

Chapter IV

Regional developments and outlook

Developed market economies

Economic activity plummeted precipitously in the developed country region over the course of 2008, with many of the major economies now technically in recession.¹ Concerns of policymakers over inflationary pressures in the summer of 2008, resulting from the surging commodity prices and possible second-round effects via increasing wage pressures, have shifted quite dramatically to concerns over real activity and the heightening risks of a protracted recessionary period.

Slumping housing markets that led to downturns in consumer spending and, more importantly, that exposed dangerous weaknesses in banking systems causing severe problems in credit markets have been a major drag on activity since autumn 2007. But the situation entered a more dangerous phase in September 2008, with risk aversion rising dramatically in many financial markets leading to a full-scale financial crisis. Investment spending is now slowing sharply in most economies in the region, and with negative growth impulses spreading across the globe, developed market exports, particularly those to fast-growing Asian and oil-producing countries, are now slowing dramatically.

North America: How severe will the recession in the United States be?

The economy of the United States of America has fallen into a recession. At issue are its depth and duration. The economy has been fragile since 2007, but until mid-2008, the major drag had been a slump in the housing sector, while strong external demand and a sizeable fiscal stimulus package had kept the economy growing at a mild pace. The situation deteriorated significantly in the second half of 2008 as the credit crisis intensified dramatically. The severe credit crunch has turned a sector-led slowdown into a full-scale retrenchment of households and businesses affecting the economy at large. In response to the financial meltdown, the Government has drastically strengthened its policy stance, including by passing the Emergency Economic Stabilization Act (EESA), which, among other measures, allocated \$700 billion to enable the Government to recapitalize banks.² Effective implementation of the EESA, along with further monetary easing, might eventually stabilize financial markets, but the package came too late to prevent the real economy from falling into recession. In the baseline outlook, gross domestic product (GDP) growth is forecast to be -1.0 per cent in 2009, compared with an estimated, still positive, growth of 1.2 per cent for 2008 (see table A.1). Risks for a much deeper and longer recession remain high should all the policy measures fail to thaw the credit markets soon.

¹ A technical recession is defined as two consecutive quarters of negative, quarter-on-quarter growth.

² See chapter I for details of the rescue plan and other unorthodox policies in use to combat the financial crisis.

The housing sector is continuing to weaken

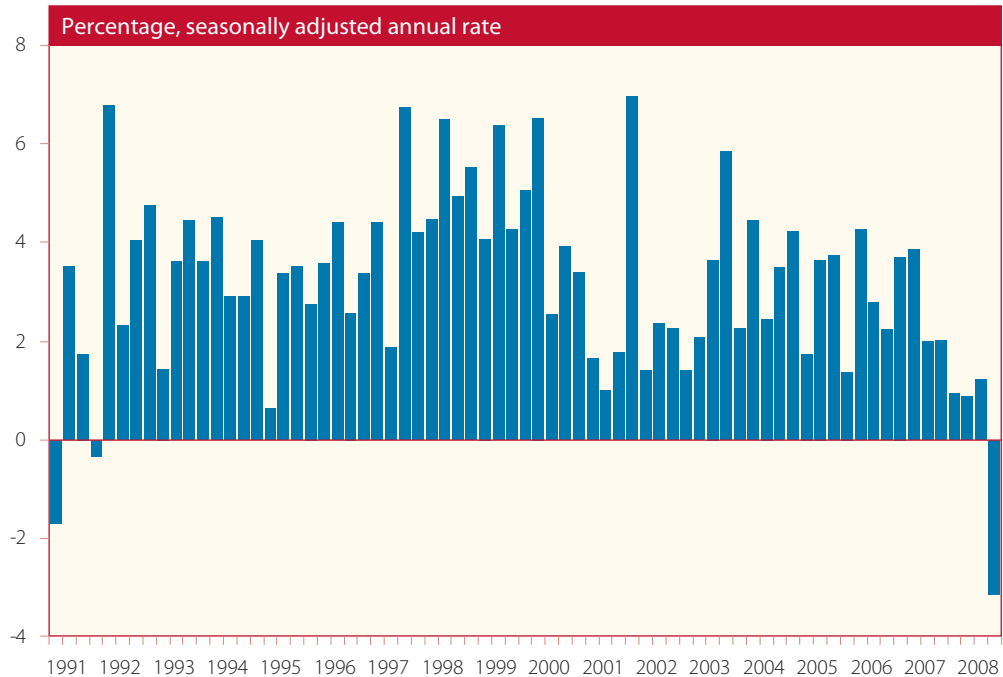
The housing sector, which was the trigger for the financial crisis, has been in a slump for two years. New home sales have dropped by 60 per cent from their peak of 2006, and existing home sales have fallen by about 40 per cent. Builders continue to reduce supply, pushing housing starts to their lowest level in more than 15 years. Although inventories of unsold homes have started to drop, they are still at a high level. House prices continued to fall in 2008, by about 16 per cent as measured by the Standard and Poor's S&P/Case-Shiller Home Price Index for twenty cities. In the outlook for 2009, the tightened credit conditions will make it difficult for the housing sector to recover, and a weakening broad economy, particularly one with rising unemployment, will continue to exert strong downward pressure on the demand for houses.

Household consumption is declining for the first time since 1991

Household consumption spending is expected to decline (see figure IV.1). Households are facing massive constraints: wage and salary income is decelerating as unemployment rises, negative wealth effects are rapidly accumulating from the sharp depreciation in the value of equities and houses, and credit is more difficult to obtain; this at a time when consumer debt is historically high and the savings rate low (outstanding household debt as a share of disposable income was 133 per cent in 2007, while the savings rate was 0.6 per cent). Moreover, consumer confidence has plunged to its lowest level in more than two decades.

Business capital spending is also expected to fall notably. Spending by businesses on machinery and equipment has in fact been falling since the beginning of 2008, although corporate spending on non-residential construction has been growing. Credit tightening, falling equity prices and softening corporate profits are all constraining business investment. The risk of the private sector's cutting capital spending on construction is also high: besides the tightened financing for commercial real estate, the demand for retail and office space is also diminishing as consumer spending and employment decline.

Figure IV.1
Quarterly growth of personal consumption expenditure in the United States, 1991-2008



Source: United States Department of Commerce, Bureau of Economic Analysis, National Economic Accounts.

The rate of unemployment is expected to rise to above 7 per cent in 2009 (see table A.7). During 2008, non-farm payrolls declined each and every month, and that decline has intensified since September. Job losses had been concentrated in construction and manufacturing, but have now spread to almost all sectors, including services. Unemployment surged to a rate of more than 6 per cent in the second half of 2008, up from the low of 4.5 per cent in 2007. Moreover, the number of discouraged workers, those who are unemployed but have given up searching for a job, has also increased dramatically.

After peaking at an annual rate of 5.6 per cent in mid-2008, headline inflation has been moderating, along with a significant correction in energy and food prices. Core inflation has remained well above 2 per cent, which is perceived as the upper bound of the comfort zone for the Federal Reserve (Fed). However, with the sharp slowing in economic activity, with no further increases in commodity prices envisaged and with inflation expectations dropping significantly from late 2008, the outlook for 2009 is for core inflation to drop below 2 per cent, with headline inflation even lower (see table A.4).

Exports of the United States have been growing at an exceptionally strong pace over the past two years. In volume terms, exports are estimated to have increased by almost 10 per cent in 2008. In contrast, the volume of imports has dropped by about 2 per cent, reflecting weak domestic demand. In the outlook, the growth of exports is expected to decelerate notably in 2009 as global demand slows. Meanwhile, imports are expected to fall further, as both consumption and investment face a retrenchment. The current-account deficit improved during 2008, standing at about \$700 billion, and is expected to narrow further in 2009, to \$540 billion, reflecting continued weak import demand, as well as a lower oil import bill.

On the policy front, both monetary and fiscal policies have almost exclusively focused on battling the financial crisis, and are expected to continue to do so in 2009.

Since the eruption of the financial crisis in late 2007, the Fed has reduced the federal funds rate, as well as the discount rate, in a dramatic manner, the former to a level of 1.0 per cent in October 2008. The Fed has also adopted a full gamut of unorthodox monetary measures to inject liquidity into markets in an attempt to quell the credit crunch.

The Government has also adopted various fiscal measures, in a broad sense, in tackling the crisis. The first fiscal stimulus package, which mainly included a tax cut for households and businesses, managed to keep GDP growing at a moderate rate until mid-2008, but it was clearly too small to avert a recession in the face of an unprecedented credit crisis of mammoth proportions. The Government also took a number of unorthodox fiscal measures. In the outlook, another fiscal stimulus package is expected in 2009.

Risks of the economy falling into a much deeper and longer recession than in the baseline forecast remain high. A self-reinforcing cycle between the financial meltdown and the recession in the real economy could form a tumultuous downward spiral: the credit freeze could lead to an additional retrenchment of consumer and business spending, followed by more job losses, further deterioration in the housing market, more losses in and failures of financial institutions, and, in turn, more severe credit tightening.

The Canadian economy will see a pronounced slowdown in growth from 2.7 per cent in 2007 to 0.4 per cent in 2008, before rebounding somewhat to 0.8 per cent in 2009. On the domestic side, higher inventories will cut into growth, as will the fading positive effect of tax cuts that took effect in the first half of 2008. Weaker investment owing to more pessimistic sentiment will generally add to the more challenging picture; fiscal policy will have only limited space in which to provide growth impulse, in view of weaker revenue growth and political reluctance to embark upon more elaborate deficit spending.

Inflationary pressures are finally starting to ease

The Fed is easing policy dramatically

Fiscal policy has also been brought to bear, with expectations of more to come

Canada's growth will be dragged down by the slowdown in the United States

On the external side, the weak United States economy will be a major drag on activity, especially through its negative effect on exporters of manufactured products in areas such as the automotive industry. At the same time, lower oil and commodity prices will slow the economic boom in the western provinces.

Lower inflation will create room for further easing of monetary policy

The financial turmoil led monetary policymakers to reduce the policy interest rate by 200 basis points from 4.25 per cent at the end of 2007 to the current level of 2.25 per cent. Moderating inflation in view of lower oil and commodity prices, as well as the slowing growth performance combined with rising unemployment, will create increasing room for further interest rate cuts in 2009.

Western Europe: Sharp deceleration with many countries now in recession

The euro area, along with most of Western Europe, started the year on a high note, with (quarter-on-quarter) growth of 0.7 per cent in the first quarter of 2008, a significant rebound from the fourth quarter of 2007. Activity decelerated sharply thereafter, however, to the point where the region is now in a technical recession. Of the major economies, Germany, Italy and the United Kingdom of Great Britain and Northern Ireland are all in recession; Spain experienced its first quarter of negative growth since 1993 and has experienced the sharpest absolute deceleration; and France has narrowly escaped a technical recession, but activity is very weak. Despite this, the strong carryover from the first quarter of the year has led to an estimated GDP growth of 1.1 per cent for the year as a whole; however, with no carryover into 2009 and no significant rebound expected in the second half of that year, GDP is expected to decline by 0.7 per cent in 2009. This would mark the first annual decline in GDP since 1993 (see table A.1).

High frequency data are revealing the speed and depth of the decline

Higher frequency data reveal the sharp drop in activity and provide a useful comparison to previous slowdowns (see figure IV.2). Industrial production remained robust in the first quarter of the year but fell sharply thereafter. Survey results show a continued worsening of growth prospects into the fourth quarter. The European Commission's economic sentiment indicator for the euro area is now well below its long-term average, and is below the troughs of 2001 and 1996 and nearing those of 1992 and 1993, when, if a regional aggregate of what has now become the euro area is made, growth registered 1.2 and -0.7, respectively.³ Country-specific surveys paint a similar picture. Germany's Ifo overall business climate index, for example, peaked at the beginning of 2007 but has since seen a very sharp decline. As of November 2008, it was just above the value registered in 1993, the lowest point since German reunification, while the component reflecting German business expectations is now at a record low within this same timespan.⁴

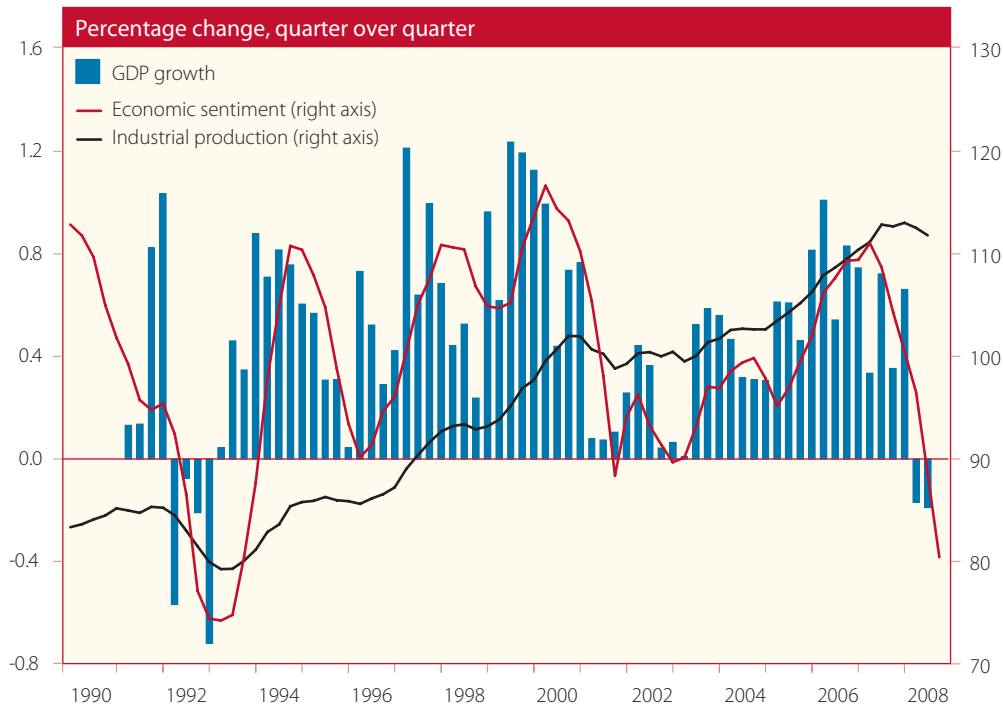
Consumption expenditure is slowing

Consumption expenditure contracted in the euro area in the first half of 2008, a pattern shared by a number of countries in the region. Sharply higher inflation that choked off any improvement in real disposable income and deteriorating confidence, stemming from fears surrounding future economic activity as well as the intensifying global financial crisis, were the major drivers. Retail sales figures have been drifting downwards since the fourth quarter of 2007, and as of September stood at 1.6 per cent below the previous year. Lending conditions to households have tightened, with higher bank lending rates

³ See Organization for Economic Cooperation and Development, *Economic Outlook*, vol. 2008/1, No. 83, June 2008.

⁴ See Ifo Institute for Economic Research, Ifo Business Climate Germany, available from <http://www.cesifo-group.de/portal/page/portal/ifoHome/a-winfo>.

Figure IV.2
Economic activity in the euro zone, 1990-2008



and tighter credit standards, and loans to households are clearly decelerating.⁵ Household wealth has been hit by declining equity markets and housing values, the latter having particular significance in countries where house prices have experienced a sharp run-up in the past, such as in Denmark, Ireland, Spain, the United Kingdom and, to a lesser extent, France. Current labour-market conditions remain favourable, but expectations for the outlook have deteriorated, with employment and wage prospects diminishing. Business surveys are already indicating that firms are expecting to reduce hiring. Some impetus can be anticipated from decelerating inflation, thus yielding moderate improvement in real compensation, but consumption expenditure is expected to be of only minimum support over the forecast period.

After a strong first quarter, investment spending has also been hit sharply, slowing external demand being a major negative impulse.⁶ In the early stage of the present global slowdown, the impact of the deterioration in the United States had been dampened by continuing robust demand from East Asia and oil-producing countries, particularly the Russian Federation, but these economies have now joined the general slowdown. Order books have deteriorated significantly and forward-looking surveys have plummeted. Capacity utilization, while still relatively high, is on a declining path. Balance sheets of non-financial corporations were still reasonably sound towards the end of 2008, stemming from high past profitability, but corporate profitability is severely deteriorating and stock markets have plummeted, which could lead to dangerously worsening balance sheets in

Investment spending is dropping sharply

⁵ See European Central Bank's "The Euro area bank lending survey", October 2008, available from http://www.ecb.int/stats/pdf/blssurvey_200810.pdf; and the discussion on "The results of the 2008 bank lending survey for the euro area" in the European Central Bank's *Monthly Bulletin*, November 2008, pp. 19-25, available from <http://www.ecb.int/pub/pdf/mobu/mb200811en.pdf>.

⁶ Some of the good performance in the first quarter can be attributed to mild weather, which boosted construction expenditure, but that reversed in the second quarter.

2009. The cost of external financing has increased significantly: corporate bond spreads have widened and banks are reporting rising margins for loans and higher credit standards. Bank lending to non-financial corporations remains strong but has been slowing continuously, registering a growth of 12.1 per cent in September of 2008 versus 14.6 per cent in the first quarter of the year. Going forward, it is probable that the deterioration in credit markets will slow borrowing further. Investment in the housing sector remains very weak and in some countries has plummeted, and there is no expectation of any significant rebound over the forecast horizon.

Exports are succumbing to a slump in global demand

Export volumes decelerated sharply in the second quarter of 2008. They are estimated to grow by only 3.8 per cent in 2008 in the EU-15 and are actually expected to decline in 2009 (see table A.16). Slowing global demand, coupled with continued strong regional currencies, provides powerful headwinds. The retreat of the euro and other regional currencies from their July peak, with further depreciation expected, provides some relief.⁷ For some countries, a favourable product mix and orientation towards fast-growing Asian and oil-producing countries, as well as strong competitiveness, provide some cushion, but all countries are expected to see significant slowing in exports, and the region as a whole is expected to continue to lose market share. Import volumes are also expected to slow in line with declining domestic demand, albeit by less than exports thereby causing net exports to detract from GDP growth.

Inflation has moderated

Headline inflation surged to its highest level in twelve years during 2008, reaching a peak of 4.0 per cent in both June and July in the euro area, but has since retreated to an estimated 3.2 per cent in October. Most of the acceleration can be attributed to the sharp rise in oil and food prices. The pass-through to general prices, a major concern for policymakers, was muted, with core inflation hovering just below 2 per cent since the beginning of 2007. Wage growth has been picking up and, with productivity slowing in the early stages of the downturn, unit labour costs have risen. But in the current negative environment, wage increases are expected to be limited. Over the past few years, the increasing strength of the euro has put significant downward pressure on prices and has, to some extent, mitigated the full impact of the rise in oil prices. While the depreciation of the euro in the second half of the year will eliminate this dampening effect, the sharp fall in oil prices (as well as in food and other commodity prices), coupled with GDP falling well below potential, is expected to lead to a further tapering off of inflation and a slow reversion towards 2 per cent. Inflation expectations,⁸ which were running significantly above 2 per cent in mid-2008, have since fallen back.

Unemployment rates reached multi-year lows but will deteriorate further in the outlook

The labour market has been a bright spot in Europe for the last few years, with unemployment trending down to multi-year lows, but it is now expected to deteriorate significantly as growth falls well below potential over the entire forecast horizon. Firms are increasingly challenged by the weaker demand outlook and tighter financing conditions. Labour costs have also risen, but are expected to remain contained going forward. Employment data are published with a significant time lag, but they show a clear deceleration in growth from the first quarter of 2007 through the second quarter of 2008. Unemployment data are timelier and show a gradual upward trend since the low point of 7.2 per cent for the euro area in the first quarter of 2008, reaching 7.5 per cent in August and September

⁷ On a trade-weighted basis, the euro peaked at a 40 per cent appreciation in July compared to its low in 2000. It has since fallen by more than 7 per cent from its peak, but still remains historically high.

⁸ Inflation expectations are measured here as the spread between French inflation-indexed and non-indexed bonds.

of 2008. To put this in perspective, unemployment is still relatively low, being well under the previous cyclical trough of 7.8 per cent in 2000. It would be necessary to go back to the 1980s to find unemployment rates as low as they are currently. So far, the construction sector has been the hardest hit, with Denmark, Ireland, Spain, and the United Kingdom most affected, but as the downturn continues, unemployment is expected to increase in all countries in the region, rising by about 1 percentage point for the region as a whole.

Fiscal positions are expected to deteriorate significantly over the forecast horizon. On the revenue side, slowing growth and falling asset prices are expected to dampen tax revenues. On the expenditure side, automatic stabilizers in the guise of social benefits and transfers will increase significantly. Some discretionary fiscal stimulus is assumed in the outlook, but it is increasingly likely that more may be necessary, at least in those countries with budgetary space, and perhaps by an even larger group. Measures to combat the intensifying global financial crisis may well dwarf these traditional policy measures. So far, the former have included capital injections into financial institutions; State-backed guarantees for bank loans; higher levels of minimum deposit insurance; and actual bailouts of financial firms, including a wave of partial nationalizations of banks in late September and October. These types of measures are likely to continue to be deployed.

At the beginning of 2008, while most central banks in the region were using traditional policy instruments to suppress increasing inflationary pressures (headline inflation rates being well above declared targets), they were, at the same time, combating problems in credit markets using unorthodox measures. The European Central Bank (ECB) raised its main policy interest rate, the minimum bid rate, by 25 basis points (bps), to 4.25 per cent in July, and during the year there was further tightening elsewhere by 75 bps in Sweden and 50 bps in Norway, while the Swiss National Bank maintained the tight policy stance it had in 2007. The unorthodox measures focused on the direct injection of liquidity into the money markets, with central banks acting as both a lender of last resort and a market maker. The ECB, for example, accepted an increasingly wide range of collateral and counterparties in its discount and repurchase operations, and at an increasing range of maturities.

As global economic conditions deteriorated further, however, policy stances shifted. The Bank of England was the first to react, lowering rates in February and April. Later, on 9 October, after the financial crisis had begun to enter a more dangerous phase in September and indicators of economic activity had begun to fall to levels associated with a recession, central banks changed course and joined in a coordinated rate cut of 50 bps. The ECB,⁹ the Bank of England, the Sveriges Riksbank and the Swiss National Bank (25 bps) all joined in the action. The Bank of Norway also cut its rate by 50 bps later in the month. Since then, the ECB has made another 50 bps cut, bringing its rate to 3.75 per cent, while the Bank of England made a staggering cut of 150 bps in November. The other central banks also loosened policy further. The cumulative change in policy rates by the end of November was 150 bps for the ECB, 200 bps for the Bank of England, 100 bps for the Sveriges Riksbank, 175 bps for the Swiss National Bank, and 100 bps for the Norges Bank.

In the outlook, policy is expected to loosen further. The ECB is assumed to cut its main policy interest rate further during the fourth quarter of 2008 from its current level of 3.25 per cent to 2.75 per cent by the end of the year, and in early 2009 another 50 bps

Fiscal policies are likely to be unorthodox

Monetary policy is shifting to rapid easing

⁹ The ECB also changed its operating procedure so that its main refinancing operations would be carried out through a fixed-rate tender procedure with full allotment at the interest rate on the main refinancing operation. This replaced its policy of setting a minimum bid rate for variable rate tenders and effectively provides sufficient liquidity to satisfy demand at the fixed rate.

Regional exchange rates
were highly volatile
during 2008

cut is assumed, with no further action for the rest of the year. Similar policy is assumed for the other regional central banks.

In the first half of the year, regional currencies continued their long period of appreciation against the United States dollar and the yen—to no small degree on account of the large and persistent global imbalances—with the euro reaching a peak of \$1.60 and ¥169. Superimposed on this long-run trend, are short- to medium-term dynamics in currency markets that have been driven largely by relative outlooks for growth, interest rates and risk assessments, the latter at times generating significant flights to safety into and out of currencies. All of these factors, both long- and short term, favoured the euro in the first half of 2008: growth was holding up, monetary policy was still tight and potentially tightening, and the risks stemming from the financial crisis were concentrated mostly in the United States. But this shifted dramatically in July as the outlook for the euro area deteriorated significantly and it also became clear that the ECB would have to cut rates in response to the slowdown. This led to a sharp decline in the euro against both the United States dollar and the yen during the summer months. In mid-September risk assessments shifted further against the United States as market participants reacted to the latest proposed bailout plan, which raised the Government's debt burden significantly. This led to a rebound of the euro, but it was short-lived, as the economic news in Europe had deteriorated further and the financial turmoil that had spread across the continent at the end of September produced a serious jolt to risk perceptions. The euro resumed its downward path reaching lows of nearly €1.25 against the dollar, while against the yen it fell to lows of nearly ¥117, as these higher risk perceptions led to a reversal of the carry trade and a repatriation of funds.

In the outlook, the euro is expected to remain close to current levels of about \$1.28 in the fourth quarter of 2008 and to depreciate further in 2009, reaching \$1.20 as interest rate differentials with the United States narrow further. Similarly, the euro is assumed to remain at ¥126 in the fourth quarter and to reach ¥109 in 2009.

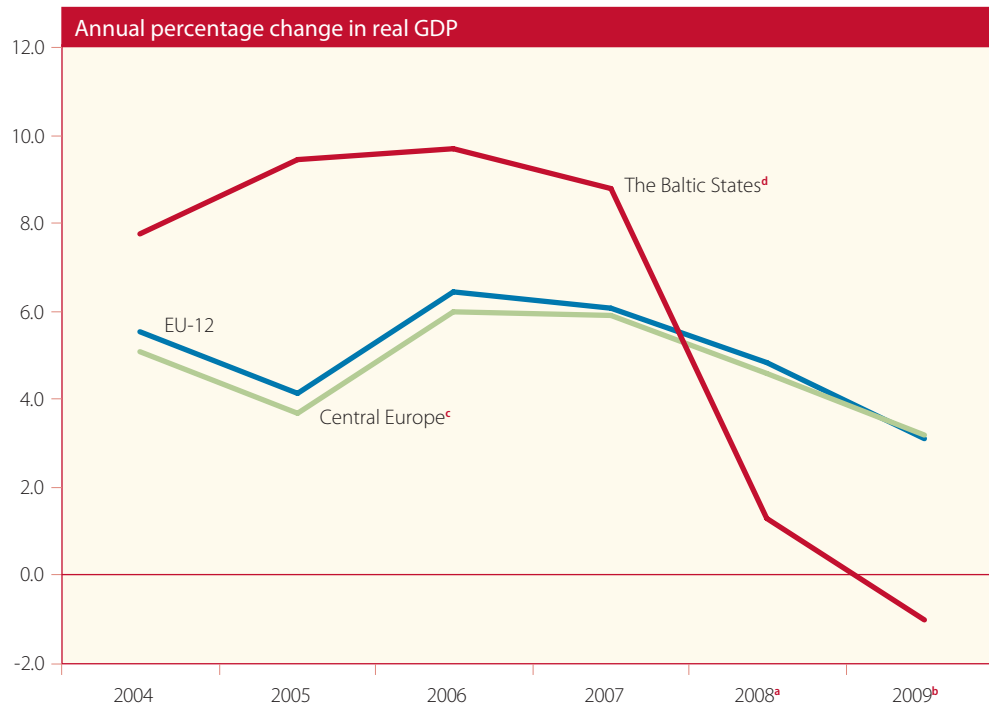
Downside risks
are worrying

Risks to the outlook are significant and biased towards the downside. The key assumption in the present outlook is that problems in financial markets will subside and that real activity will begin to stabilize in the second half of 2009. This might be optimistic as problems have continued to intensify towards the end of 2008. The longer these problems persist, the more severely private investment will be hit. Moreover, housing markets could deteriorate further and remain in a slump for a longer period of time, dragging down overall economic activity even more in some economies in the region. In addition, the economies in East Asia and oil-producing countries could be hit harder than currently expected, which in turn would further reduce demand for European exports. Another major risk could come from a collapse of the dollar which would push regional currencies back to and beyond the elevated levels of the summer of 2008, pricing many exporters out of key markets.

The new European Union member States: A divergent growth pattern in 2008, a slowdown in 2009

Following several years of buoyant economic expansion in the new European Union (EU) member States, aggregate GDP growth in 2008 is expected to slow to 4.9 per cent in 2008 and to decline further to 3.1 per cent in 2009 (see figure IV.3). While a number of economies, such as Bulgaria, Poland, Romania and Slovakia, managed to sustain or even accelerate their growth rates in or into the 5-8 per cent range, the three Baltic economies witnessed a sharp slowdown. Growth in Estonia and Latvia turned negative in 2008, with

Figure IV.3
Pattern of economic growth in the new EU member States, 2004-2009



Sources: United Nations Economic Commission for Europe; Eurostat.

a Partly estimated.

b Forecasts, based on Project LINK baseline scenario.

c Consists of the Czech Republic, Hungary, Poland, Slovakia and Slovenia.

d Consists of Estonia, Latvia and Lithuania.

further contraction expected in 2009. Growth in the remaining countries in the region was moderate in 2008 but is also expected to slow further in 2009, as their main driving force, robust domestic demand, is weakening in response to higher credit costs and accelerated inflation. In Hungary, further fiscal tightening and harder borrowing conditions will lead to negative growth in 2009. Export growth for these economies is also expected to decline owing to the economic slowdown by their main trading partners.

The generally strong growth in the region over the past several years was driven by vibrant domestic demand, underpinned by increasing real wages and the expansion of domestic credit, but it was also accompanied by a number of dangerous trends: sizeable current-account deficits that were often financed by interbank borrowing; FDI flows into much of the region that were financed by lending from parent companies, increasing the indebtedness of the private sector; a large fraction of investment that was channelled into real estate in a number of the economies, especially the Baltic countries and Bulgaria, producing domestic housing bubbles; and, finally, a sizeable percentage of loans in the region that were denominated in foreign currencies.

The tightening of global financial markets has begun to reduce the ability of the business and banking sectors to maintain their levels of foreign borrowing. As a result, domestic credit growth has declined and banks have tightened their lending policies. The generally large current-account deficits have made the region especially vulnerable to the deterioration in global credit conditions. In Hungary, the high stock of short-term private debt, denominated in foreign currencies, created a serious liquidity squeeze. To avoid a financial crisis, the country had to seek assistance from the ECB, the EU and the International Monetary Fund (IMF), which was provided quickly and in sufficiently large amounts to contain the crisis and the potential for regional contagion. Although the financial sectors of the new EU members are not significantly exposed to United States sub-prime debt, there

Economic expansion was often financed by foreign borrowing

The region is vulnerable to the global credit squeeze

is an extremely high level of foreign ownership, largely by EU-15 banks, and should these experience serious difficulties, the financial stability of the region would be seriously impacted. If the cut-off in foreign borrowing is too sharp, a true credit crunch could develop.

In 2008, domestic inflationary pressures caused by continuing wage growth, sometimes in excess of productivity gains, and increases in excise taxes and regulated prices were amplified by the surge in global food and energy prices. The impact of rising world market prices for food and oil on overall domestic inflation differed across the new EU member States on account of differences in weights for food prices in consumer price indices; differences in the degree of competition in services and in the retail sectors, explaining different cost mark-ups; and differences in exchange-rate regimes. Inflation reached double-digit levels in the Baltic States and Bulgaria, whose fixed exchange-rate regimes prevented nominal appreciation from accommodating some of the inflationary pressure. Currency appreciation dampened inflation in the Czech Republic, Hungary and Poland in the first half of 2008. By mid-2008, headline inflation had peaked and had started to subside, reflecting, among other things, the drop in world oil and commodity prices.

In response to accelerating inflation in the first part of 2008, and in the light of the shared key policy goal of a return to a disinflationary path, interest rates were increased in the Czech Republic (at the beginning of the year), Hungary, Poland and Romania. In addition, certain measures were undertaken to constrain domestic credit, such as the increased credit supervision in Slovenia. But with slowing economic growth and declining world commodity prices, policy concerns are shifting. Monetary easing has already taken place in the Czech Republic and in Hungary, but concerns about currency depreciation may limit the room for a further loosening of monetary policy.

Conditions attached to accession to the European Monetary Union remain a main focus for macroeconomic policies in the region. Slovakia will adopt the euro in January 2009, but no further accessions are anticipated for several years. The Maastricht criteria, especially the inflation target, are proving difficult to meet. Budget deficits have been reduced towards achieving the target, but not without creating a pro-cyclical impulse to a slowing economy. In the outlook, the slowdown will make it more difficult to meet fiscal targets and reduce the deficit further. However, given the limitations of using monetary policy for macroeconomic stabilization, especially under a fixed exchange-rate regime, additional fiscal stimulus will be needed to counteract the economic slowdown.

The employment situation in the new EU member States continued to improve in 2008; in Poland, for example, unemployment reached 9.6 per cent in mid-2008 compared to 19.0 per cent as recently as 2004. Nevertheless, structural problems in labour markets continue as labour-force participation rates remain low in a number of these economies. The sharp economic slowdown being forecast in the Baltic States in 2009 may lead to a 1 or 2 percentage point increase in their unemployment rates, which are currently in the range of 5 to 6 per cent. In other economies, the rate of job creation has also slowed, and the continuing return of migrants from the EU-15 back to their home countries may exert additional pressure on the labour markets. Since 2004, almost one million workers migrated to the United Kingdom alone; approximately two thirds of these came from Poland.

External deficits declined significantly in the Baltic States in 2008, reflecting an improvement in their trade balances as weakening domestic demand led to a contraction in imports. In Central Europe, however, the improvement in current-account deficits was only marginal, and in some countries the deficits increased, reflecting a decline in exports. In 2009, current-account deficits will continue to decline in the Baltic States, but will remain at about the same level in Central Europe.

Inflation surged in response to higher energy and commodity prices, but is expected to subside in the outlook

Monetary policy tightened in 2008

Labour markets continued to improve, but the worsening economic situation will reverse this positive trend

Current accounts deficits declined in the Baltic States, but remain the same in the rest of the region

In the outlook, the most serious risk faced by the region is a protracted slowdown in the EU-15; for the countries with large external deficits and a high dependence on foreign borrowing, it is the possibility of a sharp reversal of capital flows.

Developed Asia and the Pacific: Japan's economy enters recession and will contract further in 2009

In Japan, economic activity contracted in the second and third quarters, bringing another major economy into recession. Weaker export demand owing to lower growth in international markets and negative exchange-rate effects were the primary causes. Annual growth is expected to register only 0.4 per cent in 2008 and -0.3 per cent in 2009 (see table A.1). The negative effect of the global financial crisis through the external account has increasingly outweighed the country's only limited exposure to sub-prime loans in the United States as well as its strong capital position due to the high level of domestic savings. In the baseline, the economy is forecast to remain in recession into the first half of 2009 before seeing a return to positive growth rates in the third quarter of 2009.

On the domestic side, slower growth in private consumption will be a major drag on overall growth performance. The weaker trading environment for exporters and rising input costs, notably in the energy sector, exert increasing pressure on corporate profits, which will translate into softer labour demand and wage growth. In parallel, the continued relatively high consumer-price inflation due to higher commodity prices will cut into consumers' purchasing power, further eroding the potential impulse from private consumption for overall growth.

The room for fiscal stimulus seems limited in the light of the country's level of public indebtedness. Japan's public debt ratio has surged to become the highest in the industrialized world since the extensive fiscal support measures during the recession in the 1990s (see figure IV.4). The Government's looser fiscal policy stance in the form of two recent stimulus packages to support economic growth will be only temporary. In the medium term, the outlook for public finances remains bleak, as the option of higher income and consumption taxes remains on the table, holding significant downside risk for private consumption.

Business investment has shown a more moderate expansion, especially in view of the weaker external trading environment, but momentum will pick up in the second half of 2009 as firms will aim to ensure their competitiveness through technological upgrades in their production processes. Similarly, private residential investment will support growth as the slowing effect of regulatory changes fade.

On the external side, exports are suffering from the slowdown in the United States, Japan's biggest export market, as well as a stronger yen. Demand from emerging markets, especially China, has so far been a strong counterweight to slower export demand from developed countries, but the negative impact of the global crisis on economic activity in emerging markets will put further pressure on Japan's export performance.

Consumer prices are being pushed higher by the increase in energy and commodity prices. However, inflation will moderate along with the slowdown of the global economy, lower commodity prices and the appreciation of the yen. In 2008, the inflation rate is estimated at 1.6 per cent and is expected to decelerate to 1.1 per cent in 2009 (see table A.4).

In view of the weakening growth picture, the Bank of Japan cut its policy interest rate from 0.5 per cent to 0.3 per cent in October. Rates are assumed to stay at their current levels through 2009.

Consumption will be weak ...

... while the potential for fiscal stimulus remains limited

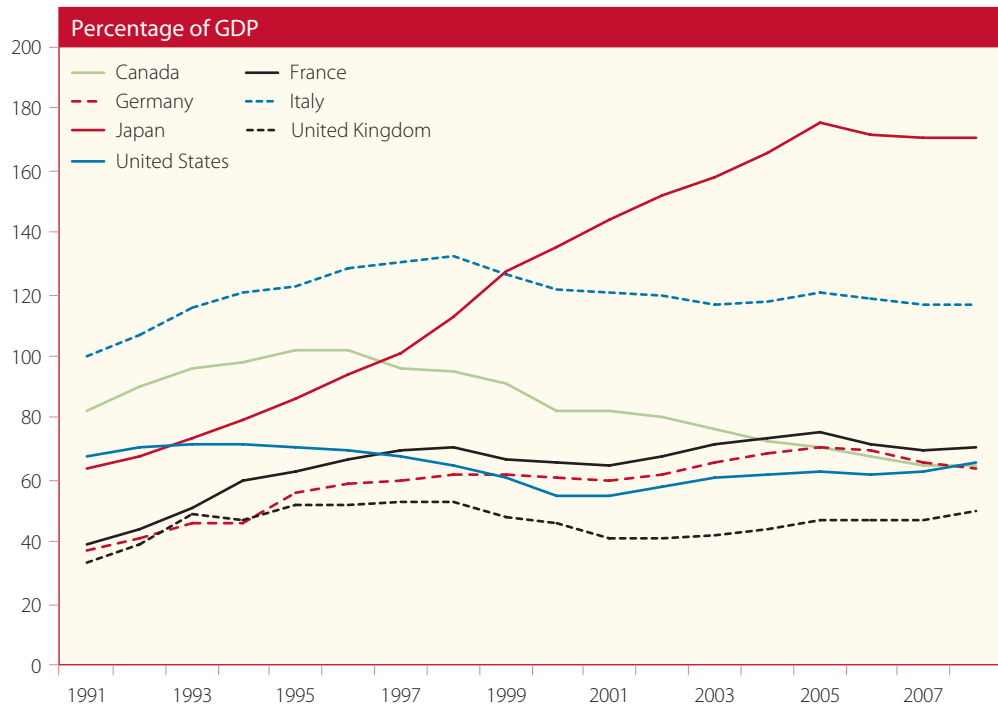
Investment remains a bright spot in the outlook

Weaker export demand will drag down growth

Inflation will moderate

Monetary policy remains on hold

Figure IV.4
General government gross financial liabilities, 1991-2007



Source: OECD.

Capital flowing into yen-denominated assets will sustain the appreciation trend

After depreciating against the dollar for much of 2008, the deterioration of conditions in global financial markets has led to increased global demand for yen-denominated liquid assets and a substantial appreciation of the yen. This trend is expected to continue in view of economic weakness and uncertainty in the United States, looser monetary policy in other major economies and increased risk aversion in the wake of the turmoil in financial markets. The latter implies a further reduction in carry-trade positions, with traders buying back the yen to close out their long positions in higher-yielding currencies that were opened by borrowing in the lower-yielding yen.

The outlook is subject to the significant downside risk of a more pronounced slowdown in Japan's main export markets. A worst-case scenario would imply a synchronized shock in the form of weaker-than-expected demand from developed economies, especially the United States, and emerging markets such as China.

Weakening consumption will reduce Australia's growth

Economic growth in Australia slowed to 2.6 per cent in 2008, from 4.4 per cent in 2007, and is projected to decelerate further to 1.1 per cent in 2009, with private consumption emerging as a major drag on overall activity. Real household incomes are being squeezed from various sides, including high interest rates, tighter credit conditions, a weakening housing market and flat real wages due to continued inflationary pressures. Sharp increases in the negotiated price for iron ore and coal, in turn, will benefit net exports and the external account into 2009, although lower commodity prices will put pressure on the trade balance thereafter.

Inflation will fall amid further monetary policy loosening

After an increase to more than 4 per cent in 2008, consumer price inflation is expected to fall towards the upper limit of monetary policymakers' target corridor of 2-3 per cent in 2009 following weaker domestic demand that will outweigh emerging inflationary pressure from a weakening Australian dollar. In view of the spreading global

financial crisis, policymakers have cut interest rates three times, from 7.25 per cent in September to 5.25 per cent in November, and there will probably be further monetary policy loosening in 2009 in order to alleviate the financial strains of households and to stimulate private consumption.

New Zealand's economic growth is expected to reach a very modest 0.6 per cent in 2008, but should rebound slightly to about 1.1 per cent in the baseline forecast for 2009. The slowdown in 2008 has been fairly broad-based, with private consumption suffering from higher inflation, high debt levels and the drop in housing prices. While business investment will remain under pressure from a weakening New Zealand dollar and relatively high interest rates, government spending is expected to provide the necessary stimulus in 2009 to prevent the economy from sliding into recession. Export growth is expected to recover in 2009 on the heels of currency depreciation and a stronger performance in the agricultural sector, as drought conditions give way to more favourable weather forecasts.

Inflation continues to exceed the central bank's target range of between 1 and 3 per cent, driven by higher food and energy prices, high capacity utilization rates and tight conditions in the labour market. However, the upward pressure on prices is forecast to recede owing to weaker domestic demand, the softening housing market and flattening commodity prices. Policymakers have begun cutting interest rates from their recent high and are expected to maintain their loosening stance in 2009 in an attempt to counter slowing economic growth as well as higher financing costs for businesses in the wake of tighter global credit conditions. The resulting smaller interest-rate differentials in favour of the New Zealand dollar, combined with increased risk aversion in financial markets, will put downward pressure on the currency, especially in the light of the closing-out of speculative positions driven by carry trades that borrow in lower-yielding currencies, such as the Japanese yen, to buy the New Zealand dollar. However, any more pronounced depreciation of the currency would create renewed inflationary pressure and, thus, limit monetary policymakers' space for further interest rate cuts.

New Zealand's slowdown will be cushioned by fiscal spending

Monetary policymakers' accommodative stance will be limited by the inflationary effect of currency depreciation

Economies in transition

In 2008, the economies in transition generally showed a surprising resilience to the impact of the global financial crisis. Despite a certain deceleration from the previous year, strong economic growth continued both in South-eastern Europe and in the Commonwealth of Independent States (CIS). Aggregate GDP in economies in transition grew by about 7 per cent, reflecting an increase of 7.1 per cent in the CIS and 5.2 per cent in South-eastern Europe (see table A.2). Two main factors underpinned the continued robust performance of these economies. First, direct financial contagion from the global crisis was initially relatively limited, not least due to underdeveloped financial systems in the region and weak financial integration with the rest of the world. Second, economic growth in most economies was mainly driven by domestic demand, while a slowdown in export demand only mildly affected domestic output during 2008. The surge in world energy and food prices during the first part of the year pushed domestic inflation sharply upwards, especially in the CIS, but also in the economies in South-eastern Europe. In late 2008, inflationary pressures started to subside following the steep fall in world commodity prices.

Despite the favourable outcomes in 2008, the outlook for the economies in transition has deteriorated considerably. With the deepening of the global financial crisis

Resilient growth amidst the global turmoil, but considerable deterioration is expected in 2009

and the developed countries' entering into recession, the economies in transition are expected to see a significant slowdown in the baseline projection for 2009, with aggregate GDP growth falling by 2 percentage points or more compared with 2008.

South-eastern Europe: Another year of good performance, though with activity likely to weaken

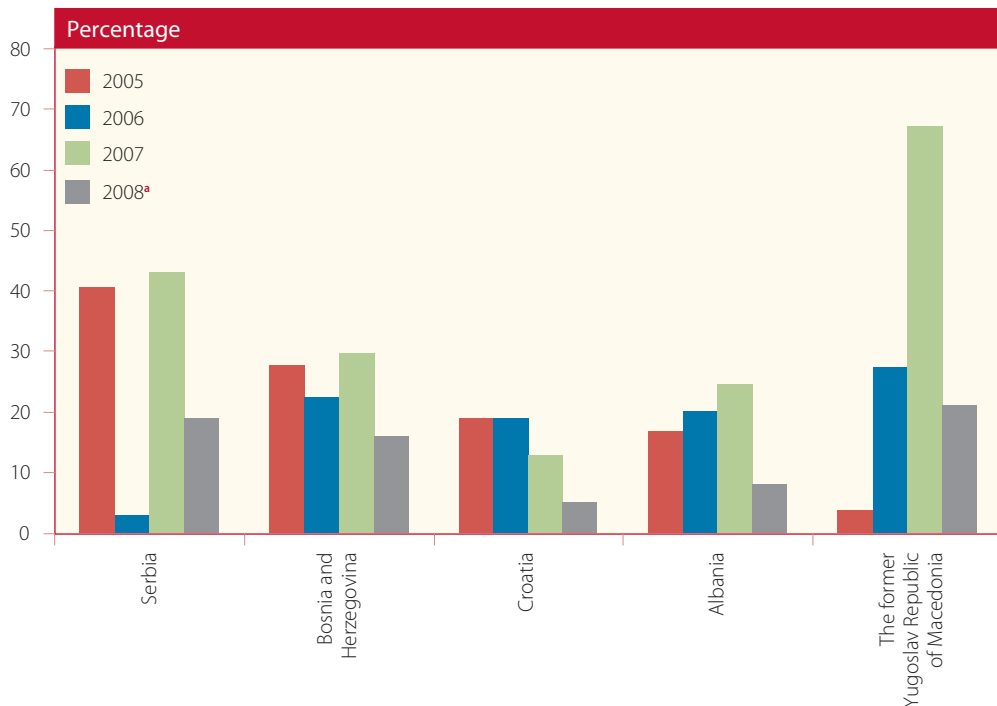
All economies in South-eastern Europe continued to grow at relatively robust rates in the order of 5 per cent or higher in 2008, with the exception of Croatia (see table A.2). Growth in 2008 continued to be largely driven by domestic demand, underpinned by rising real wages, strong FDI inflows and domestic credit expansion (see Figure IV.5). However, in the course of the year, and with the escalation of the global financial crisis, these growth factors started to lose steam and will weaken further in 2009. Hence, a further moderation in the pace of growth to about 4.5 per cent for the region as a whole is expected in the baseline scenario for 2009, down from 5.2 per cent in 2008.

The inflationary surge seems to be subsiding

Inflation accelerated in South-eastern Europe in the first half of 2008, driven by surging world food and energy prices, strong domestic demand and rising real wages. The acceleration was quite pronounced in Bosnia and Herzegovina, Croatia, Serbia and the former Yugoslav Republic of Macedonia (see table A.5). However, during the second half of the year, inflationary pressures weakened as world commodity prices started to fall from their highs and domestic inflationary pressures subsided. Given the overall domestic and global macroeconomic prospects, this trend is likely to gain further ground in 2009.

Employment conditions improved in all South-eastern European economies along with the continued dynamic economic performance in much of 2008. Nonetheless,

Figure IV.5
Growth of domestic credit in South-eastern Europe, 2005-2008



Source: IMF, *International Financial Statistics*.

^a End-2007 to mid-2008.

unemployment rates remain very high (about 16 per cent on average); only Croatia has a single-digit rate of unemployment. Nevertheless, positive labour-market developments are expected to continue in 2009 as a result of new investments in production capacity and the implementation of infrastructure projects. In Croatia, though, the rate of unemployment may increase in response to weaker performance of the tourism industry.

The general government budgets in most South-eastern European economies have become more balanced and were fortified by higher tax revenue following strong economic growth in recent years. There was some fiscal loosening in a number of countries in 2008, in part because of their electoral cycle. Fiscal deficits are expected to widen as a result of the economic slowdown and anticipated expected fiscal responses in 2009, but larger deficits do not pose an immediate threat to macroeconomic stability.

In contrast, there was a notable tightening of monetary policy in 2008, partly in response to rising inflationary pressures. Central banks increased their policy rates in Albania, Serbia (in stages) and the former Yugoslav Republic of Macedonia, while mandatory reserve requirements were increased in Bosnia and Herzegovina and Croatia. The domestic monetary tightening was coupled with deteriorating conditions of access to international financial markets. The rising cost of credit is likely to further dampen economic activity in the region.

Against the backdrop of strong domestic demand and weakening import demand in the important European markets, imports by South-eastern European economies generally outpaced their exports in 2008. As a result, both trade and current-account deficits continued to widen in all countries and, in a number of cases, have reached alarming proportions. Financing these deficits up until the 2008 crisis did not pose a problem, but financing conditions have been changing for the worse, forcing a downward adjustment in domestic demand. In November 2008, Serbia reached an agreement with the IMF on a standby loan of \$518 million dollars, although it is not clear if any funds will be drawn. The restraining effect of unfavourable financing conditions is likely to increase further in 2009 and the deficits may decline somewhat in the short run.

Fiscal deficits are expected to widen in 2009

Monetary policy has tightened

Current-account deficits are high but a downward adjustment may be under way

The Commonwealth of Independent States: Despite some deceleration, growth remains impressive

While the pace of economic activity in the CIS moderated somewhat, it remained robust in 2008: GDP in most countries grew at rates of 6 per cent or higher (see table A.2). During the latter half of the year, growth in the Russian Federation slowed somewhat from its strong performance earlier on, owing to stagnating oil production and decelerating investment. Notably though, the Russian grain harvest in 2008 was the highest in the last 15 years. In Azerbaijan, the rate of GDP growth dropped compared with previous years as the impact of newly introduced oil and gas facilities faded, but it remained the highest in the CIS. A significant deceleration of economic activity was observed in Kazakhstan as a result of an abrupt cutback in foreign borrowing amidst global financial turmoil that also spilled over into neighbouring countries (see box IV.1). The military conflict in the Caucasus had only a limited effect on oil exports, but it did, nonetheless, affect growth performance in Georgia.¹⁰ In 2009, less favourable external circumstances, including lower commodity prices and increasing difficulties in obtaining external finance, are likely

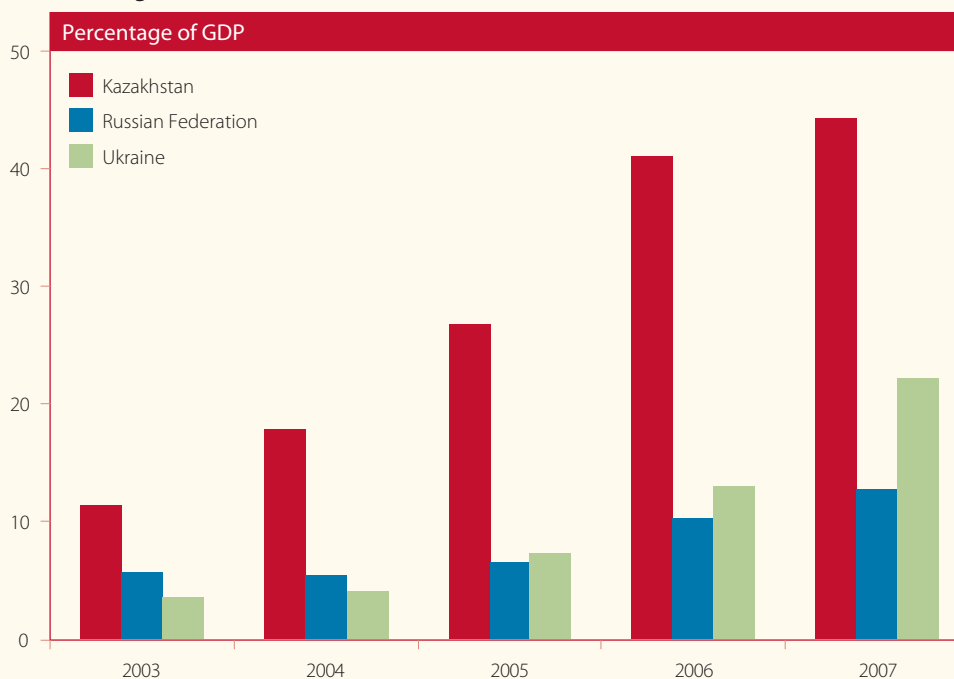
¹⁰ In September 2008, the Parliament of Georgia carried a motion to leave the Commonwealth of Independent States (technically this decision is due to enter into force in mid-2009). However, Georgia's performance is discussed in the context of this group of countries for reasons of geographic proximity and similarities in economic structure.

Box IV.1

The impact of the global financial turmoil on the banking sector of the Commonwealth of Independent States

The financial crisis, which originated in the United States sub-prime mortgage market, has also affected some of the economies of the Commonwealth of Independent States (CIS). Increased financial integration, including access to external finance, has created new channels for the transmission of shocks. The impact of global turbulence has varied across the countries of the CIS, reflecting differences in the degree of financial development and the extent to which banks and companies have relied upon foreign financing. The external debt of the banking system has increased in the largest economies in recent years, albeit to significantly different degrees (figure A).

Figure A
Banking sector: external debt, 2003-2007



Sources: National Bank of Kazakhstan, Central Bank of the Russian Federation and National Bank of Ukraine.

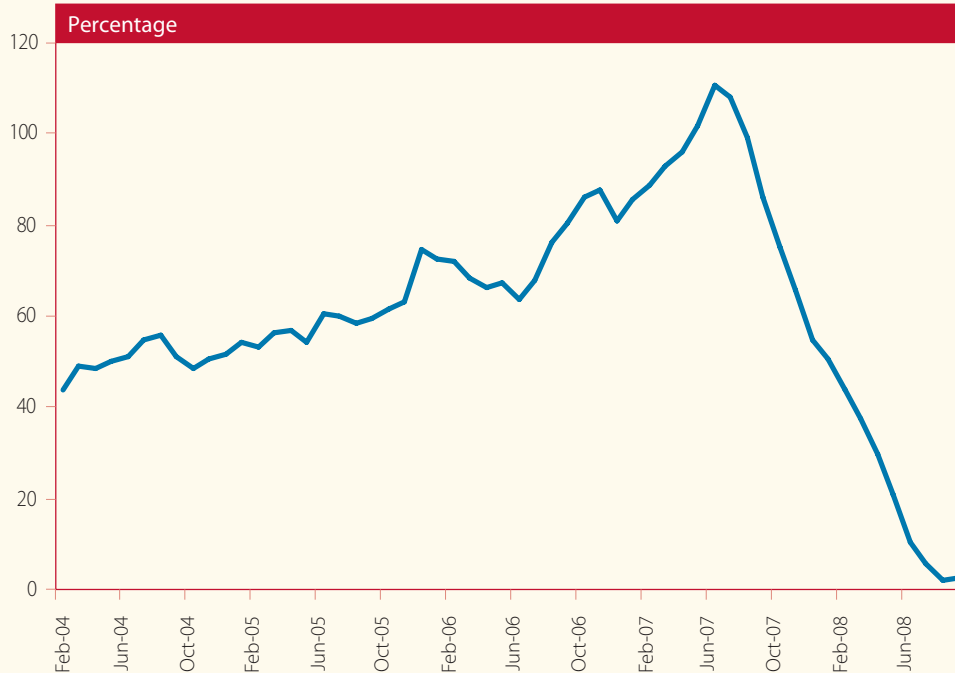
The consequences of the crisis have been the most severe in *Kazakhstan*, where the banking system has developed rapidly in recent years as a result of the strong growth of foreign liabilities fuelling fast domestic credit expansion. In recent years, these sources have covered about half of the funding needs of the sector. Good access to international markets was supported by a perceived strong regulatory and supervisory framework, improved investment grade ratings and favourable economic prospects.

The growing dependence on foreign funding was, however, also a source of vulnerability. While the authorities managed to reduce the share of short-term obligations, they did not succeed in curbing overall foreign borrowing. Global credit turmoil led to a sharp deterioration in access to external funding. In addition, falling confidence caused a temporary decline in household deposits and increased pressures over the exchange rate that required interventions by large central banks. Lending has fallen sharply, depressing growth in the non-oil sector and sharply reducing real estate prices, which, particularly in *Almaty*, had recently undergone rapid growth, fuelled by the availability of credit (figure B).

In the *Russian Federation*, the impact of the crisis was initially more muted, given the lower reliance of the banking sector on international capital markets. However, credit growth slowed

Box IV.1 (cont'd)

Figure B
Kazakhstan: annual credit growth, February 2004-September 2008



Source: National Bank of Kazakhstan.

down, and some banks with more aggressive expansionary policies funded by external financing experienced difficulties. Moreover, adverse market conditions led to the postponement of primary equity placements, which had been playing a larger role in corporate financing. The worsening of the global financial crisis in 2008 increased the severity of the problems confronting the Russian banking system. The widespread use of shares in Russian companies as collateral exposed the sector to a reversal in equity prices. A plummeting stock market led to margin calls, which reinforced downward pressures. The burgeoning domestic bond market has been negatively affected by mounting inflation and the overall liquidity problems. As market participants have become more sensitive to counterparty risk, interbank financing has suffered amidst declining trust.

Despite a current-account surplus and a solid reserve position, the private sector in the Russian Federation remains exposed to external financing conditions, including through the impact of capital flows on domestic liquidity. Capital outflows drained liquidity from the system and have forced banks to rely on short-term public funding. The Central Bank's interventions to shore up the rouble, which has been under pressure through the intensification of capital outflows, have had a contractionary impact.

Patterns of ownership in the banking sector have also acted as a channel for the regional transmission of shocks. Kazakh banks, enjoying good access to external finance, expanded into other countries in the CIS. In *Kyrgyzstan*, they accounted for almost half of total lending. The troubles of parent institutions have led to a temporary slowdown in credit growth in *Kyrgyzstan* as well. However, the low level of financial intermediation has limited the impact of this channel with regard to the transmission of shocks. In *Ukraine*, the degree of foreign ownership of the banking system initially proved to be a benign influence, as Western parent banks provided access to external financing in a difficult global environment. The situation deteriorated in late 2008, as concerns over exchange-rate stability, widening external imbalances and mounting political risks created refinancing difficulties.

The reaction of the monetary authorities to alleviate the impact of the credit crunch has been similar throughout the region and initially involved providing liquidity through various means, including widening the scope of repurchasing operations, easing reserve requirements or

Box IV.1 (cont'd)

using public institutions to inject resources into the banking system. Limits on deposit insurance were increased to shore up confidence. In addition, support programmes have addressed the refinancing needs of particular sectors, such as construction and small and medium enterprises in Kazakhstan. As the crisis deepened, fiscal allocations were made to support lending and the stock prices of State companies in the Russian Federation. Direct restrictions on new lending and deposit withdrawals were introduced in Ukraine. Government plans for the sector also include State-backed recapitalization of financial institutions through subordinated loans or direct equity stakes in the Russian Federation, Kazakhstan and Ukraine.

The global financial crisis has highlighted the dearth of domestic sources of long-term financing in the region, a common problem in the CIS, which had been temporarily overcome through access to international capital markets. In the short-term, future growth of banking assets will depend on ability to expand the deposit base. A more balanced funding structure will require a slowdown in lending, which will also be depressed by the need for increased provisioning. Ongoing inflationary pressures and exchange-rate volatility represent a challenging environment for raising deposits. State-owned banks, with their extensive branch networks, enjoy the advantage of acquiring deposits vis-à-vis other competitors, and may increase their market shares. These banks will be used as an instrument to support lending by the authorities. Some degree of banking consolidation appears unavoidable in most countries. Over the medium term, the development of domestic capital markets, including the presence of institutional investors, such as pension funds, would be necessary to provide alternative sources of financing.

Financial turbulence and credit constraints are leading to a global slowdown. Worsened economic prospects worldwide are also depressing the demand for commodities, which are critical for economic performance and investor sentiment in the CIS region. This has opened up a second channel for the transmission of negative shocks, contributing to an increase in the difficulties created by the persistence of an adverse global environment. For the banking sector, slower growth will add to concerns over the deterioration of asset quality.

to lead to a marked slowdown in the economic activity of the region, with aggregate GDP growth forecast at 4.9 per cent.

Robust domestic demand, especially private consumption, remained the main driver of economic expansion in the region. Rapid income growth, reflecting the continued robust economic performance and high inflows of worker remittances in the poorest countries, has underpinned strong consumer demand, despite the negative impact of surging inflation on purchasing power. Consumption growth compensated for the notable deceleration in fixed investment demand, including in the Russian Federation, reflecting a slowdown of construction activity and tightening credit supplies to businesses amid deteriorating confidence in economic prospects. In Kazakhstan, both private consumption and fixed investment decelerated sharply as lending to business and households stagnated because of the problems in the banking sector.

The pace of job creation in the CIS generally remained relatively strong despite the worsened performance of the labour-intensive construction sector. Armenia and Azerbaijan displayed the largest improvement in labour-market indicators. The Russian Federation has continued to attract significant migratory inflows from other CIS countries, spurred by rapid wage growth and the large wage differential vis-à-vis jobs in the home countries. In Kazakhstan, in contrast, registered unemployment increased, largely owing to a significant fall of output growth. Labour-market indicators are expected to deteriorate in 2009, however, as economic growth in the CIS is projected to slow down, the more so as construction activity enters into a slump.

Inflation rates remained high throughout the region and rose further in a number of countries in 2008 (see figure IV.6). Food spending accounts for a significant share of the

Domestic demand is driving the CIS economies

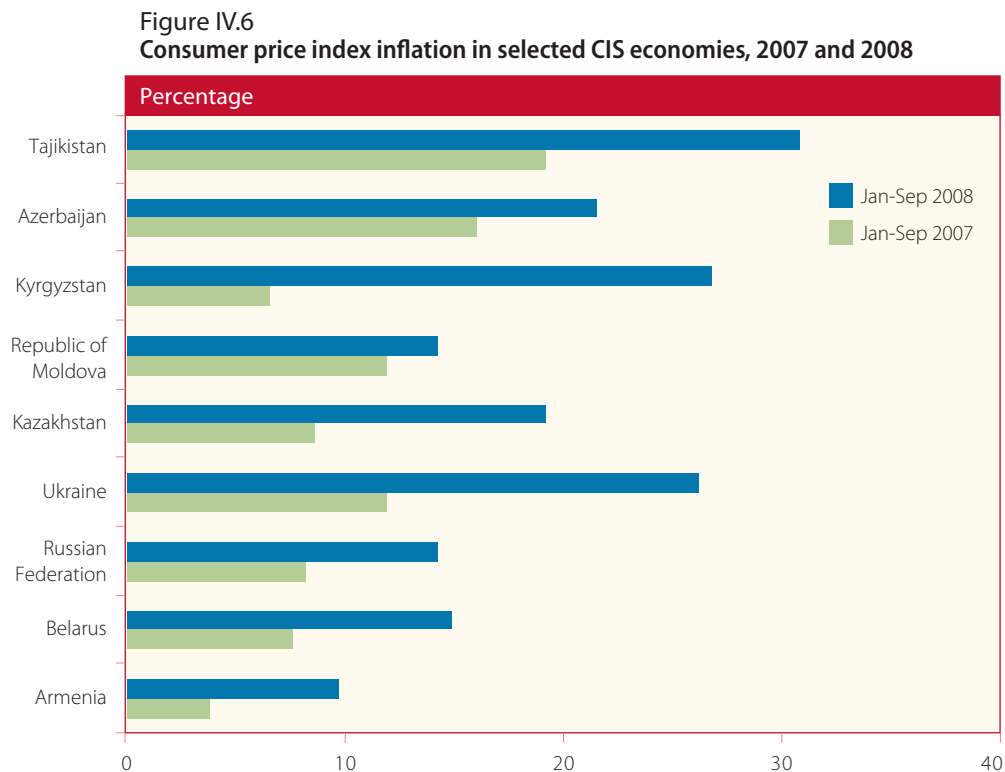
Employment growth was strong in 2008, but bleaker prospects are ahead

Inflationary pressures are high, but are abating

consumer basket in the CIS countries; hence, rising food prices have had a marked impact on headline inflation. In Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan and Ukraine, the annualized rate of consumer price inflation peaked above 20 per cent before starting to decline in the final months of the year. This reflected both external factors, such as high food and energy prices, and domestic influences, including broadly accommodative policies, and, in some cases, an ongoing adjustment of prices in regulated services. Policymakers in a number of countries resorted to various interventions in an attempt to curb inflationary pressures, such as tighter policies and exchange-rate appreciation in Armenia and export restrictions on food in Uzbekistan. In late 2008, headline inflation decelerated in most CIS economies as the effect of commodity price rises abated. Further lowering of commodity prices and more moderate domestic demand should support a moderation in inflation in 2009, which nevertheless is expected to remain relatively high.

Monetary authorities have been confronted by two major challenges, namely, strong inflationary tensions and the need to address the fallout from the global crisis, which have resulted in capital outflows and exchange-rate pressures during the second half of 2008. Monetary policies remained generally accommodative earlier in the year as the authorities, particularly in the Russian Federation and Ukraine, tolerated the monetization of strong capital inflows during this period. Reflecting the relatively loose policy stance, real interest rates were negative in a number of countries. In Kazakhstan, the authorities cut policy rates to offset the negative effects of the credit crunch on economic activity. In the second half of the year, the focus of attention, particularly in the Russian Federation, shifted to the supply of extra liquidity through a wide range of instruments to support the financial system in the face of intensified global turbulence. Currencies came under pressure, as capital flows reversed, and the authorities intervened in the markets to prop up exchange rates.

Monetary policy is driven by liquidity considerations



Source: UN/DESA, based on data from CIS Interstat Statistical Committee.

Fiscal policies have added to demand pressures

Solid growth, coupled with gradual improvements in tax administration, has boosted fiscal revenues throughout the region. Better revenue performance has generally been accompanied by strong increases in public expenditure, causing a weakening in the structural fiscal balances in many CIS countries. In Ukraine, higher social benefits and pensions have contributed to a significant widening of the fiscal deficit. In Azerbaijan, plans to develop infrastructure and raise social protection generated rising claims on public spending. In some of the low-income countries, fiscal measures have been used to shelter households from rising fuel and food costs. In the Russian Federation, after an overtly expansive fiscal stance in 2007, there has been some downward adjustment in 2008.

Export growth remained well below the expansion of imports in most of the smaller economies in the region, with Armenia, the Republic of Moldova and Tajikistan showing a particularly large gap. In the Russian Federation, rapid export growth in value terms resulted mainly from increasing oil and gas prices, while physical volumes stagnated. In volume terms, the expansion of imports continued largely to outstrip the increase of exports. By contrast, energy export volumes rose rapidly in Azerbaijan and Turkmenistan. In Kazakhstan, the positive effect of growing energy exports and high prices was coupled with a deceleration of imports as the economy cooled down. As a result, Kazakhstan's significant current-account deficit in 2007 moved into a surplus. The overall CIS current-account surplus widened due to the improved external position of energy-producing countries. In Ukraine, the external deficit widened sharply owing to continued acceleration in import growth and poor export performance. The country is expected to suffer a significant deterioration in its terms of trade in 2009 as a result of falling steel prices and a hike in Russian gas prices. A better export performance was observed in Belarus, but anticipated increases in the price of gas imports will also have a negative impact on its external position.

The global slowdown will affect growth in 2009

The difficulties experienced in the global economy have considerably increased the downside risks for the economic growth of the CIS. A severe and protracted global slowdown could further depress commodity prices, which remain a major factor in the economic performance of many countries in the region. Financial turbulence has exposed the dependence of the largest economies on external sources of long-term financing. In turn, an eventual downturn in the Russian Federation could impair the economic prospects of the smaller economies in the region through lower trade, remittances and FDI inflows. Most commodity-exporting countries have put in place fiscal arrangements, such as reserve funds, that give them the possibility of intervening in order to mitigate the effects of a possible downturn, including one related to external payments problems. By contrast, Ukraine, which built only modest reserves, has been forced to request IMF support to allay concerns about its ability to fund its large external financing gap. In any case, there is a risk of inadequate policy action given the lack of experience of most CIS countries in coping with a rapidly deteriorating external environment.

Developing economies

Although growth in the developing economies moderated to 5.9 per cent in 2008 from 7.1 per cent in 2007, the region was able to maintain its sixth consecutive year of growth of over 5 per cent. Growth was mainly supported by strong commodity-export revenues in the first half of 2008, accompanied by robust domestic demand and government expenditures on infrastructure development. East and South Asia again led growth in the region, as high commodity prices and industrial activity supported economic performance

throughout most of the year. Africa's growth, also above 5 per cent, was likewise driven by the commodity sector, but saw strong support from the recovery in agriculture and improved domestic demand.

Growth in all countries of the region is expected to slow considerably in 2009, to 4.6 per cent. The region, which initially seemed immune from the financial crisis, is now affected by the precipitous decline in commodity prices and is experiencing sharp foreign capital outflows as investors seek "safe havens", thus threatening the financial stability of some economies. Additionally, this has led to depreciating currencies and tightened credit conditions. As the impact of the global economic slowdown spreads throughout the region, it will have stronger adverse effects on export demand, commodity prices and, subsequently, investment and aid flows.

Africa: The end of the commodity boom

Amidst a deteriorating economic environment, growth in Africa slowed in 2008, but the region managed to maintain its fifth consecutive year of growth of over 5 per cent. Having been propped up by increased revenue from the continent's commodity exports in the first half of the year, as well as continued improvements in non-oil sectors, such as agriculture and tourism, growth dropped to 5.1 per cent, from 6.0 per cent in 2007 (see table A.3). This figure masks considerable disparities across the region as household spending has been constrained in many cases by rapid inflation growth, higher interest rates and, to a lesser extent, domestic disturbances. As the global economy and commodity prices weaken further, growth is expected to decelerate to 4.1 per cent in 2009.

Africa's lack of integration into the global financial system kept it relatively immune from the direct effects of the global financial crisis in 2008, but the region is already being affected indirectly through slower global growth and credit tightening, which is having an impact on investment flows, export demand, commodity prices and exchange-rate vulnerability. In South Africa, which had made considerable progress towards macroeconomic stability, the rand weakened by about 23 per cent against the United States dollar between September and November 2008 as a "flight to safety" triggered a sell-off in equities and bonds. The Government of Nigeria was forced to revise its 2009 budget downwards in response to lower oil prices, and there are growing fears about the stability of the country's currency, despite its ample foreign reserves totalling \$63 billion.

Although oil and other commodity prices have generally fallen in the second half of 2008, they remained high on average for the year by historical standards. Oil-exporting African countries grew at 6.1 per cent in 2008 compared with a 4.3 per cent growth rate in the net fuel exporters (see figure IV.7). High energy and food prices, and slowing aid and private capital inflows were among the key factors that contributed to the growth slowdown in the oil-importing African economies.

Growth decelerated in all subregions in 2008, with the exception of Central Africa, but remained generally strong owing to healthy commodity exports and a rebound in agricultural output in the first half of 2008. As the global downturn extends into 2009, weakened trade with Europe and the United States, along with dampened commodity exports to China and the rest of the world, will curtail growth in most economies of the region.

North Africa recorded a 5.1 per cent growth rate in 2008, as high oil revenues, the construction boom and tourism receipts boosted both public and private consumption in most countries; in Central Africa, however, robust growth was mainly due to the rebound in oil production in the Congo. In West Africa, growth in 2008 was supported by

Africa's growth slowed in 2008

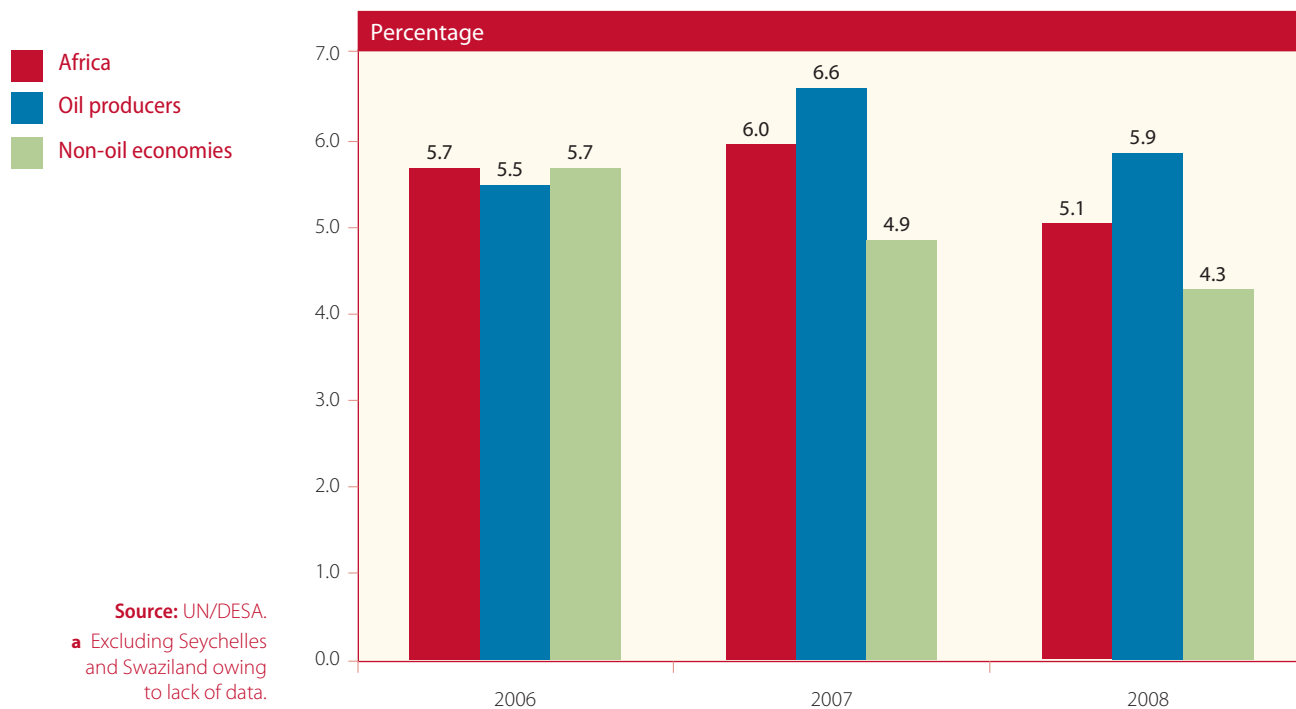
The global financial turmoil will have indirect effects on the region

Oil exporters benefited from strong revenues in the first half of 2008

The slowdown will accelerate in 2009

Subregional growth is supported by tourism, agriculture and recovery in conflict areas

Figure IV.7
Growth in Africa,^a oil versus non-oil economies, 2006-2008



conflict recovery and improved stability in Côte d'Ivoire and Liberia, increased oil production and prices in Nigeria and the expansion in mining activity, construction and tourism in many countries of the subregion.

East Africa, led by Ethiopia, continued to maintain the highest growth in the continent, benefiting from improved agricultural performance, healthy aid inflows and strong growth in tourism and investment in the first half of 2008. However, growth in most of the countries of this subregion remains constrained by infrastructure bottlenecks, especially those related to energy and transportation. In addition, reduced aid and investment flows in 2009 will significantly curtail growth.

In Southern Africa, economic performance moderated from 6.2 per cent in 2007 to 4.2 per cent in 2008, led by sharply lower growth in South Africa owing to a tightening in consumer spending and the slowdown in mining and quarrying. Delays in donor funding, power shortages and high interest rates weakened growth in the other countries of the region.

Inflation in Africa, excluding Zimbabwe, was 10.7 per cent in 2008, up from 6.4 per cent in 2007. Over 90 per cent of the 51 African countries with available data recorded a 5 per cent or more rate of inflation in 2008, up from 60 per cent in 2007. Only three countries (the Central African Republic, Côte d'Ivoire and the Comoros) had inflation rates of less than 5 per cent in 2008, while Zimbabwe's hyperinflation rate of over 11 million per cent remains the highest in the continent. Most of Africa's recent inflation has been imported through high energy and food prices in world markets, but domestic factors have also played a role, including widening government deficits and strong domestic demand growth, especially in the oil-exporting countries of the region. Poor harvests in Burundi, Eritrea, Ethiopia and Kenya placed additional domestic pressure on food prices, leading to double-digit increases in inflation in 2008 and widespread food insecurity

South Africa experiences a sharp slowdown

Inflation is up in 2008, but is expected to subside in the outlook

throughout the region. Although improvements in food supplies from the fall harvests and lower international commodity prices should lower prices and lead to a deceleration of inflation in 2009, the food crisis still exists and remains a long-term challenge for the region (see box IV.2).

Unemployment is expected to increase throughout Africa, as the expansion in the services, construction and public works sectors, which helped to boost employment creation in urban areas, particularly in North Africa, is expected to weaken. Slower formal sector job creation will also push a greater number of workers into the already large informal economy.

Employment conditions will deteriorate

Box IV.2

Africa's response to the food crisis

Over the last four decades, Africa has witnessed frequent food shortages leading to heavy dependence on food imports and aid, making Africa particularly vulnerable to shocks in the international food market. One third of the population of sub-Saharan Africa suffered from chronic hunger in the period 1990-1992, a proportion that had declined by only 4 percentage points by 2003-2005, while the absolute number of people suffering from hunger increased from 169 million to 212 million over the same period.^a

The situation worsened dramatically following the most recent global food crisis, especially for African net food importers. It is estimated that an additional 24 million people in sub-Saharan Africa were malnourished in 2007 owing to the increase in food prices; inflation also increased from 6.4 per cent in 2007 to 10.7 per cent in 2008, driven mainly by increases in prices for food, transport and energy.^b Although food and oil prices have come down in the second half of 2008, the problem persists, as the recurrent crises in Africa are largely the result of longer-term issues related to the neglect of the agriculture sector and poor and inconsistent agricultural development policies.

As a short-term response to the food crisis, the international community increased food aid to the worst affected countries; at the domestic level, policies focused on stabilizing food supplies, controlling prices and increasing transfers (see table below). These policies had mixed effects, some of which contributed to further price increases. For example, in Egypt, subsidized bread was diverted to feed animals, thereby exaggerating the shortage in the market, while export restrictions may have led to panic and hoarding of certain commodities (see chapter II, box II.1).

Most African countries have also started to introduce measures to increase supply. In Senegal, where prices for rice have doubled between July 2007 and 2008, fertilizer subsidies have been expanded, leading to a substantial increase in areas devoted to the cultivation of food crops. Additionally, the forecast for total cereal production in Africa for 2008 has increased to 152.8 million tons, up from the 141.3 million tons estimated for 2007, and slightly higher than the 2006 harvest.

Although short-term supply increases may help to mitigate the crisis in the near term, in the long run, solving Africa's food crisis requires strategies to further enhance agricultural investment and productivity. High food prices have offered an incentive to increase private investment in agriculture, but more still needs to be done by Governments to provide an enabling environment. The African Union's decision in July 2008 to focus its long-term commitment on investments for increased productivity and risk mitigation, including enhanced institutional and human capacities for agricultural development, is a step in this direction. These strategies build on the New Partnership for Africa's Development (NEPAD) Comprehensive Africa Agriculture Development Programme (CAADP) framework that was agreed in 2003. Some components of the strategy include:

a) Increased agricultural productivity

In addition to more investment in better technologies, increasing agricultural productivity requires better access to credit and land, a revival of extension services and public investment in related infrastructure such as transport, communication, storage and irrigation. Although most African countries still have large areas of unused arable land with which to increase production, there are limits owing to high population growth and competing demands for non-

^a Food and Agriculture Organization of the United Nations, "Hunger on the rise: Soaring prices add 75 million people to global hunger rolls", briefing paper, 17 September 2008, available from <http://www.fao.org/newsroom/common/ecg/1000923/en/hungerfigs.pdf>.

^b Ibid.

Box IV.2 (cont'd)

Table
African Government policy responses to the food crisis, January 2006-August 2008

Country	Tax reductions on food staples	Trade restrictions	Trade liberalization	Consumer subsidy	Social protection	Supply increases
Algeria			×		×	×
Angola	×			×	×	
Benin			×	×		×
Burkina Faso	×		×	×	×	
Burundi	×				×	
Cameroon	×		×		×	
Comoros				×		
Congo			×			×
Côte d'Ivoire			×		×	×
Egypt		×		×	×	×
Ethiopia	×	×		×	×	×
Gambia			×			
Ghana			×			×
Guinea					×	
Guinea-Bissau			×			
Kenya						×
Liberia		×	×		×	×
Madagascar	×	×		×		
Malawi		×				×
Mali	×	×	×		×	×
Morocco	×		×	×		
Namibia				×	×	
Niger		×	×		×	×
Nigeria	×	×	×	×		×
Rwanda						×
Senegal			×	×		×
Sierra Leone		×	×	×	×	×
Somalia		×				
South Africa	×			×	×	
Sudan	×	×				×
Togo				×		×
Tunisia	×			×	×	
Uganda					×	×
United Republic of Tanzania	×	×	×	×		
Zambia	×	×				×
Zimbabwe	×		×	×		
Frequency	15	13	18	17	17	20

Sources: International Food Policy Research Institute (IFPRI), 2008 and World Bank, 2008.

Box IV.2 (cont'd)

food production and industry. In many African countries, dual property systems also exist, with State-regulated property rights and customary management overlapping. In such cases, it is important to strengthen land tenure security, which can in turn facilitate access to credit.

b) Market access and regionally integrated value chains

Regionally integrated value chains are important for expanding input and output markets, particularly for smallholder farmers who are often at a disadvantage regarding access to both domestic and export markets. Such integration can create the scope to exploit economies of scale and improve access to new technologies and complementary infrastructure and services. To enable smallholders to participate, however, requires coordination at the regional level in order to improve the quality and safety of products, harmonize standards and ensure adequate flow of information to potential value chain participants.

c) Mobilizing resources for investment in agriculture

The commitment by African countries to spend at least 10 per cent of national budgets on agriculture and rural development (see also chapter II, box II.1) will go a long way to making more resources available. However, given the huge gaps in research, information and financial support for agriculture, this effort needs to be complemented by development partners. In this regard, the proposal by the Conference of African Ministers of Finance, Planning and Economic Development, held in Addis Ababa on 2 and 3 April 2007, to establish a funding mechanism (in consultation with the African Development Bank and the International Fund for Agricultural Development) to scale up agricultural investment in the continent should be pursued. In addition, the Aid for Trade Initiative can play an important role in increasing investment and productivity in African agriculture. It is crucial that the current financial crisis not result in a reduction of aid; rather, donors should honour their commitments to increase the volume and quality of aid, including by ensuring better allocation in line with recipient priorities.

In most African economies, monetary policy is taking either a tightening or neutral stance in order to keep inflation under control. In Nigeria, the Central Bank increased the amount of foreign exchange sold to retail banks to offset the rise in government expenditures from windfall oil profits. As commodity prices fall and the dollar gains strength, currency depreciation is also a concern for some commodity exporters. In Ghana and Mozambique, the central banks switched to a tightening stance in 2008 to stabilize exchange rates and control imported inflation, the Bank of Ghana increasing its prime rate from 16 to 17 per cent in July in an attempt to combat inflationary pressures. In South Africa, however, the benchmark rate has held at 12 per cent since August, despite the continued rise in inflation and rand depreciation, owing to the weakness in the economy.

High energy and food prices pushed the proportion of oil-importing countries with fiscal deficits up from 76 per cent in 2007 to 86 per cent in 2008. On average, these countries recorded a fiscal deficit of -1.7 per cent of GDP, compared with a surplus of 7 per cent for oil-exporting countries. To maintain fiscal stability, many countries resorted to additional measures to control public spending and finance their deficits, such as reducing expenditures on development projects and service delivery. With a rapidly deteriorating external environment, these countries will likely be in need of further debt relief. A scaling-up of aid may also be necessary in order to sustain the progress made in the past few years in macroeconomic management and stability, as well as in achieving the Millennium Development Goals.

Relatively high energy and food prices, particularly in the first half of 2008, led to a widening of current-account deficits in oil-importing African countries, from -6.3 per cent of GDP in 2007 to -7.2 per cent as of September 2008. At the same time, the

Monetary policy remains a challenge as growth subsidies

Fiscal deficits are widening

Current-account balances also worsened in 2008

current-account surplus of oil-exporting countries increased from 10.5 per cent to 17.7 per cent. Therefore, the continent's overall current-account position, which was showing a surplus of 7.4 per cent in September 2008, is a reflection of the high revenues generated by oil-exporting countries. Although the current moderation in commodity prices should improve the terms of trade and lower the import bills of many net fuel importers in 2009, it comes at a time when export demand has weakened globally, thus potentially offsetting the overall effects. Similarly, while most African currencies for which data are available appreciated against the United States dollar in the first half of 2008, the trend reversed from the third quarter of 2008.

Risks remain tilted towards the downside

The continent's prospects for 2009 are subject to strong uncertainties stemming mainly from the recent global financial crisis. However, risks remain tilted towards the downside owing to the global slowdown. Although the decline in oil and food prices will ease the economic burden on the net fuel and food importers, there are adverse consequences from a sharp decline in commodity prices for the region as a whole. In general, a hard landing of commodity prices could set in motion a calamitous chain of events leading to capital flight, significant depreciation of currency, increased inflation and interest rates, and a further decline in growth. Also owing to the global financial crisis and economic downturn, lower aid and private capital flows, especially FDI and remittances would have a significant impact on growth in 2009. Moreover, despite some improvements in security, Africa remains vulnerable to political conflicts. An escalation of the conflict in the Democratic Republic of the Congo could have repercussions for political stability in other parts of the region.

East Asia: A continuation of deceleration

East Asian economic growth is still decelerating

As a consequence of the deepened international financial crisis, the deceleration of economic activity in East Asia will continue during 2009, as GDP growth is expected to drop to 6.0 per cent, down from 6.9 per cent in 2008 and 9.0 per cent in 2007 (see table A.3). The baseline scenario for the growth outlook assumes that there will be economic recovery in the developed economies in the second half of 2009. Should this not occur, however, GDP growth in the region would slow to 3.7 per cent in 2009.

The financial system is prudent, but is still subject to the impact from the global financial turmoil

Overall, East Asian countries initially seemed insulated at the onset of the financial turmoil emanating from the United States and Europe. Banks were prudently leveraged and had limited exposure to sub-prime mortgage debt. Additionally, the \$3 trillion in foreign-exchange reserves, which is more than 10 times the usable resources of the IMF,¹¹ gives economies some measure of confidence to defend their currencies in the event of a speculative attack. Nonetheless, there is growing evidence that the economies in the region will be hit hard. As the financial crisis and subsequent slowdown continued to unfold, some countries experienced sharp capital outflows, threatening financial stability towards the end of 2008. For instance, in the Republic of Korea, the won dropped 21 per cent in just two months, between August and October of 2008. Although a special \$30 billion swap line extended by the United States Fed helped stabilize the won, other countries in the region remain vulnerable to the substantial decrease in foreign-exchange reserves and may require emergency financial support.

Commodity-exporting countries suffered less from the global slowdown in 2008

The effect of the global slowdown on export demand, and subsequently on GDP growth, in 2008 was pervasive across countries in the region. In China, the region's locomotive, GDP growth dropped from 11.9 per cent in 2007 to a lower, albeit still high, 9.1 per cent in 2008. The decline would have been greater had it not been for the contin-

¹¹ November 2008 data.

ued strong growth in domestic final demand. Cambodia, the Philippines and Singapore, with their heavy reliance on manufacturing exports to industrialized countries, have been affected the most by the global slowdown, with GDP growth dropping by about 3 percentage points in 2008 compared with 2007. In contrast, record high prices of export commodities, including rice, palm oil and energy, in the first half of 2008 allowed countries such as Thailand, Indonesia and, to a lesser extent, Malaysia, to sustain growth rates in 2008 at levels similar to those in 2007.

On average, the year-on-year consumer price index (CPI) headline inflation rate is expected to drop to 3.6 per cent in 2009, from 6.4 per cent in 2008, as commodity and energy prices decline. During 2008, inflation climbed most steeply in South-East Asia, reaching a peak in July (see figure IV.8). In Hong Kong Special Administrative Region (SAR) of China, the Republic of Korea and Taiwan Province of China, the trend was less steep, but also peaked in July. In contrast, the inflation rate in China peaked in February and then started to decline owing to the gradual recovery in the production of meats and fresh vegetables; by October it had reached its lowest level in 16 months. As commodity prices continue to decline and export demand from industrialized countries cools further, all countries in the region are expected to experience a moderation of inflation in 2009.

As economic growth slows, the employment situation in some economies has already started to show signs of deterioration. Recent statistics for Hong Kong SAR, Singapore and Taiwan Province of China show rising unemployment rates from mid-2008. In some other economies, anecdotal evidence also points to a weakening of employment growth. Given the decline of economic growth in East Asia, unemployment rates for many countries are expected to increase by about 1 percentage point in 2009 over 2008.

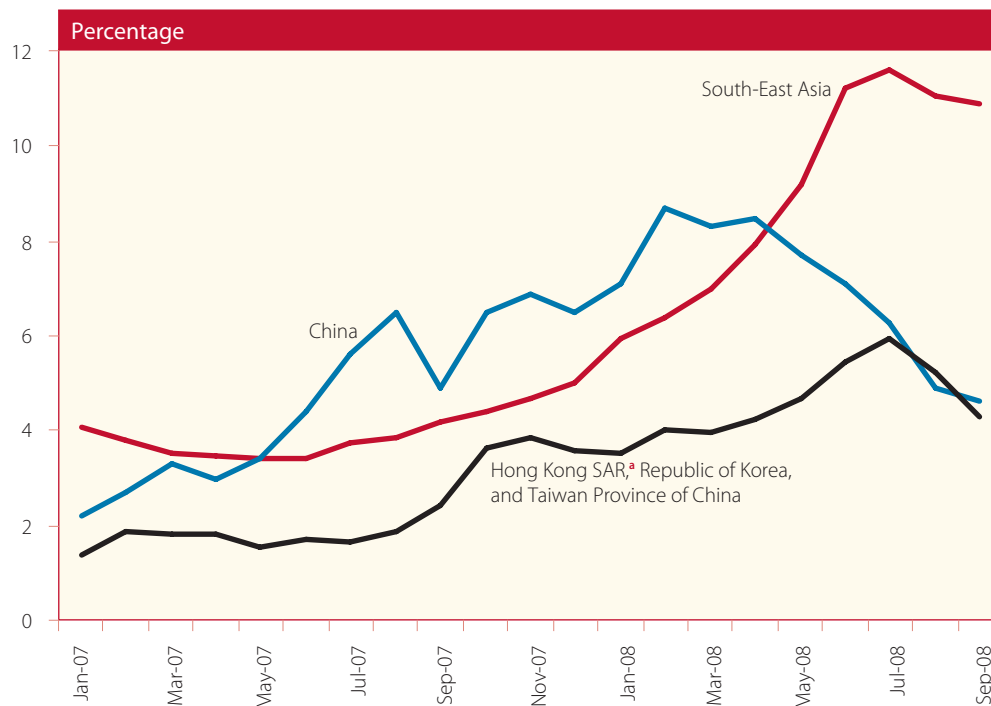
The monetary policy response to the twin risks of rapidly rising commodity prices and the international financial crisis varied across countries. In South-East Asia, where inflation increased most steeply in the first half of 2008, the central banks initially

Widespread inflation has peaked in East Asia

The employment outlook is not very bright

Monetary policy is displaying a mixed stance

Figure IV.8
Year-on-year headline consumer price index inflation rates, 2007-September 2008



Source: Various National Statistical Offices.
a Special Administrative Region of China.

reacted by increasing interest rates. The Bangko Sentral ng Pilipinas (the central bank of the Philippines), the Bank of Thailand and the Bank of Indonesia all had multiple increases in their key policy rates in mid-2008. By early October, however, the People's Bank of China and the Bank of Korea cut interest rates in concert with the loosening stance of the central banks in developed economies.

China is leading fiscal stimulus in the region

Fiscal policy was expansionary in East Asia during 2008. During the first half of the year, many countries implemented or expanded subsidy programmes to soften the impact of rapidly rising fuel and food prices on vulnerable groups, thereby worsening fiscal balances. In Malaysia, the cost of fuel and food subsidies tripled in 2008 compared with the previous year, increasing the fiscal deficit from 3.2 per cent of GDP in 2007 to 4.8 per cent in 2008. In the Republic of Korea, whose fiscal surplus dropped from 3.8 per cent of GDP in 2007 to 1.1 per cent of GDP in 2008, the Government implemented an economic stimulus package amounting to \$11 billion dollars (1.2 per cent of GDP); in China, the Government has introduced a massive stimulus package, in an amount that is almost equal to total government spending in 2006, to be implemented during 2009 and 2010. Although the details of the package have not yet been released, back-of-the-envelope calculations suggest that the package, while large (\$586 billion, or 15 per cent of GDP, to be spent over two years), would provide an additional stimulus of about 2 per cent of GDP per year, after deducting recent trend growth of public expenditures. The aim of China's package is to strengthen domestic demand through public investment in infrastructure. The targeted areas include low-income housing, rural infrastructure, water, electricity, transportation, the environment, technological innovation and rebuilding from several disasters, most notably the earthquake of 12 May. This package is also designed to boost the income of the poor through measures including higher subsidies and an increased government purchase price for grains in 2009.

Current-account surpluses fell and current-account deficits widened in 2008

External balances came under pressure across East Asia in 2008 owing to the high cost of commodities and weakened export demand. Nevertheless, most countries continued to exhibit current-account surpluses. China, for instance, experienced a reduction in its current-account surplus from 11.5 per cent of GDP in 2007 to 8.5 per cent of GDP in 2008, while in the Republic of Korea, a surplus of 0.6 per cent of GDP in 2007 turned into a deficit of 3.3 per cent of GDP in 2008 on account of the rising costs of commodity imports and increased tourism spending abroad. Consistent with these shifts in current-account positions, nominal exchange rates depreciated in most countries, with the exception of China, reversing previously appreciating trends.

Given the sombre outlook for the global economic environment, economic prospects in East Asia, too, face serious downside risk. The most compelling concern is the potential for a complete meltdown of the financial system in the developed economies that would directly undermine the financial sector in East Asia. This would drag down the regional growth rate by at least 1-2 percentage points.

South Asia: Expectations of a slowdown in robust growth

The slowdown will spread from the industrial to the service sector

Economic growth in South Asia remained robust in 2008 at 7.0 per cent, despite a slowdown in a number of countries in the region. Growth was upheld by high commodity export earnings in the first half of 2008 in Bangladesh, the Islamic Republic of Iran, Pakistan and Sri Lanka; there was also improved political stability in Nepal. However, the region's GDP growth is expected to slow to 6.4 per cent in 2009 amidst the fallout

from the global financial crisis. While the slowdown has thus far mainly been limited to the industrial sector, it is expected to spread to the service sector as the squeeze on costs becomes more pervasive and demand slackens.

Although financial institutions in South Asian countries had little direct exposure to the United States sub-prime mortgage market, the global financial crisis has had indirect effects on domestic financial markets, with money markets experiencing an unusual tightening of liquidity. In addition, outflows of foreign capital have posed serious problems in both India and Pakistan. In India, during the first two weeks of October 2008, foreign-exchange reserves fell by more than \$17 billion, partly due to foreign capital outflows. In the case of Pakistan, foreign-exchange reserves, which had stood at \$16.5 billion in October 2007, decreased to about \$7 billion a year later.

In India, economic activity, which had been growing at 9 per cent or more on average over the past three years, has been moderating in response to stepped-up monetary tightening, the hardening of commodity prices in international markets and global financial strains. Pakistan is forecast to see a fall in its growth rate to 3.8 per cent owing to continued political uncertainty, problems of law and order and severe electricity shortages. Growth in the Islamic Republic of Iran, which is the only net oil exporter in the sub-region, will moderate from 6.0 per cent in 2008 to 5.6 per cent in 2009, after robust growth momentum owing to high oil revenues as well as strong private consumption and investment. Some deceleration in growth is also expected in Bangladesh, Nepal and Sri Lanka because of weaker performance in the commodity-producing sectors and a slowdown in the service sector.

Inflation rates have increased throughout the region, owing mainly to higher international commodity prices. In India, inflation rose moderately from 6.4 per cent in 2007 to 8 per cent in 2008, but in Pakistan it increased by over 4 percentage points, to 12 per cent in 2008, with food inflation reaching 17.6 per cent. In Bangladesh, inflation was about 10 per cent—despite the fact that much of the increase in fuel oil prices had not been passed on to consumers—while in the Islamic Republic of Iran and Sri Lanka, prices increased by more than 20 per cent. The economic slowdown and lower energy and commodity prices will reduce inflationary pressures in 2009, although supply constraints and an upward revision in administered prices of fuel oil and electricity will offset part of these effects in some countries (Pakistan, for instance).

Most countries in the region, with the notable exception of the Islamic Republic of Iran, pursued strict monetary policies to contain inflation in 2008. In addition, some Governments introduced new or strengthened existing short-term measures to curb food-price increases. In Bangladesh, for example, these included the open-market sale of food grains at subsidized prices and a reduction in the interest rate on credits for food imports.

While government revenues increased in a number of countries, the increase in expenditures was much larger, owing primarily to increased subsidies and increases in public sector wages. In Pakistan, the budget deficit rose to 7.4 per cent of GDP in 2008, the highest level in the past 10 years, while in Sri Lanka, the budget deficit is estimated to remain at about 7 per cent of GDP. In India, increases in government salaries and subsidies on food, fertilizers and certain fuel oil products are expected to lead to a deficit of 3.5 per cent of GDP in 2008. In the outlook, however, as in a number of other countries in the region, India's fiscal deficit is expected to increase, owing to slower growth in tax revenues in the light of weaker economic growth as well as the likely need for further fiscal stimuli to overcome the negative impacts of the current global economic crisis.

The financial crisis has led to tighter liquidity and shrinking currency reserves

Growth rates will be lower across the region

High inflation will remain problematic

Monetary policies have been in a tightening mode

Fiscal balances will deteriorate further ...

... while weaker exports will keep external balances under pressure

The surge in prices of fuel oil, food and other commodities wreaked havoc on external balances in the region, as higher import costs have led to both deteriorating trade balances and further pressure on foreign-currency reserves. In Pakistan, for example, the value of imports in dollar terms was roughly double the value of exports in 2008, and the merchandise trade deficit of \$20 billion was about 12 per cent of GDP. In 2009, trade balances in the region will remain under pressure, as weaker demand in overseas markets will lead to a stagnating export performance.

The slowdown will negatively affect employment, although remittances will remain a stabilizing factor

Employment in the region will suffer in the light of the global economic crisis, whose effects will be especially felt in labour-intensive export industries such as textiles. However, the large amount of workers' remittances has so far remained a stabilizing factor for aggregate household income in the region. In Bangladesh, remittances increased by 32 per cent in 2008 and were close to \$8 billion; remittances in Nepal increased by about 20 per cent to roughly \$1.7 billion; and Pakistan received a record \$6.5 billion in terms of remittances in 2008. Since most of these remittances originate from the oil-rich Middle Eastern countries, if oil prices fall considerably over a sustained period, remittances will likely decline, with large shares of the population losing an important source of livelihood and aggravating the problem of poverty.

Factors of uncertainty include a prolonged financial crisis and internal conflicts

Risks to the outlook are mainly on the downside. The external environment is particularly uncertain at the present time because of the unfolding global financial crisis and the volatility of oil prices. The global financial crisis, if it worsens, will prolong the global slowdown, adversely affecting the economies of the subregion through export demand, investment flows and exchange-rate volatility. In addition, several countries in the subregion face political conflicts that add to the uncertainty.

Western Asia: Resilience amidst deteriorating external conditions

Economies remain resilient, but growth is slowing down markedly

The Western Asia region went through a rapidly changing external environment in 2008, showing considerable resilience to deteriorating global conditions. Driven by high average oil prices and strong consumption and investment spending, economic activity in the region expanded at a robust pace of 4.9 per cent in 2008, compared with 4.7 per cent in 2007 (see table A.3). Against the background of the global financial crisis, economic growth in the region is expected to slow down to 2.7 per cent in 2009.

Export revenues are dropping sharply as global demand weakens

The region will experience a sharp decline in export revenues in the outlook as average oil prices are forecast to drop by 35 per cent in 2009 amidst slowing global demand. In addition, tighter credit conditions and deteriorating business and consumer confidence are likely to weaken domestic demand throughout the region, possibly triggering delays in several large investment projects. The global credit crisis has had a severe impact on the banking sectors in Kuwait, Saudi Arabia and the United Arab Emirates owing to their direct linkages to international money and capital markets. However, decisive actions by central banks to ensure liquidity and guarantee bank deposits helped to stabilize the financial sector in the region. While the main oil exporting countries in the region are not immune to the crisis, their strong fiscal and external positions will cushion them against the global economic downturn and sharply lower oil prices.

Oil exporters benefited from high prices and increased production in 2008

Surging international commodity prices in the first half of 2008 and higher production volumes led to strong growth in energy-related sectors, including crude oil, liquefied natural gas and petrochemicals. In the countries of the Gulf Cooperation Council (GCC), robust growth in wealth in recent years, coupled with improved business and con-

sumer sentiment, negative real interest rates and large public sector salary hikes, boosted domestic demand in 2008. This contributed to a broad-based expansion in non-petroleum sectors, in particular, business and transport services, communications, finance and construction. Average GDP growth in the GCC countries increased to an estimated 6.2 per cent in 2008, but is forecast to drop to 3.2 per cent in 2009 as oil prices trend lower and investment growth decelerates.

Western Asian countries with more diversified economies continued to benefit from the buoyant conditions in the GCC countries through increased remittances, foreign direct investment flows, and tourism and export receipts. In Iraq and Lebanon, political progress and improved security conditions contributed to economic recoveries in 2008. While the more diversified economies in the region, with the exception of Turkey, have not experienced any significant direct effects from the financial crisis, the sharp economic downturn in the developed and GCC countries will have a negative impact on their growth in 2009.

The Turkish economy faces a severe slowdown as both external and domestic demand weaken. GDP growth is expected to average only 2.8 per cent in 2008—the lowest rate since 2001. The outlook for 2009 remains bleak as the economy is hit by the global credit crunch and probable recessions in major export markets. Weak demand will severely affect the manufacturing sector, most notably the automotive, textile and electronics industries. In spite of having stronger macroeconomic fundamentals than in the past, the Turkish economy remains vulnerable to deteriorating credit conditions and capital reversals owing to the size and composition of its current-account deficit. This became clear in October 2008, when Turkish bond spreads widened significantly and the Turkish lira dropped sharply against the United States dollar. However, market conditions improved in November 2008, and the country is expected to avoid recession in 2009.

Economic activity in Israel continued to expand at a robust pace throughout the first half of 2008, but slowed considerably later in the year. While the Israeli economy remains fundamentally sound, weaker export demand and reduced availability of venture capital and other financing sources are likely to have an impact on economic activity in the short run. GDP growth is forecast to decline from 4.0 per cent in 2008 to 1.8 per cent in 2009.

Despite the economic recovery in recent years, unemployment and underemployment rates, particularly among youth, remain staggeringly high in many Western Asian countries, most notably in the non-oil exporting economies. In Jordan, where unemployment declined slightly from 13.1 per cent in 2007 to 12.9 per cent during the first eight months of 2008, about three quarters of the unemployed are concentrated in the 15-29 year-old age group. In Turkey, the unemployment rate had started to rise even before the financial turmoil intensified, averaging 10.1 per cent during the first seven months of 2008. Meanwhile, unemployment in Israel dropped to a two-decade low of 5.9 per cent in the second quarter of 2008 as a result of the country's broad-based economic expansion.

Western Asian countries experienced further acceleration of consumer price inflation in the first half of 2008. Annual inflation is expected to surpass 10 per cent in all countries, except Bahrain and Israel, averaging 10 per cent for the region as a whole. Sharply higher food prices and housing costs were the main drivers of inflation. This resulted, in part, from trends in global markets, especially the rise in commodity prices and the weakness of the United States dollar, to which most countries in the region peg their currencies. Yet, domestic factors and policies continued to add to inflationary pressures as ample liquidity, the rapid expansion of consumer credit and increased subsidies fuelled domestic demand. In

Global slowdown clouds the outlook for diversified economies

Turkey has been severely hit by the financial turmoil and the recession in developed countries

Growth in Israel is slowing considerably despite sound fundamentals

Labour-market challenges have increased with the global crisis

Inflation soared owing to high commodity prices and buoyant domestic demand

addition, average wages were on the rise, particularly in the GCC countries, driven by public sector wage hikes and shortages of skilled labour in the private sector. Given the substantial decline in commodity prices and the strengthening of the United States dollar, inflation across the region is expected to fall gradually, but will remain at historically high levels.

GCC countries remain committed to exchange-rate pegs

In the GCC countries, central banks maintained stable foreign-exchange rates against nominal anchors, particularly the United States dollar, despite considerable debate and speculation about revaluations of national currencies. This is all the more important as authorities in GCC countries, with the exception of Oman, remain committed to the creation of a monetary union, even though the target date of 2010 is unlikely to be met (see box IV.3). Interest rates in the GCC countries, thus, largely followed United States interest rates downwards in 2008. As a result, central banks faced difficulties in implementing effective monetary measures to absorb excessive domestic liquidity and alleviate inflationary pressures.

Box IV.3

The creation of a Gulf Cooperation Council monetary union

a Michael Sturm and Nikolaus Siegfried, "Regional monetary integration in the member states of the Gulf Cooperation Council", European Central Bank, Occasional Paper Series, No. 31, June 2005; United Nations Economic and Social Commission for Western Asia, "Macroeconomic policy analysis for regional cooperation in the ESCWA region: The effect of real exchange rate variability on intraregional trade", Doc. No. E/ESCWA/EAD/2003/1, 31 March 2003.

b Dubai International Financial Centre, Office of the Chief Economist, "An Assessment of the progress toward GCC monetary union", Economic Note No. 1, 19 August 2008.

Since its inception in 1981, the Gulf Cooperation Council (GCC) has progressively worked towards advancing the economic integration of its member countries. This process includes the creation of three key institutional frameworks: a customs union, a common market and a proposed monetary union. The GCC Customs Union was launched in January 2003, and the GCC Common Market was declared in January 2008; the target for a single currency was set for January 2010.

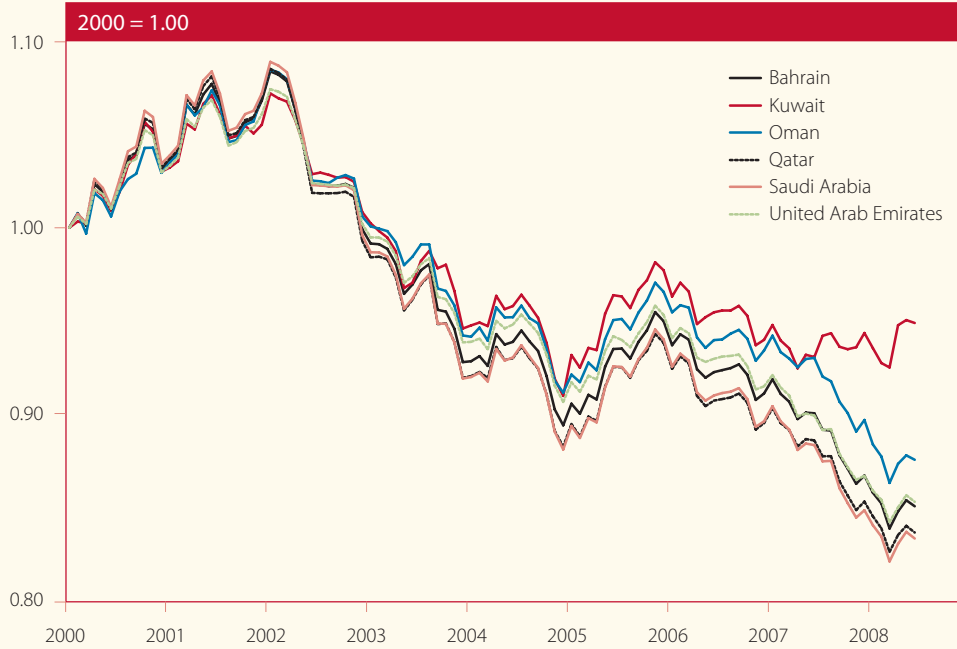
While major technical and legislative obstacles remain, the member countries, with the exception of Oman, have repeatedly emphasized their commitment to the target date for the monetary union. At a meeting in September 2008, the GCC finance ministers approved a set of proposals for the creation of a monetary council as a precursor to a GCC central bank as well as for a draft charter for the monetary union. As GCC policymakers have increasingly become aware of the necessity for coordinated multilateral actions to promote economic stability among member States, a new set of institutional arrangements are expected to be established after endorsement by the GCC Heads of State at its summit in December 2008.

In addition to geographic proximity and a similar cultural background, GCC member countries share similar economic structures dominated by the production and export of hydrocarbons (crude oil and natural gas) and similar economic diversification strategies. Although similarities in macroeconomic structures, dynamics and trade patterns have led to a high degree of monetary convergence, fiscal convergence has remained less prominent.^a Following the precedent set by the European Monetary Union, GCC member countries agreed to meet a set of convergence criteria before introducing a common currency. A recent study conducted by the Dubai International Financial Centre^b shows that all monetary and fiscal criteria have been met, except inflation targets and a common foreign exchange-rate regime with all currencies pegged to the United States dollar. As of 31 December 2007, Qatar and the United Arab Emirates had not met the inflation criterion. Moreover, surging headline inflation in most member countries in the first half of 2008 has further impeded meeting that target. As for the foreign-exchange rate criterion, Kuwait is the only GCC country outside the criteria, as it has dropped the peg to the United States dollar and instead now pegs its currency to a basket of currencies of its major trading partners.

Recent economic events, such as the surge in international commodity prices, have highlighted the issue of real parity among the national currencies. Figures A and B below show the estimated nominal effective exchange rates (NEER) and the real effective exchange rates (REER) of the GCC countries. Owing to the peg to the United States dollar and similarities in trade structures, a close convergence among member countries, with the exception of Kuwait, has been achieved in the NEER. However, cumulative differences in domestic inflation rates have led to a divergence in terms of the REER, particularly since 2005. This situation implies different possibilities for price adjustments after the introduction of the single currency, depending mostly on expectations. Price levels

Box IV.3 (cont'd)

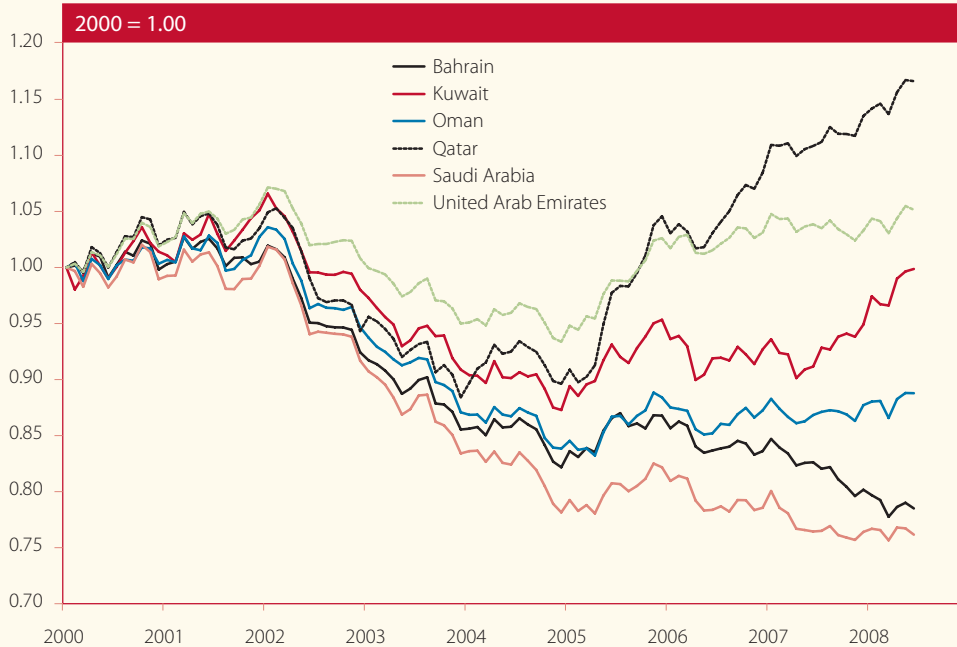
Figure A
Nominal effective exchange rates of the
Gulf Cooperation Council (GCC) countries, 2000-2008



Source: United Nations Economic and Social Commission for Western Asia, staff estimates.

Note: The nominal effective exchange rate (NEER) measures the nominal value of a national currency against a basket of currencies of major trading partners (China, India, Japan, Republic of Korea, the euro zone, United States, United Kingdom and regional partners).

Figure B
Real effective exchange rates of the
Gulf Cooperation Council (GCC) countries, 2000-2008



Source: United Nations Economic and Social Commission for Western Asia, staff estimates.

Note: The real effective exchange rate (REER) measures the value of a national currency against a basket of currencies of major trading partners (China, India, Japan, Republic of Korea, the euro zone, United States, United Kingdom and regional partners), adjusted by domestic and foreign price levels.

Box IV.3 (cont'd)

c See "Adopting the euro: economic and communication challenges," *European Economy News*, No. 2, April 2006.

d It is still unclear whether the introduction of a single currency will take place in one stage, including cash changeover, or in multiple stages starting with the introduction of a common currency unit that is equivalent to the European Currency Unit (ECU).

may converge downwards towards those of Saudi Arabia, the largest economy in the GCC. However, this favourable scenario would most likely require highly integrated goods, capital and labour markets. Another possibility is that price levels will converge upwards in line with market expectations. For example, the cash changeover to the euro in 2002 resulted in high perceived inflation in the euro area, as opposed to a rather stable actual inflation.^c Such high perceived inflation, if it were to occur in the GCC countries, could translate into higher actual inflation through wage pressures. Considering recent price dynamics, a short-term transitory acceleration of inflation in several countries is therefore likely if the planned introduction of the single currency includes an imminent cash changeover^d.

It should be emphasized that the monetary union is well placed to be a catalyst for further economic integration and economic development of GCC member countries. The resulting integration of money and capital markets will have scale effects, thereby reducing the financing costs in member countries and encouraging economic diversification. However, several technical and legislative obstacles still remain, in particular the effective harmonization of national institutions, including payment systems, financing facilities of central banks and money markets, and the jurisdiction of financial transactions, as well as a harmonization of policy infrastructure. In addition, policymakers need to decide upon the institutional and governance structure of a supranational central bank. That includes, among other things, the amount of foreign currency reserves that the common central bank would maintain. Given that, in 2007, all countries met the foreign reserves target (which requires that total holdings cover at least four months worth of goods' imports), this decision seems relatively uncontroversial, with total foreign reserves of a common central bank expected to slightly exceed \$100 billion.

Increased subsidies strain government budgets in the more diversified economies

Governments in most Western Asian countries pursued expansionary fiscal policies in 2008, including higher spending on health, education and infrastructure. Despite strong expenditure growth, the GCC countries ran substantial fiscal surpluses in 2008. In countries with a weaker revenue base such as Jordan, Lebanon, the Syrian Arab Republic and Yemen, high international commodity prices became a serious fiscal burden as subsidies on basic food items and fuel products increased sharply, prompting Jordan and the Syrian Arab Republic to reduce fuel subsidies in 2008.

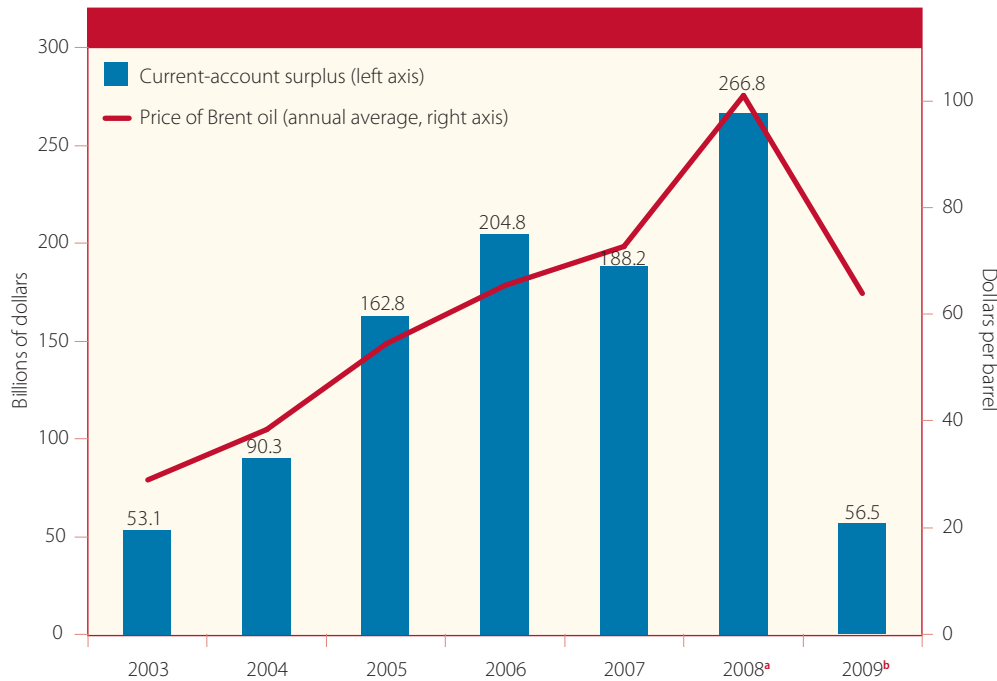
Current-account surpluses in the GCC countries were reaching record levels in 2008

Trends in trade and current-account balances differ sharply between the oil-exporting and importing economies. Higher average prices for oil and gas, along with increased production, led to massive increases in export earnings in the GCC countries and Iraq. Despite strong import growth, current-account surpluses in those countries, in 2008, are expected to exceed the already high levels of 2007 (see figure IV.9). In 2009, trade and current-account surpluses of oil-exporting countries will drop substantially. In Jordan, Lebanon, Turkey and Yemen, rising import costs outpaced increased export revenues, resulting in widening current-account deficits. However, these deficits have been well financed by the inflows of foreign capital and remittances as the countries recorded a steady increase in foreign reserves. While lower oil and food prices are expected to reduce import spending in 2009, financing of the current-account deficits is likely to become more difficult as FDI inflows decline and access to credit tightens.

Downside risks include the collapse of oil prices and the sudden reversal of capital flows

There are substantial downside risks to the economic outlook for the Western Asia region, including, most importantly, a collapse of oil prices and a further deterioration of global financing conditions that result in a sudden reversal of capital flows. A sharp and lasting decline in oil prices would not only impact private and public investment in oil-exporting countries, but would also have adverse spillover effects on the more diversified economies in the region. Additionally, sharply higher borrowing costs and massive capital outflows are a serious threat for the economies in the region that face large external imbalances, especially Turkey.

Figure IV.9
Oil prices and combined current-account surplus in
Western Asian oil-exporting countries, 2003-2009



Source: UN/DESA, based on IMF International Financial Statistics and national sources.

Note: Oil-exporting Western Asian countries include: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, United Arab Emirates and Yemen. Iraq is excluded due to lack of data.

a Estimated.

b Forecasts.

Latin America and the Caribbean: Significant slowdown in 2009

GDP growth in Latin America and the Caribbean is expected to decrease significantly in 2009. Following five consecutive years of GDP growth over 4 per cent, economic growth is expected to slow significantly, to 2.3 per cent in 2009, down from 4.3 in 2008 and 5.5 per cent in 2007 (see table A.3), owing to a significant drop in commodity prices, weaker external demand and a tightening of financial conditions.

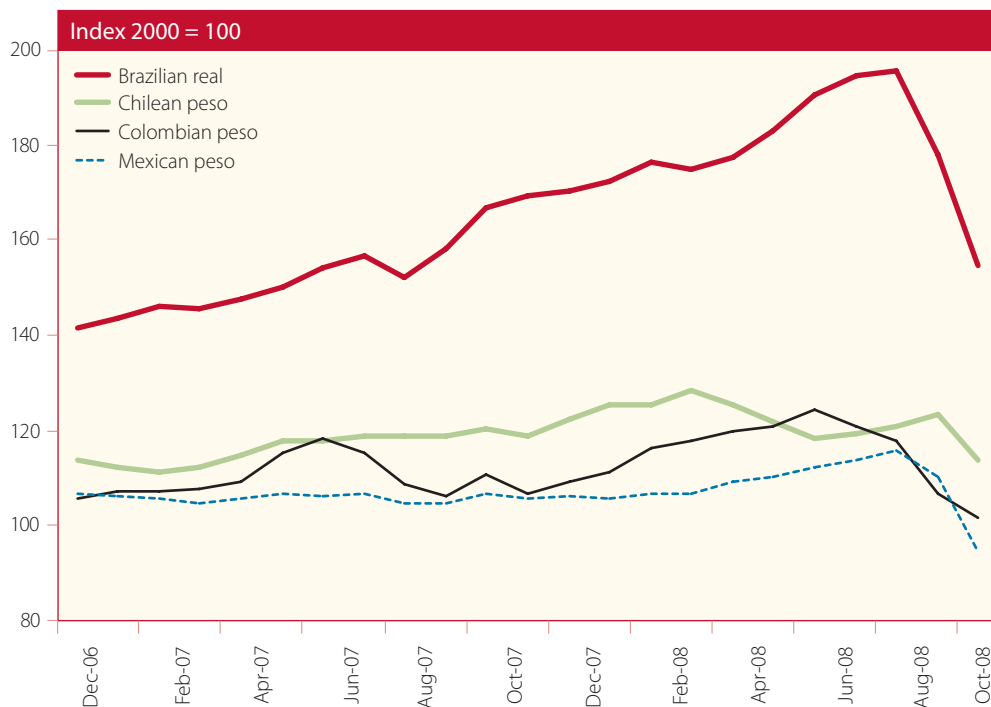
In the fallout from the global financial crisis, financial flows are expected to exhibit a reversal in the region, as investors cope with substantial market uncertainty. Additionally, the six-year-long appreciation trend for Latin American currencies has come to an end as regional currencies were down about 23 per cent against the United States dollar between end-June and October 2008. This depreciation of national currencies against other major currencies, notably in Brazil, Chile, Colombia and Mexico (see figure IV.10) is another clear sign of the contagion effects of the global financial crisis. Yet, the region is better equipped to deal with the crisis than it has been in the past, owing to lower external debt and the large accumulation of foreign reserves.

High commodity prices and buoyant internal demand, the main driving forces of economic growth in 2008, will be less favourable in 2009. In 2008, the average terms-of-trade index for the region as a whole was 45 per cent higher compared to that observed in the 1990s. Terms of trade also improved on average for the year 2008, driving GDP growth along with strong consumer demand and increased demand for gross fixed investment. These factors compensated for the weaker external demand for other exports from the region and explain the better-than-expected performance during the first half of 2008.

The region is better equipped to deal with the crisis

High commodity prices and expanding internal demand drove economic growth in 2008

Figure IV.10
Real currency depreciations in Latin America, December 2006–October 2008



Source: JPMorgan Chase.

However, in 2009, external shocks are expected to worsen growth prospects, albeit to varying degrees across countries.

Mexico and Central America will be the most strongly affected by the global economic slowdown

In South American countries, where export revenues are mostly derived from oil, metal or mineral products, lower commodity prices will negatively affect the terms of trade. In addition, domestic demand will slow because of tighter financing conditions, as has already become evident in Brazil during the last quarter of 2008. GDP growth for South America is expected to fall to 2.9 per cent in 2009, down from 5.4 per cent in 2008. Growth in Central America and Mexico is expected to fall to 0.9 per cent in 2009, from 2.2 per cent in 2008. The subregion will be directly hit by the recession in the United States, which provides the market for most of its manufactured exports and jobs for its migrant workers. The Caribbean countries are equally highly sensitive to the United States economic downturn but, being net importers of commodities, are expected to see some compensation through an improvement in the terms of trade; fiscal stimulus through public investment in infrastructure (for example, in Trinidad and Tobago) is also likely to mitigate some of the growth deceleration caused by the global slowdown.

Lower inflation rates are expected in 2009

In most Latin American and Caribbean countries, inflation surged during 2008, owing mainly to the increased costs of energy, transportation and food, but lower inflation rates are expected in 2009. Central American and Caribbean countries were particularly hard hit, since they are commodity importers. In the Bolivarian Republic of Venezuela, however, prices rose more than 30 per cent in 2008, because of the gap between strong domestic demand and shortages in the supply of consumer products. As, more recently, the global downturn has reduced commodity demand expectations, inflation pressures are expected to decelerate in 2009. For the region as a whole, the inflation rate is expected to decline from an average 8.1 per cent in 2008 to 7.3 per cent in 2009.

However, further depreciation of national currencies in the short run amidst the global financial turmoil will become a major factor in keeping inflationary pressures high, despite the reduced influence of world commodity prices.

As economic growth slows, unemployment rates are expected to rise above 8 per cent in 2009, reversing the positive trend of formal sector job growth during the past five years. Until the second half of 2008, the steady expansion of economic activity had been reflected in improved labour-market indicators. Unemployment rates declined from 9.1 per cent in 2005 to an expected rate of 7.5 per cent in 2008, and job quality improved, as reflected in an increase in the share of formal wage employment.

The region is expected to register a deficit in the current account in 2009, after several years of surpluses and a relatively small deficit in 2008. Since the last quarter of 2007, imports have been growing at a faster pace than exports, owing to strong demand for foreign capital goods, increased energy prices, currency appreciation and lower export expansion. In addition, remittances slowed, increasing by only 3.3 per cent in 2007, compared to 20.1 per cent in 2006, owing essentially to a deteriorating United States labour market. In 2008, only a small number of countries, including Argentina, Ecuador and Venezuela (Bolivarian Republic of), ran current-account surpluses, attributable to an improvement in their terms of trade. In the outlook, the significant economic downturn in the United States and the euro zone will aggravate the external balances of Mexico, Central America and the Caribbean. Although many of the net importers of fuel and other commodities in this subregion will see their situation improve, the export sector will be less dynamic and inflows of remittances are expected to decrease. In South America, adverse terms of trade and lower global demand for commodity exports will lead to lower current-account surpluses or widening deficits.

The fiscal position of the region as a whole will deteriorate as oil and non-oil commodity exporters face a sharp fall in commodity prices and export demand, affecting government revenue. The previously higher export revenues had a positive impact on public revenues and primary surpluses, while reducing public debt and allowing expansionary fiscal policies. However, structural budget positions (when expenditures and revenues are projected according to the trend values of their determinants) have weakened. Public revenues are expected to fall along with slowing economies and the fall of commodity prices that commenced in mid-2008. In countries highly dependent on oil revenues, such as the Bolivarian Republic of Venezuela, the Government will not be able to continue to expand public consumption at the same pace as in recent years.

During 2009, central banks are expected to ease monetary policies in response to emerging liquidity shortages stemming from the ongoing global financial crisis. This is a turnaround from 2008, when interest rates were increased in attempts to control inflationary pressures. At the same time, if export demand falls sharply and uncertainty induces a credit crunch, authorities will be forced to take counter-cyclical measures. The scope for doing so, however, is limited in many countries of the region. As mentioned above, exchange-rate depreciation is exerting new inflationary pressures limiting monetary expansion, while high levels of public indebtedness will limit fiscal expansion. The space for counter-cyclical measures may be larger in those countries with effective fiscal stabilization funds already in place, with structural budget rules or with ample foreign-exchange reserves.

Further downside risks mostly depend on the external situation. A deeper economic slowdown in the United States would affect Mexico, Central America and the Caribbean more directly, while South America will be more sensitive to lower economic

Unemployment rates are expected to rise

Current-account deficits will increase in 2009

Fiscal positions will deteriorate, as public revenues are expected to fall

Interest rate cuts are expected in response to liquidity shortages

Downside risks are mainly external

dynamism in Europe, China and other important Asian export markets. Additionally, increased risk aversion by foreign investors could reverse capital flows, cause exchange-rate volatility and strong pressure on national currencies to depreciate, and severely tighten domestic credit supplies. As mentioned, fiscal sustainability remains a challenge for many countries in the region. In order to stimulate the economy and mitigate the social effects of external shocks, countries will need to see their fiscal stimulus measures supported by internationally concerted policies to reactivate the global economy (as argued in chapter I) with a view to keeping the burden on future incomes within manageable proportions.