

## World Economic Situation and Prospects 2008

Press Release

### UN sees risk of global economic recession rising

**UNITED NATIONS, New York, 9 January:** The world economy faces serious challenges in sustaining the strong economic growth of the last few years, the UN says in *World Economic Situation and Prospects 2008*, released today in New York.

The baseline forecast of the United Nations is for world economic growth to moderate to 3.4 per cent this year, following the trend line down from 3.9 per cent in 2006 and 3.7 per cent in 2007.

But there is a clear and present danger of the world economy coming to a near standstill. In the second half of 2007, the bursting of the housing market bubble in the United States and the unfolding credit crisis have induced uncertainty across global financial markets. This, together with the decline of the dollar and the unresolved problem of the large global imbalances, could combine to further drag world output down. To prevent this from happening, the UN advises concerted international policy action to address the global imbalances and calm currency markets.

During 2007, world economic growth was robust and notably broad-based. More than one hundred economies achieved three per cent growth of per capita output or more. Developing country growth averaged nearly 7 per cent. Remarkably, economic growth in Africa strengthened in 2007 to near 6 per cent, and in the baseline scenario this pace is expected to accelerate to over 6 per cent in 2008.

This economic fortune may reverse, however. The major uncertainty for 2008 now emanates from the US economy. A further slowdown in the world's major economy will hit many of the poor nations hard, as it will slow world trade and put an end to the boom in commodity prices that benefited them over the past years.

#### Growth of world output, 2002-2008

Annual percentage change							
	2002	2003	2004	2005	2006	2007 <sup>a</sup>	2008 <sup>b</sup>
<b>World output<sup>c</sup></b>	1.9	2.7	4.0	3.4	3.9	3.7	3.4
<b>of which:</b>							
Developed economies	1.3	1.9	3.0	2.4	2.8	2.5	2.2
Economies in transition	5.0	7.2	7.6	6.6	7.5	8.0	7.1
Developing economies	3.9	5.2	7.0	6.5	7.0	6.9	6.5
<b>of which:</b>							
Least developed countries	6.3	6.6	7.9	8.4	8.1	6.7	6.9
<b>Memorandum items:</b>							
World trade	4.4	5.8	10.7	7.0	9.9	7.2	7.1
World output growth with PPP-based weights	3.0	4.0	5.2	4.8	5.4	5.3	4.9

Source: UN/DESA.

<sup>a</sup> Partly estimated.

<sup>b</sup> Forecasts, based in part on Project LINK.

<sup>c</sup> Calculated as a weighted average of individual country growth rates of gross domestic product (GDP), where weights are based on GDP in 2000 prices and exchange rates.

The ongoing housing downturn in the United States became much more serious in the third quarter of 2007, with the meltdown of sub-prime mortgages triggering a full-scale credit crunch that reverberated throughout the global financial system.

Central banks of the major economies have adopted various measures to attenuate financial stress. But these actions do not address the root causes of huge imbalances between financial surplus nations, such as China, Japan and the major oil producers, and the deficit countries, the United States in particular. These imbalances need to be addressed, the UN advises, through economic stimulus in the surplus countries to offset the effects of demand deflation in the US.

Significant spill-over effects of financial turmoil originating in the US sub-prime mortgage markets have spread to major European countries and, to a lesser extent, to Japan and other developed economies. Their 2008 growth prospects have been downgraded by UN economists, indicating that other major developed economies are still not strong enough to replace the United States as the engine of global growth.

### Run of strong growth in the developing world

2008 could be the fourth straight year in which growth of developing economies averages near 7 per cent. Strong demand has created jobs and reduced unemployment in most countries, albeit at a lesser rate than overall economic growth and, in much of Africa, with job creation still lagging, population increase. Inflation has been tame, outside of some least developed countries experiencing commodity booms.

As their weight in the world economy increases, developing countries as a group could be perceived as running the table, in economic terms. The share of world trade of economies that are developing and in transition increased from 35 per cent in 2000 to over 40 per cent in 2007. Terms of trade for most primary commodity-exporting countries improved for the fifth year in a row in 2007, while the external financing costs for emerging market economies remain low. Equity investments have flooded many emerging market economies, owing to their higher growth rates and – in a notable role reversal – their perceived relative security compared with the high uncertainty reigning in developed country financial markets.

Export-led economic growth has enabled developing countries to amass over \$3 trillion in international currency reserve holdings, a full three quarters of the world total. These reserves provide a buffer against possible adverse shocks, but also pose challenges to economic management of their economies in avoiding strong currency appreciations. Being invested in dollar-denominated assets, the build up of large monetary reserves by developing countries is part and parcel of the problem of the large global imbalances as developing countries act as the financier of the US external deficit. Further dollar depreciation will erode the value of their reserve holdings, and a diversification into other currencies could precipitate an even steeper fall of the dollar.

There are other indications that 2008 could pose the severest economic test in some time for the developing world.

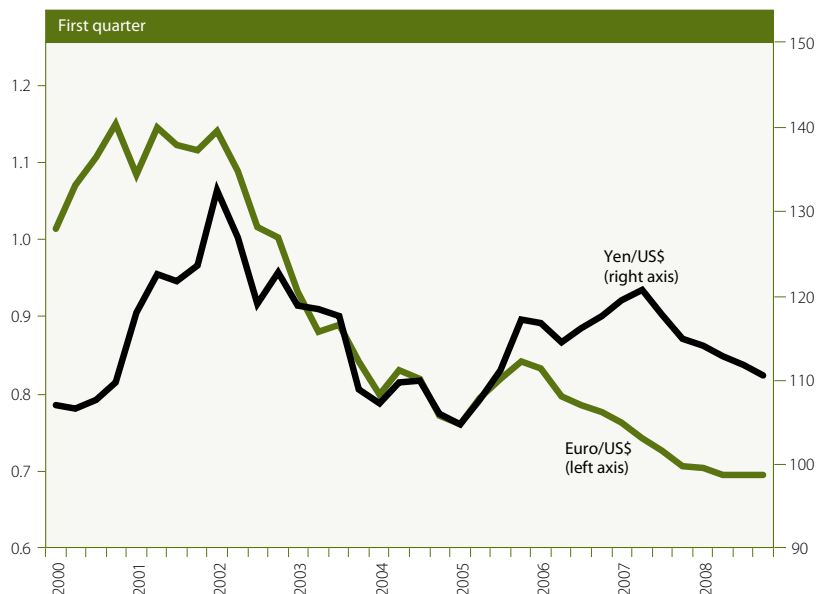
The slowing of the US and other developed economies will take air out of the rising commodity prices which have buoyed developing country growth. The slowdown will undercut world trade, which in 2007 had already tailed off from the high growth rates of 2004 and 2006. Also apparent in 2007 was greater volatility in investment flows – and emerging market economies have already had experience with investment booms that turned to busts.

### Pessimistic scenario

Given that inflation-adjusted prices for houses rose by about 90 per cent in the United States in the ten-year period leading up to 2006, there is substantial room for a downward adjustment in housing prices, UN economists say. The risk is compounded by household indebtedness that has risen sharply in the US in recent years. A 15 per cent drop in housing prices would be likely to affect consumer demand and take 2 per cent off of US growth, bringing the US economy to a virtual standstill in 2008.

The economies of Japan and Western Europe, already operating near production potential, are not in a position to take up the slack. It is notable that trade is taking on an ever-greater role in global economic growth, with exports now averaging nearly 40 per cent of GDP for all economies outside the US. The domino effect of a US recession would be to knock down export growth from China, Europe and Japan, in turn reducing their demand for exports from developing countries.

A hard landing of the dollar?



The housing bubble in the US and other developed countries is organically linked with the global financial imbalances that have developed over the past ten years. Significantly, the UN notes, most economies that have experienced a substantial appreciation of house prices have also undergone widening current account deficits.

With a US net external liability position of roughly \$3 trillion in 2007, the perception exists that the US debt position is approaching an unsustainable level. The risk of a disorderly unwinding of global imbalances has probably increased, the UN notes, with the downward spiral of the housing market in the US and associated debacle in the sub-prime mortgage market. A hard landing for the dollar would further depress US demand for goods from the rest of the world, reducing exports from developing nations and cutting into the standard of living of US households.

### **Concerted policy actions needed**

While realignment of exchange rates is one ingredient in addressing global imbalances, the UN warns and has warned (see *World Economic Situation and Prospects 2006 and 2007*) that relying exclusively on exchange rate adjustment risks a loss of confidence in and run on the dollar, only hastening its hard landing.

To avoid financial turmoil and safeguard the development gains of the last few years, the UN favours coordinated policy action.

Under more normal circumstances, the current US slowdown could successfully be treated with ongoing interest rate cuts to stimulate the economy. But in the current context these could precipitate a further depreciation of and loss of confidence in the dollar. It would be safer and more useful to obtain stimulus through stronger demand in countries with large savings and current account surpluses, such as China and Japan and the oil exporters. In China, this could be accomplished through stepped-up public investment and spending on health, education and social security. In Europe and Japan, continued low inflationary pressures justify putting an end to monetary tightening and taking a neutral to moderately stimulatory stance.

Along with the coordinated stimulatory measures, Governments should take joint action to avoid a rout of the dollar, because a rapid and disorderly descent would have the recessionary repercussions as outlined above. International action should entail an agreed exchange rate realignment which would foster a soft rather than a hard landing.

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 US to run an external deficit.

Over time, greater stability could be obtained through an officially backed multi-currency reserve system. A well-designed multilateral financial system should create equal conditions for all parties and avoid unfair competition and 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.

**For interviews or to obtain more information**, contact the Development Section of the UN Department of Public Information through Newton Kanhema, 1-212-963-5602, [kanhema@un.org](mailto:kanhema@un.org)

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