

# Monthly Briefing on the World Economic Situation and Prospects

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## Summary

- The impact of the financial crisis on economic activity has intensified worldwide.
- Industrial production and international trade flows have declined sharply, and unemployment is rapidly rising globally.
- Countries need to move more swiftly to forceful and globally coordinated policy actions to prevent the financial crisis from turning into a large-scale economic and social crisis.

## Global issues

### *Considerable, globally coordinated fiscal stimulus is urgently needed to fight off a global depression*

The world economy has begun 2009 on a grim note. The major developed economies had already fallen into a deep recession, while developing countries are now also experiencing a dramatic downturn. After tens of trillions of dollars of financial wealth have evaporated, the global financial crisis has also begun to take a tremendous toll on human capital. Unemployment rates are rising at an alarming pace worldwide and many more job losses are expected to follow in the coming months. As a result of the demand retrenchment in the major developed countries, global industrial production and trade have fallen precipitously in recent months, sharply dragging down growth in many developing countries with the accompanying risk of rising poverty rates.

Financial markets remain under great strains worldwide. The balance sheets of major financial institutions continue to deteriorate and credit markets remain clogged. More seriously, a vicious interaction between the financial crisis and the economic recession is forming. In order to avert another Great Depression, policymakers worldwide need to act swiftly to adopt considerable fiscal stimulus packages in an internationally concerted manner. A number of countries have announced fiscal stimuli (see table 1), but the size of the stimulus packages may not be large enough to deal with the scale of the crisis. The packages so far would amount to more than 3 per cent of World Gross Product, but are to be spent in most cases over a number of years, making the likely impulse much smaller than what many see as required. Meanwhile, as there is a lack of international coordination for these packages, the effectiveness of these policies remains uncertain. Hesitation also remains in some countries in view of major concerns regarding the possible negative repercussions in the longer run from widening fiscal deficits, which are already ballooning in some countries as a result of the financial crisis. While such concerns are legitimate, the benefits of these stimulus packages, when effectively coordinated, should outweigh the economic and social costs of the prolonged and deep global recession that would most likely be the consequence of inaction.

Many agencies have downgraded their forecasts for 2009, including the International Monetary Fund (IMF), which trimmed its growth projection for the world economy in 2009 by 1.7 percentage points from its forecast of November 2008.

**Table 1. Fiscal stimulus (announced)**

Country	GDP (percentage)	Value (billion US dollars)
Australia	4.0	36.4
Brazil	0.2	2.6
Bulgaria	0.8	0.3
Canada	2.0	28.7
Chile	2.8	4.6
China	15.0	586.0
Czech Republic	0.4	0.7
Egypt	0.3	0.4
France	1.5	38.9
Germany	3.1	102.9
India	1.3	14.3
Indonesia	1.5	6.5
Italy	4.3	90.5
Japan	2.0	87.6
Korea, Republic of	1.0	9.7
Malaysia	1.0	1.9
Mexico	0.7	7.2
New Zealand	4.0	5.1
Philippines	4.0	5.8
Russian Federation	1.1	14.2
Singapore	8.2	13.2
Slovenia	1.4	0.6
Taiwan Province of China	1.7	6.5
Thailand	1.7	4.2
United Kingdom	1.1	30.8
United States	5.8	800.0
Viet Nam	1.1	0.8
<b>Total</b>		<b>1900.5</b>

**Sources:** Announcement by individual countries.

**Note:** The definition and the contents of the policy measures vary from country to country, and some are for one year while others for a span of several years. The size of these packages may not be comparable across countries.

in increased inventories and the stabilization of crude prices within the range of \$40-45 pb. OPEC's announcements in the fourth quarter of 2008 to cut production by a total of 4.2 million barrels per day and a relatively high compliance rate by member countries have also contributed to the stabilization at the present price level. Thus far, however, the measure has not had the intended effect of reversing the price decline and raising the oil price to levels needed by many OPEC countries to balance their fiscal budgets.

## Developed economies

**United States: collapsing growth, employment and housing market activity have led to further policy action**

The United States economy shrank at an annualized rate of 3.8 per cent in the fourth quarter of 2008. The decline was mainly caused by the stark reduction in personal consumption and fixed investment. Increases in inventories and larger government spending partly compensated for the decline in private sector demand, but without preventing the drop in GDP. In addition, net exports came to a complete halt, after having been an important contributor to GDP growth during the previous 18 months.

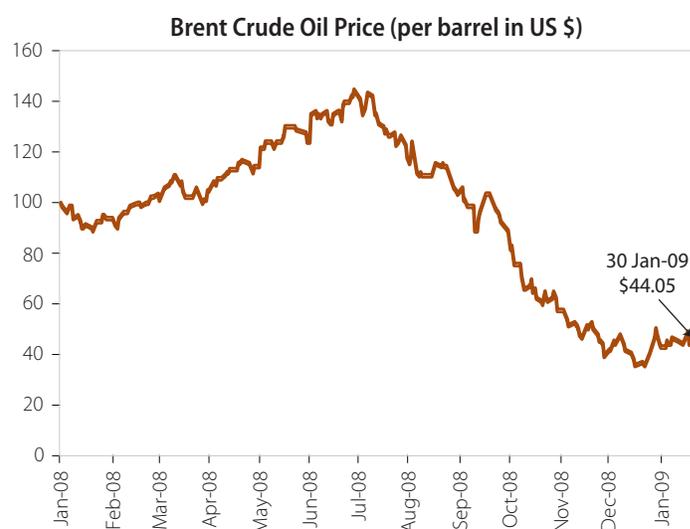
## International trade is contracting, while protectionism is on the rise

At the end of 2008, international trade activity had shrunk significantly. In November 2008, the value of total world trade was about 14 per cent lower than in November 2007. Besides the decline in prices for traded goods, this contraction mainly reflects reduced demand from developed economies. The shortage of trade credit caused by the global credit crunch was also conducive to the contraction and is hurting developing countries in particular. Financial rescue operations should consider measures that will unclog trade credit flows, including through guarantees.

Over the last months, more than 20 developed and developing countries have adopted measures to protect their domestic industries, especially through export subsidies, import restrictions or higher tariffs and non-tariff barriers. Meanwhile, unilateral interventions leading to currency depreciations have been a growing concern as they have the same effect as protectionist measures. This has led to calls for more elaborate coordination among countries to avoid the negative-sum-game that protectionism implies.

## Oil prices traded sideways

Brent crude oil prices rose from \$34.68 per barrel (pb) to \$48.76 pb at the beginning of January 2009 owing to cold weather, uncertainty related to the gas dispute between Russia and Ukraine and the military conflict in Gaza. However, because of ever bleaker economic prospects in the major economies, global demand for crude oil continued to fall, resulting



About 3 million workers lost their jobs during 2008 and the pace of job losses has accelerated dramatically over the past few months. In the fourth quarter of 2008, non-farm payrolls showed the largest quarterly decline since 1945, with the unemployment rate rising to 7.2 per cent by the end of 2008.

The housing slump continues. New-home sales fell 14.7 per cent in December, with the median price plunging by more than 9 per cent from the previous year. While the inventory of unsold new homes fell 10 per cent from November, it is still equivalent to 12.9 months of sales. Meanwhile, starts of new housing projects declined nearly 70 per cent in the fourth quarter of 2008, despite the notable decline in mortgage interest rates since the Federal Reserve announced in late November it would buy up to \$500 billion in mortgage-backed securities to get banks to lend more money in the hope of bolstering the troubled housing market. Further measures are expected to be adopted this month in an attempt to put more pressure on financial institutions to resume lending.

The House of Representatives of the United States Congress passed the American Recovery and Reinvestment Act worth \$819 billion to jump-start the economy. The package was also approved by the United States Senate after several amendments. The package includes tax cuts for middle-income families and spending in areas such as clean and more efficient energy, science and technology, health care, education, infrastructure and employment services.

### *Canada: fiscal stimulus accompanies further loosening of monetary policy*

The Bank of Canada cut its key overnight interest rate by 50 basis points (bp) to 1 per cent. In parallel, Canada's government unveiled a stimulus package worth \$32 billion over five years that includes infrastructure spending and tax cuts. The government predicts that the plan will boost the economy by 1.4 per cent this year and create 190,000 jobs by 2011, after the country lost more than 100,000 jobs in the last two months of 2008.

### *Western Europe and the EU: deteriorating economic conditions have led to further stimulus measures*

In Western Europe, the economic situation remains precarious. In the UK, for example, GDP contracted by 1.5 per cent in the fourth quarter, the sharpest decline since 1980. Survey data for January indicate a further contraction of activity going forward, although the indices were slightly more stable than in previous months, which had been characterized by sharp drops in readings.

After a long period of improvement, unemployment rates are rising across the region, with euro-area unemployment now standing at 7.8 per cent. Spain has been especially hard hit, with its economy moving officially into recession and the unemployment rate jumping from a cyclical low of 8.0 per cent in April and May 2007 to 13.4 per cent in January 2009.

Against the backdrop of falling inflation, central banks in the region continued to ease policy. The European Central Bank lowered its policy rate by 50 bp, bringing it to a level of 2.0 per cent. The Bank of England also lowered its policy rate by 50 bp, to 1.5 per cent.

On the fiscal side, the German government announced a second fiscal stimulus package worth 50 billion euros for 2009 and 2010, which will be in addition to a plan worth 32 billion euros that was announced two months ago, bringing the total stimulus to about 3 per cent of GDP. To date, France has announced stimulus worth 1.5 per cent of GDP, Italy 4.3 per cent of GDP and Britain 1.1 per cent of GDP. In comparison, the US stimulus is 5.8 per cent of GDP.

Amid continuing volatility in the currency markets, the dollar rebounded from relative lows above \$1.40 against the euro at the beginning of January to reach \$1.28 at the end of the month, while against the Yen, after a brief upward move to ¥94, it lost ground and returned to the ¥88-90 range.

### *The new EU member states: policy makers face constraints in addressing the economic downturn*

Economic activity in the new EU member states continued to weaken. Output growth slowed sharply in Central Europe and was in negative territory in the Baltic States, with GDP declining by 10.5 per cent in Latvia in the fourth quarter of 2008, for instance, while industrial production declined in most parts of the region, including Poland, which is less dependent on exports to the EU-15.

To counteract the crisis, a number of governments drafted fiscal stimulus packages, although the room for fiscal maneuvering is limited given the budget shortfalls due to the economic slowdown. A number of central banks, such as those

of Hungary and Poland, reduced interest rates in January in order to restore credit flows in the economy.

The region was seriously affected in January by the gas dispute between Russia and Ukraine, which interrupted industrial production at large-scale manufacturing facilities.

At the beginning of the year, Slovakia joined the euro zone.

### *Japan: economic indicators are worsening, with the return of deflation looming*

Japan is facing a further deterioration in economic activity and entered its third quarter of recession. New economic indicators were worse than expected. Weakening external demand and the appreciation of the yen continue to affect exports, in particular in the automobile and electronic sector. In December, Japanese industrial production fell by 9.6 per cent month-on-month, while private consumption weakened by 4.6 per cent. Unemployment climbed at the fastest monthly rate over the last 41 years to reach 4.4 per cent in December and could go up to 5.5 per cent over the next months.

All these negative indicators led the Bank of Japan to review downward its forecasts: deflation is expected to return as prices should fall by 1.1 per cent during the fiscal year of 2009-10 and 0.4 per cent in fiscal 2010-11, while GDP is now expected to contract by 1.8 per cent in 2008-09 and by 2.0 per cent in 2009-10.

The Japanese government stepped up its efforts to combat the credit crisis by setting aside 1,500 billion yen (\$16.9 billion) in public funds to encourage banks to buy shares in cash-strapped companies. Meanwhile, the Japanese parliament adopted a budgetary supplement of 4,790 billion yen (\$53.1 billion) to finance new stimulus measures which include the provision of cash to households. However, since the central bank's interest rate target is already 0.1 per cent and public investments remain sluggish due to tight fiscal conditions, the ongoing recession is likely to last over the next year at least.

### *Australia and New Zealand see reduction in policy interest rates*

As a response to the decline in exports and the downward revision of inflation expectations, the Reserve Bank of Australia decided to reduce the cash rate by 100 bp to 3.25 per cent and the Reserve Bank of New Zealand lowered its benchmark official cash rate by another 150 bp to 3.5 per cent.

## **The economies in transition**

### *CIS: contracting economic activity and falling exchange rates have triggered further policy actions*

Economic activity in the Commonwealth of Independent States (CIS) continued to deteriorate, causing a downward revision to the forecasts for 2009 GDP growth in many countries. Given the sharp declines in economic activity across the region and the continued credit crunch at the beginning of 2009, unemployment, wage arrears and short-term employment arrangements have increased across some countries. Business investment has significantly slowed in light of tight credit conditions and growing uncertainties both in the domestic and international markets. By contrast, consumption remained still resilient, underpinned by real wage growth in the public sector in a number of countries.

In the Russian Federation, the government has responded to the deteriorating labour market by increasing the monthly unemployment benefits starting 2009 and by expanding active labour market policies, such as regional programmes to create jobs and assistance with job searches.

The currencies in much of the CIS have depreciated and some central banks have made attempts to smooth the devaluation pressure. The central bank of the Russian Federation has widened the trading band of the rouble against a basket of currencies over 20 times since early November in order to help the country accommodate a gradual devaluation of the currency. As a result, the rouble lost about 19 per cent of its value against the dollar and about 22 per cent against the euro. In Ukraine, the central bank moved to a flexible exchange rate policy after an initial re-pegging of the currency. The value of the currency has experienced a precipitous decline as the country continues to suffer from a large terms-of-trade shock and a deep credit crisis.

Belarus received \$2.46 billion in balance-of-payments support from the IMF in order to mitigate the adverse effects of the global downturn on its economy.

### *South-Eastern Europe: weaker output growth is compounded by fewer remittances*

In most of the region, output growth and inflation continue to decline. The region is also facing a decline in remittances. The interruption in the flow of Russian natural gas in January forced some countries such as Serbia to purchase emergency gas supplies and to halt production at many companies.

In Serbia, the central bank reversed its monetary policy stance in January by reducing interest rates in response to weakening output growth and slowing inflation.

## **Developing economies**

### *Africa: suffering from a downturn in mining and tourism*

Africa's growth continues to weaken as the impact of the global slowdown deepens. The mining sector has taken a considerable hit as global demand for metals has waned and prices have plunged. A sharp contraction in South Africa's mining sector contributed to a slowing of annualized growth for the economy to 0.2 per cent in the third quarter and a slight upward tick in unemployment to 23.2 per cent. Mining companies have released thousands of workers and fourth-quarter estimates suggest that South Africa's economy may already be in recession. In the Democratic Republic of Congo (DRC) and Zambia, two other important mining exporters in Africa, there has been a significant drop in revenues from oil, diamonds, copper and other metals, with many new projects being either delayed or abandoned altogether. This has impacted on an important source of tax revenue for these countries and is threatening an untold number of jobs in the sector. In an effort to halt the rapidly deteriorating situation, the DRC is currently seeking a \$200 million emergency loan under the IMF's External Shock Facility for low-income countries.

Tourism, another prominent sector for many African economies, is also undergoing a significant downturn. In Tanzania, tourism receipts, which were already down 18 per cent in 2008, are expected to see more significant declines in 2009, while in Egypt, weakened tourism, coupled with lower investment and Suez Canal receipts (which represent 3 per cent of GDP), prompted the country to revise its growth forecasts downwards to 5.2 per cent for the first half of 2009. To shore up the industrial sector and maintain employment, the Egyptian government recently announced a LE 15 billion package (\$2.73 billion) for the fiscal year ending June 2009.

### *East Asia: governments fight accelerating economic crisis*

As economic conditions in East Asia continue to deteriorate rapidly, governments and central banks across the region have announced a series of measures to cushion the economic downturn. Recent data show sharp declines in exports and slowing domestic consumption and investment spending, indicating that East Asia will experience a deeper and probably more prolonged crisis than previously expected. Strongly export-oriented economies such as Hong Kong Special Administrative Region of China, the Republic of Korea, Singapore and Taiwan Province of China are most severely hit by the crisis and face severe contractions of economic activity.

China reported a significant deceleration in its GDP growth, which fell to 6.8 per cent year-on-year in the fourth quarter of 2008, compared to growth of 13 per cent for 2007 as a whole. A sharp decline in external demand has been the major drag as exports fell by double-digits year-on-year by the end of the year, which led to a drop in industrial production. On the other hand, there were some tentative signs of stabilization of the domestic economy in December, including stabilizing property markets, in the light of sizable fiscal stimuli and aggressive monetary easing.

Unemployment has started to rise in several countries, with 20 million migrant workers from the countryside reported to have lost their jobs in China alone, raising concerns over the social consequences of the crisis. Against the backdrop of rapidly worsening economic conditions and slowing inflation, many central banks in the region, including those of Indonesia, Malaysia, the Philippines, Thailand and Viet Nam, further lowered their benchmark interest rates. At the same time, the governments of China, Indonesia, the Republic of Korea, Singapore and Taiwan Province of China announced large fiscal packages to stimulate demand, support the business sector and alleviate the social impact of the crisis. China's \$586 billion stimulus package, which was announced in November, consists of tax cuts and additional government spending on a wide range of projects, including construction of low-income housing and transportation systems as well as

the development of rural infrastructure. Singapore's government unveiled an ambitious stimulus package, which includes additional spending of approximately \$13.6 billion (or about 8 per cent of its GDP).

### *South Asia: less reliance on exports will cushion the effect of the crisis*

While economic growth in South Asia is slowing, the downturn is expected to be less severe than in other developing regions. Exports account for a relatively small share of GDP and domestic demand is forecast to hold up reasonably well in most countries. Yet, there are new signs of weakening economic activity. In October and November, India's merchandise exports contracted and growth in industrial output decelerated markedly. In addition, the service sector is suffering from the largest corporate fraud in the country's history. India's government has responded to the deteriorating economic conditions by announcing two fiscal stimulus packages. At the same time, India's central bank further reduced its key interest rate. In Pakistan, the agreement with the IMF on a \$7.6 billion emergency package in November led to an increase in foreign currency reserves. However, with exports falling and the government facing the need to reduce the fiscal deficit, the country's economic prospects for 2009 remain bleak.

### *Western Asia: lower oil prices put pressure on fiscal balances*

At the annual summit meeting of the Gulf Cooperation Council (GCC), member states reiterated their intention to create a monetary union at the beginning of 2010 and agreed on an institutional framework as well as the regulations applying to the monetary council, which will be the precursor of a common central bank.

As a further sign of the pressure on fiscal budgets caused by the fall in oil prices, Oman announced that an average oil price of less than \$45 pb would necessitate a revision of its budget and a cut in public spending projects. In addition, Moody's cut its outlook on Bahrain's sovereign rating from stable to negative, citing the recent fall in oil prices and the limited financial reserves available to cushion the negative effects of the oil-price drop.

Monetary policy was further loosened in several countries. Turkey's slowing economy, as illustrated by a decline in industrial production by 13.9 per cent year-on-year in November due to weaker exports as well as slowing domestic consumption, and expectations of a further fall in inflation from 10.1 per cent year-on-year in December underpinned a cut in the country's policy interest rate by 200 bp to 13.0 per cent. Similarly, Israel's central bank announced a reduction in its policy interest rate by 75 bp to 1.0 per cent, bringing the aggregate cut in interest rates to 325 bp since September of last year.

### *Latin America: falling output is feeding a rise in unemployment*

Economic activity in Latin America is deteriorating more quickly than expected. In Brazil, Mexico and Colombia, industrial output fell by 6.2 per cent, 5.4 per cent and 13.3 per cent respectively year-on-year in November 2008, the worst decline since 1999 for Brazil and Colombia. The factors leading to this serious slowdown are not only the dramatic deceleration of external demand, but also increased restraints on trade credits, a reversal in capital flows and a significant slowdown in domestic demand.

As a result, job losses are increasing rapidly, especially in the manufacturing sector. In Mexico, unemployment stood at 4.3 per cent in December, the highest since 2000. In Brazil, the Ministry of Labour recorded a net job loss of 654,000 in the formal sector during December 2008, the highest since 1999.

Central banks and governments announced counter-cyclical measures to revitalize the economy. Monetary policy easing has become more aggressive in countries like Brazil and Chile, with benchmark interest rates cut by 1 percentage point, to 12.75 per cent and 7.25 per cent, respectively. In Mexico, the benchmark interest rate was cut by 50 bp to 7.75 per cent. However, inflation remains high in countries like Venezuela, Bolivarian Republic of (31 per cent in 2008), Guatemala (9.4 per cent in 2008) and Uruguay (9.2 per cent in 2008), whose central bank decided to increase this month its interest rate by 2.25 percentage points to 10 per cent.

On the fiscal side, a large number of governments announced plans for additional public spending to stimulate the economy. However, several countries face severe financing constraints regarding any stimulus measures. In support, the World Bank approved loans to some countries in Central America and the Caribbean, for example a \$450 million loan for El Salvador and a loan worth \$100 million for Jamaica.