were grossly inadequate for handling the scale and nature of the crisis.



Only after the systemic risks for the global financial system became manifest in September 2008 did six major central banks decide to move in a more coordinated fashion by agreeing to cut their respective official target rates simultaneously and scale up direct liquidity injections into financial markets.

Further monetary easing is expected in the world economy in the outlook for 2009. However, with consumer and business confidence seriously depressed and banks reluctant to lend, further lowering of interest rates by central banks will do little to stimulate credit supplies to the non-financial sector or to encourage private spending. Indeed, it may end up merely expanding the money base within the banking system.

Massive fiscal stimulus is needed

Restoring confidence in financial markets in order to normalize credit flows remains of primary importance. However, as long as fears for a deep recession prevail, consumers and investors will likely remain severely risk averse. Hence, counter-cyclical macroeconomic policies are needed to complement the efforts to rescue the financial sector from widespread systemic failure.

With limited space for monetary stimulus, fiscal policy options will need to be examined as ways of reactivating the global economy. The severity of the financial crisis calls for policy actions that are commensurate with the scale of the problem and that should thus go well beyond any normal range of budgetary considerations. The United States adopted a fiscal stimulus package in early 2008, totalling some \$168 billion, or about 1.1 per cent of annual GDP, mainly in the form of a tax rebate for households. While some analysts believe the package had worked well to keep the economy buoyant for at least one quarter, others doubted the permanency of its effects. It is now clear that the size of the fiscal pack-

age was too small in comparison with the seriousness of the situation and failed to sustain the economy. At the end of 2008, a second, more substantial, fiscal stimulus package was under discussion in the United States. Similarly, European countries were easing monetary policies and preparing for significant fiscal expansion in 2009.

Counter-cyclical fiscal policies are also needed in developing countries

A large number of developing countries and the economies in transition have been reluctant to ease monetary policy over concerns of inflationary pressures and currency depreciation. Inflationary pressures should taper off during 2009, however, as world food and energy prices are now retreating and global demand is weakening. This should provide some space for monetary easing, as well as for fiscal stimulus, at least in those countries that still possess ample foreign-exchange reserves.

The scope for counter-cyclical policies will vary greatly across developing countries, mainly for two reasons. First, many countries have a history of pro-cyclical macroeconomic policy adjustment, partly driven by policy rules (such as inflation targeting). Providing greater monetary and fiscal stimuli in such cases will thus require a departure from existing policy practice and policy rules. Second, not all countries have equally sufficient foreign-exchange reserves and some are likely to suffer stronger balance-of-payments shocks.

There are countries with ample policy space for acting more aggressively to stave off a recession. The Chinese Government has already started to use its policy space, for instance, and has designed a large-scale plan of fiscal stimulus amounting to 15 per cent of its GDP to be spent during 2009 and 2010, which should contribute to reinvigorating global demand. The Republic of Korea has also announced a fiscal stimulus package equivalent to 1 per cent of its GDP.

For many of the middle- and low-income countries, the scope for providing such stimuli will be even more limited, as they may see their foreign-exchange reserves evaporate quickly, with either continued capital reversals taking place or strong reductions in the demand for their export products, or both. In order to enhance their scope for counter-cyclical responses in the short run, further enhancement of compensatory financing and additional and reliable foreign aid flows will be needed to cope with the drops in export earnings and reduced access to private capital flows caused by the global financial crisis.

As they fight fires today, policymakers worldwide must look to tomorrow

Looking to the long run, however, a broadening of the development policy framework is needed to conduct active investment and technology policies so as to diversify these countries' economies and reduce their dependence on a few commodity exports, thereby allowing them to meet key development goals, including reaching greater food security, addressing climate change and meeting the Millennium Development Goals. This will require massive resources for public investment in infrastructure, food production, education and health, and renewable energy sources. The crisis also presents various opportunities to align fiscal stimulus packages with long-term goals for sustainable development.

The fiscal stimulus needs to be coordinated internationally

To ensure sufficient stimulus at the global level, it will be desirable to coordinate fiscal stimulus packages internationally. In a strongly integrated world economy, fiscal stimulus implemented by only one country tends to be less effective because of high import leakage

effects. By coordinating fiscal stimulus internationally, the positive multiplier effects can be amplified through international economic linkages by 30 per cent or more, thereby providing greater stimulus to both the global economy and the economies of individual countries. As in the case of a coordinated monetary easing, internationally coordinated fiscal stimuli can also limit unnecessary fluctuation in cross-country interest rate differentials and in exchange rates among major currencies. Compared with coordinated interest rate policies, fiscal policy coordination tends to be more difficult to attain, both technically and politically, and hence may be difficult to achieve through ad hoc agreements, requiring instead a more institutionalized platform for coordination.

Without adequate coordination, global economic reactivation may be delayed, and it may take longer before market confidence is restored. This may prolong the credit crunch and keep borrowing costs high for developing country Governments and private firms, thereby undermining their efforts to counteract the crisis.

Internationally coordinated policy action among deficit and surplus countries is also critical for achieving a benign adjustment of the global imbalances and avoiding a disruptive hard landing of the dollar. Now that the financial crisis has already turned a disorderly adjustment into a synchronized global downturn, the need for international policy coordination and cooperation is more pressing than ever.

Reform of the international financial system

Even in the most optimistic scenario, however, it will take time before confidence is restored in financial markets and recovery can take place. As immediate solutions are being worked out, it is important to address the systemic causes that led to the present crisis.

Global economic governance mechanisms are inadequate

The depression of the 1930s had been aggravated by “beggar-thy-neighbour” policies, disintegration of the global economy and resurgent protectionism. Under the promise “never again”, it led to the design of the Bretton Woods institutions, including the creation of the International Monetary Fund (IMF) and the World Bank, to safeguard the stability of the global economy and promote growth and development. But over time, the ability of the IMF to safeguard the stability of the global economy has been hampered by limited resources, and it has been increasingly undermined by the vastly greater (and more volatile) resources of private actors with global reach. More exclusive and ad hoc country groups, such as the Group of Seven (G7) or the Group of Eight (G8), have become the platforms where international policy coordination has taken place in practice.

The apparent irrelevance of the Bretton Woods institutions in today’s crisis also stems from their skewed voting structures and governance, which do not adequately reflect the importance of developing countries in today’s world economy. The lack of a credible mechanism with broad representation for international policy coordination is an urgently felt lacuna which is limiting swift and effective responses to the present crisis.

Regulatory frameworks are deficient

The financial crisis has revealed major deficiencies in the regulatory and supervisory frameworks of financial markets. First, the new approach to the regulation of finance, including that under the New Basel Accord (Basel II) rules, places the burden of regulation on the

financial institutions themselves. Second, the more complex the trade in securities and other financial instruments has become, the greater the reliance on rating agencies who proved inadequate to the task at hand, in part because of conflicts of interest over their own sources of earnings, which are proportional to the trade volume of the instruments they rate. Consequently, risk assessments by rating agencies tend to be highly pro-cyclical as they react to the materialization of risks rather than to their build-up. Third, existing approaches to financial regulation tend to act pro-cyclically, hence exacerbating a credit crunch during a crisis. At times of boom, when asset prices and collateral values are rising, loan delinquency falls and results in inadequate provisioning and overexpansion of credit. When the downturn comes, loan delinquency rises rapidly and standard rules on provisions can lead to a credit crunch. Fourth, the spread of financial networks across the world, and the character of securitization itself, has made practically all financial operations hinge on the “confidence” that each institution in isolation is capable of backing up its operations. But as insolvencies emerge, such confidence is weakened and may quickly vanish, generating a generalized credit freeze. The risk models applied by regulatory agencies typically disregard such “contagion” effects and fail to account for the vulnerabilities of the financial system as a whole, at home and abroad.

The basic objectives of the reform of prudential regulation and supervision of financial sectors should thus be to introduce strong, internationally concerted counter-cyclical rules supported by counter-cyclical macroeconomic policies.

The risk of a hard landing of the dollar is intrinsic to the nature of the international reserve system

The risk of a hard landing of the United States dollar is intrinsic to the very nature of the global reserve system, which uses the national currency of the United States as the main reserve currency and instrument for international payments. Under this system, the only way for the rest of the world to accumulate dollar assets and reserves is for the United States to run an external deficit. However, as the net liability position of the United States continues to increase, investors will start anticipating a readjustment and confidence in the dollar will erode.

The world lacks an international lender of last resort

Over the past decade, many developing countries have accumulated vast amounts of foreign-currency reserves, providing some “self-insurance” against external shocks. However, both the carry cost of holding such reserves and the opportunity costs of not using them for long-term investment purposes are high. The tendency to accumulate a large amount of reserves in developing countries has its roots in more fundamental deficiencies of the international monetary and reserve system. Improved macroprudential capital-account regulation can help reduce the need for the cost of self-insurance via reserve accumulation. The need for self-insurance can be reduced further with more effective mechanisms for liquidity provisioning and reserve management at the international level, both regionally and multilaterally.

More generally, all IMF facilities should be significantly simplified and include more automatic and quicker disbursements proportionate to the scale of the external shock. Recent action has been undertaken in this direction with the reform of the IMF Exogenous Shocks Facility. But total resources remain limited and much more is needed to provide collective safeguards for large-scale crises.

The way forward

Given the existing systemic flaws, it seems paramount that deliberations on a new international financial architectures should address at least four core areas of reform:

- (a) The establishment of a credible and effective mechanism for international policy coordination. To guide a more inclusive process, the participation not only of major developing countries but also of more representative institutions of global governance is required; hence, a fundamental revision of the governance structure and functions of the IMF and the World Bank is needed.
- (b) Fundamental reforms of existing systems of financial regulation and supervision to prevent the re-emergence of excesses.
- (c) Reform of the present international reserve system, away from the almost exclusive reliance on the United States dollar and towards a multilaterally backed multi-currency system which, perhaps, over time could evolve into a single, world currency-backed system.
- (d) Reforms of liquidity provisioning and compensatory financing mechanisms backed through, among other things, better multilateral and regional pooling of national foreign-exchange reserves and avoiding the onerous policy conditionality attached to existing mechanisms.

The crisis is global; hence, global solutions are needed

World leaders have acknowledged these needs for reform. At the *Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus*, held in Doha, Qatar, from 29 November to 2 December 2008, Governments agreed to address systemic problems and fundamentally reform the global financial system.

At the Conference, donors also promised to honour all commitments to bridge existing deficiencies in official development assistance to developing countries and emphasized that the financial crisis should not stand in the way of achieving this.

The global financial crisis could motivate countries to recur to greater trade protection. At the Doha conference on financing for development, Governments pledged to resist such temptation, but also stressed the need to break the impasse in the negotiations to complete the *Doha Round* of multilateral trade negotiations and safeguard its development dimensions, in particular the principle of special and differential treatment.

It will not be easy to find consensus among all stakeholders on the precise shape of a new system of global economic governance, but the risk of endangering global peace and prosperity by failing to address the systemic problems underlying the present crisis are simply too high. This awareness should be the common ground for seeking common solutions.

