2009 High-level Segment
GLOBAL POLICY DIALOGUE

Informal Note
Executive Summary of WESP Mid-2009:
World Economic Situation and Prospects 2009-10

Faced with the worst recession since World War II, the world economy is deeply mired in severe financial and economic crisis. Although its impacts are not uniform, no country has been immune from the current downturn. As its impact increases 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). If it prolongs much further, the crisis will also bear profound consequences for global security and stability.

In the baseline scenario of the United Nations forecast, 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 gross product 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. A mild recovery in WGP growth is expected in the baseline scenario for 2010, but this will require that fiscal stimulus measures worldwide gain traction and financial sector problems ease during 2009. Even though some observers see ‘green shoots’ as signs of possible nascent recovery, most key economic indicators suggest that the recession has far from bottomed out. The risks for a more prolonged recession still remain very high if the vicious circle between financial destabilization and retrenchment in the real economy cannot be sufficiently contained and the fiscal stimulus packages of national governments fail to take sufficient effect.

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.

Developing countries are disproportionately hard hit by the crisis and suffer from capital reversals, falling export earnings and declining remittances. Growth of per capita GDP is expected to drop to zero on average for all developing countries, down from 4 per cent in 2008 and an average of 6 per cent per year during 2004-2007. The setbacks are across the board, but strongest in the Commonwealth of Independent States (CIS), Sub-Saharan Africa and Latin America. At least 60 developing countries are expected to suffer negative per capita income growth. This will imply significant setbacks in poverty reduction. Unless urgent countercyclical action is undertaken, there will be major disruptions in the hard-won progress made towards the other MDGs as well.

A rapid rise in the worldwide 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. 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.

The global policy response has been unprecedented, including monetary, financial and fiscal measures to stabilize financial markets and revive global growth. 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.However, greater efforts are needed, particularly in four major areas.

Policy challenges

First, further decisive and cooperative action is needed to clean the financial system of the toxic assets and restore the financial health of banks, especially in developed countries. 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. Without coordinating, the size and timing will limit the multiplier effects of the stimuli. 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. However, 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. 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.

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. 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 inherent pro-cyclical tendencies that are present in the financial system. 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. 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. More fundamentally, over time a new global reserve system which no longer relies on a single national currency should be considered. For such a new system several complex reforms would need to be worked out, including a rearrangement of how international reserves are pooled at the regional and international levels and an enhanced capacity to emit international liquidity (SDRs or some equivalent thereof) so as to create a more stable global financial system.

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. 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. Given its mandate and near universal membership, the IMF would be an obvious candidate to provide such a platform, all the more so following reform of its governance structure and revision of its functions as currently being discussed. Its ministerial steering body, the International Monetary and Financial Committee (IMFC) could be explicitly 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.

Suggested key questions:

(1) As not all countries are in a position to respond to the crisis with countercyclical measures, what are the specific strategies needed to reduce vulnerability in developing countries and allow countries to cope with the crisis while at the same time addressing long-term development needs?

(2) A significant part of fiscal support is given to specific domestic industries. What are the medium- and long-run global implications of such policies both at national and international levels?

(3) Given growing unemployment worldwide, how can policymakers at the national level better balance rising social needs with growing fiscal deficits?

(4) What strategies for policy coordination should policymakers at national level and international levels adopt in order to align these strategies with the national and global sustainable development objectives?

Growth of world output, 2004 – 2010, annual percentage change

	2004-2007 [a]	2008 [b]	2009 [c]	2010 [c]		
				Baseline Scenario	Optimistic Scenario	Pessimistic 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
USA	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
CIS	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 (excl. South Africa, 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 (excl. 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

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