



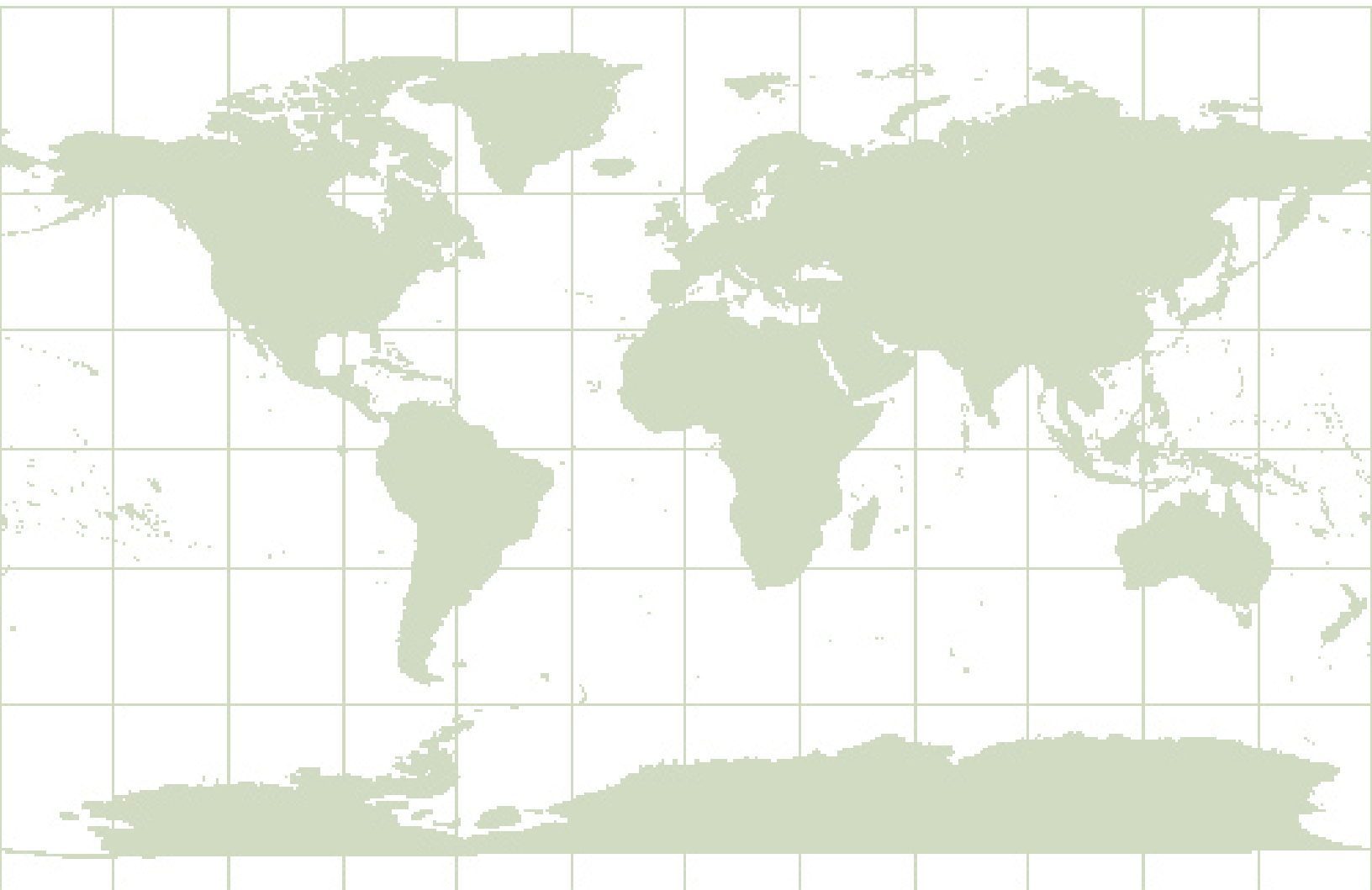
World Economic Situation and Prospects 2008

Executive Summary



United Nations

World Economic Situation and Prospects 2008



United Nations
New York, 2008

Full Report can be downloaded at:

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

Executive Summary

The global outlook

The world economy facing uncertain times

After several years of robust growth, the world economy is now facing some serious challenges in sustaining its brisk pace. The end of the housing bubble in the United States of America, as well as the unfolding credit crisis, the decline of the United States dollar vis-à-vis other major currencies, the persistence of large global imbalances and high oil prices will all threaten the sustainability of global economic growth in the coming years.

Slower, but nonetheless robust, global economic growth in 2008

The growth of the world economy moderated somewhat from 3.9 per cent in 2006 to a nonetheless robust 3.7 per cent during 2007. The baseline forecast of the United Nations for 2008 is for growth of the world economy to slow further to 3.4 per cent, but the darkening clouds of downside risks are looming much larger than a year ago.

Slower growth of the United States economy the main drag for the world economy

The major drag on the world economy is coming from a slowdown in the United States, driven by the slump in the housing sector. The ongoing housing downturn in the United States became much more serious in the third quarter of 2007 with the sub-prime mortgage meltdown, which triggered a full-scale credit crunch that reverberated throughout the global financial system. Central banks of the major economies have adopted various measures to attenuate the financial distress, but these measures did not address the more fundamental problems rooted in the unregulated workings of the global financial system and its links with the world economy.

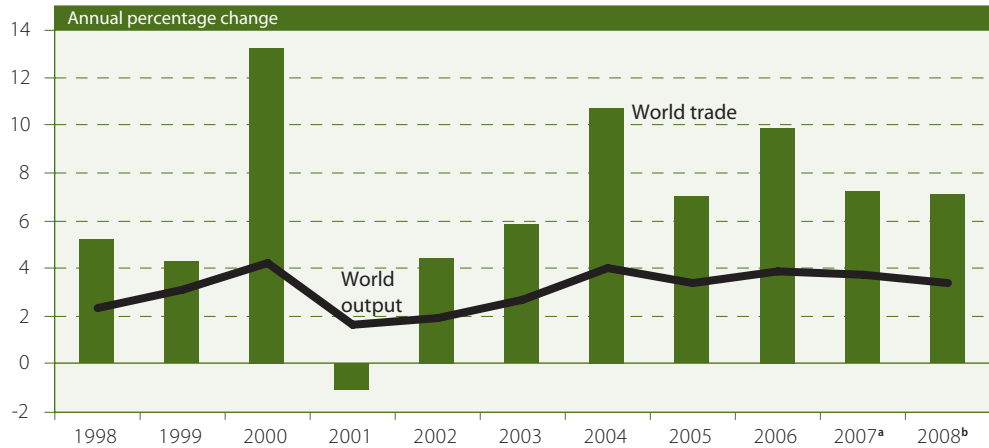
Significant spillover effects of the financial turmoil originating in the sub-prime mortgage markets in the United States have been found in major European economies and, to a lesser extent, in Japan and other developed countries. The growth prospects of these economies in 2008 have been downgraded also, confirming that the growth of the other major developed economies is still not strong enough to replace the United States as the main engine of global growth.

Continued robust growth in most developing countries

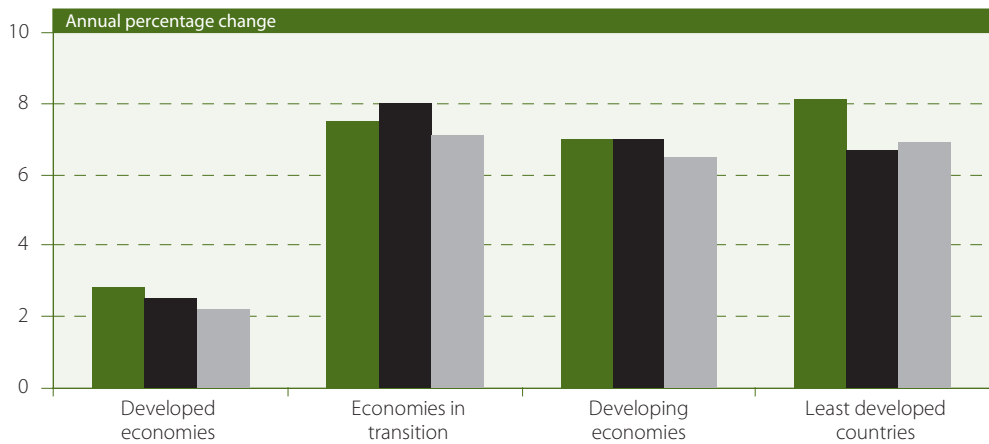
Economic growth in developing countries remained robust at 6.9 per cent in 2007. Growth accelerated among the economies in transition to 8.0 per cent as a result of buoyant commodity prices and strong domestic demand.

Most developing countries and economies in transition have felt the effects of the global financial turmoil, mainly through increased volatility in their local equity markets and a measurable widening of the yield spreads on their external debts, but neither effect appears to have been long lasting. The relative resilience of these economies is partly due to their improved macroeconomic conditions and their large accumulation of foreign

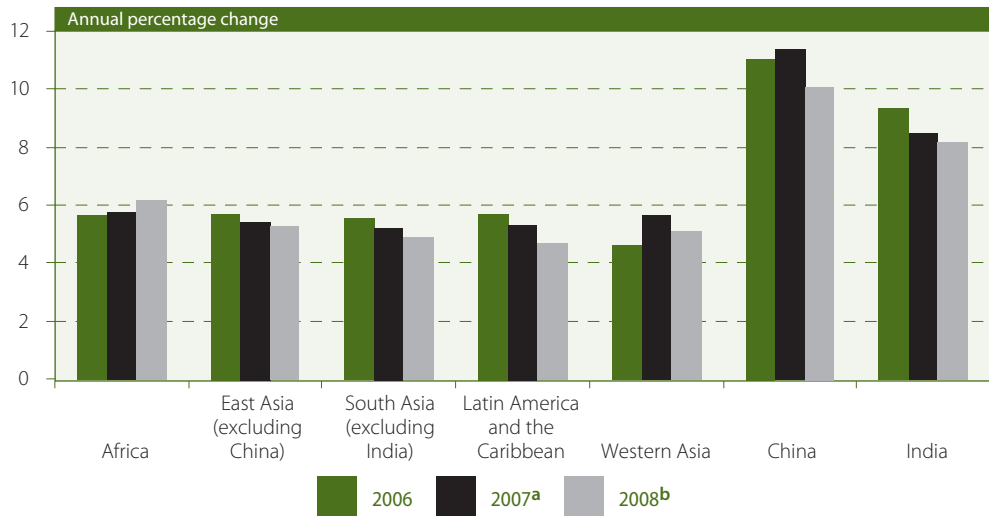
World economic growth expected to slow down in 2008



Growth in developing countries and economies in transition weakening but still robust



Growth in Africa accelerating, slower growth in other developing regions



Sources: UN/DESA and Project LINK.

^a Partly estimated.

^b Forecast.

exchange reserves, along with vigorous growth over the past few years. Part of that strength can also be traced to their growing interdependence, driven by the sustained, rapid growth in the two most populous emerging economies, China and India. Nevertheless, the growth in most of these economies has been far from self-sustaining and remains highly dependent on the wider international economic environment, which in turn is largely determined by the economic policies and performance of the major developed countries.

Remarkably, economic growth in Africa strengthened in 2007, and that momentum is expected to be maintained in 2008 at a pace above 6 per cent. Furthermore, the performance of the least developed countries (LDCs) remained strong on average, despite slowing somewhat in 2007 compared with 2006. In 2008, the poorest countries are again expected to post an almost 7 per cent growth. This good performance of the LDCs as a group obscures important differences across countries, with several countries performing poorly as a consequence of adverse weather conditions, terms-of-trade shocks and/or continued civil strife. The countries also remain highly vulnerable to a possible downturn of the global economy.

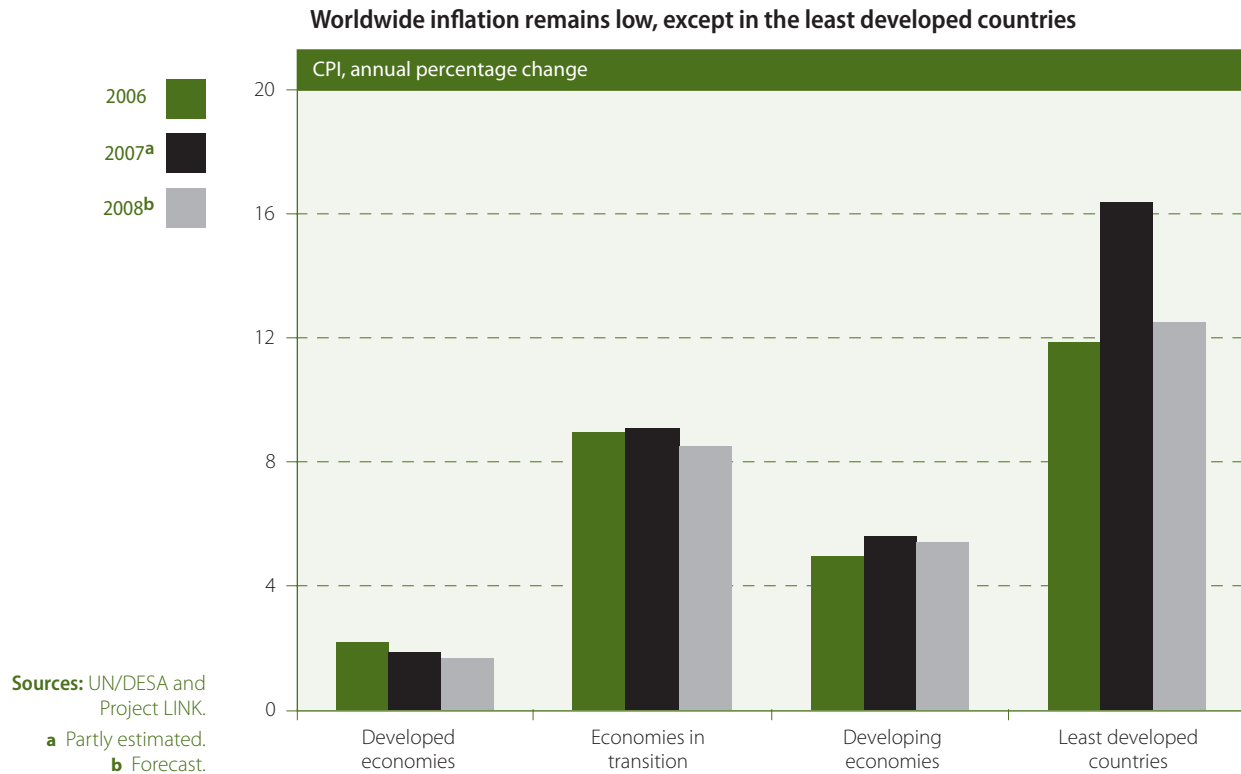
In the outlook for 2008, economic growth in most developing countries and the economies in transition will likely moderate, albeit with considerable variance.

Some improvement in employment conditions, but high unemployment remaining in many developing countries

Amidst robust economic growth, the employment situation continued to improve in 2006 and 2007 in a large number of economies. In the developed and transition economies, as well as in a number of developing countries, strong employment growth led to declining unemployment rates and has in many instances put upward pressure on wages. Many developing economies, however, witnessed only small employment gains despite robust output growth. In Africa, unemployment and underemployment rates remain especially high as labour-force increases continued to outstrip limited employment creation. In the outlook, it is expected that employment growth will retreat or remain modest in most economies in 2008 as a result of slower overall economic growth.

Inflation not expected to escalate

Despite upward pressures from higher energy and food prices, worldwide inflation remains low and is expected to recede from the peak levels registered for the decade in 2006. The global trend is dominated by the deceleration of inflation in the developed countries in the second half of 2007 to an estimated 1.9 per cent for the year, with a further deceleration to 1.7 per cent expected for 2008. Inflation in the United States is expected to drop below 2 per cent in 2008 on the heels of the slowdown in the economy, and is expected to remain low in Europe, at 2 per cent. The appreciation of the European currencies is mitigating the inflationary pressures from higher world market prices for energy and food. The economies in transition are also expected to see a visible deceleration of inflation in 2008. Inflation in developing economies accelerated in 2007 to 5.6 per cent, up from 5.0 per cent in 2006. Higher energy and food prices have generally pushed the aggregate price level up, and differences in their weight in consumer baskets explain, to an important extent, the divergences in inflationary trends among developing countries. More expensive energy and food explain for a good part substantially higher inflation in the LDCs. Their impact is expected to taper off as the global economy slows and world commodity prices weaken somewhat. Consumer price inflation is expected to decelerate to 5.4 per cent on average for the developing world.



Uncertainties and downside risks

The financial turmoil during the third quarter of 2007 has once more signalled downside risks for the global outlook. Not only did this reveal the lack of adequate supervision and regulation of domestic financial markets, it also signalled the increased threat of contagion in increasingly integrated, but also less transparent, international markets. In addition, the turmoil has again turned the spotlight on the problem of global macroeconomic imbalances. The main risks originate in the United States, where a deeper and longer slump in the housing market and a hard landing of the value of the United States dollar could trigger a worldwide recession and a disorderly adjustment of the global imbalances. These risks are not new and were anticipated in previous issues of the *World Economic Situation and Prospects*. The recent financial turmoil has heightened these risks.

A deeper and longer housing recession in the United States

The downturn in the housing sector of the United States accelerated during the course of 2007, and the prospects for 2008 remain bleak. By the end of 2007, most housing indicators had dropped to their lowest level in a decade. In the baseline outlook, housing activity in the United States is expected to shrink further. Risks remain, however, for a much sharper correction of house prices.

The housing downturn had an impact on financial markets from mid-2007, as the debacle in the sub-prime mortgage loan sector triggered full-blown global financial turmoil. Although sub-prime mortgages are a relatively small fraction of the total mortgage market and an even smaller fraction of the total credit market, a complex financial system—with overstretched leverage, lack of transparency and inadequate regulation—served to spread and multiply the risk beyond the sub-prime market. The tightening of

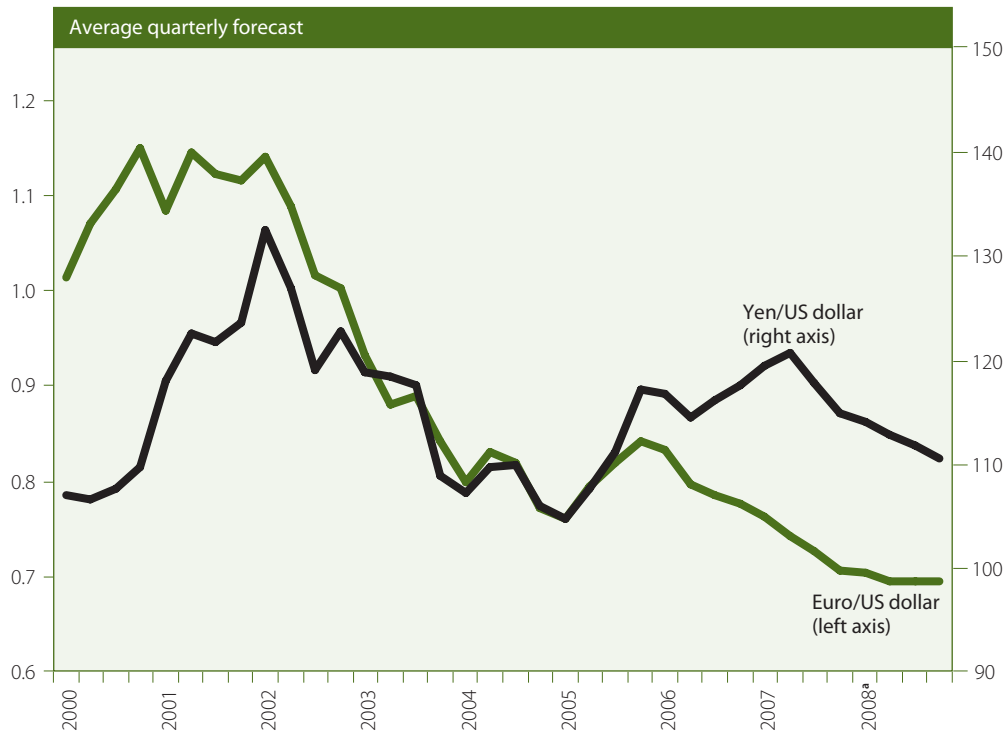
terms and standards in the mortgage markets, especially in the non-prime markets, is therefore likely to intensify the housing downturn in 2008. Delinquencies on these mortgages are expected to increase further, implying more stress in financial markets at large. Continued credit tightening and a sharper fall of house prices will depress consumer demand, possibly triggering a full-blown recession in the United States with worldwide repercussions.

Risk of a hard landing of the dollar

In light of recent trends, the risk of a disorderly unwinding of the global imbalances has increased. Current-account imbalances across countries narrowed somewhat in 2007 and are expected to narrow further in 2008. Despite this projected narrowing of the deficit of the United States, however, the risk of a disorderly adjustment remains as the indebtedness of the United States continues to deepen. As a result of the chronic current-account deficits over the past decade, the net external liability position of the United States is estimated to be near \$3 trillion in 2007, about 25 per cent of GDP.

The large current-account deficit and perceptions that the United States debt position is approaching unsustainable levels have been among the major factors underlying the depreciation of the United States dollar by about 35 per cent against other major currencies since 2002. About one quarter of this depreciation occurred between January and November 2007. This suggests that the risk of a hard landing of the dollar has heightened. Should this occur, there will likely be a disorderly unwinding of the global imbalances and much greater instability in the global financial system. This would have strong adverse effects on global economic growth. A steep fall of the dollar would immediately depress United States demand for goods from the rest of the world. In addition, since many developing countries are holding a large amount of foreign reserves in dollar-denominated assets, a sharp depreciation of the dollar would entail substantial financial losses for these countries.

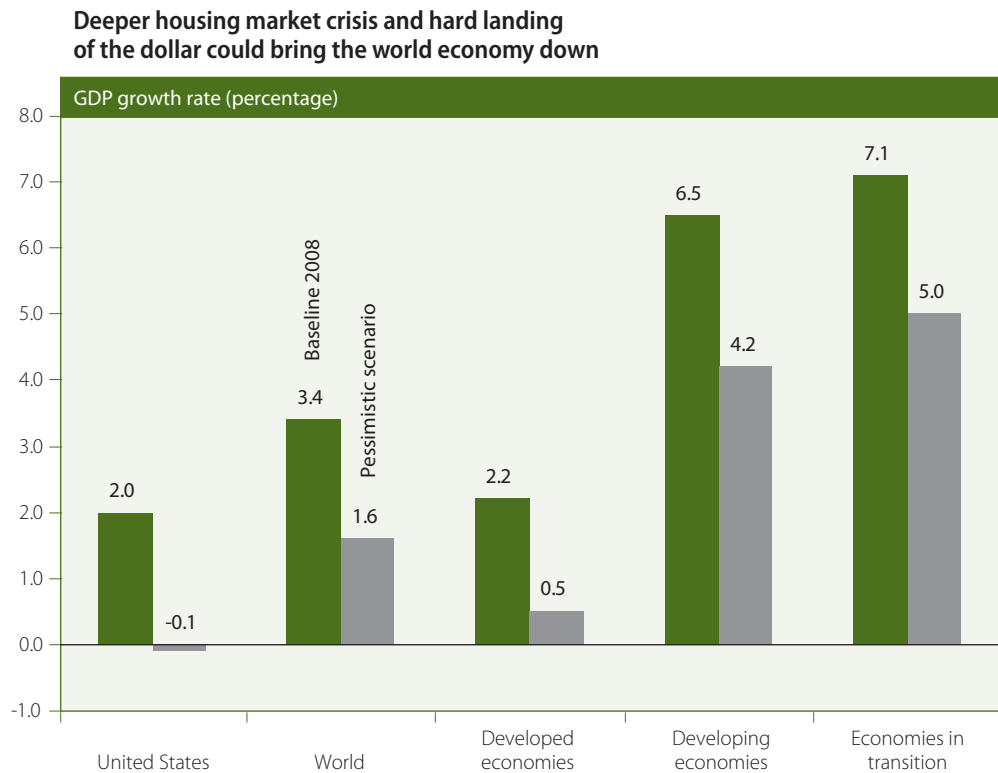
A hard landing of the dollar?



a Forecast.

In the pessimistic scenario, slowdown of world economic growth to 1.6 per cent

World economic growth would slow significantly should these risks indeed play out, and there would be a much more protracted crisis in the United States housing and mortgage markets along with a steep and accelerated fall of the dollar. A more pessimistic scenario, triggered by such a crisis, would project an outright recession in the United States and a deceleration of world economic growth to 1.6 per cent in 2008.



Policy challenges

Policymakers in developed and developing countries are faced with the challenge of how to avoid a global recession and safeguard robust economic development amidst risks of continued financial turmoil and a weakening dollar. The stakes are high. For developing countries, maintaining strong economic growth, while not the only condition, is essential to supporting their endeavours and generating the necessary resources to achieve the Millennium Development Goals. For the advanced countries, too, continued expansion of economic activity is essential for tackling long-term challenges such as those posed by population ageing, and new investments are needed to address the challenge of climate change.

Coordinated policy action to redress the global imbalances

A global demand stimulus will be needed if the slowdown in the United States economy is not to slip into a recession and spill over to the rest of the world. The below-trend growth in the United States would justify further interest rate cuts to stimulate the economy,

but this may not be sufficient in the current context if consumer and business confidence weakens sharply, and could in any event precipitate a further depreciation of the dollar. Global rebalancing would thus require stimuli from other parts of the world. In China, the appreciation of the renminbi has not prevented the growth of the external surplus. A more structural rebalancing of aggregate demand would be needed to reduce the economy's surplus, by means of stepping up public spending on social security, health and education services, especially those geared towards the rural population. In the major oil-exporting countries, there is ample room for undertaking much-needed domestic investment plans. In Europe and Japan, continued low inflationary pressures would justify putting an end to monetary tightening and preserve at least a neutral to moderately stimulatory stance.

The International Monetary Fund (IMF) has initiated multilateral consultations to deal with the global imbalances through concerted policy actions. The participants in this dialogue, which include the United States, Japan, the euro area, China and Saudi Arabia, seem to agree on the desirability of correcting the global imbalances without jeopardizing sustained growth and on the need for concerted action. They have not yet followed through with any concrete policy actions, however. It is important that the discussions be broadened to involve more parties, developing countries in particular, and that agreement be reached on multi-year policy adjustment schedules that can be monitored in order to make participants accountable and enhance the likelihood of compliance with agreed concerted action.

Parties, cognizant of the recent financial turmoil should see the urgency of addressing the problem of the global imbalances and initiate actions before the world economy moves into a recession and the dollar is forced into accelerated decline.

Realignment of exchange rates and reform of the reserve system

A multilateral agreement to reduce global imbalances should also include a realignment of exchange rates and ensure that such realignment takes place in an orderly fashion. Thus far, the process of dollar depreciation has been orderly. Dollar depreciation by itself, however, will not resolve the global imbalances. Along with the stimulatory measures in the surplus countries, proposed above, Governments should take joint action to avoid a possible steep and abrupt decline of the dollar. The risk of a hard landing is heightened by the very nature of the global reserve system, which uses the national currency of the United States as the main reserve currency and instrument for international payments. Under this system, the only way for the rest of the world to accumulate dollar assets and reserves is for the United States to run an external deficit. However, as the net liability position of the United States continues to increase, investors will start anticipating a readjustment, and confidence in the dollar will erode.

Over time, more fundamental reforms of the current international reserve system will be needed to prevent the current constellation of imbalances from re-emerging. A more immediate reform would be to promote an officially backed multi-currency reserve system. A well-designed multilateral financial system should create equal conditions for all parties and avoid unfair competition as well as an asymmetric burden-sharing of exchange-rate adjustments. It should also help to increase stability in the international financial system by reducing the likelihood of a crisis scenario where capital flight out of the major single reserve currency causes potentially far-reaching repercussions throughout the global economy.

Strengthening financial regulation and financial safety nets

Some hard lessons need to be learned from the recent financial turmoil. The problems in mortgage markets have highlighted the need for greater transparency over risks in the financial sector, including off-balance-sheet exposures and risks in derivatives markets. Credit-rating mechanisms need to be closely scrutinized and stronger rulings may be required to ensure that loan originators have the right incentives to carefully assess the solvency of debtors.

Multilateral arrangements for adequate liquidity provisioning for developing countries need to be completed. While the strong build-up of reserves provides countries with a substantial degree of “self insurance” against external shocks, in the event of a hard landing of the dollar, this self insurance could quickly evaporate. The design of a new precautionary financial arrangement is under discussion at the IMF but is far from completed. If such a mechanism could emulate the lender-of-last-resort functions of central banks, it could reduce the demand for high reserve build-ups in developing countries. This would not only assist a more orderly unwinding of the global imbalances, but would also create more policy space in developing countries by easing mounting pressures towards exchange-rate appreciation.

International trade

Merchandise trade growing twice as fast as output

Merchandise trade continues to be a driving force of the world economy. Both in volume and in dollar value terms, world merchandise trade has grown twice as fast as world output over the past four years. During 2007, however, world trade growth seems to have lost some of its strength, particularly for developed economies. During the upward cycle that started in 2001, merchandise trade growth has been driven by the developed countries and East Asia, led by China. The estimates and forecasts for 2007 and 2008 are below recent trend levels for both developed country and East Asian export and import growth.

Recent trends in merchandise trade growth have contributed to a slight correction of global imbalances. Strong export growth in the United States, stimulated in part by the significant depreciation of the dollar, has surpassed import demand growth, leading to a reduction in the economy’s trade deficit. This is reflected in smaller surpluses elsewhere, especially in Europe, Japan and some developing country regions. The adjustments are small and are not yet contributing in any major way to the required global macroeconomic rebalancing.

Commodity prices rising further, but a correction imminent

Non-oil commodity prices have continued increasing on the heels of robust global demand, but they have also become more volatile. Metal prices will likely remain high in the outlook, but will be much less bullish than during 2006 and 2007. World market prices for many food crops have risen significantly during 2007. This has been the case for wheat and maize in particular, driven in part by increased biofuel demand.

Oil prices surged to nearly \$100 per barrel in 2007, as strong demand, especially from developing countries, eliminated much of the slack capacity in the oil market. This, together with the weakening United States dollar, could drive further increases in oil

prices. Oil prices are expected to stay high in the baseline outlook for 2008, but oil market conditions remain highly uncertain.

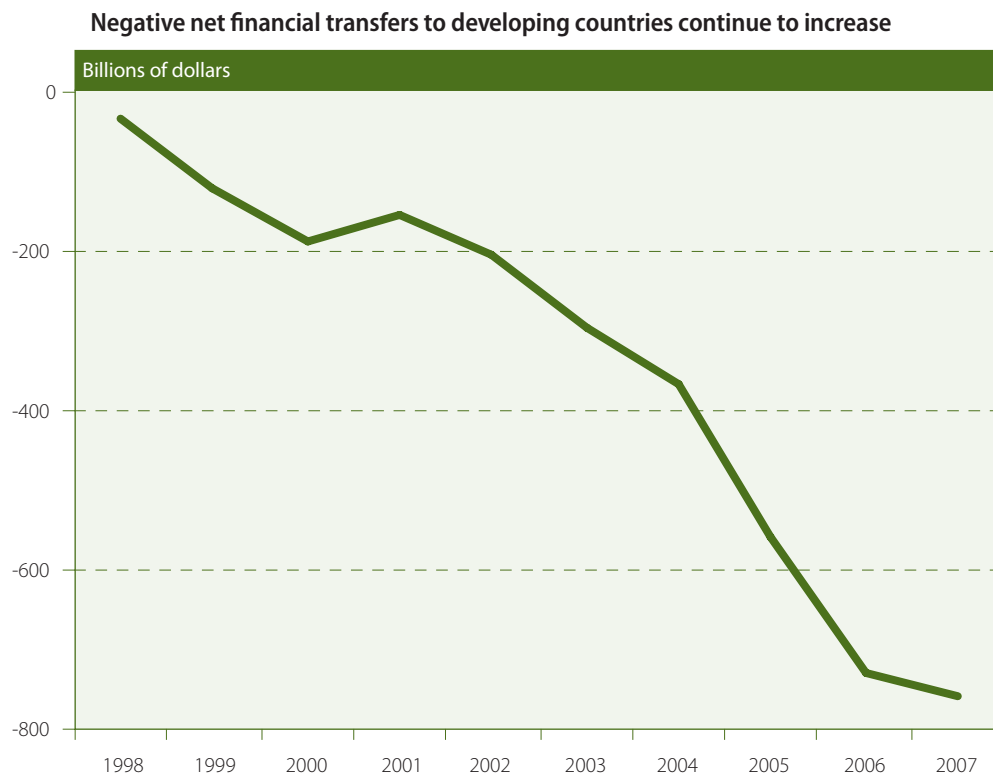
Continuing impasse in the Doha Round negotiations

The off-again, on-again multilateral trade negotiations in the Doha Round picked up towards the end of 2007, but with less attention to the development dimension. The positions of the major negotiating parties have remained largely unchanged so far, despite intense diplomatic activities since the formal resumption of negotiations in February 2007. Discussions continue to be focused on agriculture and non-agricultural market access. The prospects for rapid conclusion of the Doha Trade Round are gloomy.

International finance

Continued net financial transfers from developing to developed countries

Developing countries continued to make significant outward transfers of financial resources to developed economies, albeit at a slower pace than in previous years. Total net financial transfers from developing countries, that is to say, net capital flows less net interest and other investment income payments, increased from \$728 billion in 2006 to \$760 billion in 2007. The increase in net transfers comes almost exclusively from East and South Asia, while other developing country sub-groups registered some decline in net resource outflows.



Outward net transfers taking place in a context of robust private capital flows to developing countries

These net outward transfers take place in the context of continued substantial net private capital inflows to developing and transition economies. This trend of robust private capital flows to these economies has helped to sustain growth in emerging markets and has thus far helped insulate them from the turmoil emanating from developed country financial markets. The risk of this increased exposure lies in the possibility that this form of financing could suddenly dry up if the housing-sector collapse spreads to the whole financial system, inducing a severe economic slowdown in advanced countries.

The combination of current-account surpluses and strong private capital inflows has led to an unprecedented build-up of international official reserves, part of the pattern of net outward transfers from developing countries. Most reserves are held in dollar-denominated assets. The recent sharp decline in the value of the dollar, likely to continue with the unwinding of global imbalances, adds to the pace of rebalancing, since both private and public investors must now consider further losses on their dollar investments.

ODA below the target formulated in the Monterrey Consensus

Net real official development assistance (ODA) disbursements by Development Assistance Committee (DAC) member countries fell in 2006 for the first time since 1997 and are expected to be even lower in 2007. Moreover, ODA flows included substantial net debt-relief grants, contradictory to the commitments made by donor countries as part of the Monterrey Consensus, which provided that debt relief would be additional to conventional forms of ODA. ODA, net of debt relief, declined in 2006 to 0.25 per cent of the gross national income (GNI) of DAC members, down from 0.26 per cent in the previous year. This was well below the 0.33 per cent level that was reached in the early 1990s and the 0.7 per cent target reaffirmed at the 2002 International Conference on Financing for Development.

Since aid flows tend to be pro-cyclical, a global slowdown would have a negative impact on aid-dependent economies, as it would be accompanied by sudden changes in the size of resource commitments. When aid falls, it often leads to fiscal adjustments in the form of increased taxation and spending cuts that reinforce the cyclical impact of declining aid flows. Moreover, aid flows continue to be volatile, and such volatility is often exacerbated by the gap between commitments and disbursements. Multi-year agreements with donors on support to the medium-term expenditure frameworks of recipient countries could help mitigate the problems in aid delivery.

Progress in providing debt relief

As part of the Heavily Indebted Poor Countries (HIPC) Initiative, debt reduction packages have so far been approved for 32 out of 41 eligible countries. The debt service paid by the beneficiary countries has declined on average by almost 2 per cent of their GDP between 1999 and 2006. In parallel with this, government expenditures on health, education and other services in the beneficiary countries increased to a level equal to about five times the amount of debt-service payments. Before the HIPC Initiative, debt servicing exceeded such social spending by eligible countries. Despite this progress, the aim of the Initiative, to bring external debt of poor countries to sustainable levels, has not yet been realized in most beneficiary countries, and a significant number of these countries continue to face moderate-to-high risk of severe debt distress.

*Insufficient progress towards governance
reform of international financial institutions*

The reform of governance at the Bretton Woods institutions continues to be high on the agenda, not least because of the recognition of the fundamental changes that have occurred in the structure of the global economy. Furthermore, for the multilateral consultations on policy coordination to work, the legitimacy of the mediator (that is to say, the IMF) needs to be enhanced. This requires a reform of the voting power and governance structure of the IMF to ensure a better representation of developing countries. Given the imminent risks of a disorderly adjustment of the global imbalances and of a hard landing of the dollar, governance reform is urgently needed. At the 2006 Annual Meetings in Singapore, the IMF Board of Governors approved an agenda and time frame for quota and voice reform to bolster the legitimacy and relevance of the institution. Yet, these reform proposals are still under discussion among member States, and reaching agreement has, thus far, proven to be challenging. Without the reform, concerted action to address the problem of the imbalances in the world will likely remain far removed from what is needed and enhance the risk of a much deeper slowdown in world economic growth.

