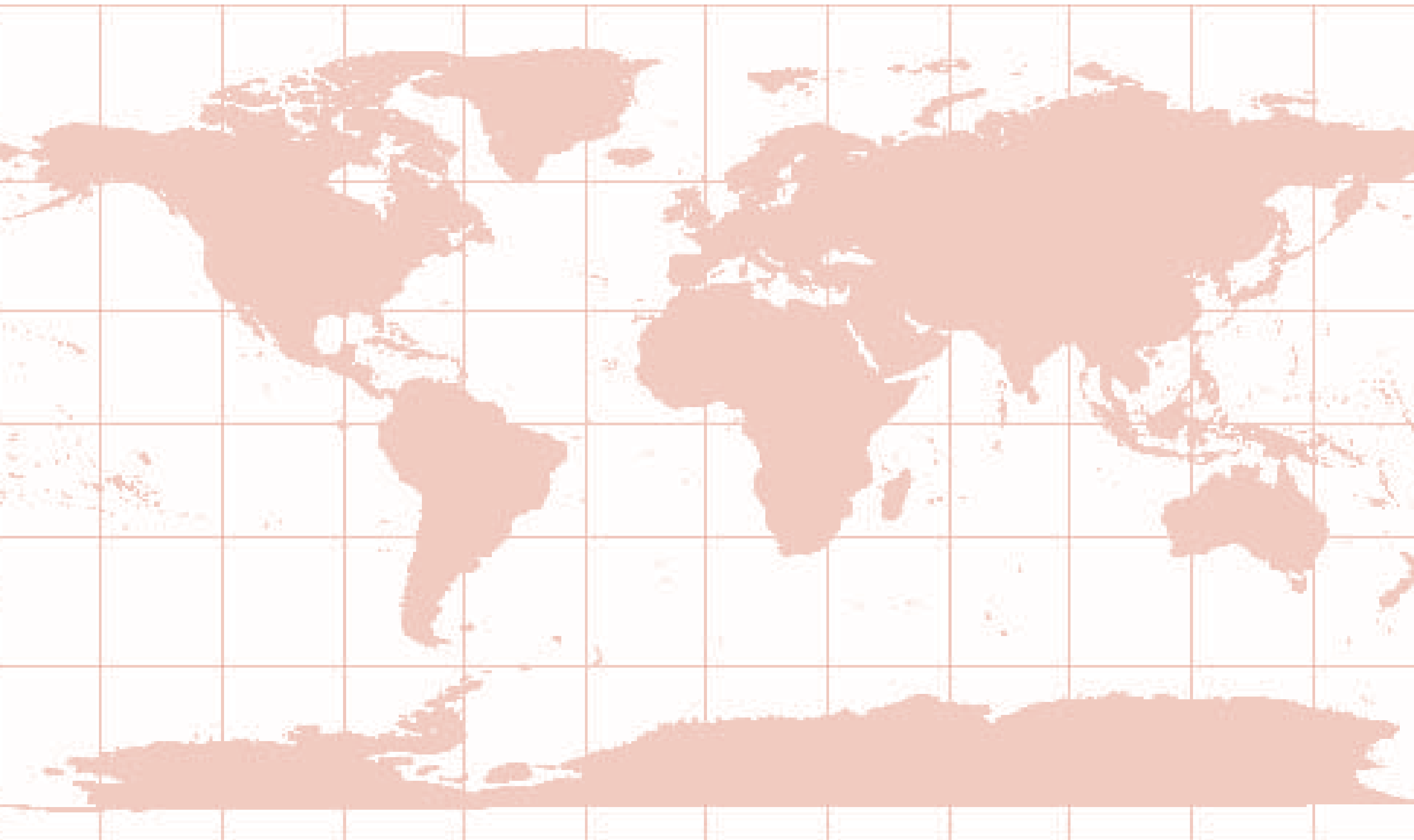
PRE-RELEASE

World Economic Situation and Prospects 2009

— Global Outlook 2009 —



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This report is a joint product of the Department of Economic and Social Affairs (DESA), the United Nations Conference on Trade and Development (UNCTAD) and the five United Nations regional commissions (Economic Commission for Africa (ECA), Economic Commission for Europe (ECE), Economic Commission for Latin America and the Caribbean (ECLAC), Economic and Social Commission for Asia and the Pacific (ESCAP), and Economic and Social Commission for Western Asia (ESCWA)). It provides an overview of recent global economic performance and short-term prospects for the world economy and of some key global economic policy and development issues. One of its purposes is to serve as a point of reference for discussions on economic, social and related issues taking place in various United Nations entities in 2009.

Pre-Release

This is a pre-release of Chapter I of the ***World Economic Situation and Prospects 2009***, released on 1 December 2008 in Doha, Qatar. The full report, including regional overviews and detailed trends in global trade and finance is due out in early January, 2009.

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Chapter I
Global outlook

The financial crisis and the prospects for the world economy

The world economy is mired in the most severe financial crisis since the Great Depression

It was never meant to happen again, but the world economy is now mired in the most severe financial crisis since the Great Depression. In little over a year, the mid-2007 sub-prime mortgage debacle in the United States of America has developed into a global financial crisis and started to move the global economy into a recession. Aggressive monetary policy action in the United States and massive liquidity injections by the central banks of the major developed countries were unable to avert this crisis. Several major financial institutions in the United States and Europe have failed, and stock market and commodity prices have collapsed and become highly volatile. Interbank lending in most developed countries has come to a virtual standstill, and the spread between the interest rate on interbank loans and treasury bills has surged to the highest level in decades. Retail businesses and industrial firms, both large and small, are finding it increasingly difficult to obtain credit as banks have become reluctant to lend, even to long-time customers. In October 2008, the financial crisis escalated further with sharp falls on stock markets in both developed and emerging economies. Many countries experienced their worst ever weekly sell off in equity markets.

Early responses failed to prevent the crisis from spreading

Since early October, policymakers in the developed countries have come up with a number of more credible and internationally concerted emergency plans. Compared with the earlier piecemeal approach, which had failed to prevent the crisis from spreading, the latest plans are more comprehensive and better coordinated. The measures have reshaped the previously deregulated financial landscape; massive public funding was made available to recapitalize banks, with the Government taking partial or full ownership of failed financial institutions and providing blanket guarantees on bank deposits and other financial assets in order to restore confidence in financial markets and stave off complete systemic failure. Governments in both developed and developing countries have started to put together fiscal and monetary stimulus packages in order to prevent the global financial crisis from turning into another Great Depression.

New, better coordinated measures, if effective, will take time to show results

Will this work? It is hard to predict, but doing nothing would almost certainly have further aggravated the downside risks and more likely than not pushed the world economy into a deeper crisis. It should be appreciated, however, that 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 seen 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 period ahead and that recovery may not materialize any time soon, even if the bailout and stimulus packages 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.

Developed countries have entered into recession and are dragging the world economy down

Most developed economies entered into recession during the second half of 2008, and the economic slowdown has spread to developing countries and the economies in transition. According to the United Nations baseline forecast, world gross product (WGP) 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 in previous years (table I.1). The baseline forecast assumes that it will take six to nine months for financial markets in developed countries to return to normalcy, assuming central banks in the United States, Europe and Japan provide further monetary stimulus from the end of 2008 and on into 2009 (see box I.1).

Uncertainties surrounding this forecast are high, as shown by the confidence interval around the baseline forecast (figure I.1). In a more pessimistic scenario, both the fire sale of financial assets and the credit crunch would last longer, while monetary stimulus would prove ineffective in the short run and fiscal stimulus would turn out to be too little, too late. This would then lead to worldwide recession in 2009, with global output falling by 0.4 per cent, and postpone recovery to, at best, the following year. In a more optimistic scenario, a large-scale fiscal stimulus coordinated among major economies would stave off the worst of the crisis, yet—for the reasons indicated—it would not prevent a significant slowdown of the global economy in 2009. Both of these scenarios are also shown in table I.1 and figure I.1 and discussed further below.

Table I.1
Growth of world output, 2003-2009

Annual percentage change

	2003	2004	2005	2006	2007	2008[a]	2009[b] Baseline scenario	2009[b] Pessimistic scenario	2009[b] Optimistic scenario
World output[c]	**2.7**	**4.0**	**3.5**	**4.0**	**3.8**	**2.5**	**1.0**	**-0.4**	**1.6**
of which:									
Developed economies	1.8	3.0	2.4	2.9	2.5	1.1	-0.5	-1.5	0.2
United States	2.5	3.6	2.9	2.8	2.0	1.2	-1.0	-1.9	-0.5
Euro zone	0.8	2.1	1.7	2.8	2.6	1.1	-0.7	-1.5	0.3
Japan	1.4	2.7	1.9	2.4	2.1	0.4	-0.3	-0.6	0.5
Economies in transition	7.3	7.6	6.5	7.8	8.3	6.9	4.8	2.7	6.1
Developing economies	5.2	7.1	6.7	7.0	7.1	5.9	4.6	2.7	5.1
China	10.0	10.1	10.2	11.1	11.4	9.1	8.4	7.0	8.9
India	7.3	7.1	11.5	7.3	8.9	7.5	7.0	4.7	7.5
Brazil	1.1	5.7	2.9	3.7	5.4	5.1	2.9	0.5	3.0
Mexico	1.4	4.2	3.0	4.8	3.2	2.0	0.7	-1.2	1.5
of which:									
Least developed countries	5.2	7.2	7.9	7.7	7.8	6.4	5.1	2.0	6.1
Memorandum items:									
World trade	5.6	11.2	8.0	8.8	6.3	4.4	2.1	-3.1	3.1
World output growth with PPP-based weights	3.6	4.9	4.5	4.9	4.9	3.7	2.3	1.3	3.0

Source: UN/DESA.

a Partly estimated.
b Forecasts, based in part on Project LINK.
c Calculated as a weighted average of individual country growth rates of gross domestic product (GDP), where weights are based on GDP in 2005 prices and exchange rates.

Box I.1

Key assumptions for the baseline forecast and the pessimistic and optimistic scenarios

The baseline forecast

The baseline forecast assumes that it will take six to nine months for financial markets in developed countries to return to normalcy while central banks in the United States, Europe and Japan provide further monetary stimulus from the end of 2008 and on into 2009.

The Federal Reserve (Fed) is assumed to maintain its main policy interest rate, the federal funds rate, at its current level of 1 per cent throughout 2009. In addition, the Fed (as well as other major central banks) is expected to continue using direct injections of liquidity into the financial system through some special facilities, including the Term Securities Lending Facility, and the extension of non-recourse loans at the primary credit rate to depository institutions and bank holding companies to finance their purchases of high-quality asset-backed commercial paper (ABCP) from money market mutual funds.

The European Central Bank (ECB) is assumed to cut its main policy interest rate, the minimum bid rate,[a] further during the fourth quarter of 2008 from its current level of 3.25 per cent to 2.75 per cent by the end of the year. In 2009, it is expected to cut an additional 50 basis points (bps), bringing its policy rate to 2.25 per cent and then to maintain this stance for the rest of the year.

The Bank of Japan is assumed to hold its policy rate, the target Uncollateralized Overnight Call Rate, at its current 0.3 per cent until the end of 2009.

The euro peaked against the United States dollar during the second quarter of 2008, at $1.60, and has depreciated significantly since then. It is assumed to remain close to the current levels of around $1.28 in the fourth quarter of 2008 and to depreciate further in 2009, reaching $1.20 as interest-rate differentials against the United States narrow further.

The Japanese yen is expected to stay close to current levels of Y99 to the United States dollar for the fourth quarter of 2008 and then to appreciate and average Y91 in the fourth quarter of 2009.

Brent oil prices are expected to average $64 per barrel in 2009, compared with an estimated average of $101 per barrel in 2008.

A pessimistic scenario

Given the great uncertainties with regard to how deep this financial crisis could become and how effective the policy measures in place would be, risks for the world economy to perform even worse than in the already gloomy baseline outlook remain high. The key factor in a more pessimistic scenario of this kind would be a much sharper-than-anticipated decline in net lending to households and businesses in major developed countries, not unlike the experience of the United Kingdom of Great Britain and Northern Ireland, Japan and the Scandinavian countries during their respective financial crises in the early 1990s. The lack of confidence and trust in the financial sector would be prolonged, especially if, for instance, large “off balance-sheet” positions of financial institutions continued to disguise risks at much larger financial losses.

As a result, the fire sale in equity markets and drops in asset prices will also be prolonged, along with deteriorating indicators of the real economy, including falling business profits and rising unemployment. As financial institutions continue to deleverage and investors become even more risk averse, the pessimistic scenario assumes an extended vicious circle of asset price deflation and perceptions of rising financial risk. House prices in the United States, which have declined by about 20 per cent since the housing bubble burst, are assumed to fall by another 15-20 per cent during 2009. The wealth losses from a further sell-off in assets worldwide could completely dwarf the attempts at recapitalization of financial institutions and corporate businesses put in place by the Governments of major developed countries, and make the financial rescue look seemingly impossible. This will erode market confidence further. Developing economies would be hurt more through a deeper recession in the developed economies, a steeper fall in commodity prices and a sharper reversal of capital inflows. Aid budgets could come under greater pressure and affect low-income countries relying on official development assistance not only for their long-term development but also as a cushion against external shocks.

a In order to supply further liquidity to the markets, the ECB has now changed its main refinancing operations from a variable rate to a fixed-rate tender, and is supplying unlimited liquidity at the stated fixed rate.

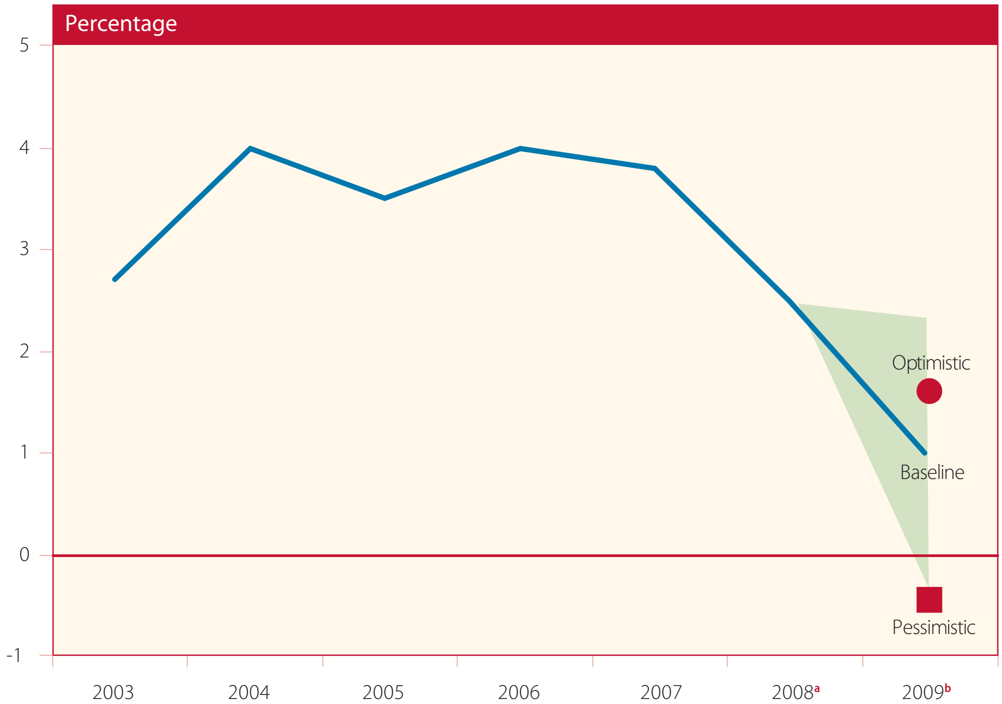
Box I.1 (cont'd)

In this scenario, fiscal and monetary stimulus is likely to be less effective. First, it could push the United States and parts of Europe into a "liquidity trap"—akin to that of Japan during the 1990s—where monetary easing would fail to stimulate private consumption and investment. Second, the deep risk aversion and lack of confidence force banks to use any liquidity injections to shore up their balance sheets without enhancing the credit supply to households and businesses. Third, fiscal stimulus also fails to restore confidence among market agents as they fear that Governments lack sufficient means to finance ever-larger bailouts of the financial system or that exorbitant increases in public debt will be a threat to economic stability in the future.

An optimistic scenario

In contrast, in a more optimistic scenario, it is assumed that financial market confidence is restored as quickly as assumed in the baseline. In addition, it is assumed that during the first half of 2009, fiscal stimulus packages of between 1.5 and 2 per cent of gross domestic product (GDP) are introduced in coordinated fashion. Also, compared with the baseline, greater monetary easing is assumed through further interest-rate cuts.

Figure I.1
World economic growth, 2003-2009



Indicates confidence interval at two standard deviations from historical forecast errors

Source: UN/DESA.
a Partly estimated.
b Projections, based on Project LINK.

World income per capita will fall in 2009

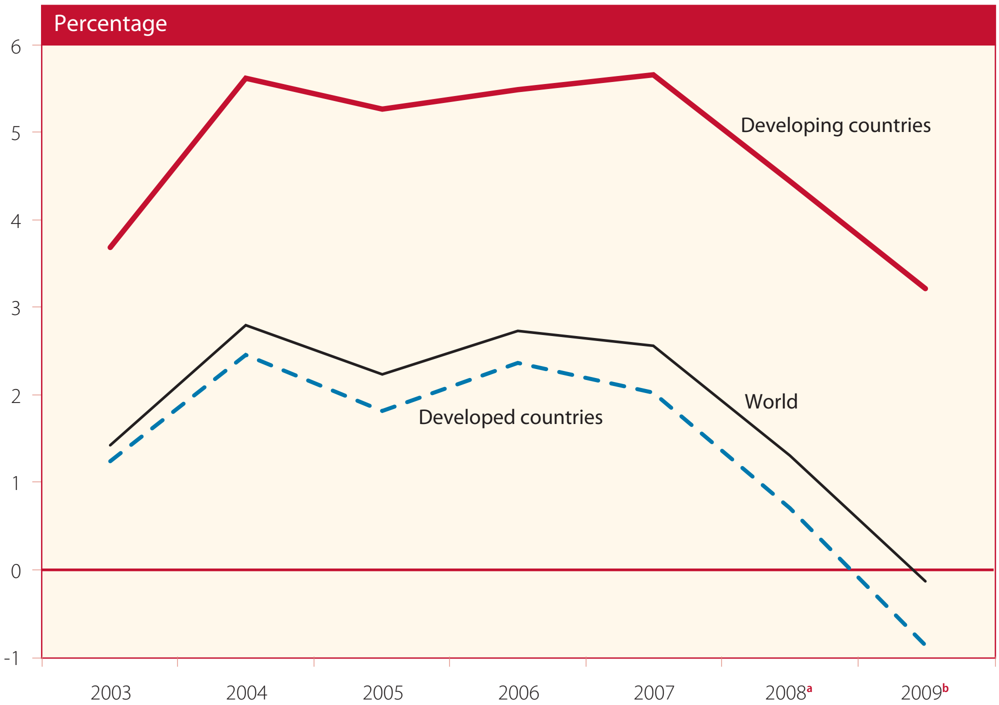
In the baseline scenario, income per capita for the world as whole is expected to decline in 2009 (figure I.2). This will be the case not only in the developed economies but also in many developing countries, where per capita income growth will be negative or well below what is needed to address poverty reduction.[1]

The vast majority of countries are experiencing a sharp reversal in the robust growth registered during the period 2002-2007. For example, among the 160 economies in

1 As a rule of thumb, 3 per cent per capita income growth is sometimes seen as the minimum required growth rate for achieving significant reductions in poverty, even in the absence of income redistribution.

the world for which data are available, the number of economies that had an annual growth in gross domestic product (GDP) per capita of 3 per cent or higher is estimated to have dropped from 106 in 2007 to 83 in 2008, and this is expected to decline further, to 52, in 2009 (see table I.2). Among the 107 developing countries, this number is estimated to have dropped from 70 in 2007 to 57 in 2008, and to decline significantly further in 2009 to 29.

Figure I.2
Real per capita GDP growth in developed and developing countries, 2003-2009



Source: UN/DESA.
a Partly estimated.
b Projections, based on Project LINK.

Table I.2
Frequency of high and low growth of per capita output, 2006-2009

	Number of countries monitored	Decline in GDP per capita				Growth of GDP per capita exceeding 3 per cent			
		2006	*2007*	*2008*[a]	*2009*[b]	*2006*	*2007*	*2008*[a]	*2009*[b]
		Number of countries							
World	**160**	**10**	**15**	**14**	**36**	**97**	**106**	**83**	**52**
of which:									
Developed economies	35	0	0	7	21	18	18	7	6
Economies in transition	18	0	0	0	0	16	18	18	17
Developing countries	107	10	15	7	15	63	70	57	29
of which:									
Africa	51	9	14	6	9	25	29	24	16
East Asia	13	0	1	1	2	11	12	8	1
South Asia	6	0	0	0	0	5	5	5	4
Western Asia	13	1	0	0	1	8	7	7	2
Latin America	24	0	0	0	3	14	17	13	6

Table I.2 (cont'd)

	Number of countries monitored	Decline in GDP per capita				Growth of GDP per capita exceeding 3 per cent			
		2006	2007	2008[a]	2009[b]	2006	2007	2008[a]	2009[b]
		Number of countries							
Memorandum items:									
Least developed countries	39	6	11	5	10	17	20	16	10
Sub-Saharan Africa[c]	44	9	14	6	9	20	23	19	13
Landlocked developing countries	25	2	5	2	3	12	15	15	13
Small island developing States	17	2	2	1	4	9	12	9	5
	Share[d]	Percentage of world population							
Developed economies	15.8	0.0	0.0	1.7	13.7	2.5	2.5	1.5	1.4
Economies in transition	5.0	0.0	0.0	0.0	0.0	4.9	5.0	5.0	4.2
Developing countries	79.1	0.9	1.6	0.7	3.3	67.2	72.2	65.9	49.4
of which:									
Africa	13.5	0.9	1.6	0.7	1.0	7.0	10.2	8.4	6.4
East Asia	30.5	0.0	0.0	0.0	0.1	30.4	30.5	28.3	20.9
South Asia	23.7	0.0	0.0	0.0	0.0	25.7	26.1	26.5	24.1
Western Asia	2.8	0.1	0.0	0.0	0.3	1.8	2.0	0.6	0.4
Latin America	8.5	0.0	0.0	0.0	2.0	4.7	6.3	5.2	0.7
Memorandum items:									
Least developed countries	10.5	0.4	1.1	0.5	1.2	6.6	7.6	6.4	5.0
Sub-Saharan Africa[c]	8.4	0.9	1.6	0.7	1.0	4.5	5.5	4.6	3.1
Landlocked developing countries	4.9	0.3	0.8	0.3	0.5	2.7	2.9	2.9	2.7
Small island developing States	0.8	0.0	0.0	0.0	0.2	0.5	0.6	0.5	0.2

Source: UN/DESA, including population estimates and projections from *World Population Prospects: The 2006 Revision.*

a Partly estimated.
b Forecast, based in part on Project LINK.
c Excluding Nigeria and South Africa.
d Percentage of world population for 2000.

This trend suggests a significant setback in the progress made in poverty reduction in many developing countries over the past few years. The prospects for the least developed countries (LDCs), which generally did so well on average over the past several years, are also deteriorating rapidly (see box I.2). Meanwhile, divergences in economic performance among the low-income countries remain greater than among the mainly middle-income countries in Asia or Latin America (figure I.3), although with the synchronized global downturn, growth divergences have narrowed somewhat from preceding years.

The story of a crisis foretold?

Policymakers have grossly underestimated the global consequences of the financial crisis in the United States

The crisis should have taken no one by surprise. That analysts and policymakers are now expressing bewilderment at the extent of the crisis suggests not only a gross underestimation of the fundamental causes underlying the crisis but also unfounded faith in the self-regulatory capacity of unfettered financial markets. Past issues of the *World Economic Situation and Prospects* have repeatedly pointed out that the apparent robust growth pattern that had emerged from the early 2000s came with high risks. Growth was driven to

Box I.2

Prospects for least developed countries

Growth in the least developed country (LDC) group decelerated from 7.8 per cent in 2007 to 6.4 per cent in 2008, breaking a four-year trend of growth over 7 per cent. In 2009, growth is expected to slow further to 5.3 per cent. These figures, however, obscure a significant variation across countries. Cape Verde recently graduated from LDC status. Of the remaining 38 countries with data coverage, only five had growth over 7 per cent in 2008—the minimum rate of growth needed to achieve the Millennium Development Goals (MDGs). Growth was between 3 and 7 per cent in 25 countries, while the remaining 8 countries, most of which were mired in conflicts or political instability, had growth of less than 3 per cent (see table).

Table
Growth in least developed countries, 2008

Less than 3 per cent	*Between 3 and 7 per cent*		*Greater than 7 per cent*
Chad	Bangladesh	Mozambique	Angola
Comoros	Benin	Niger	Democratic Republic of the Congo
Eritrea	Burkina Faso	Nepal	Equatorial Guinea
Guinea	Burundi	Rwanda	Ethiopia
Somalia	Central African Republic	Sudan	Liberia
Togo	Djibouti	Sao Tome and Principe	
Myanmar	Gambia	Senegal	
Haiti	Guinea-Bissau	Sierra Leone	
	Lesotho	United Republic of Tanzania	
	Madagascar	Uganda	
	Malawi	Yemen	
	Mali	Zambia	
	Mauritania		

The majority of countries with growth above 7 per cent in 2008—for example, Angola, the Democratic Republic of the Congo and Equatorial Guinea—were oil- and mineral-exporting economies, thus underscoring the importance of the recent commodity boom for the export and growth performance of the group and also highlighting that their growth remains susceptible to volatility in the international commodity markets. Although the value of merchandise exports rose by 43 per cent in the LDCs between 2007 and 2008, quadrupling since 2003, this was largely due to the rising prices of oil and mineral exports. The LDCs remain marginalized in terms of their share in world trade, accounting for only 1 per cent of global exports.

In addition, about half of the LDCs, many of which are high-growth performers, experienced a de-industrialization of their economies in the past decade. This suggests the lack of structural transformation and economic dynamism necessary for reducing commodity dependence and bringing about long-term sustainable growth.

Most LDCs are net food importers and have therefore been strongly affected by the rise in commodity food prices, deteriorating terms of trade and widening current-account deficits. After experiencing a declining trend since 2001, inflation in the LDCs increased to 13.5 per cent in 2008, up from 9.5 per cent in 2007, triggered mainly by rising world market prices of food and fuel. In the oil-exporting countries, this was compounded by strong domestic demand growth. Of the 38 LDCs monitored, half had inflation rates over 10 per cent in 2008, up from 13 countries in 2007.

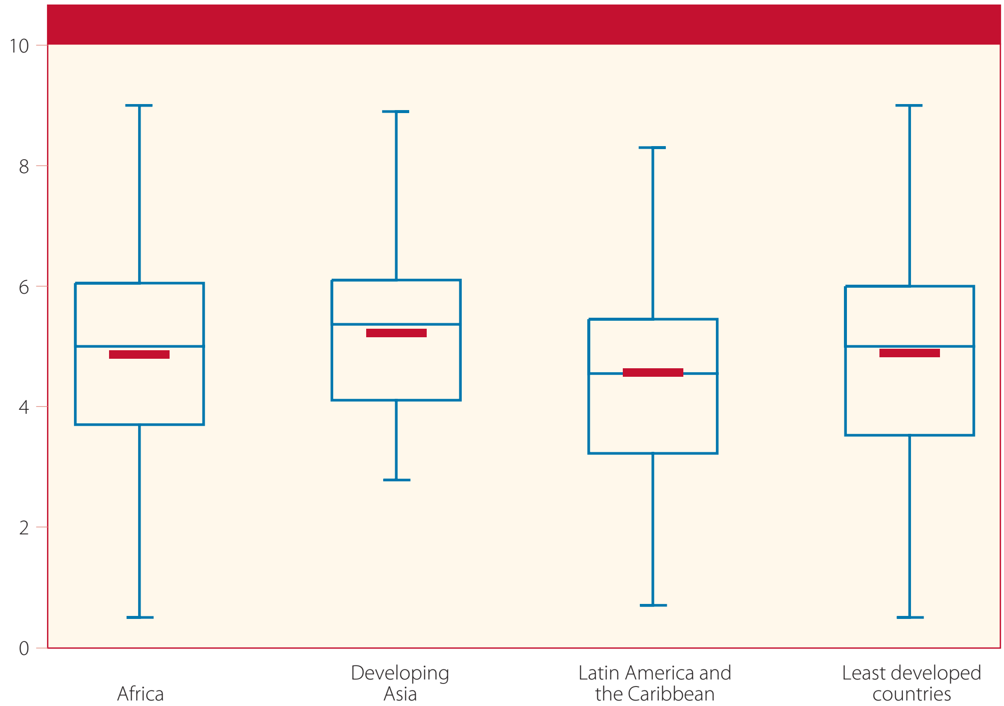
Food import bills of LDCs climbed by 37 per cent in 2008, from $17.9 million in 2007 to $24.6 million in 2008 and after having risen by 30 per cent in 2006, owing to surging prices of rice,

Box I.2 (cont'd)

wheat and vegetable oils. By the end of 2008, the annual food import basket in LDCs cost more than three times that of 2000, not because of the increased volume of food imports, but as the result of rising food prices. The moderation in commodity prices which began in 2008 is expected to improve the terms of trade of oil-importing and net food-importing LDCs in the near term, yet much of the damage has already been done, as the surge in food prices has led to double-digit levels of inflation, sparked food riots in at least eight LDCs (Burkina Faso, Guinea, Haiti, Mauritania, Mozambique, Senegal, Somalia and Yemen) and slowed progress towards the MDGs.

The global economic downturn will affect the LDCs through lower commodity prices, weaker investment and trade flows, and higher exchange-rate vulnerability. Aid flows, which are important for funding improved social service delivery, large-scale infrastructure projects and industrial development, may recede if traditional donors mired in the financial crisis renege on their aid commitments, thus further hampering progress towards achieving the MDGs.

Figure I.3
Divergence in economic performance across developing countries in 2008



Source: UN/DESA and Project LINK.

Note: For each region, the red bar within the box corresponds to the regional mean value of growth rates. The five blue horizontal bars, from bottom to top, correspond to the smallest observation, the first quartile, the median, the third quartile and the largest observation, respectively. The outliers are excluded from the determination of the smallest and the largest observations.

a significant extent by strong consumer demand in the United States, stimulated by easy credit and underpinned by booming house prices, and by 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 accumulating large foreign-exchange reserves and 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 on), 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"). 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 now under way has brought down established financial institutions and led to the rapid evaporation of global liquidity that together threaten the normal operations of the real economy.

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 that mounting household, public sector and financial sector indebtedness in the United States and elsewhere would not be sustainable over time.[2] As strains in the United States mortgage market were transmitted to the wider financial sector, fears of a meltdown escalated and spread around the world.

The financial turmoil of August 2007 was an early sign of larger problems ahead

Severe problems in United States mortgage markets and increasing volatility in interest-rate spreads in the markets for interbank and emerging market lending surfaced in August 2007 as early signs of emerging global financial turmoil. Despite massive liquidity injections and an increasingly loose monetary policy stance in the United States, Japan and parts of Europe, the turmoil continued into 2008. Major warning signs came with the collapse of Bear Stearns, the fifth-largest investment bank in the United States, which had to be rescued by joint action of the United States Federal Reserve (Fed) and JPMorgan Chase. In September 2008, the financial turmoil intensified once again, this time turning into a global financial tsunami characterized by a severe credit freeze, a precipitous sell-off in stock markets worldwide and the collapse or near collapse of major financial institutions in the United States and Europe. Several developed countries, including Iceland and Hungary, needed massive emergency loans from the International Monetary Fund (IMF) to cope with their financial problems.

The continued housing slump in the United States triggered the collapse of this financial house of cards. House prices continued to decline in 2008 at an annual rate of about 17 per cent. Mortgage delinquency rates surged, particularly for sub-prime loans. No less than 40 per cent of the sub-prime mortgage loans originated in 2006 were delinquent by the second half of 2008. As a result, the value of mortgage-related assets deteriorated significantly. By the third quarter of 2008, financial institutions worldwide had written down a total value of about $700 billion worth of asset-backed securities, of which more than $500 billion related to the commercial banking sector. Many more write-downs are forthcoming as the prices of these securities continue to drop, leading to an accelerated erosion of the capital base of financial institutions and severely constraining their ability to lend.

Deregulation and financial innovations led to excessive risk-taking by financial instititutions

Moreover, the complex way in which those asset-backed securities were constructed made it difficult to assess their value. Having been cavalier about risk during the boom years, investors have become extremely risk averse along with the plummeting market confidence, resulting in further declines in asset prices and a further drying up of liquidity in a number of funding markets. Banks have become extremely reluctant to lend to each other, losing confidence in the creditworthiness of counterparties. The credit market stress was reflected in the surge of the spread between the interest rate on interbank lending and

2 For example, as early as 2006, the *World Economic Situation and Prospects 2006* (United Nations publication, Sales No. E.07.II.C.2) warned of the "vulnerability of the global economy derived from the possible burst of the house price bubble in some countries" (p. 23) and cautioned that the related widening of the global imbalances posed a threat to the stability of the financial system.

the interest rate on Treasury bills. In late September and early October, this spread reached its highest level in decades. It had soared to nearly 400 basis points, whereas under normal market conditions, the spread would be about 20 to 30 basis points (figure I.4).

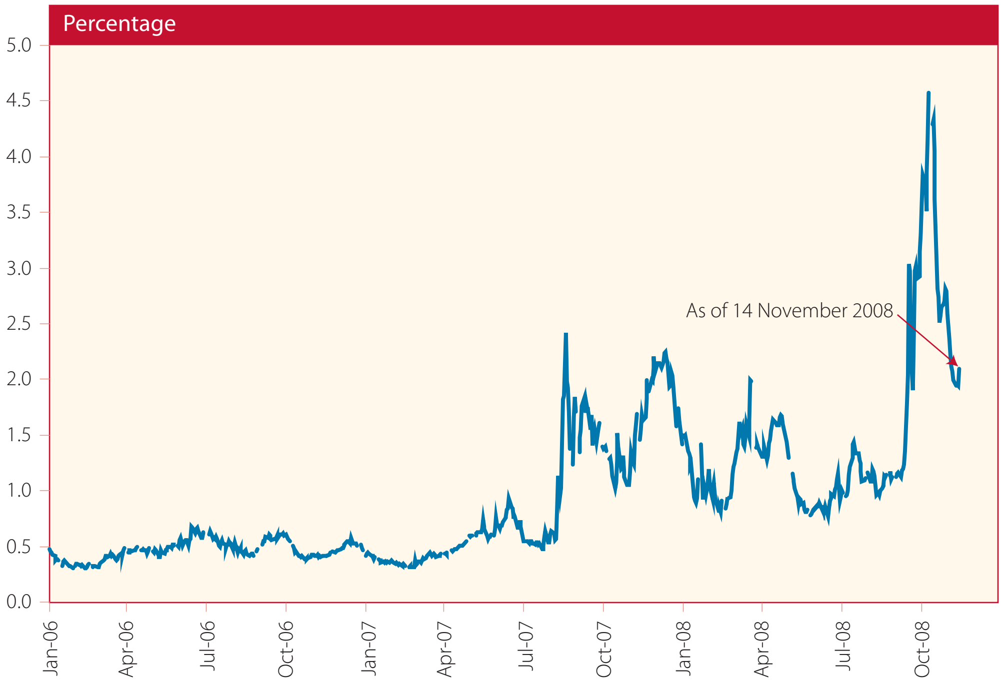
The credit crunch has become widespread, and even some large, financially sound non-financial corporations were unable to roll over their commercial paper in the money market to fund working capital needs.

A fire sale in asset markets followed the collapse of major financial institutions in the United States and Europe

Prices of financial companies' stocks were under tremendous pressure even before September, but a further erosion of investor confidence, combined with a significant downgrading of the outlook for the real economic sector, triggered another round of asset sell-offs worldwide in late September and October. Equity markets remained highly volatile thereafter. In the first ten days of October alone, equity markets worldwide plummeted by about 20 per cent on average, losing roughly $10 trillion worth of equity. Many markets, including those of the United States and some Asian countries, experienced the worst sell-off recorded in a single week. For the year, global equity markets have declined by about 40 per cent on average. In several emerging markets, the decline has been even steeper, with stock exchanges dropping by more than 60 per cent in China and the Russian Federation, for example.

A number of large financial institutions came under severe financial stress and were cut off from access to long-term capital and short-term funding markets. In the United States, these included the two government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, as well as Lehman Brothers, American International Group (AIG), Inc. and Washington Mutual. Fannie Mae and Freddie Mac hold about $5 trillion worth of mortgage loans, about half of all the mortgage loans in the United States. They are also the issuers of multi-trillion-dollar bonds bought by many other financial institutions worldwide, including the central banks of many countries, as well as pension funds. The

Figure I.4
Daily spread between three-month LIBOR and three-month United States Treasury bill interest rate, January 2006-November 2008



Sources: British Bankers' Association and the United States Federal Reserve Bank.

failure of these two companies would inevitably have caused unacceptably large dislocations in the global financial system. Therefore, the Federal Housing Finance Agency (FHFA) put Fannie and Freddie under conservatorship of the United States Government, and the Treasury provided financial support.

AIG is one of the largest insurance companies in the world. It has more than one trillion dollars in assets and operates in more than 100 countries. AIG plays a central role in a number of markets by insuring risks for many other companies. For example, it holds a swap portfolio valued at about $500 billion for the insurance of the debts of many other major financial institutions. Given the size and composition of its obligations, a failure of AIG would also severely threaten global financial stability. To salvage AIG, the United States Treasury provided an emergency credit line of $85 billion in exchange for about 80 per cent equity ownership in AIG, after which further support was given, raising the bailout to $150 billion in November of 2008.

Two more large financial institutions failed: Lehman Brothers and Washington Mutual had to file for bankruptcy, the former being the largest firm to do so in United States history, while the latter is the largest bank ever to fail.

The international financial landscape changed dramatically after September 2008

September 2008 marked a sea change in the international financial landscape, including the end of independent investment banking in the United States and an end to previous faith in the virtues of unfettered financial markets. Investment banks either went bankrupt, merged with other commercial banks, or converted themselves into commercial banks. Between September 2007 and October 2008, 16 banks in the United States filed for bankruptcy, and more than 100 out of some 7,000 banks are on the Fed's watch list. While this proportion is still small compared with the Great Depression, when about 700 out of a total of 9,000 banks failed, its ramifications in an integrated financial world are every bit as big. In November, the United States Government also had to come to the rescue of Citigroup, backing about $306 billion in loans and securities and investing $20 billion directly in the financial institution considered "too big to fail".

The crisis quickly spread around the globe

The credit crisis quickly spread to Europe, with a number of large European financial institutions teetering on the edge of collapse, such as the Dutch-Belgian bank Fortis, the French-Belgian Dexia, the British mortgage lender Bradford & Bingley, Germany's Hypo Real Estate, as well as the Dutch bank and insurance company ING and the Dutch insurance giant Aegon. In Iceland, three major banks collapsed, dragging the country to the brink of bankruptcy as the total external liabilities of the three banks accounted for five times Iceland's annual GDP. The contagion effects of the crisis also spread rapidly to emerging economies. Hungary was among the first of the emerging market countries to suffer. Both Iceland and Hungary had to recur to the IMF (and other sources) to alleviate the immediate financial market stress, becoming the first two European countries to do so in over 30 years. Ukraine also ran into acute liquidity problems, as its access to international capital markets was curtailed sharply, its currency was sold off and the credit-rating agencies downgraded the country's debt. Ukraine also had to recur to the IMF for a $16.4 billion loan. Belarus and Serbia also filed requests for substantial emergency support from the IMF. Pakistan also entered into acute balance-of-payments' problems and filed for IMF support, as its foreign reserve level dropped to less than a few weeks worth of imports.

Fears of systemic failure have led to massive financial sector rescue plans

The intensification of the global financial crisis from late September-October 2008 onwards heightened the risk of a complete collapse of the global financial system. In response, policymakers worldwide, particularly those in major developed countries, drastically scaled up their policy measures in October. Most importantly, they made two strategic changes in the way they deal with the crisis. First, as noted above, the initial piecemeal approach was abandoned and replaced with a more comprehensive one. Second, unilateral national approaches have given way to more international cooperation and coordination.

Totalling about $4 trillion, these policy measures aimed at unfreezing credit and money markets by recapitalizing banks with public funds, guaranteeing bank lending and insuring bank deposits. Interbank lending rates retreated somewhat following the start of the large-scale bailout. However, congestion and dysfunction remain in important segments of the credit markets. Meanwhile, great uncertainty remains in credit derivatives, with $400 trillion to $500 trillion in notional value of derivatives outstanding.

Given the stark erosion of confidence and massive destruction of financial capital over the past year, it will take months, if not years, before beleaguered banks significantly revive lending and fraught investors see confidence restored. It will take even longer for these policy measures to show their effects in terms of a regaining of strength in the real economy. Meanwhile, the crisis has already had a severe impact on global commodity markets and has led to reversals in private capital flows to emerging markets, with far-reaching implications for the prospects of the developing world at large.

The deteriorating international economic environment for developing countries

The myth of a "decoupling" of developing country growth led to an underestimation of the global repercussions

There had been complacency about the impact of the global financial crisis on developing countries and the economies in transition. In fact, the broader international economic environment for developing countries and the economies in transition has deteriorated sharply, and since October 2008 the financial stresses have shifted rapidly towards these economies. The cost of external borrowing has risen considerably and capital inflows are reversing. Both currency and commodity markets have become extremely volatile, with the exchange rate depreciating at an alarming pace in several countries and prices of primary commodities tumbling. Export growth in these economies is decelerating and the current-account balances of many countries have shifted back into a rising deficit. These economies are facing even bigger challenges in the outlook for 2009.

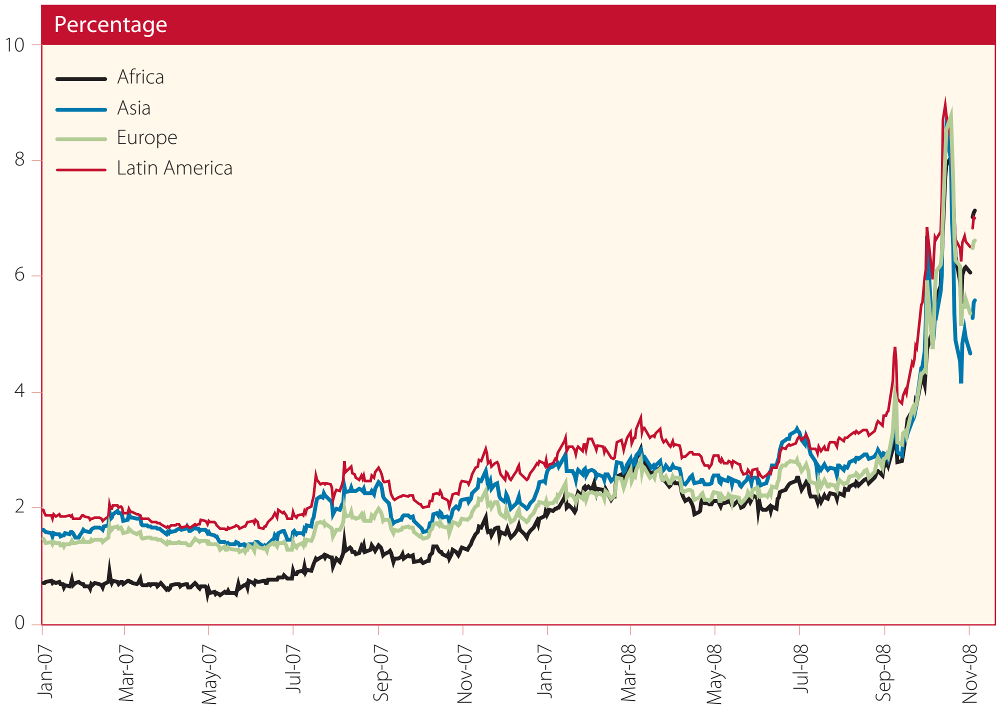
Tightening and more costly external financing

Spreads on emerging market bonds have more than doubled

In the second half of 2007, *external financing costs* for emerging market economies started to edge up from record lows, but remained within normal range until September 2008. Costs surged thereafter with the tightening global credit market. Spreads, as measured through the Emerging Markets Bond Index (EMBI), soared from 250 to about 550 basis points within the space of a few weeks during the second half of September (figure I.5). Unlike in recent years where the spread varied significantly across regions and countries as an indication that investors were discriminating among country-specific risks, the latest surge has been uniform, suggesting that contagion and generalized 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, but some renewed differentiation in the spreads across regions and countries may re-emerge once it becomes clearer which individual countries are better able to cope with the crisis.

Private capital inflows to emerging market economies were relatively robust in the first half of 2008, after peaking in 2007, but have dropped sharply since the third quarter of 2008. Declines in bank lending and portfolio equity inflows explain most of the drop. The volume of bank loans to emerging markets declined by about 40 per cent

Figure I.5
Daily yield spreads on emerging market bonds, January 2007-November 2008



Source: JP Morgan Chase.
Note: Last observation as of 14 November 2008.

from 2007 levels as a consequence of the freeze in interbank lending worldwide. The decline further reflects an adjustment in the surge in lending seen in 2007, when the volume of lending doubled the flows to the Russian Federation and the Republic of Korea, for instance. Portfolio equity inflows fell on average by about 30 per cent from the previous year, also coinciding with the wave of sell-offs in emerging equity markets. In some emerging markets, equity prices dropped by as much as 60 per cent. By contrast, foreign direct investment (FDI) inflows to these countries remained relatively stable; a decline of about 10 per cent is estimated for 2008 from the record highs of 2007.

Private capital flows to developing countries will weaken in 2009

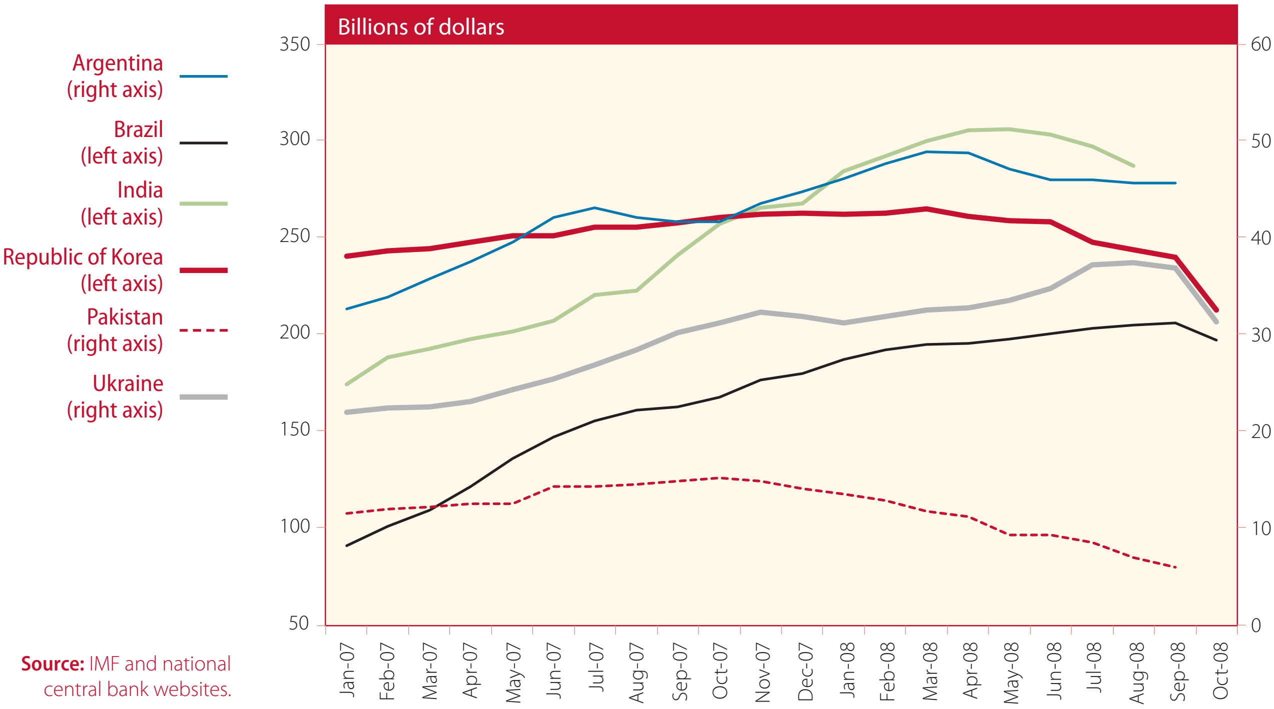
In the outlook for 2009, capital inflows to emerging market economies are projected to drop further. A continued deleveraging in the large financial institutions of developed countries and the eroded confidence of international investors are likely to limit portfolio inflows to emerging market economies, while the pro-cyclical nature of FDI flows will also imply a slowdown in FDI along with weakening growth prospects for emerging market economies. On the other hand, as emerging market economies are not at the epicentre of this financial crisis and as growth in many of them remains stronger in relation to that of developed economies, capital flows to these countries may gradually regain impetus as global financial markets start to stabilize.

The *outflow of capital* from emerging to developed market economies continued to be larger than the inflow. On balance, emerging market economies continue to be net lenders to the rest of the world, financing the external deficits of the United States and other developed economies. Sovereign wealth funds (SWFs) of emerging market economies continued to grow and totalled about $4 trillion at the end of 2008. During the early stage of the global financial crisis, many SWFs injected sizeable amounts of money into the beleaguered financial institutions of developed countries, but became more prudent after registering considerable losses.

Foreign reserves of developing countries increased further in 2008, but may dwindle in 2009

Most of the net transfer of financial resources from developing to developed countries is achieved through the accumulation of international reserves. The total value of the *official foreign-exchange reserves* of developing countries reached about $3.1 trillion in 2007, and that amount rose further in the first half of 2008. China's foreign-exchange reserves, for example, rose from $1.5 trillion at the end of 2007 to about $1.9 trillion in the third quarter of 2008. Nevertheless, a significant deceleration in the pace of reserve accumulation has been reported for many developing countries amid the intensification of the global financial crisis (figure I.6). In the outlook, the foreign reserves of developing countries are expected to stagnate, or even decline in some countries, as more of these countries are expected to experience either weakening current or capital accounts, or both.

Figure I.6
Foreign reserves of selected countries, January 2007-October 2008



Source: IMF and national central bank websites.

Increased exchange-rate volatility and the risk of a dollar collapse

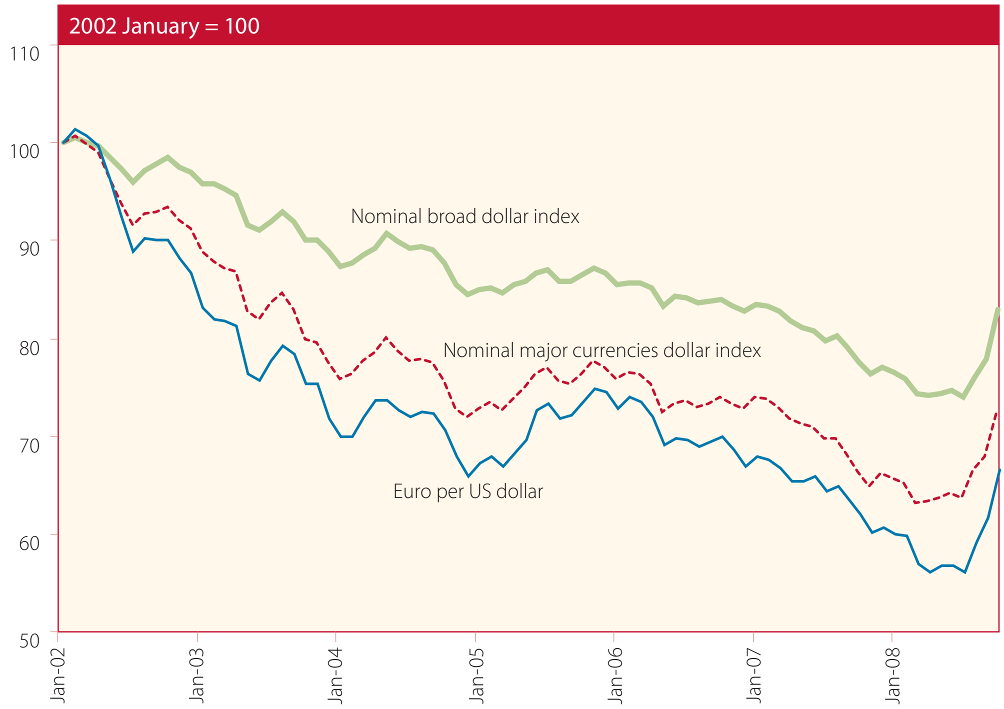
The dollar has appreciated during the crisis …

Volatility in *foreign-exchange markets* has also increased substantially with the deepening of the global financial crisis (figure I.7). 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. Many currencies in developing countries have also either reversed their earlier trend of appreciation vis-à-vis the dollar or slowed their appreciation. 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 of 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.

… but persisting global imbalances could precipitate a hard landing in 2009

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, as stressed in previous issues of the *World Economic Situation and Prospects*. As the global financial crisis intensifies, the world economy is experiencing an abrupt adjustment of the global imbalances. The current-account imbalances across the globe narrowed somewhat in 2008

Figure I.7
Exchange-rate indices for the United States, 2002-2008[a]

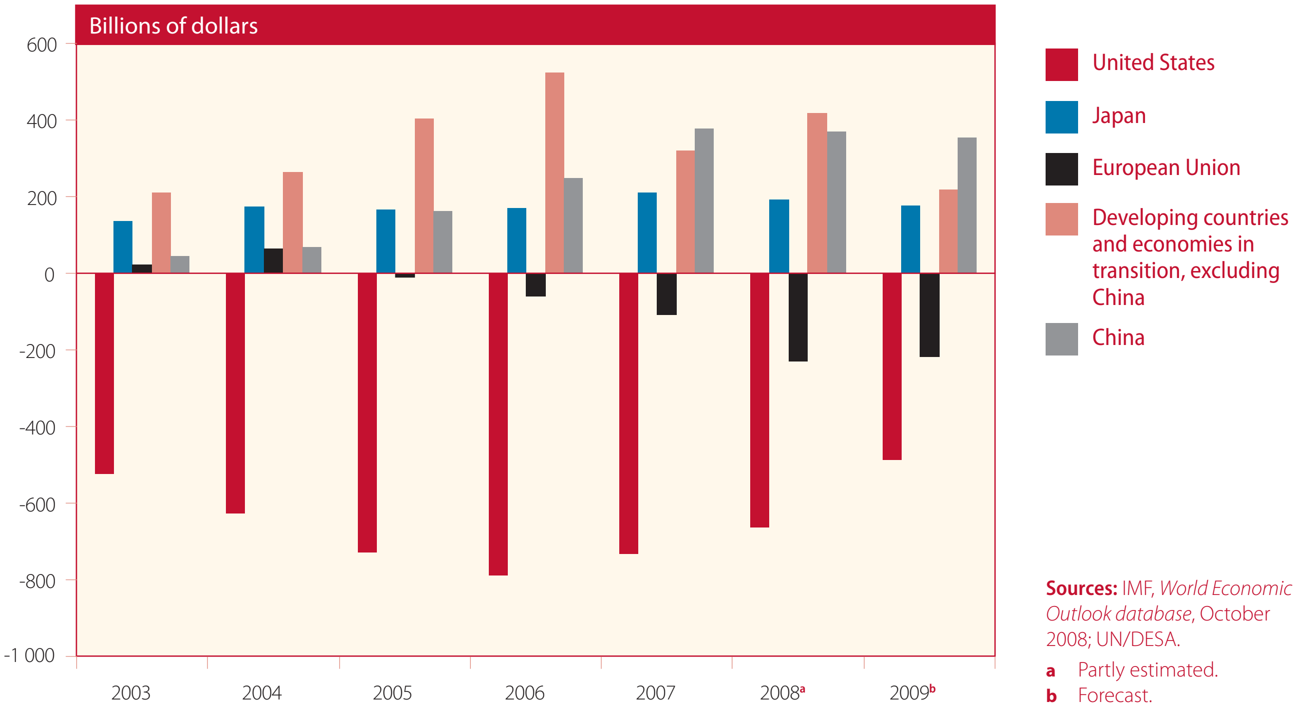


Source: United States Federal Reserve Board. Rebased by UN/DESA.

Note: The major currencies index contains currencies of most developed countries; the broad index incorporates currencies of emerging economies into the other index. A decline in the index represents a depreciation of the dollar.

a Until October 2008.

Figure I.8
Current-account balances, 2003-2009



Sources: IMF, *World Economic Outlook database*, October 2008; UN/DESA.

a Partly estimated.
b Forecast.

and are expected to narrow further in 2009 (figure I.8). The deficit of the United States is estimated to be about $690 billion in 2008, down only slightly from the $732 billion gap of 2007. Developed economies as a whole still registered a deficit of more than $600 billion in 2008. Most developing regions continued running savings' surpluses.

The narrowing of the United States current-account deficit during 2008 occurred in the wake of the financial crisis, which led to a downward adjustment in private sector spending through weakening household consumption and business investment. In the third quarter of 2008, household consumption expenditure dropped at an annualized rate of more than 2 per cent, the largest decline in 28 years, as the large wealth losses forced households to rebuild savings. This was only partially offset by rising government spending, which increased notably following the emergency measures adopted in response to the crisis. Declining import demand on the heels of further retrenchment in domestic consumption and investment will probably also dominate external adjustment in 2009.

Despite its narrowing current-account deficit, the net international liability position of the United States has continued to increase. Over the past few years, the increase in net external indebtedness has been smaller than the annual current-account deficit, however, as a consequence of the dollar depreciation, which has facilitated an appreciation of the value of United States-owned assets abroad and a depreciation in the value of United States liabilities owed to the rest of the world. Being the issuer of the international reserve currency, the United States might thus try to "inflate" its way out of its external indebtedness. However, the favourable revaluation effects are not nearly large enough to outweigh the adverse trend associated with sustaining large current-account deficits. As equity markets worldwide plummeted during 2008, the value of both the United States-owned assets abroad and the foreign-owned assets of the United States has dropped significantly. The official estimate of the valuation adjustment for 2008 will be available in mid-2009, but a rough estimate suggests a further increase in the net debt position of the United States to about $2.7 trillion by the end of 2008, up from $2.5 trillion in 2007.

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. During 2008, the dollar became highly volatile, driven by a number of factors related to the global financial crisis.

In the first half of 2008, when investors seemed to believe that the financial problems were mainly confined to the United States, dollar depreciation accelerated, with the dollar dropping from $1.45 to the euro at the beginning of the year to $1.60 to the euro by mid-2008. Since then, however, the dollar has appreciated significantly vis-à-vis most other major currencies (except the Japanese yen) and moved to about $1.25 to the euro in the last quarter of 2008.

The rebound of the dollar was driven by a flight to safety

This sharp rebound of the dollar was mainly driven by the effects of a flight to safety as the global financial crisis intensified in September-October and spread to Europe and the rest of world. Many European financial institutions were suddenly found to be on the verge of collapse, the growth prospects for emerging economies were downgraded significantly, the prices of oil and other primary commodities tumbled, and many financial institutions, including hedge funds and mutual funds, either started to deleverage or were forced to redeem. All these factors, plus a heightened risk aversion in general, caused a massive move of financial assets worldwide into United States Treasury bills, driving their yields to almost zero and pushing the dollar sharply higher.[3] At the same time, however, the situation is pushing the external indebtedness of the United States to new heights, possibly precipitating a renewed slide of the dollar once the process of deleveraging has ended.

Consequently, the disorderly adjustment of the global imbalances and a hard landing of the dollar remain major downside risks to the global economy, as an accelerated fall of the dollar could cause renewed turmoil in financial markets. Investors might renew their flight to safety, though this time away from dollar-denominated assets, thereby forcing the United States economy into a hard landing and pulling the global economy into a deeper recession.

Weakening world trade and commodity prices

Prices of oil and non-oil primary commodities have also shown strong fluctuations during 2008, largely driven by financial factors, as well as shifts in the balance between supply and demand. The prices of most commodities rose sharply in the first half of 2008, continuing a multi-year upward trend that began in 2003. Food prices, especially the price of rice, surged the most in early 2008, leading to a food crisis in some 40 developing countries. Oil prices also soared by about 50 per cent in the first half of the year. While some commodity-specific factors on either the supply or demand side could explain part of the surge in these prices, a common factor had been the relocation of funds by investors from other financial assets towards commodity markets, along with the declining value of other financial assets.

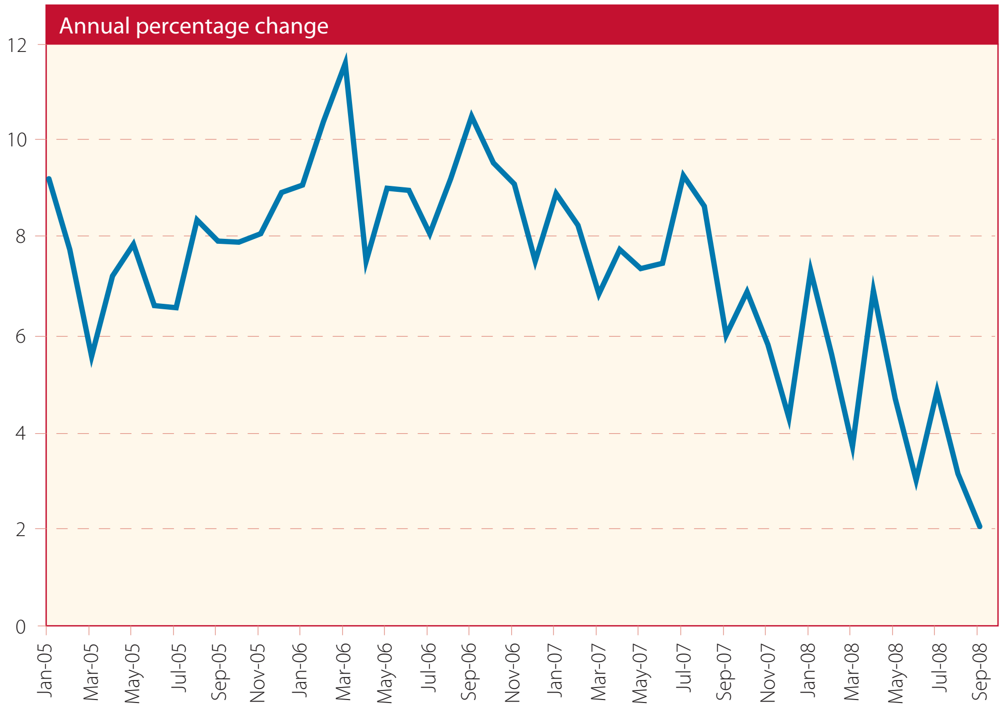
Commodity prices have starkly declined from mid-2008

These trends reversed sharply in mid-2008, however (see chapter II for details). Oil prices plummeted by more than 60 per cent from their peak levels of July to November. The prices of other commodities, including basic grains, have also declined significantly. In the outlook, most of these prices are expected to even out further along with the moderation in the global demand, but a cut in the supply of oil, as already indicated by the Organization of the Petroleum Exporting Countries (OPEC), may keep oil prices from falling.

Growth of world *trade* decelerated to 4.4 per cent in early 2008, down from 6.3 per cent in 2007, mainly owing to a decline in imports of the United States. United States imports, which account for about 15 per cent of the world total, have registered a decline in each 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 dropped to about 2 per cent by September 2008 to about one third of the rate of growth in the previous year (figure I.9). In the outlook, import demand in most economies is expected to diminish further, leading to a further weakening of growth in global trade in 2009 (see chapter II for more details).

3 The strengthening of the Japanese yen vis-à-vis the dollar, as well as other major currencies during the second half of 2008, can be explained mainly by two factors: the exposure of Japanese financial institutions was very limited, and the "carry trade" in foreign-exchange markets reversed. Over the past few years, traders in foreign-exchange markets had borrowed yen at very low interest rates to invest in government bonds denominated in other currencies paying much higher interest rates. Since mid-2008, however, as interest rates in other countries were also decreasing, the traders reduced "carry-trade" positions and repaid the loans in yen they had borrowed earlier, thus pushing up the exchange rate of the yen. Moreover, as the yen appreciated, the margin of returns on the "carry trade" were squeezed, forcing more traders to liquidate their positions and further pushing up the yen in an unstable spiral.

Figure I.9
Growth of world trade volume, January 2005-September 2008



Source: UN/DESA, based on data from the CPB Netherlands Bureau for Economic Policy Analysis online database, available from http://www.cpb.nl/eng/research/sector2/data/trademonitor.html (accessed on 21 November 2008).

A synchronized global downturn

Developed economies are leading the global downturn, the majority of them already experiencing a recession in the second half of 2008. Meanwhile, through international trade and finance channels, the weakness has spread rapidly to developing countries and the economies in transition, causing a synchronized global downturn in the outlook for 2009. Such a globally synchronized slowdown may be the first of its kind in the post-war era.

The crisis is likely to undo employment gains of recent years

The employment situation is expected to deteriorate in most regions during 2009 and much of the employment gains could be lost because of the global economic slowdown. Employment began to change course in many economies in the second half of 2008, with unemployment rising rapidly in some (the United States, for instance) as lower consumption, production and trade started to have an adverse impact on the demand for labour. The employment situation worldwide is expected to deteriorate more significantly in 2009.

Inflationary pressures are giving way to fears of deflation worldwide

Global inflation is expected to decelerate significantly in the outlook for 2009, with the risk for deflation increasing in some economies. Surging commodity prices, particularly those for oil and food, boosted global inflation in 2008, leaving consumer price inflation at its highest level in a decade. Inflation was markedly higher in developing economies and economies in transition than in the developed economies. In the second half of 2008, however, inflationary pressures dissipated rapidly following the steep fall in world commodity prices (despite the lag in the pass-through effect from international to domestic prices) and weakening demand worldwide. The projected economic downturn is expected to weaken inflationary pressures further in 2009, and the concern of policymakers should focus on staving off sharp downfalls in economic growth (figure I.10).

Figure I.10
Inflation versus growth in selected developed and developing countries, 2008[a] and 2009[b]

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

Developed economies

The United States economy is expected to decline in 2009

Among *developed economies*, the economy of the *United States* is expected to decline by 1 per cent in the baseline scenario for 2009. The most severe credit crunch since the Great Depression has turned a housing sector-led slowdown into a full-scale retrenchment of households and businesses, affecting the economy at large. Even though effective implementation of the Emergency Economic Stabilization Act (EESA), together with other measures, may eventually stabilize financial markets, it came too late to prevent a recession in the real economy. The unemployment rate is expected to rise above 7 per cent as job losses in almost all sectors of the economy increase sharply. Inflation, by contrast, is expected to abate notably. Should all the policy measures fail to unclog the credit markets soon, the United States most probably will suffer a much deeper and longer recession.

Japan is in recession and its economy will stagnate in 2009

Japan's economy is in a recession and is expected, at best, to stagnate in 2009. While the direct losses from the global financial crisis have been contained so far, the indirect effects are becoming increasingly significant, including those brought on by weakening external demand as well as the appreciation of the yen.

Major European countries are in recession

Since September 2008, the global credit crunch has transformed a sharp slowdown in *Western Europe* into a full-fledged recession, and the major European economies have technically entered into recession. Having lost all growth momentum, GDP is expected to contract further in the first half of 2009, with little likelihood of recovery in the second half, leaving a negative growth rate for the year as a whole. After a long period of improving labour market conditions, unemployment rates began to drift upwards from mid-2008 and are expected to move up further by nearly a full percentage point on average for the region as a whole in 2009. With activity slowing, and commodity prices falling well below their peaks of mid-2008, inflation is expected to decelerate significantly from the highs experienced during 2008. Risks continue to be slanted towards the downside, particularly as regards the effectiveness of current and anticipated policies in stabilizing financial markets.

Following several years of buoyant economic expansion throughout the entire region, the *new EU member States* exhibited divergent growth patterns in 2008. Domestic demand is weakening in response to higher credit costs and accelerated inflation, and export growth is also likely to decline. Growth is expected to weaken and inflation to moderate in 2009. While the new EU members are not directly exposed to the sub-prime loans of the United States, the region's banking system is subject to the shocks generated by the troubles among financial institutions in the EU-15. The high stock of short-term private debt in foreign currencies has already created a serious liquidity squeeze in Hungary. The risks for the region include a protracted slowdown in the EU-15, as well as a sharp reversal of capital flows.

In *other developed economies*, growth in both Australia and New Zealand are slowing as consumer demand has weakened owing to tighter credit conditions, higher inflation and falling asset prices. The Canadian economy will suffer from the economic slowdown in the United States, especially in sectors such as the automotive industry.

Economies in transition

Economies in transition will suffer a marked slow down

Among *the economies in transition*, growth of the members of the *Commonwealth of Independent States* (CIS) is heading for a marked slowdown in 2009, largely dragged by the impact of the 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. The smaller CIS economies will likely be affected by declining worker remittances and FDI inflows. The adverse effects of a domestic credit squeeze and increased costs of external financing will be significant on the real economy of the region, despite some recently adopted offsetting policy measures. The unemployment rate will increase in some countries, while inflation is set to moderate, although it could remain at elevated levels. Among the downside risks, a worse-than-expected growth in the Russian Federation would have recessionary effects on other members.

In *South-eastern Europe*, growth in 2008 continued to be largely driven by domestic demand, underpinned by rising real wages and the lasting credit boom, as well as by strong FDI inflows. With the global financial crisis, these growth factors have started to lose momentum. In view of the weak demand in their main export markets, it is also unlikely that the region would be able to switch to a more export-oriented pattern of economic growth in the short run. Therefore, a further moderation of economic growth is expected in 2009.

Developing countries

The crisis will hit growth prospects of developing countries hard

Developing countries will be hurt by the crisis through international trade and finance channels. The drop in commodity prices will hurt primary exporters in particular, but lower demand in the developed countries will affect export growth throughout the developing world. Some emerging market economies, such as Brazil, are already facing severe curtailments in access to trade credit, while the threat of a sudden reversal in private capital flows has heightened. The vast amounts of foreign reserves accumulated by developing countries still provide a buffer and allow some space for counter-cyclical measures, but these reserves could well dwindle rapidly as the global crisis deepens further. A growing number of developing countries have already witnessed a significant deceleration in economic growth. This, no doubt, is diminishing the prospects of achieving the Millennium Development Goals (MDGs).

Growth in Africa will suffer from lower commodity prices and weakening export demand

Growth in *Africa* is expected to decelerate to 4.1 per cent in 2009 from 5.1 per cent in 2008, as the contagion effects of the global economic slowdown spread throughout the region, while inflationary pressures continue to dampen consumer demand. Africa would be impacted through weakened export demand, lower commodity prices and a decline in investment flows to the region. Consequently, employment growth in Africa is anticipated to weaken, pushing unemployment rates higher and forcing more workers into the already large informal economy. Inflation is expected to subside from 2008 levels. Risks for greater growth retardation exist if donor countries do not live up to their aid commitments, threatening not only the achievement of the MDGs, but also undermining past progress.

Growth in East Asia is affected by the weakening of global demand and the global credit crunch

Growth in *East Asia* is expected to decline notably in 2009, as exports will decelerate significantly. Some economies in the region will also experience sizeable financial losses as a result of their relatively high exposure to global financial markets. An outflow of capital from this region will further intensify the difficulties experienced by the local financial institutions. Inflation in the region is expected to moderate, and the employment situation will start to deteriorate. Further monetary easing is expected in the region, and most countries have enough policy space to adopt more expansionary fiscal policy necessary for stimulating domestic demand. Some countries, such as China and the Republic of Korea, have already taken action in that direction.

Capital outflows and waning investor confidence dim growth prospects in South Asia

South Asia is experiencing an overall slowdown in economic growth from the industrial sector to the service sector as a result of the negative impact of higher costs and the global financial turmoil. Inflation is forecast to moderate in view of the retreat in energy and food prices, resulting in lower pressure on government budgets related to price subsidies. During 2008, external balances suffered from higher import prices for fuel oil, food and other commodities, although continued solid remittances exerted a certain stabilizing effect in this regard. The financial sector in the region has had only very limited direct exposure to the global financial crisis, but the tightening in liquidity emerged as a major indirect impact. In parallel to this, waning investor confidence has led to capital outflows and shrinking foreign-exchange reserves. A number of downside risks include a more prolonged slowdown in global growth, unsustainable fiscal balances and current accounts, natural disasters and political instability. Pakistan is a case in point where all of these factors have already come to a head.

Lower oil prices and the global slowdown affect growth prospects in Western Asia

Growth in *Western Asia* is anticipated to slow down significantly in 2009, to the lowest rate in seven years. The region will register a sharp decline in export revenues as average annual oil prices are expected to drop. Lower oil revenues and deteriorating credit conditions in the countries of the Gulf Cooperation Council (GCC) are likely to trigger a delay of large investment projects throughout the region. Facing large current-account deficits, the economies of Jordan, Lebanon and, in particular, Turkey appear to be the most vulnerable to a drop in FDI inflows and tighter financing conditions. By contrast, strong fiscal and external positions will allow authorities in GCC countries to maintain an expansionary fiscal policy stance in order to weather the economic downturn. While labour markets have already started to deteriorate in a number of countries, most pronouncedly in Turkey, the high inflation rates throughout the region are expected to decline moderately.

Latin American and Caribbean economies will slow markedly in 2009

Economic growth in *Latin America and the Caribbean* is expected to slow markedly in 2009. The key drag is the fall in commodity prices. In addition, domestic credit is expected to tighten in many economies. Inflationary pressures, which surged during 2008 owing to the increasing costs of energy, transportation and food, should decelerate in 2009, but Governments of the region may not be able to ease monetary policy in the face of currency depreciation. Stimulus will have to come through counter-cyclical fiscal policies, for which most countries have some room to manoeuvre given improvements in external and fiscal positions in preceding years. However, the region remains very vulnerable to an intensification of the global credit crunch, particularly a sharper reversal of capital inflows and a further decline of external demand.

Macroeconomic policies to stimulate the global economy

Policy responses have fallen well behind the curve

In general, policymakers worldwide have underestimated the depth and breadth of this financial crisis. As a result, policy actions by and large fell behind the curve, and early on policy stances were grossly inadequate for handling the scale and the nature of the crisis. In Europe and the United States, policies initially focused almost exclusively on providing additional liquidity to financial markets and were myopic to the greater underlying risk of insolvency of large financial institutions. Later, in September 2008, when policy measures moved towards the bailout and recapitalization of those important financial institutions seen to pose systemic risks, the economies of most developed countries had already entered into recession. Policymakers in emerging economies were in turn complacent about the resilience of their economies, believing they would be sufficiently insulated from the financial sector woes of the United States and Europe. Until the fourth quarter of 2008, containing inflation was their main concern in setting macroeconomic policy, and they were caught by surprise when the crisis rapidly spread to hit their economies also in October 2008.

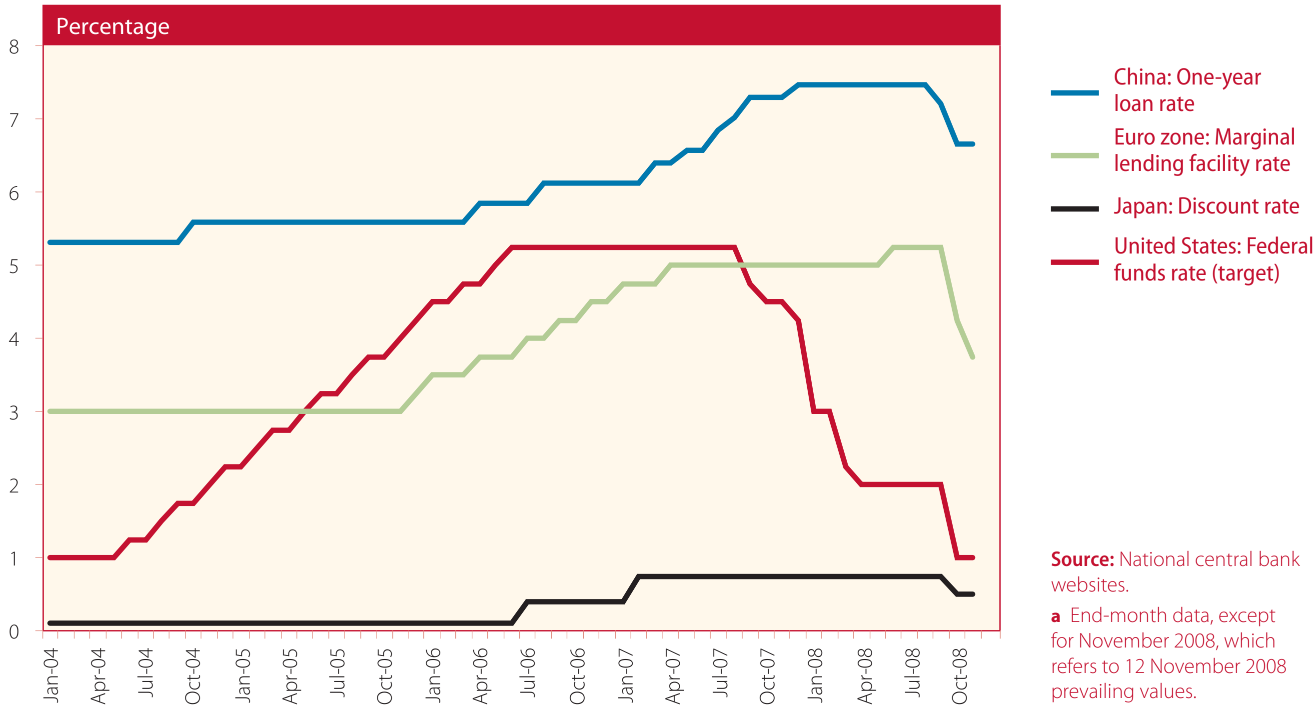
Monetary policies became aggressively expansive….

In the first half of 2008, *monetary policy* in the United States was aggressively expansive in attempts to stave off a recession, while central banks in Europe maintained a tightening stance over inflationary concerns. Only after the risk of a systemic failure in global financial markets became manifest, did six major central banks—the Fed, the ECB, the Bank of England, the Bank of Canada, the Swiss National Bank and the Swedish Riksbank—decide to move in a more coordinated fashion and agree to cut their respective official target rates simultaneously by 50 basis points (bps). At the same time, the Fed and other major central banks also scaled up their unorthodox measures to inject liquidity more directly into financial markets, particularly credit markets. Since then, more central banks have followed suit, some of them reducing interest rates drastically (figure I.11). Further monetary easing is expected in the world economy in the outlook for 2009.

…. but a liquidity trap is now looming

During October 2008, some retreat in the spread between the interbank lending rate and the return on Treasury bills was observed in the United States. Yet, tighter-than-normal credit conditions continued to strain markets into the fourth quarter. The macroeconomic situation now resembles the liquidity trap in which Japan found itself during the 1990s and into the 2000s, rendering monetary policy ineffective as nominal interest rates near zero. With consumer and business confidence seriously depressed and banks reluctant to lend, further lowering of interest rates by central banks would do little to stimulate credit supplies to the non-financial sector or encourage private spending.

Figure I.11
Policy interest rates of major economies, January 2004-November 2008[a]



Source: National central bank websites.

a End-month data, except for November 2008, which refers to 12 November 2008 prevailing values.

Rather, it would end up expanding base money within the banking system. With limited space for monetary stimulus, fiscal policy options will need to be examined as ways to reactivate the global economy.

Fiscal stabilizers in developed countries are too weak

Many developed economies have a certain built-in counter-cyclical budgetary stance by virtue of so-called "automatic stabilizers". For instance, during a recession, tax revenue tends to fall while unemployment benefits and welfare transfers increase, leading to a more expansionary fiscal stance. These automatic stabilizers may well be too weak to counteract the recessionary effects of the large-scale financial crisis that is currently raging. Additional discretionary fiscal measures will be needed. 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 believed the package had worked well to keep the economy buoyant for at least one quarter, others doubted its effects would be more permanent. It is now clear that the size of the fiscal package was too small in comparison with the seriousness of the situation, and it failed to sustain its effects. A second fiscal stimulus package is under discussion in the United States, as well as in some European economies.

Strong additional fiscal stimulus is needed

Governments are hesitant to move quickly on such stimulus packages, fearing possible negative repercussions in the medium run from a further widening of fiscal deficits, which are already ballooning as a result of the emergency fiscal measures to recapitalize the financial institutions and the workings of automatic stabilizers. These are not normal times, however. The severity of the financial crisis calls for policy actions that are commensurate with the scale of the problem and should thus go well beyond any normal range of budgetary considerations.

A large number of developing countries and the economies in transition have not been easing monetary policy so far over concerns of inflationary pressures and currency depreciation. Most Latin American economies and many economies in transition, as well as several Asian developing countries, have either further increased policy interest rates or kept them constant in late 2008. Inflation has remained high in these countries in part because of the lags in the pass-through effect of the rise in energy and food prices during the first half of 2008. Inflation also remained a concern during the third and fourth quarters of 2008 following the strong depreciation of the countries' currencies on the heels of a strengthening dollar, as discussed above. Inflationary pressures should taper off during 2009, however, as world food and energy prices are 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 still possessing ample foreign-exchange reserves. Most developing countries and the economies in transition have weak automatic stabilizers; hence, much of the stimulus would depend on discretionary fiscal measures.

Counter-cyclical fiscal policy is also needed in developing countries

The scope for a counter-cyclical stance will vary greatly across developing countries. 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 will thus require a departure from existing policy practice and policy rules in such cases. Second, not all countries possess equally sufficient foreign-exchange reserves, and some are likely to suffer stronger balance-of-payments shocks. Some countries still have ample policy space for acting more aggressively to stave off crisis. China has already begun to use its policy space and has designed a large-scale plan of fiscal stimulus which could potentially contribute to reinvigorating global demand. The fiscal stimulus package of $586 billion (or 15 per cent of China's GDP), to be implemented during 2009 and 2010, is aimed at strengthening domestic demand through investment in public infrastructure and social transfers, and would rebalance an economy that is facing a likely increase in excess capacity of manufacturing export production in the wake of a declining external demand.[4] The Republic of Korea has also announced a fiscal stimulus package equivalent to 1 per cent of its GDP.

For many middle- and low-income countries, the scope for conducting such policies will be even more limited as they may see their foreign-exchange reserves evaporate quickly, to the extent that they are hurt by either sharp capital reversals or strong reductions in the demand for their exports, 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 as a result of the global financial crisis.

Fiscal stimulus in response to the crisis should be aligned with long-term development goals

Over the longer 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 and thereby help them to meet key development goals, including reaching greater food security, addressing climate change and meeting the MDGs. This will require massive resources for public investments in infrastructure, food production, education and health, and renewable energy sources. Box I.3 exemplifies this challenge as it relates to the investment requirements for dealing with the global food crisis. In the case of energy and climate change, it should be expected that with the global downturn, demand for oil (and energy in general) will fall in the short run, likely leading to a drop in greenhouse gas (GHG) emissions (see appendix table A.22). Since this would simply be the result of a cyclical downturn, however, it should not provide a deterrent to making the necessary long-term investments to reduce the energy intensity of production worldwide and shift radically away from the use of fossil fuels towards sustainable energy sources. The crisis presents a unique opportunity to align fiscal stimulus packages with long-term goals in favour of sustainable development.

Internationally coordinated fiscal stimulus will be more effective

Furthermore, to ensure sufficient stimulus at the global level, it will be desirable to coordinate the fiscal stimulus packages internationally. In a strongly integrated world economy, fiscal stimulus in 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, thereby providing greater stimuli to both the global economy and the economies of individual countries.[5] As in the case of 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 achieve, both technically and politically, and hence may be difficult to settle through ad hoc agreements, requiring instead a more institutionalized platform (see below). As a consequence, the baseline forecast does not foresee the emergence of fully coordinated fiscal stimuli any time soon. Should this come about more quickly, however, as in the more optimistic scenario (see box I.1), the

4 Policy directions of that nature were also suggested for China in *World Economic Situation and Prospects 2007* (United Nations publication, Sales No. E.07.II.C.2) and *World Economic Situation and Prospects 2008* (United Nations publication, Sales No. E.08.II.C.2). For a more detailed discussion of fiscal stimulus in China to redress the global imbalances, see Pingfan Hong, Rob Vos and Keping Yao, "How China could contribute to a benign global rebalancing", *China and the World Economy*, vol. 16, No. 5, September-October 2008, pp. 35-50.

5 For an example of the output effects of coordinated fiscal policies, see *National Institute Economic Review*, vol. 206, No. 1, October 2008, which suggests that coordinated policies could increase the multiplier effects of fiscal stimulus by at least 30 per cent.

Box I.3

Don't forget the food crisis

In spite of falling international commodity prices, the food crisis still exists and high price levels will remain, at least in the short term. In addition, the global financial crisis threatens to worsen the situation. The present food crisis, which started in early 2008, was triggered by rapidly rising international prices of grains, propelled by a series of short-term factors forming a "perfect storm"; more importantly, however, many underlying longer-term factors had been brewing in the market for some time, making the crisis inevitable (see chapter II).

According to the Food and Agriculture Organization of the United Nations (FAO), there are currently still 36 countries in critical situations owing to exceptional supply shortfalls, general lack of access or severe localized food insecurity of displaced populations requiring immediate food assistance.[a] Most of these countries have not seen their situation improve, and in some cases the situation has worsened because of persistent high prices, as food prices have been sticky on the downside and the dollar appreciation has offset some of the price effects of falling commodity prices. Adverse weather conditions, political strife and worsening economic conditions in the face of a global economic slowdown are also prevalent. Between 109 million and 126 million people may have fallen below the $1 per day poverty line since 2006 owing to the increase in food prices, with the vulnerable populations located in South Asia and sub-Saharan Africa.[b] All else being equal, the incidence of extreme poverty in sub-Saharan Africa may have risen by almost 8 percentage points, implying that the recent food price increases have more than offset the poverty reduction achieved between 1990 and 2004.

On the macroeconomic side, about 50 low- and middle-income countries are experiencing a weakening of their balance of payments and are expected to remain vulnerable through 2009.

Inflationary pressures, which had been present prior to the food price surge because of higher oil and non-food commodity prices, as well as rising domestic demand in the oil-exporting economies, were exacerbated by the rising food prices. The surge in world market prices for grains had immediate pass-through effects on domestic food prices. Given the large weight of food in the consumer price index (CPI) in most developing economies, this sent headline inflation soaring. The International Monetary Fund (IMF) has noted that annual food price inflation for 120 low-income and emerging market economies had risen by 12 per cent at the end of March 2008, up from 10 per cent three months earlier.[c]

Net food importers were the most affected by the rising prices, causing deterioration in their terms-of-trade and current-account balances. Africa saw its net food imports increase to 1.6 per cent of gross domestic product (GDP) in 2007. Countries in sub-Saharan Africa (excluding South Africa) imported 1.9 per cent of GDP worth of net food imports. Latin America and the Caribbean as a whole had net food exports owing to South American exporters, but food imports of Central America and Mexico accounted for 0.6 per cent of GDP, while the Caribbean imported 3.7 per cent of its GDP in food. Relatively, Western Asia's net food imports were the highest in the Asian region.

Prices of grains started to decrease starkly from mid-year 2008. The emerging financial crisis has been one factor in this regard, as speculators started to retreat from commodity markets to salvage asset positions in the financial system. The related dollar appreciation (see main text) and the falling price of oil have compounded the drop in international grain prices. Shifts in the supply and demand for grains have also pushed prices downwards. These could continue to decline now that the production of cereals has recovered, caused in part by better weather conditions and also since the global demand for grains is weakening with the worldwide economic slowdown. The sharp decrease in the price of oil may weaken incentives to further increase biofuel production, which had been an important factor in pushing up the demand for grains in recent years. However, the average price levels of rice, corn and wheat, the three most-consumed grains, will still be substantially higher in 2008 compared to 2007, but are expected to decline in 2009. The observed high price volatility, however, may be detrimental to long-term investment in the production of grains and could sustain conditions of food insecurity for some time to come, unless counteractive measures are taken.

a Food and Agriculture Organization of the United Nations, *Crop Prospects and Food Situation*, No. 4, October 2008.

b Based on UN/DESA estimates.

c International Monetary Fund, "Food and Fuel Prices—Recent Developments, Macroeconomic Impact, and Policy Responses", report prepared by the Fiscal Affairs, Policy Development and Review and Research Departments, 30 June 2008.

Box I.3 (cont'd)

The massive underinvestment suffered by the agricultural sector over the past two decades must be compensated for. In order to return to the levels of three decades ago, government spending in agriculture would need to double or triple in most developing countries. The United Nations, through its High-Level Task Force on the Global Food Security Crisis, has proposed a Common Framework of Action (CFA)[d] as a comprehensive strategy for tackling the crisis. The CFA estimates that an additional $25 billion to $40 billion will have to be invested every year, financed through domestic resource mobilization and official development assistance, for food and nutrition security, social protection, agricultural development and a better functioning of food markets. According to CFA estimates, approximately one third of the resources would be needed for immediate food assistance and short-term budgetary and balance-of-payments support, and the rest for investments in rural infrastructure, education, clean water and agricultural research. The largest sums need to be invested in South Asia, followed by Latin America, although on a per capita basis, Africa will require the greatest investment push.

The present commitments by the international community still fall short of bridging the gap identified in the CFA. In order to regain lost ground in reducing rural poverty, initial support and reform programmes should be targeted at small producers of food, especially those in sub-Saharan Africa, since they are the most vulnerable and least-productive group. It has been estimated, for instance, that if all Asian countries could manage to lift agricultural productivity to the present yield levels of Thailand, one third of the region's mostly rural poor—or about 220 million people—could be lifted out of poverty.[e]

In view of the present global financial crisis, it is more important than ever to strengthen the development finance architecture, not only to limit the negative effects of such crises and to enable countries to respond effectively, but also to ensure that the internationally agreed development goals can be met without diverting either external or domestic resources away from ensuring food security. The key challenge is to secure adequate resources for the necessary long-term investments in agriculture and rural development through better coordinated support from the international community which can be sustained over an extended period of time.

d See http://www.un.org/issues/food/taskforce/Documentation/CFA%20Web.pdf.

e United Nations Economic and Social Commission for Asia and the Pacific, Economic and Social Survey of Asia and the Pacific 2008: Sustaining Growth and Sharing Prosperity (United Nations publication, Sales No. E.08.II.F.7).

recessionary effects of the financial crisis could be contained to a considerable degree during 2009 (see table I.1 and figure I.1).

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

The need for reform of the international financial system

Systemic failures

Even in the most optimistic scenario, it will take time before confidence is restored in financial markets and recovery can take place. As immediate solutions are being worked out, it remains important to understand the systemic causes of the present crisis, which—in a nutshell—relate to weaknesses in global economic governance, excessive financial deregulation, the problem of global (current- and capital-account) imbalances and related systemic shortcomings in the international reserve system and the lack of an international lender of last resort. Understanding these deeper causes makes it clear that much more fundamental change is needed to reform the international financial system in order to provide better safeguards for preventing a recurrence of the present crisis and to create a framework for global economic governance in line with twenty-first century realities.

The need for systemic reforms is now widely recognized

World leaders have acknowledged this need for reform. Proposals for reforming the economic governance architecture should be addressed, through, among other things, the appropriate organs of the United Nations system, including the Bretton Woods institutions. The reform discussion on new rules for governing the global economy needs to be embedded in the wider United Nations system so as to ensure that a more inclusive and open exchange of ideas, in line with democratic governance principles, informs the debate and that any reforms adopted are owned by the full membership of the international community. The same kind of visionary multilateral spirit that informed the discussion in Bretton Woods in 1944 and San Francisco in 1945 is needed today, one which recognizes that peace, stability and prosperity are indivisible and that delivering these goals requires fundamental reforms of the international financial architecture.

Lack of credible mechanisms for international policy coordination

"Beggar-thy-neighbour" policies in the 1930s aggravated the depression of the 1930s

The immediate priority in today's context is to prevent the global financial crisis from turning into a 1930s-style Great Depression. As discussed in the previous section, and as recognized by most parties, this requires internationally concerted policy actions. The first of these major systemic failures is the lack of an institutionalized and credible mechanism for such policy coordination. The depression of the 1930s had been aggravated by "beggar-thy-neighbour" policies, disintegration of the global economy and resurgent protectionism. More than a decade later, under the promise "never again", it led to the design of the Bretton Woods system, including the creation of the IMF and the World Bank as institutions to safeguard the stability of the global economy and to promote growth, employment and development. But over time, the ability of the IMF to safeguard the stability of the global economy has been hampered by, among other things, limited resources and 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) and the Group of Eight (G8), have become the platforms where international policy coordination has taken place in practice.

The lack of a credible mechanism for policy coordination is limiting adequate responses to the crisis

As a consequence, the IMF has, by and large, been sidelined in handling the present crisis. The apparent irrelevance of the Bretton Woods institutions in today's crisis also stems from their skewed voting structures and governance, which are more reflective of the distribution of economic power in the world that prevailed in 1944 than of the present day, where developing countries carry much larger weight. Also, developing countries as a group are net creditors to the rest of the world, and their savings will quite likely provide, directly or indirectly, a major source of funding to cover the costs of the multi-trillion-dollar bailouts of financial institutions in the United States and Europe. Quite apart from this, they clearly have an abiding interest in taking an active part in any concerted solution. The lack of a credible mechanism with broad representation for international policy coordination reflects an urgently felt lacuna which is limiting swift and effective responses to the present crisis.

Inadequate financial regulation

Deregulation has induced greater global financial fragility

Second, this crisis is systemic in nature both because it has affected all financial institutions and markets simultaneously and because it has spread to the real economy. To a significant degree, this has been a result of the dismantling of firewalls within and across financial sectors over the past two decades. This was part of a relentless drive to promote efficient and innovative financial markets which were expected to better manage risk ("securitization"); instead—as it has turned out—the deregulation added to global financial fragility. Particularly critical has been the pace and reach of new financial instruments which were encouraged despite the glaring absence of international surveillance and regulations.

Four key areas of deficiencies in the international financial regulatory framework need to be addressed

It is generally the case that international regulation lags behind domestic regulation because of the inherent difficulties in designing standardized "rules of the game" across a large number of countries. But the problem has been amplified for four main reasons:

a) The new approach to the regulation of finance, including under the New Basel Capital Accord (Basel II) rules, places the burden of regulation on the financial institutions themselves. This has generalized the problem of moral hazard, caused by a belief that as long as financial institutions are expanding their international operations they would be deemed too big to fail by (national) central banks, and has encouraged the proliferation of irresponsible behaviour across a range of financial institutions. The hypertrophying of Iceland's financial system to ten times the size of its national GDP is an extreme example of this trend.

b) The more complex the trade in securities and other financial instruments, the greater the reliance on rating agencies who proved inadequate for 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. In consequence, 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. The lack of supervision and regulation of the quality of rating agencies, as much as of the operations of most non-bank financial institutions and of the transactions through offshore financial centres, has further encouraged reckless risk-taking.

c) Existing approaches to financial regulation tend to act pro-cyclically, hence exacerbating a credit crunch during a crisis. This also applies to the international standards set by Basel I and Basel II rules and is most clearly the case for loan-loss provisions based on current rates of loan delinquency. 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. Similar difficulties also apply to capital charges. Banks typically lose equity when an economy is hit by a massive exit of capital, hikes in interest rates and declines in the currency. Enforcing capital charges under such conditions would only serve to deepen the credit crunch and a recession. This was the case in Asia during the 1997-1998 financial crisis, as a result of extensive efforts to strengthen regulatory regimes as part of the IMF packages of financial support.

d) 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 credit freeze that spreads to the business sector, which in turn makes that sector increasingly vulnerable. The risk models applied by regulatory agencies typically disregard such "contagion" effects and, consequently, may fail to foresee the systemic risks posed by the failure of one or the other financial institution. The growing interaction among markets implies, in fact, that correlation of market swings has increased, limiting the room for effective risk diversification.

Improved financial regulation needs to be complemented with counter-cyclical macroeconomic policies

The regulatory deficit has made all these problems more severe. The basic implication for prudential regulation, which has been largely ignored in the past, is simple: since the basic problem of financial markets lies in strong cyclical swings, the basic objective of prudential regulation and supervision should be to introduce strong counter-cyclical rules to complement and fortify counter-cyclical macroeconomic policies.

The dollar as the reserve currency

The use of the dollar as the global reserve currency is an intrinsic source of instability

The third systemic failure is the world's reliance on one single national currency—the United States dollar—as the major reserve currency. The Bretton Woods system originally gave the dollar this central role as part of a system of fixed exchange rates. The new system was put to a major test in the late 1960s when the United States was running large budget and current-account deficits, caused to a significant extent by the escalating costs of the Vietnam War and an increasingly overvalued dollar. The deficits were financed by the large current-account surpluses leading to high dollar reserve accumulation in Germany and most of the rest of Europe, and Japan. The ensuing monetary growth led to a rise in inflation and a rise in commodity prices worldwide, making the holding of low-yielding dollar assets less attractive and making the "dollar standard" of fixed exchange rates untenable. In 1971, the growing imbalances led to the collapse of the Bretton Woods "dollar standard" regime and a shift to flexible exchange rates for major currencies, followed by almost a decade of stagflation and a weakening dollar.

The dollar remained as the de facto world reserve currency and, as indicated, a similar pattern has been building up over the past decade: the United States has run up rising budget and external deficits stimulated by far-reaching financial deregulation, and these deficits were conveniently covered through loose monetary policy and mounting reserve accumulation in surplus countries, this time not just in Europe and Japan, but most importantly also in China and other parts of developing Asia as well as in major oil-exporting countries, many of which have in practice managed exchange-rate regimes with their currencies pegged to the dollar.[6] Strong export-led economic growth, especially in Asia, has fed renewed commodity price inflation and loose monetary policy in the United States and has elsewhere cheapened the cost of borrowing, leading to accelerated credit growth and feeding an asset price bubble worldwide. The risks of this global growth pat-

6 This is officially the case in China and with most of the oil exporters in the Middle East. Many Asian countries formally moved to a flexible exchange-rate regime after the 1997-1998 financial crisis. In practice, however, in attempts to avoid a strong appreciation of those currencies that had collapsed during the crisis as part of export-led growth strategies, most countries have managed their currencies.

tern were conveniently ignored. Moving forward, the same problems will persist if not adequately addressed. Also, as argued above, the risk of a hard landing of the dollar will remain high even after confidence in financial markets has been restored, as the problem of the global imbalances will not automatically disappear as a result.

Inadequate liquidity provisioning

The tendency of accumulating vast amounts of foreign currency reserves in developing countries has its roots in more fundamental deficiencies of the international monetary and reserve system. Improved prudential capital-account regulation can help reduce the need for and the cost of self-insurance via reserve accumulation. The need for self-insurance can be further reduced with more effective mechanisms for liquidity provisioning and reserve management at the international level, both regionally and multilaterally (see below).

Existing mechanisms for liquidity provisioning are inadequate

Current mechanisms are limited in coverage, too narrowly defined, or subject to unduly strict conditionality.[7] The establishment in 1997 of the Supplemental Reserve Facility provided some collective insurance to countries hit by capital-account crises, but the Facility did not provide enough protection in the case of a typical sudden reversal in capital flows; when it was first used in the Republic of Korea, it did not prevent an economic implosion there, possibly because it was accompanied by pro-cyclical policy conditionality. The Contingent Credit Line (established in 1999) remained unused and expired in 2003, and little has been done to revitalize the Compensatory Financing Facility (established in 1963), which provided liquidity to developing countries to manage terms-of-trade shocks.

In October, the IMF proposed establishing a Reserve Augmentation Line as part of the Supplemental Reserve Facility to provide emergency liquidity to members who have strong macroeconomic policies, a sustainable debt situation and proven credibility in policy implementation, but who are still faced with shocks through the capital account. To overcome the potential stigma associated with the Facility, there is a need to enhance the reliability of access to financial resources and reinforce positive signalling to markets. A significant number of emerging market members should qualify based on the information available from past IMF Article IV consultation reports. Allowing automatic front-loaded drawing of up to 500 per cent of quota for eligible members, based on simple and transparent guidelines, would send a clear signal to private markets that the line is an insurance facility. If such a mechanism could emulate the lender-of-last-resort functions of central banks, it could reduce the demand for high reserve build-up in developing countries. This in turn could create more policy space in developing countries by offloading pressures towards exchange-rate appreciation.

More generally, all IMF facilities should be significantly simplified and include more automatic and quicker disbursements proportionate to the scale of the external shocks, without onerous policy conditionality attached to them. Recent action has been undertaken in this direction with the reform of the IMF Exogenous Shocks Facility. But total resources remain limited and more is needed to provide collective safeguards for large-scale crises.

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7 See, for example, Stephany Griffith-Jones and José Antonio Ocampo, "Compensatory financing for shocks: what changes are needed?", background paper prepared for the tenth session of the Committee and Development Policy, March 2008, available from http://www0.gsb.columbia.edu/ipd/pub/CompensatoryFinancing_24apr_sgj_topost.pdf; and *World Economic and Social Survey 2008: Overcoming Economic Insecurity* (United Nations publication, Sales No. E.08.II.C.1), chapter II.

The way forward

In today's world of increased economic and political interdependence, achieving a broad-based, rapid and sustained growth in incomes and employment involves even more complex policy challenges than in the past. Certainly, the external environment of developing countries has undergone a number of fundamental changes that are unlikely to be reversed in the foreseeable future. The multilateral arrangements designed at Bretton Woods in 1944 did not include a global regime for capital movements, given that capital mobility was expected to be limited. However, no such regime has emerged even after the breakdown of these arrangements, and despite the surge in private capital flows. In the aftermath of the Asian crisis, various codes and standards were established through international institutions, not just with respect to the financial sector, but also with regard to auditing and accounting, data collection and so on. While these could have benefits over the longer term, they will not necessarily contribute to financial stability, and in many cases they will involve substantial costs.

Another major outstanding challenge for the international financial institutions is to help developing countries mitigate the damaging effects of volatile capital flows and commodity prices and provide counter-cyclical financing mechanisms to compensate for the inherently pro-cyclical movement of private capital flows. A number of options are available to dampen the pro-cyclicality of capital flows through better macroprudential regulation and the provisioning of counter-cyclical multilateral financing, and thereby help create a better environment for sustainable growth and poverty reduction.

An inclusive, multilateral system of global economic governance is needed

The failure to create a truly inclusive system of global economic governance—for adequate counter-cyclical policies in the short term and appropriate regulatory reform in the medium term—has frustrated a coordinated, comprehensive and inclusive international response to the current crisis. These flaws were also recognized during the financial crises in emerging markets in the 1990s, but relevant proposals for reform did not lead to much change in actual practice.[8] The failure of the international community to draw lessons from the financial crises of the 1990s is now proving to be highly costly.

There is no legitimate forum, other than the United Nations itself, in which the interests of all countries can be articulated, considered and reconsidered to ensure more inclusive and equitable—and thus credible and effective—global economic governance. A decade after the collapse of the inter-war international financial system, the 1944 Bretton Woods Conference, which created the IMF and the World Bank, formed part of the new post-war system of inclusive multilateralism, led by the United Nations.

Systemic reforms need to focus on four core areas

This is not the place to provide a blueprint but given the existing systemic flaws, it seems paramount that deliberations on a new international financial architecture should address at least four core areas of reform:

a) The establishment of a credible and effective mechanism for international policy coordination.[9] To guide a more inclusive process, adequate participation and representation of developing countries in the process of policy coordina-

8 For one of many elaborate reform proposals, see, for instance, José de Gregorio, Barry Eichengreen, Takatoshi Ito and Charles Wyplosz, *An Independent and Accountable IMF*, Geneva Report on the World Economy No. 1 (Geneva: International Center for Monetary and Banking Studies, and London: Centre for Economic Policy Research, September 1999).

9 This could be carried out along the lines suggested in *World Economic Situation and Prospects 2007* (United Nations publication, Sales No. E.07.II.C.2), pp. 24-34.

tion and in the institutions of global governance is required, implying the need for a fundamental revision of the governance structure and functions of the IMF and the World Bank;

b) Fundamental reforms of existing systems of financial regulation and supervision leading to a new internationally coordinated framework that can avoid the excesses of the past;

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—which avoid the onerous policy conditionality attached to existing mechanisms.

Such reforms will not easily find consensus among all stakeholders, 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.