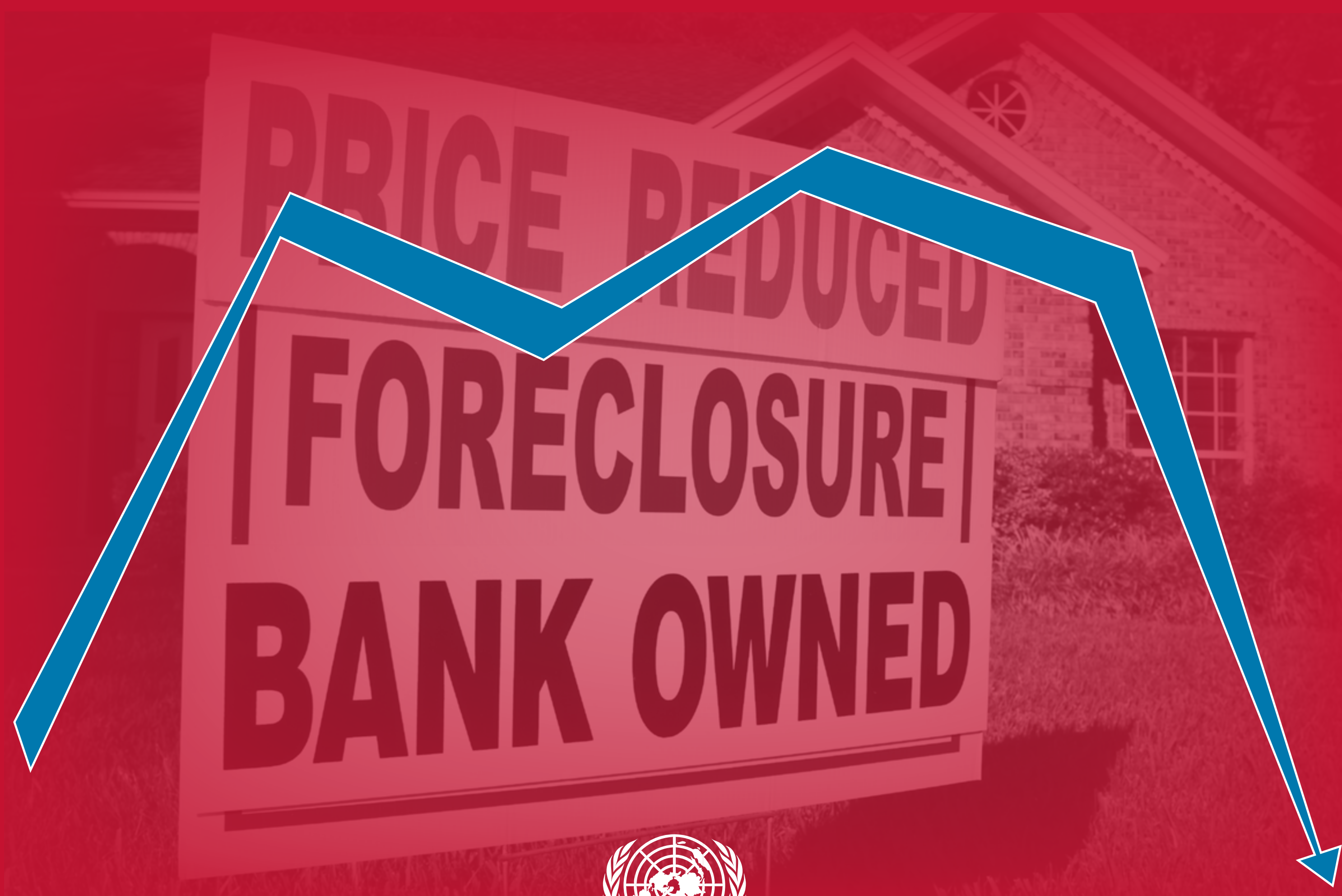
World Economic Situation and Prospects 2009



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Executive Summary

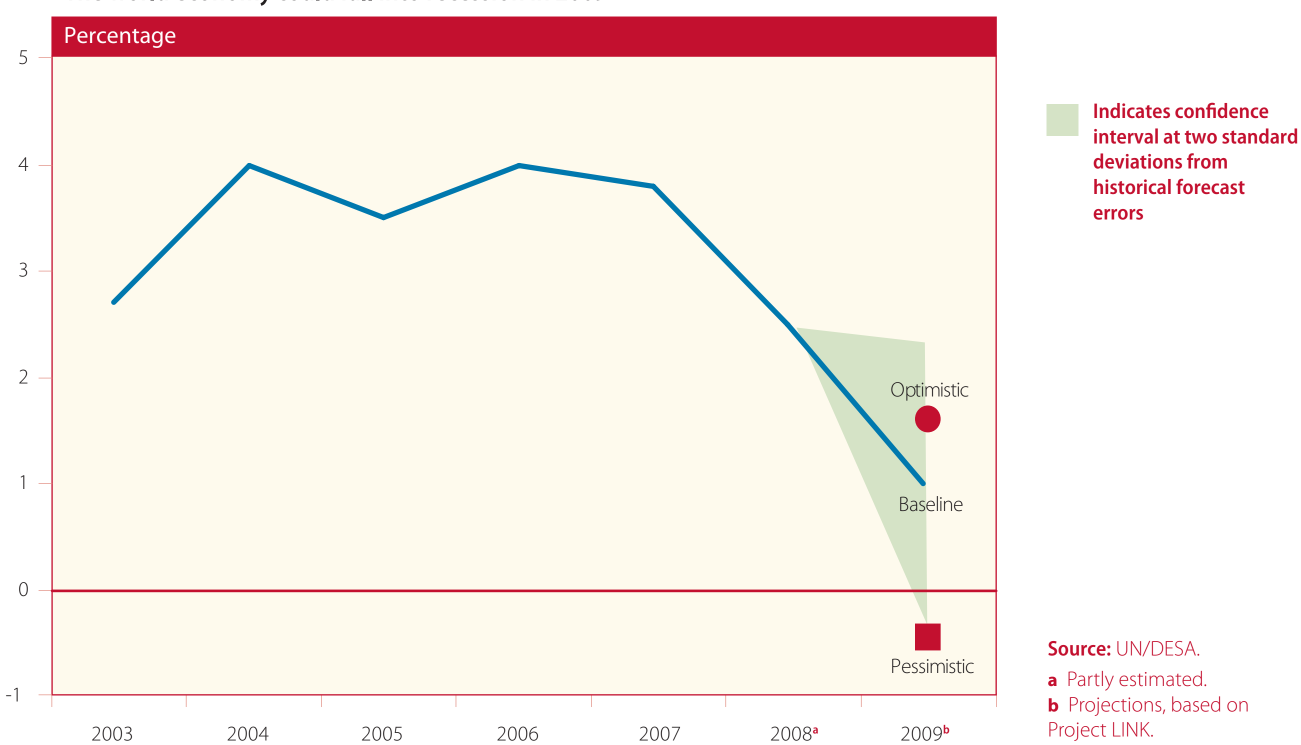
The global outlook

The world economy is entering into a recession

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

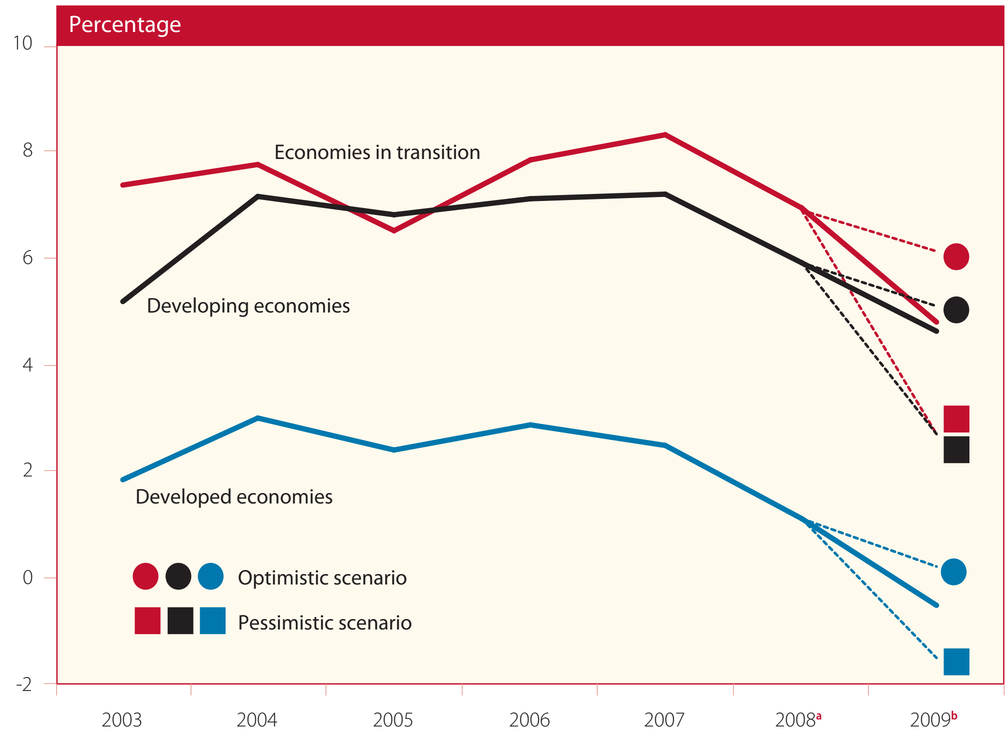
In the baseline scenario of the United Nations forecast, world gross product is expected to slow to a meagre 1.0 per cent in 2009, a sharp deceleration from the 2.5 per cent growth estimated for 2008 and well below the more robust growth of previous years. At the projected rate of global growth, world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

The world economy could fall into recession in 2009



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

Synchronized global slowdown, led by a recession in developed countries



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

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

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

Origins of the global financial crisis

The story of a crisis foretold

The intensification of the global financial turmoil in September-October 2008 revealed the systemic nature of the crisis and heightened fears of a complete global financial meltdown. Although the problems originated in the major developed countries, the mounting financial fragility was closely tied to an unsustainable global growth pattern that had been emerging as far back as the early 2000s, a risk forewarned early on in previous issues of *WESP*. As part of this pattern, growth was driven to an important extent by strong consumer demand in the United States of America, stimulated by easy credit and underpinned by booming house prices as well as very high rates of investment demand and strong export growth in some developing countries, notably China. Growing United States deficits in this period were financed by increasing trade surpluses in China, Japan and other countries that had accumulated large foreign-exchange reserves and were willing to buy dollar-denominated assets.

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

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

Policymakers worldwide have taken unprecedented measures to deal with the crisis …

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

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

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

Implications for world trade and finance

Commodity prices have become increasingly volatile …

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

… and prospects for world trade are bleak

Growth of world *trade* decelerated to 4.3 per cent in early 2008, down from 6.4 per cent in 2007, owing mainly to a decline in imports by the United States. United States imports, which account for about 15 per cent of the world total, have registered a decline in every quarter since the fourth quarter of 2007 and dropped as steeply as 7 per cent in the second