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World Economic Situation and Prospects 2009

Update as of mid-2009*

United Nations
New York, 2009

* The present document updates *World Economic Situation and Prospects 2009* (United Nations publication, Sales No. E.09.II.C.2), released in January 2009.

http://www.un.org/esa/policy/wess/wesp.html

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Summary

Faced with the worst recession since World War II, the United Nations' baseline forecast for world economic growth has been revised downward compared with the pessimistic scenario of the ***World Economic Situation and Prospects 2009*** published in January. The world economy is expected to shrink by 2.6 per cent in 2009 after an expansion of 2.1 per cent in 2008 and nearly 4 per cent per year during 2004-2007. While a mild recovery is expected in 2010, risks remain on the downside. Developing countries are disproportionately hard hit by the crisis.

The global policy response has been unprecedented, including monetary, financial and fiscal measures to stabilize financial markets and revive global growth. However, greater efforts are needed, including through better policy coordination and larger financial transfers to developing countries, in order to achieve a balanced process of global demand reflation which also allows developing countries to take adequate countercyclical action, protect their vulnerable populations and align the response with long-run sustainable development goals.

* The present document updates *World Economic Situation and Prospects 2009* (United Nations publication, Sales No. E.09.II.C.2), released in January 2009.

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Contents

Boxes

Figures

Tables

Global macroeconomic trends

A synchronized downturn

The world economy is deeply mired in the most severe financial and economic crisis since World War II. With its increasing impact both in scope and depth worldwide, the crisis poses a significant threat to the world economic and social development, including to the fulfilment of the Millennium Development Goals (MDGs) and other internationally agreed development goals. The crisis, if it prolongs much further, likely will also bear profound consequences for global security and stability.

World gross product (WGP) is expected to fall in the baseline scenario by 2.6 per cent in 2009, compared with positive growth of 2.1 per cent in 2008 and average annual growth of almost 4 per cent per year prior to the crisis during 2004-2007 (table 1). While a mild recovery in growth of WGP is possible for 2010, risks remain on the downside. A more prolonged global recession is possible, if the vicious circle between financial destabilization and retrenchment in the real economy cannot be sufficiently contained and farther-reaching, concerted global policy actions are not taken. Between September 2008 and May 2009, the market capitalization of banks in the United States and Europe declined by 60 per cent (or $2 trillion). But despite enormous write downs and massive financial sector rescue operations by Governments, problems have not gone away. The global credit crunch has continued straining the real economy worldwide. If financial markets do not unclog soon and if the fiscal stimuli do not gain sufficient traction, the recession would prolong in most countries with the global economy stagnating at lower welfare levels well into 2010. In addition, the fragile situation could be exacerbated if the A/H1N1 influenza virus outbreak in Mexico becomes a pandemic with significant consequences for human life and economic activity.

In a more optimistic, but increasingly less likely scenario, world economic recovery would begin in the second half of 2009 and WGP would expand by 2.3 per cent in 2010. This scenario would require problems in financial markets to be, by and large, resolved in the first half of 2009 with fiscal stimulus measures taking visible effect during the year. By May 2009, such conditions were far from present.

While the crisis originated in developed countries and these countries are also leading the economic downturn, developing countries are being hit hard as well through capital reversals, rising borrowing costs, collapsing world trade and commodity prices, and subsiding remittance flows. In the baseline scenario, world income per capita is expected to decline by 3.7 per cent in 2009. At least 60 developing countries (of 107 countries for which data are available) are expected to suffer declining per-capita incomes, while only 7 would register per-capita GDP growth of 3 per cent or higher—considered as the minimum required growth rate for achieving significant reduction in poverty—down from 69 countries in 2007 and 51 in 2008 (figure 1). Economic setbacks are expected across the board, though strongest in the Commonwealth of Independent States (CIS), Sub-Saharan Africa and Latin America. Also, the least developed countries (LDCs) will be severely affected, with growth decelerating by 3.5 percentage points from the robust growth witnessed in recent years.

Table 1
Growth of world output, 2004-2010

Annual percentage change

	2004-2007[a]	2008[b]	2009[c]	2010[c] Baseline scenario	2010[c] Optimistic scenario	2010[c] Pessmistic scenario
World	**3.8**	**2.1**	**-2.6**	**1.6**	**2.3**	**0.2**
Developed economies	2.6	0.8	-3.9	0.6	1.1	-0.4
United States	2.6	1.1	-3.5	1.0	1.5	0.0
Japan	2.1	-0.6	-7.1	1.5	2.0	0.4
European Union	2.6	0.9	-3.5	0.0	0.6	-1.0
EU15	2.5	0.7	-3.7	-0.1	0.5	-1.1
New EU	5.5	4.0	-1.7	1.5	2.4	-0.4
Euro zone	2.4	0.8	-3.7	-0.1	0.5	-1.2
Other European	3.0	1.9	-3.0	0.1	0.7	-1.1
Other developed countries	3.1	1.0	-2.3	0.4	0.9	-0.5
Economies in transition	7.6	5.3	-5.1	1.4	2.4	-0.5
South-eastern Europe	5.3	4.2	-1.9	1.0	1.8	-0.3
Commonwealth of Independent States	7.8	5.4	-5.4	1.5	2.5	-0.6
Developing economies	7.1	5.4	1.4	4.3	5.5	2.0
Africa	5.9	4.9	0.9	4.0	5.3	1.7
North Africa	5.2	5.3	2.9	3.9	4.9	2.1
Sub-Saharan Africa	6.2	4.7	-0.1	4.0	5.5	1.4
Sub-Saharan Africa (excluding South Africa and Nigeria)	7.1	5.5	1.5	4.5	6.3	1.6
East and South Asia	8.5	6.2	3.2	5.6	6.5	3.7
East Asia	8.5	6.1	3.0	5.6	6.5	3.9
South Asia	8.3	6.8	4.1	5.4	6.5	3.1
Western Asia	5.9	4.5	-0.7	2.9	5.0	-1.1
Latin America and the Caribbean	5.2	4.0	-1.9	1.7	3.2	-0.7
South America	5.6	5.3	-0.9	1.9	3.5	-0.5
Mexico and Central America	4.1	1.7	-4.3	1.2	2.3	-1.0
Caribbean	8.5	3.9	0.7	2.6	4.3	-0.8
Least developed countries	8.1	6.1	2.7	4.6	6.3	2.2
Least developed countries (excluding Bangladesh)	8.6	6.2	2.1	4.5	6.5	1.7
Memorandum items:						
World trade	7.8	2.4	-11.1	4.1	5.1	0.5
World output growth with PPP-based weights	4.9	3.3	-1.0	2.7	3.4	1.2

Source: UN/DESA.

a Average annual percentage change.
b Partly estimated.
c Forecast, based in part on Project LINK.

Figure 1
Number of countries with declining GDP per capita, 2008-2010[a]

Source: UN/DESA.

a 2008 data are partly estimated. 2009 and 2010 data are forecasts, according to baseline scenario of WESP update per mid 2009.

Rising unemployment

The deepening of the global financial crisis entails a heavy toll on employment worldwide. A rapid rise in the unemployment has been witnessed since 2008 and is expected to worsen in 2009-2010. Initial projections put the rise in unemployment at 50 million over the next two years, but as the situation continues to deteriorate, this number could easily double.[1] Higher unemployment rates may persist for some time. Lessons from past financial crises indicate that it typically takes four to five years for unemployment rates to return to pre-crisis levels after economic recovery has set in. This is because massive rises in long-term unemployment and greater labour market "informalization"—exacerbated by return migrants and large-scale reverse migration from urban to rural areas—are very difficult to reverse. If these trends take root, the negative effects of the crisis will be long-lasting. As global recovery should not be expected before the end of 2009 and will be weak, at best, in 2010, most countries will need to achieve strong growth acceleration during 2011-2015 to offset the job destruction and displacement of workers caused by the crisis.

Setbacks in progress towards poverty reduction and other MDGs

The reduction in employment and income opportunities no doubt will lead to a considerable slowdown in progress towards poverty reduction and the fight against hunger. UN-DESA

1 International Labour Organization (2009). 'The Financial and Economic Crisis: A Decent Work Response', Paper submitted to ILO's Governing Body Committee on Employment and Social Policy (document GB.304/ESP/2), Geneva: ILO

estimates that between 73 and 103 million more people would remain poor or fall into poverty in comparison with a situation in which pre-crisis growth would have continued (table 2). Most of this setback will be felt in East and South Asia, with between 56 and 80 million likely to be affected, of whom about half are in India. The crisis could keep 12 to 16 million more people in poverty in Africa and another 4 million in Latin America and the Caribbean. These projections likely underestimate the true poverty impact of the crisis as the distributional consequences of the crisis are not adequately accounted for. Workers at the lower end of the job ladder, including youth and female workers, are more likely to lose their jobs or suffer income losses. Also, workers are already visibly shifting out of dynamic export-oriented sectors, and either becoming unemployed or displaced to lower productivity activities (including moving back from urban to rural areas). In China alone, 20 million workers were displaced in this sense at the end of 2008. These trends are likely to jeopardize poverty reduction more structurally as it may take some time before economies readjust and workers can shift back to activities with higher remuneration.

A substantial slowdown in progress towards the other MDGs should be expected as well. Even prior to the crisis and despite significant progress, many countries were not on track to meet most MDGs.[2] Increasing income poverty and lower government revenue will also lead to lower public and private spending on social services, affecting

Table 2

Estimated impact of the crisis on extreme poverty, crisis versus pre-crisis scenarios,[a] 2009

Millions and per cent

	Change in extreme poverty (below $1.25 per day) (crisis versus pre-crisis)			
	Number of poor (millions)		*Change in poverty incidence (percentage points)*	
	2009 vs 2004-2007	*2009 vs 2008*	*2009 vs 2004-2007*	*2009 vs 2008*
Economies in transition	**0.9**	**0.9**	**0.3%**	**0.3%**
South-eastern Europe	0.0	0.0	0.0%	0.0%
Commonwealth of Independent States	0.9	0.9	0.3%	0.3%
Developing economies	**102.0**	**72.5**	**1.9%**	**1.3%**
Africa	16.3	11.9	1.6%	1.2%
North Africa	0.4	0.3	0.2%	0.2%
Sub-Saharan Africa	15.9	11.6	1.9%	1.4%
East and South Asia	80.4	56.4	2.2%	1.5%
East Asia	29.0	27.2	1.5%	1.4%
South Asia	51.4	29.2	3.1%	1.8%
Western Asia	1.3	0.7	0.6%	0.3%
Latin America and the Caribbean	4.0	3.6	0.7%	0.6%
South America	3.2	2.9	0.8%	0.7%
Mexico and Central America	0.8	0.6	0.5%	0.4%
Caribbean	0.0	0.0	0.1%	0.1%

Source: UN-DESA based on per capita GDP growth estimates and forecasts of World Economic Situation and Prospects database and recent household survey data for 69 countries drawn from the World Bank's POVCAL database.

a Estimates represent the shortfall in poverty reduction caused by the drop in per capita income growth in 2009 as compared with average growth in 2004-2007 and with 2008, respectively. The poverty threshold is the international poverty line of $1.25 per person per day at purchasing power parity dollars. For the calculations it was assumed that income distribution stays constant in all country cases.

2 United Nations (2008) *The Millennium Development Goals Report 2008*, New York: UN-DESA.

all other MDGs. If no swift countercyclical action is undertaken, significant additional costs will have to be made to bring countries back on track towards the MDG targets set for 2015 likely requiring significant additional efforts and costs, though these may vary from country to country (see box 1).

Box 1

The impact of the crisis on the MDGs in Latin America

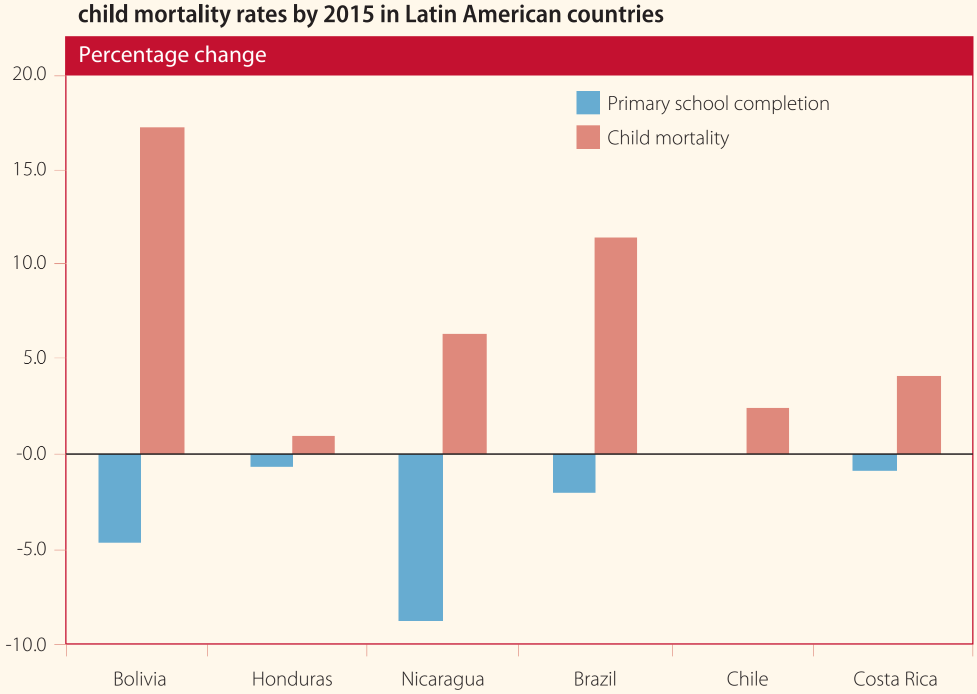
Substantial slowdown in progress towards the MDGs should be expected as a consequence of the global economic downturn. Unless additional action is undertaken promptly, many countries, especially in sub-Saharan Africa, are unlikely to meet most of the targets. The precise magnitude of the setbacks caused by the global financial and economic crisis is difficult to estimate and varies from country to country according to existing fiscal policy space and institutional capacity to respond to the crisis.

A new study by UN-DESA, using a comprehensive modelling framework for six Latin American countries, finds that a projected recession in 2009 and 2010 and a slow and gradual recovery towards pre-crisis growth levels by 2015 would put some of the region's low-income countries (Bolivia, Honduras and Nicaragua) substantially further off track towards the MDGs for primary school completion, child and maternal mortality and access to drinking water and sanitation.[a] Brazil, Chile and Costa Rica, which seemed well on track towards achieving most of the MDGs by 2015, would fall short in meeting several targets because of the crisis (figure A).

Governments of Bolivia, Honduras and Nicaragua would need to spend an extra 1.5 to 2.0 per cent of GDP per year on education, health and basic services between 2010 and 2015 to achieve the MDGs, as compared with the pre-crisis scenario. This would come on top of an additionally required annual social spending of 2 per cent of GDP in Bolivia, 5 per cent in Nicaragua and 7 per cent in Honduras in the absence of the crisis. For Brazil, Chile and Costa Rica, the required additional spending caused by the expected impact of the crisis would be between 0.5 and 1.5 per cent of GDP per annum. Clearly, additional costs of this magnitude may stretch government

a Marco V. Sánchez and Rob Vos (2009), 'Impact of the global crisis on the achievement of the MDGs in Latin America', UN/DESA technical paper (in preparation). The analysis uses an economy-wide framework (MAMS) for assessing the determinants and costs of MDG achievement.

Figure A
Impact of the crisis on primary school completion and child mortality rates by 2015 in Latin American countries



Source: Sanchez and Vos (2009), ibid.

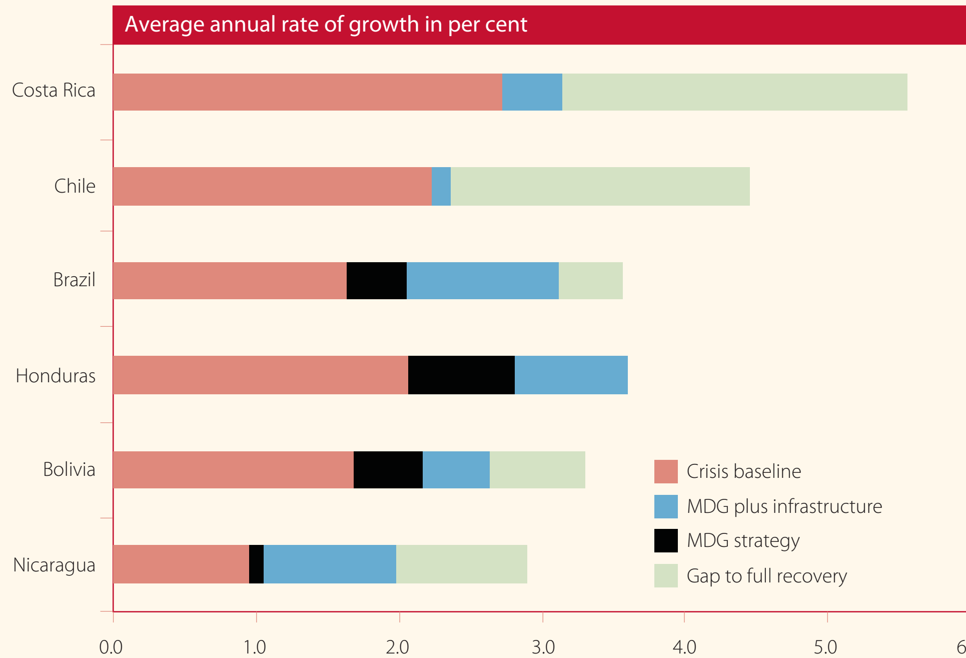
Note: Results refer to percentage change in primary school completion rates and child mortality rates, respectively, comparing outcomes for crisis and pre-crisis baseline scenarios by 2015. The pre-crisis scenario assumes that the GDP growth trends of 2000-07 would continue up to 2015. The crisis baseline scenario assumes significant growth deceleration during 2009 and 2010, and gradual recovery from 2011 to return to pre-crisis GDP growth rates by 2015.

Box 1 (cont'd)

finances, lead to unsustainable increases in public debt and become a source of macroeconomic instability in the future, if recovery and sustained growth do not set in swiftly.

Further analysis shows that increased social spending would contribute to growth recoveries. However, countries would not return swiftly to pre-crisis levels of economic growth and employment as spending on MDG-related services represents relatively low shares of aggregate demand in these countries (figure B). Stronger growth effects are likely to emerge over time as improved education and health outcomes underpin stronger productivity growth. The countercyclical response becomes much stronger if the MDG strategy is complemented by needed investments in public infrastructure. For a full recovery, however, other factors need to contribute as well, especially the resumption of external demand. This will require globally concerted stimulus measures to take effect.

Figure B
Simulated countercyclical impact of increased MDG spending on GDP growth, 2010-2015



Source: Sanchez and Vos (2009), ibid.

Regional Outlook

Developed economies

In the baseline scenario, GDP in *the United States* is expected to contract by 3.5 per cent in 2009 and to only recover to a meagre rate of 1.0 per cent in 2010, well below what is needed for recovery from the downturn. The slump in the housing sector that started in 2006 is still ongoing, while the credit crunch, asset price deflation and rising unemployment underpin sharp retrenchment of business investment and household consumption. Policy measures have been scaled up significantly in 2009, including a continuous expansion of the balance-sheet of the United States Federal Reserve Bank, a new fiscal stimulus package of $787 billion, and the Public-Private Investment Programme of more than $1 trillion to dispose of non-performing bank assets. However, it will take time for these measures to unclog the financial system and to restore economic growth. Uncertainties remain about the effectiveness of these measures. With unemployment rising sharply and financial de-leveraging continuing, the risk of the economy falling into a protracted deflation is still increasing. In the optimistic scenario that things would fall into place by the third quarter of 2009, the United States economy could recover in the second half of the year and post growth of about 1.5 per cent in 2010.

Japan's economy is falling into a deep recession. The severe downturn in global demand, particularly for automobiles, information technology and machinery, has led to a collapse of Japanese exports, causing sharply falling corporate profits, tightening financial conditions, rising unemployment, declining household wealth, and weakening domestic demand. In response, the central bank reduced interest rates along with a number of other measures to stabilize financial markets and ease corporate financing. The government has adopted a series of fiscal stimulus packages, with additional government spending totalling about 5 per cent of GDP. In the outlook, GDP is expected to fall by 7.1 per cent in 2009. A mild recovery is possible in 2010, but this will be highly dependent on global recovery.

Western European economies have been hard hit by the crisis. GDP in the Euro area is expected to fall by 3.7 per cent in 2009 after registering 0.8 per cent growth in 2008. Despite the assumption that current fiscal and monetary stimuli gain some traction over the course of 2009, the EU economies should expect no more than a gradual stabilization of activity with an expected near zero growth of GDP in 2010. Economic woes differ across Western Europe as countries face differing degrees of exposure to downturns in housing markets, construction sectors, manufacturing exports and banking sectors. Across the region, though, unemployment rates are surging and are expected to continue to increase even after the decline in output has stopped. On average, the unemployment rate in the Euro area is expected to increase to 10 per cent in 2009, up from 7.5 per cent in 2008.

The economies of *the new EU member States* have steadily deteriorated in 2008, with growth entering negative territory in the Baltic States and Hungary, and declining to nearly zero in the other countries in the last quarter of 2008. The sluggishness continued through the first half of 2009, reflected in double-digit declines in industrial production, heavy drop in exports and retail trade and depressed consumer and business confidence. While the recession in the EU-15 can be accounted as the primary reason for this contraction, the region is also affected by the contagion effect of the global financial crisis causing sharply increased costs of external borrowing and the sudden stop in access to international bank lending. GDP of the new EU member States is expected to shrink by 1.7 per cent in 2009 and to recover modestly by 1.5 per cent in 2010. In a more pessimistic scenario of no global recovery, these countries should expect economic stagnation in 2010.

The economies of *Australia, Canada* and *New Zealand* are also expected to shrink in 2009, suffering from falling global demand and commodity prices. In Australia, the unemployment rate is expected to jump from 4.2 per cent of 2008 to over 6 per cent in 2009, and 8 per cent in 2010. In Canada, the rate is expected to surge to 9.0 per cent in 2009. Despite fiscal and monetary stimuli, only a mild recovery is expected in 2010, however, mainly on the back of the moderate recovery of the global economy if the baseline conditions prevail.

Economies in transition

Economic conditions in the *Commonwealth of Independent States* (CIS) have deteriorated sharply from the end of 2008, affected by the global credit crunch, collapsing world trade and falling commodity prices, especially those of oil and metals, and—for some countries—falling remittance flows. Regional GDP is expected to fall by 5.4 per cent in 2009, down by more than 10 percentage points from growth in 2008 and the average of the preceding seven years. A modest economic recovery is possible for 2010—with an average growth rate of about 1.5 per cent—but the risks are slanted to the downside. The resource-rich economies of the CIS have been able to take countercyclical policy measures, making use of saved fiscal resources and reserves accumulated during the oil-price boom. The Russian Federation, for example, has introduced stimulus measures totalling 9.1 per cent of GDP. Other economies lacking such a buffer have had to turn to the IMF for rescue. Belarus, Armenia, Kyrgyzstan and Ukraine signed stand-by arrangements with the IMF in order to support their currencies from collapsing and to mitigate major balance-of-payments deficits. Further consolidation of the banking sector and supplementary stimulus measures could, together with baseline expectations of global recovery in 2009, brighten growth prospects for the CIS in 2010. Risks for a prolonged slump remain, however, if there is no global recovery. Rising social unrest and political turmoil already observed in parts of the CIS, have added to the already substantial degree of economic uncertainty.

In *South-eastern Europe,* growth weakened notably in the last quarter of 2008 and decelerated further through 2009. These economies suffered massive setbacks owing to shrinking exports, lower foreign direct investment, and portfolio capital inflows, declining remittance inflows, slowing domestic credit growth, and the higher cost of external financing. As a result, the combined GDP of the region is expected to decline by 1.9 per cent in 2009 and to recover by 1.0 per cent in 2010 in the baseline. In an optimistic scenario, assuming a sooner-than-expected upturn in the EU, regional growth might reach 1.8 per cent in 2010. Without global recovery, however, the economies of South-eastern Europe should also expect to face a prolonged recession.

Developing economies

Growth in *Africa* is sharply decelerating, mostly driven by collapsing world trade and commodity prices, lower foreign direct investments, subsiding remittances, and falling tourism revenues. In 2009, GDP growth is expected to slow to 0.9 per cent, down from 4.9 per cent in 2008. Oil exporters are severely hit by the sharp drop in hydrocarbon prices. The economies of Angola and Nigeria, for instance, are expected to contract by 4.2 and 0.5 per cent, respectively, in 2009. South Africa is falling into recession because of falling global demand which is hurting its manufacturing sector in particular. Other manufactured exporters, such as Botswana, Mauritius, Morocco and Tunisia, are suffering similarly from the recession in Europe and the United States. Net food exporters in the region are less affected as the demand for food products has been relatively inelastic to the global downturn, though these countries are facing lower export prices compared with 2008. Net food and energy importers in the region face strongly declining demand for their exports, which is only partially being offset by improved terms of trade because of the decline in world food and oil prices. Despite falling world market prices, inflation is expected to remain high in the countries of the region at around 10 per cent in 2009. Emerging balance-of-payments problems have caused strong currency depreciations in many African countries, pushing up domestic prices of imported goods, including food prices. Unemployment and precarious employment are on the rise as lower export earnings and government revenue are affecting all economic activity. Also, economies with large subsistence agriculture sectors that would seemingly insulate them from a global economic downturn are being hit hard, as their cash economies are heavily dependent on a few exports, including niche export industries such as textiles, cut-flowers, vegetables, and tourism. Conditional on global recovery, Africa's growth is expected to pick up in the second part of 2010 in the baseline scenario. However, real threats are looming if the recovery of the global economy is postponed and aid flows stagnate.

Despite seemingly strong macroeconomic fundamentals, *East Asia* has suffered a severe economic downturn since September 2008. GDP growth in the region is expected to slow from an average of 6.1 per cent in 2008 to 3.0 per cent in 2009. Over the past six months, collapsing final demand in developed economies, combined with major reversals of capital flows, have led to sharp contractions of exports, industrial production and investment spending in most countries of the region. Also, China is expected to register much slower growth in 2009 than in recent years. With output plummeting, the number of layoffs has increased markedly in the region. So far, official labour market statistics do not reveal the full magnitude of the crisis, with most of the surge in unemployment likely to come in 2009. After peaking in mid-2008, inflation has declined rapidly owing to the drop in commodity prices and the slowdown in domestic demand. Inflation is likely to continue to fall throughout 2009. In the baseline forecast, regional economic growth is expected to return to a relatively robust 5.6 per cent in 2010, led by a recovery of domestic demand in China fuelled by the massive fiscal stimulus package the country is implementing. The region's growth recovery would further depend on recovery in developed economies.

Most economies of *South Asia* were hit by the global financial and economic crisis at a time when they were still struggling with the adverse effects of high food and energy commodity prices, causing strongly widening external and fiscal deficits and pushing up domestic inflation. As access to external borrowing dried up in the second half of 2008, external vulnerabilities became apparent in several countries, most notably in Pakistan where a balance-of-payments crisis was averted through an IMF-supported $7.6 billion emergency package. Nonetheless, the downturn in South Asia is expected to be less severe than in some other developing regions since exports account for a smaller share in GDP and domestic demand is anticipated to hold up reasonably well. Average growth in the region is expected to drop from 6.8 per cent in 2008 to 4.1 per cent in 2009 before recovering to 5.4 per cent in 2010. In India, export demand is weakening rapidly, but increased government expenditure and resilience in domestic consumption will help mitigate the slowdown. The slowdown is exerting strong pressure on the labour markets in the region, resulting in increased unemployment, underemployment and working poverty. Meanwhile, inflation fell markedly in recent months, after trending upward in 2008. The scope for fiscal stimulus across the region is limited, however, owing to sizeable budget deficits of recent years that have led to high levels of public debt. Even so, Bangladesh, India and Sri Lanka have announced fiscal stimulus packages to cushion the downturn. There are substantial downside risks to the economic outlook, including a further deterioration of global economic conditions. This could lead to massive capital outflows from the region, especially from India, which in turn would put further pressures on national currencies to depreciate and constrain domestic demand.

After achieving GDP growth of 4.5 per cent in 2008, *Western Asian* economies will contract by 0.7 per cent in 2009 and, with global recovery, return to positive growth of 2.9 per cent in 2010. The fall in oil prices and cuts in oil production are major driving forces for the regional slowdown, with Saudi-Arabia, Kuwait and the United Arab Emirates expected to see their economies contract in 2009. If oil prices stabilize at a somewhat higher level in 2010, this should also help bring growth in the oil-exporting economies back to moderate positive territory. Qatar and Yemen are expected to be positive outliers owing to the start-up of major energy projects. The same holds for Iraq where the improved security situation should facilitate some economic catch-up despite the global crisis. In the non-oil exporters of the region, the sharp contraction in global trade and a marked slowdown in tourism will depress overall economic activity. Weakening economic activity and rapid growth of the labour force underpin rising unemployment rates throughout the region, putting additional strains on fiscal budgets through increased spending on social benefits and measures aimed at employment creation. Remittances, especially from workers in the oil-exporting economies, are expected to fall, putting pressure on household incomes and consumption. Inflation has been falling due to economic slowdown, lower commodity prices and, in the case of pegged currencies, the strengthening of the dollar. This trend is expected to continue in 2009 in view of weak domestic demand. In 2010, stabilizing economic activity will support moderate price increases. The regional outlook is subject to two notable risk factors. Lower-than-expected crude oil prices would directly affect growth of the oil-exporting countries, while a steeper or prolonged contraction in global demand would affect all economies in the region.

Economic activity in *Latin America and the Caribbean* deteriorated rapidly at the end of 2008, dragged down by weakening external demand and rapid contraction of domestic demand due to tight credit conditions and fears of growing unemployment. After five consecutive years of growth of more than 4.0 per cent per annum, GDP will fall by 1.9 per cent in 2009, before rebounding to 1.7 per cent in the baseline forecast for 2010. Mexico and Central America are expected to be hit hard, given their strong dependence on manufactured exports to and workers remittances from the United States. Most South American countries are dependent on primary exports and will be affected most by lower commodity prices. Capital reversals and the rising costs of external borrowing are affecting domestic activity and private investment, despite swift policy responses in some countries, such as Brazil in the last quarter of 2008. The Caribbean will see a mild growth in 2009, reflecting relatively strong economic performance in Cuba, expected from the easing of US restrictions on Cuba's economy. Unemployment is expected to rise significantly throughout the region in 2009, reversing the trend of formal sector job growth in the past five years. The prospects for economic recovery in the region in 2010 will be highly dependent on global conditions. Should the world economic recession prolong and commodity prices weaken further, exports will stay down, causing further balance-of-payments problems, weakening national currencies and discouraging capital inflows.

Rapidly deteriorating global economic environment for developing countries

Since late 2008, the financial crisis intensified in major developed economies and spilled over into the developing countries and economies in transition through international financial and trade channels. While private capital and trade flows to developing countries have fallen precipitously, international prices of primary commodities have collapsed. This inauspicious international economic environment is expected to persist during 2009 and could even protract, posing tremendous challenges to developing countries in financing investments for long-run sustainable growth and development.

Sharp reversal of private capital inflows and rising costs of external financing

Net private capital inflows to emerging economies (which consist of some 30 large developing countries and economies in transition) are estimated to have declined by more than 50 per cent during 2008, dropping from the peak level of more than $1 trillion in 2007 to less than $500 billion. A further dramatic decline of 50 per cent is expected for 2009.

Among all the components of net private capital inflows, the sharpest drop was in *bank lending* to emerging economies, reversing inflows of about $400 billion in 2007 into a projected net outflow in 2009. Economies in transition, including the Russian Federation and Ukraine, and several economies in Central and Eastern Europe have experienced the most drastic reversal in international bank lending. *Net portfolio equity* investments reversed to outflows from emerging economies, as international investors reacted aggressively to the sell off in the equity markets worldwide. While *FDI flows* are less volatile than other components of private capital flows, they also declined by 15 per cent in 2008.[3]

While small in global terms, Africa has also been relying increasingly on private capital inflows. Given the size of most domestic capital markets, even a small decline in these flows could have a sizeable impact on securities' prices. There have been no international bond issues by African countries in 2008 as a consequence of the global credit crunch. Kenya, Nigeria, Tanzania, and Uganda have already had to cancel plans to raise funds in international capital markets for infrastructure projects.

In the outlook, net private capital flows to developing countries and economies in transition are expected to scale back further in 2009-2010. Institutional investors in developed countries are expected to continue reducing their exposure in emerging economies, while international banks may further curtail their cross-border lending. Various banking rescue measures adopted in developed countries might in effect exacerbate this trend. FDI is also not expected to recover amidst falling global capital spending, sharp decline in corporate profits, the continued downtrend in primary commodity prices and weakening real estate prices in emerging economies.

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3 *UNCTAD (2009) Assessing the impact of the global financial and economic crisis on FDI flows,* Geneva (UNCTAD/DIAE/IA/2009/3).

External financing costs for emerging economies and other developing countries have surged since late 2008. The Emerging Markets Bond Index (EMBI), soared from 250 to about 800 basis points within a few weeks in the third quarter of 2008. The latest surge has been uniform, suggesting that contagion and generalized aversion to investing in emerging markets has taken hold among investors.

The shortage of affordable financing will have major repercussions for infrastructure spending, which is critical for longer-term growth. Investments in public and private infrastructure projects in sub-Saharan Africa and Latin America declined substantially after various crises and fiscal adjustments in the 1980s and 1990s, while infrastructure investment also dropped substantially after the financial crisis of the late 1990s in East Asia and had not recovered to pre-crisis levels by 2007. Maintaining, constructing or rehabilitating much needed public infrastructure is critical to sustained development and growth, including by influencing the location of new private sector activities.

World trade is collapsing and remittances are subsiding

Collapsing world trade is hurting developing countries disproportionately hard. Trade flows worldwide sharply declined from the end of 2008 and have continued to decline in the first quarter of 2009 at an annual rate of more than 40 per cent in the three months up to February 2009. For the year 2009, the volume of world trade is expected to fall by 11 per cent, the largest annual decline since the Great Depression of the 1930s. The impact of falling global demand is compounded by a drying up of trade finance and a rise in protectionist trends.

The sharpest declines in trade have been observed among Asian economies, in some cases at annualized rates of 50 per cent or more. Also China (23 per cent in April 2009) and India (2 per cent) have registered significant year-over-year declines in their exports for the first time in decades. Also imports from these countries are falling sharply, which—together with the drop in demand in industrialized countries—is affecting commodity exports by low-income countries.

Sharp declines in commodity prices compound the adverse impact for many developing countries, especially those heavily dependent on primary exports. From 2002 to mid-2008, many countries gained from the upward, albeit volatile trend in the prices of oil and non-oil commodities. The intensification of the global financial crisis since mid-2008 has led to a sharp reversal of this trend. Oil prices have plummeted by more than 70 per cent from their peak levels of mid-2008. Prices of metals dropped by 50 per cent. Also, those of other commodities, including basic grains, declined significantly. Although these prices are showing some stabilization in the first quarter of 2009, no significant rebound is expected in the outlook, continuing to depress export earnings and government revenues in many developing countries. Food and energy-importing countries may see their terms of trade improve, though in most cases, this gain will be more than offset by the collapse in export demand, rising costs of borrowing and/or falling remittance flows. Among net exporters of commodities, low-income countries are being hit hardest by plunging world market prices, as primary exports comprise on average 70 per cent of their total exports and also a high share of government revenue comes from these exports.

Remittances to developing countries have also moderated significantly. Totalling more than $300 billion in 2008, or three times the Official Development Assistance (ODA) flows to developing countries, remittances have been important sources for supporting consumption and broad development. For several small economies, remittances account for more than 20 per cent of their GDPs. Remittance flows used to be relatively stable, and even counter-cyclical. Facing the severe global financial crisis, however, these flows are expected to fall in 2009, particularly in Latin America and Caribbean, South Asia and some CIS countries, such as the Republic of Moldova, Tajikistan and Kyrgyzstan, though the decline is expected to be much smaller than that of other foreign-exchange earnings.

Mounting balance-of-payments problems

The severe external shocks are heavily impacting on the balance-of-payments positions of emerging economies and other developing countries. Prior to the eruption of the global financial crisis, many developing countries and economies in transition had accumulated significant foreign reserves, totalling more than $4 trillion in 2008. Since mid-2008, however, a sharp reversal of capital inflows and deteriorating current accounts have led to a decline in the foreign-exchange reserves of many of them, except for China and a few other Asian economies. Capital flight and attempts at defending national currencies from precipitous depreciation have also caused large depletions of foreign reserves of some economies, such as the Russian Federation.

Reserve accumulation by developing countries in the past decade was seen to be 'excessive' until recently, but in many cases, is now swiftly proving to be highly insufficient for 'self-protection' given the magnitude of the external shocks caused by the present global financial and economic crisis. In 2009, more than 100 developing countries would have inadequate current account surpluses to cover private debt due, and a financing gap ranging between $200 billion and $700 billion is expected. Reserves of some 30 low-income countries have dropped to below the critical level of three months of imports.

Currencies of many developing countries are under pressure. Both the deteriorating external conditions and the appreciation of the United States dollar caused by deleveraging the financial system and carry-trade speculation since August 2008 have led to depreciating currencies of developing countries. Numerous middle- and low-income countries have seen large devaluations over the past 6 to 9 months, sometimes as big as between 20 and 50 per cent. The exchange-rate depreciations have made external debt service obligations much more expensive in terms of local currency and are already affecting the budget positions of governments and businesses. These factors are also putting debt sustainability under severe stress in many developing countries. Many developing countries face difficulties rolling over their foreign debts, with some $3 trillion of emerging-economies' foreign debt maturing during 2009. Many low-income countries are also at increased risk, including those that have received substantial debt relief under the heavily-indebted poor countries (HIPC) initiative. Recent data also show that about one-third of low and middle-income countries in sub-Saharan Africa have external debt-to-GNP ratios of more than 50 per cent, and debt service-to-GNP ratios of more than 2 per cent, which would classify these as vulnerable to external shocks and at risk of debt distress.

To compensate for the decline in private capital flows to developing countries, and to provide additional resources to mitigate the impact of the financial crisis on their efforts to achieve the MDGs, increased official financing will be needed. Prior to the crisis, ODA flows to developing countries were falling measurably during 2006-2007. In 2008, aid flows from DAC donors increased again, reaching almost $120 billion. The crisis may put downward pressure on aid flows as many donors target annual aid flows as a share of their gross national income (GNI), such that the value of aid will fall with income even if the share stays fixed. Even though donor countries have repeatedly reiterated their ODA commitments, timely follow through on these may still be disrupted if the present crisis is protracted.

Meanwhile, the IMF and World Bank have significantly stepped up lending operations. By April 2009, a dozen emerging economies received emerging financing from IMF programmes, totalling some $50 billion. The Fund has also increased lending to low-income countries, but still lacks the resources to double lending capacity to $23 billion, well short of what is needed.

At their London Summit in April 2009, the leaders of the "Group of 20" agreed to provide $1.1 trillion in international financial support for countries with external financing problems, including tripling the resources available to the IMF to $750 billion (including a new SDR allocation of $250 billion), additional lending by multilateral development banks of at least $100 billion, and support of trade finance of $250 billion. While significant, it may not be enough to meet the challenges posed by this worldwide crisis.

Policy challenges

Since the intensification of the financial crisis in September 2008, Governments worldwide have made massive public funding (amounting to $18 trillion or almost 30 per cent of WGP) available to recapitalize banks, taking partial or full government ownership of ailing financial institutions and providing ample guarantees on bank deposits and other financial assets. Further, recognizing that monetary and financial measures will not be enough to stave off a recession, many countries have also adopted fiscal stimulus plans, totalling about $2.6 trillion (about 4 per cent of WGP), but to be spent over 2009-2011. While significant, this may still fall somewhat short of the stimulus of 2-3 per cent of WGP *per year* that would be required to make up for the estimated decline in global aggregate demand.

More concerted action will be needed in four major areas.

- *First*, further decisive and cooperative action is needed to restore the financial health of banks, especially in developed countries. As indicated, despite the unprecedented support given so far, problems in financial sectors remain and additional efforts for adequate recapitalization of banks will be needed to facilitate resumption of domestic and international lending. Without this, the fiscal stimulus is not likely to be very effective.
- *Second*, the fiscal stimulus measures should be better coordinated and aligned with global sustainable development objectives**.** Thus far, there has been no true coordination of the fiscal measures being undertaken by national governments. Without adequate coordination, the stimulus measures may fall short of what is needed**.** Without coordinating the size and timing will limit the multiplier effects of the stimuli, thus reducing the impact on global economic growth and employment. Further, importantly, more than 80 percent of the stimulus is being undertaken by the major developed countries. Facing a stronger downturn and with greater response capacity, most countercyclical efforts should indeed originate in those countries, but this does not ensure adequate rebalancing of the global economy. Moreover, since much of the stimulus will

come from the major deficit countries, without corrective action, this would perpetuate the problem of the global imbalances (see box 2). Meanwhile most developing countries lack the resources to undertake needed countercyclical measures for their economies. While significant, the additional international liquidity to be provided by the international community as agreed by the "Group of 20", is insufficient to give developing countries the resources they need to ensure a more balanced global stimulus aligned with long-term development needs.[4] Another concern is that many of the stimulus packages imply (often unintended) unfair trading practices by providing subsidies and incentives to domestic firms. The implication is that this may constrain recovery of economies that do not have the resources for fiscal stimulus and support to domestic industries. Global coordination should also deal with this concern.

Simulations with UN-DESA's Global Policy Model suggest that a more balanced and coordinated global macroeconomic stimulus as suggested would

Box 2

Disorderly adjustment of global imbalances poses a continued risk

The present crisis emerged from an unsustainable pattern of global growth, which manifested itself, among other things, in widening global financial imbalances with increasing current account deficits of the United States financed through rising surpluses in China, Japan, some European countries, major oil exporters and several developing countries. As this pattern prolonged, the risk of a steep depreciation in the world's main reserve currency, the United States dollar, heightened. In fact, prior to the present crisis, the dollar had indeed weakened significantly and showed increased volatility against other major currencies.

The global imbalances have narrowed visibly in 2008. Unfortunately, however, this is a result of a deflationary process caused by collapsing trade and worldwide financial deleveraging rather than the outcome of more benign adjustment. As a consequence and in view of insufficient coordination of stimulus packages among the major economies, the risk of major exchange-rate volatility, including a dollar collapse, has increased rather than decreased.

The United States external deficit narrowed to $670 billion in 2008, and is expected to decline further to about $400 billion in 2009. Among the originally major surplus economies, the euro area has shifted into deficit, while Japan's large surplus has almost completely vanished since mid-2008. Surpluses of the oil-exporting countries also have declined substantially. Only China's surplus has continued to grow (to $420 billion in 2008), as imports have fallen more steeply than exports.

The impact of the fiscal stimulus packages adopted by the major economies on the global imbalances is uncertain. In the case of the United States, however, it is expected that the Federal government deficit will increase to about $1,580 billion (11.3 per cent of GDP) in 2009, up from $450 billion (3.1 per cent of GDP) in 2008. Increased US household savings (up by about 4 per cent of GDP) will help finance part of the increase in the fiscal deficit, but the remainder (about half) would need to come from foreign savings or additional money printing. Either way, this likely will put renewed downward pressure on the dollar as investors may increasingly fear for future losses in their dollar asset holdings. Without adequate coordination of the fiscal stimulus packages worldwide and the way these are financed, uncertainty about the unwinding of the global imbalances could thus become a source of further financial instability.

4 Much of the $1.1 trillion would be allocated in accordance to existing quota in the IMF and most will be for short-term emergency lending, implying only a minor part will become directly available for long-term development financing in middle- and low-income developing countries. See also Report of the Secretary-General on the World Financial and Economic Crisis and its Impact on Development (A/CONF.214/4).

yield significant global growth gains compared with a scenario of uncoordinated stimuli as implied by the existing fiscal stimulus packages being individually undertaken by national governments. In the coordinated scenario, the stimulus efforts by countries which now have large external surpluses would be larger than is currently the case, while additional resource transfers would be made available to developing countries for development financing (about $500 billion extra over 2009-2012 compared with the uncoordinated scenario).[5] The additional resource transfers needed would include about $50 billion for the LDCs. Apart from supporting the countercyclical responses of developing countries by strengthening of their social protection systems and making long-term investments in sustainable development, the coordinated scenario would also include concerted efforts to provide countries with greater access to developed country markets as envisaged in a truly developmental Doha Round of multilateral trade negotiations. In such a coordinated, development-oriented policy scenario, the world economy would recover to an annual growth rate of around 4-5 per cent in 2010-2015, led by robust growth of about 7 per cent per year in developing countries (figure 2). In the uncoordinated scenario, developing country growth would recover to only 3-4 per cent per year.

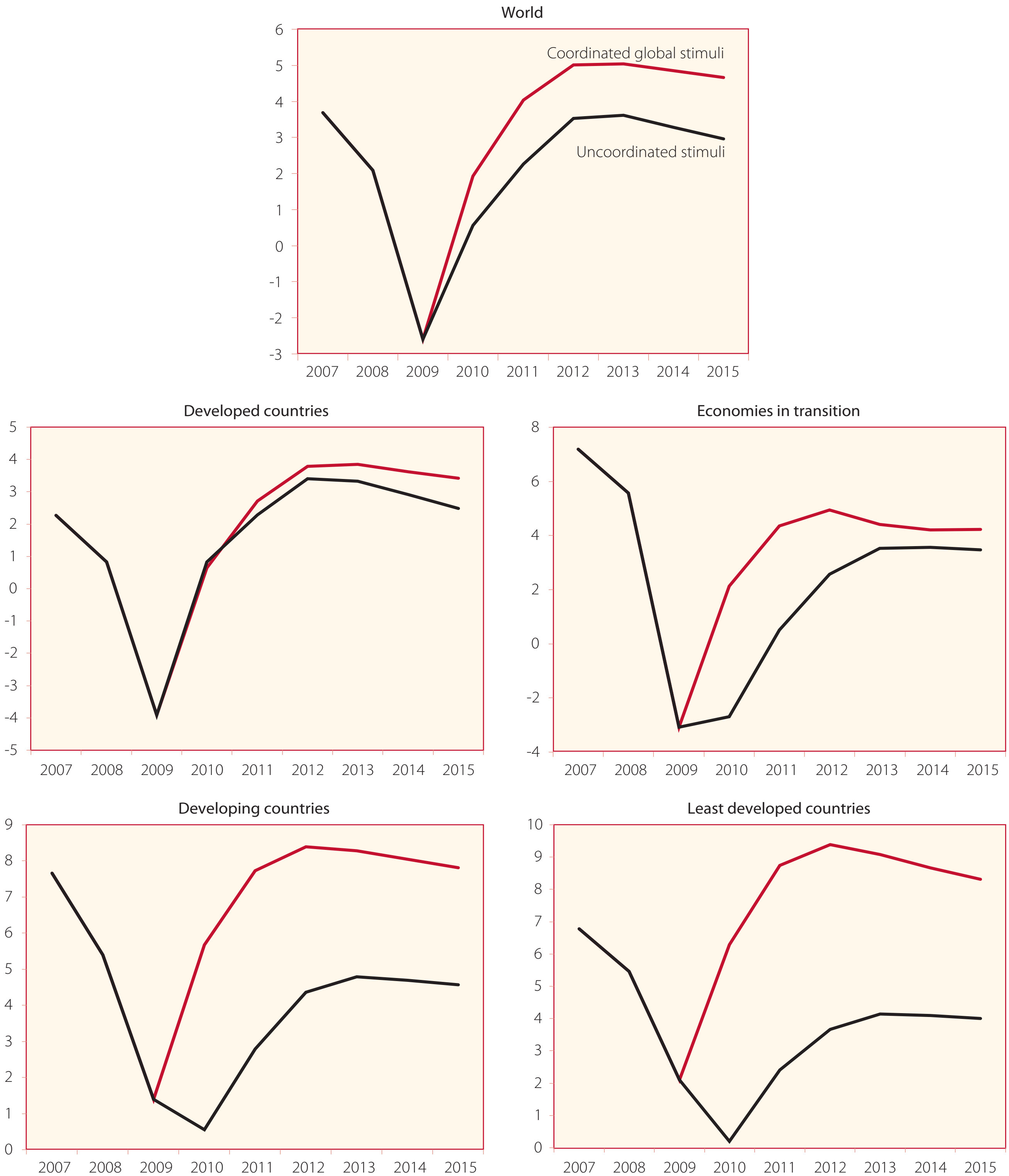
Developed countries clearly also gain from the proposed policy coordination and would see GDP growth accelerate to about 4 per cent per year, up from 2-3 per cent in the uncoordinated scenario. Furthermore, the simulation results for the coordinated policy scenario predict a benign unwinding of global imbalances, keeping external asset and liability positions of major economies in check, which would in turn support greater exchange-rate stability. The additional transfer of resources developing countries would thus seem to have a high pay-off worldwide. Of course, it will require, (global and national) conditions to effectively use them. Policy coordination needs to be accompanied by monitoring mechanisms to ensure accountability and this credibility for the concerted efforts.

- *Third*, fundamental reforms of the international financial system are needed to overcome the systemic flaws which caused this crisis in the first place and in order to guard against future crises. Without elaborating in detail here,[6] such reforms should first deal with the major weaknesses in the regulation and supervision of the international financial system. Existing mechanisms are now generally seen as insufficient for mitigating the inherent pro-cyclicality of the financial system, which tends to foster asset price bubbles. A macro-prudential regulatory system needs to be created, based on countercyclical capital provisioning, to develop institutions for the supervision of all financial market segments concentrating systemic risk, including hedge funds and cross-border flows.

5 The uncoordinated scenario is similar to the assumptions of the baseline forecast as presented in table 1, but adds the potentially adverse effects on global trade and its bias against developing countries of the protectionist elements contained in the stimulus and financial rescue packages.

6 See *World Economic Situation and Prospects 2009*, United Nations publication, Sales No. E.09.II.C.2; UNCTAD (2009) 'The Global Economic Crisis: Systemic Failures and Multilateral Remedies (UNCTAD/GDS/2009/1) and Report of the Secretary-General on the World Financial and Economic Crisis and its Impact on Development (A/CONF.214/4).

Figure 2
Economic recovery under coordinated and uncoordinated global stimulus, 2009-2015



Source: UN/DESA, based on policy stimulations with the UN Global Policy Model.

Strengthened international tax cooperation should form a critical element of a more effective global system of financial regulation. Such cooperation should help reduce tax evasion which is often linked with money laundering, corruption, financing of terrorism, and drug trafficking. As tax evasion is pervasive, improved tax coordination to combat it should also help boost the fiscal capacity of governments worldwide, which in turn would enhance financing available for recovery and development. For developing countries, it will be critical to establish an international mechanism for sovereign debt restructuring and relief based on a flexible approach towards debt sustainability while providing additional funding. As analyzed, the balance of payments of many countries is rapidly deteriorating because of the global crisis, while Governments will need to undertake massive countercyclical responses. Where needed, standstill agreements and temporary moratoriums on existing debt-payment obligations should be part of the package to give countries some additional financial breathing space. This would also reduce requirements for new funding. Beyond this immediate need for action, an orderly sovereign debt workout mechanism and an improved framework for handling cross-border bankruptcies are needed.

Most fundamentally, a new global reserve system which no longer relies on national or regional currencies as the major reserve currency must be created. Overcoming the major insufficiencies of the current system requires a set of broad reform measures. A new system which allows for better pooling of reserves at the regional and international levels and which is not based on a single or even multiple national currencies needs to be developed. It should permit the emission of international liquidity (SDRs or some equivalent thereof) so as to create a more stable global financial system. To make such a more prominent role of SDRs effective, it would need to be accompanied by further reform and policy measures.

- *Fourth*, a new framework for global economic governance in line with early 21st century realities needs to be created. Fundamental reform of the governance structure of the Bretton Woods institutions is needed. At the Doha Conference on Financing for Development, Member States agreed in December 2008 that such a reform must be comprehensive so that they can more adequately reflect changing economic weights in the world economy, be more responsive to current and future challenges and strengthen the legitimacy and effectiveness of these institutions. Existing inequities in voting weights in these institutions prevent them from incorporating the needs of users of their funds adequately in their operations and are in conflict with their public character and role as facilitators of international cooperation. These reforms should also lead to the establishment of a credible and legitimate mechanism for improved international coordination of macroeconomic policies. The global responses so far have been concerted at the level of the G7, G8, G20 or other ad hoc fora, lacking the participation or representation of important parts of the international community, especially from developing countries. Institutionalized macroeconomic policy coordination should be embedded in a more representative multilateral framework. The IMF could provide such a platform following adequate reform of its governance structure and revision of its functions.

Its policy making body, the International Monetary and Financial Committee (IMFC) could be tasked with mediating agreements of international policy coordination, including measures to guard against policies that can lead to unsustainable imbalances at the global level.

Broader global economic governance reforms must also be considered to ensure coherence in the global governance of the international financial architecture, the multilateral trading system, the framework for addressing climate change, the development agenda, and peace and security. Such coordination could take place through a new Global Economic Council that is part of the UN system, as proposed by some Member States, or through deep reform of the UN's Economic and Social Council. Whichever the mechanism, it is essential that a body be created which can provide coordination and oversight of responses to the broader range of global challenges and set the world on a new but sustainable development path.

For further information,

see http://www.un.org/esa/policy/wess/wesp.html

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