



Downside risks to world economic growth call for concerted policy action

The global economy expanded by 3.8 per cent in 2006, continuing its strong performance since 2003 (see figure 1). But can this benign pattern of global growth be sustained, particularly since the recent economic expansion has involved ever-widening global financial imbalances?

Figure 1: Growth performance in selected regions
(Annual change in per cent)

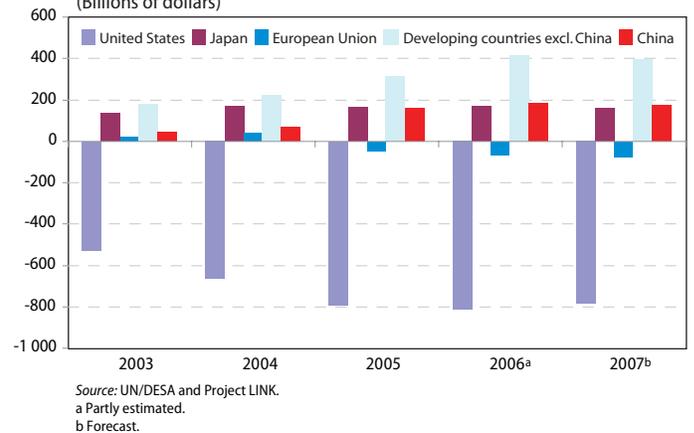


Led by China and India, developing economies continued their good performance and expanded, on average, by 6.5 per cent in 2006. Also, the average growth rate in the least developed countries, many in Africa, remained particularly strong, reaching almost 7 per cent. The world's largest economy, the United States, expanded by 3.3 per cent, and growth also recovered in the previously sluggish Japanese and European economies.

Strong domestic demand growth in the US has been an important driver of global economic growth. The US demand pull has been sustained by low borrowing costs and rising asset prices. The credit-driven demand has bolstered growth of manufactured exports elsewhere, which has intensified international competition, helping to keep inflation down.

Greater manufacturing output boosted demand for energy and raw materials from the developing world, pushing up commodity prices, thus benefiting many poor countries. The savings generated in Europe, East Asia and the major oil-exporting countries increased global liquidity, which have helped finance the widening US current account deficit, which reached \$815 billion in 2006 (see figure 2).

Figure 2: Global imbalance continues to widen
(Billions of dollars)



The risk of a global economic slowdown

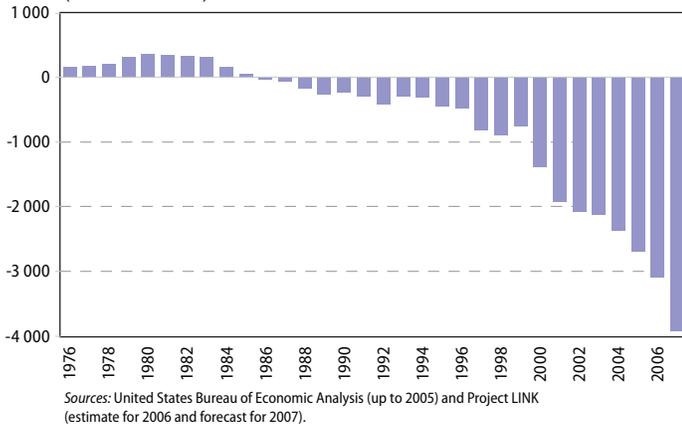
In the *World Economic Situation and Prospects 2007*, the United Nations warns of a possible global economic downturn, with significant risks attached. The US housing market or the currency market is the most likely trigger of such a slowdown.

The main driver of US demand is household spending. From 1997, growth in household spending strongly increased with the boom in the housing market as consumers took on more and more debt underwritten by the rising values of their homes. This led to a clear weakening of the US housing market from 2006, which slowed economic growth and is expected to significantly weaken consumer demand in 2007.

The net result is a two-pronged risk: slower growth in the US will be transmitted to the rest of the world, without any other major economy able to replace it as the main engine of global growth. The second and third largest economies, Japan and Germany, will need to urgently revive domestic demand (which they have failed to in the recent past). China, the fourth largest economy, is not yet large enough to compensate for a US slowdown, as its own export growth will be affected by slower US growth.

Another downside risk to global economic growth relates to investor sentiment about the US dollar. The US has built up net liabilities with the rest of the world expected to reach \$4 trillion in 2007 (see figure 3). Foreigners' dollar assets held

Figure 3: Net international investment position of the United States
(Billions of dollars)



in the US have tripled to almost half the national incomes of their home countries since the early 1990s.

It is difficult to predict how much more of their asset portfolios foreigners will be willing to invest in the US, but only a small change in market sentiment and expectations of a dollar decline may trigger a massive withdrawal of dollar-denominated assets, precipitating strong downward pressure on the dollar. This, in turn, could have a destabilizing effect on financial markets.

Urgent need for internationally coordinated macroeconomic policies

National economic policies and existing multilateral arrangements have not been designed to effectively mitigate the risk of a global slowdown or to address global imbalances.

For example, monetary and fiscal policies in Europe and Japan have been tightening in response to domestic concerns, further slowing the world economy. Likewise, while the build-up of official reserves in East Asia and other developing countries will bolster their ability to deal with possible external shocks, it will, at the same time, continue to limit the expansion of domestic demand and import growth. This is exacerbating, rather than redressing, the global imbalances.

It is unlikely that any one government will be prepared to bear the costs of policies needed to correct the imbalances on its own. But there is scope for an internationally coordinated set of macroeconomic policies which could help reduce the risk of weaker growth in the major economies, maintain confidence in the stability of international financial markets and avoid a hard landing of the dollar.

This set of policies would require, for instance, stimulating demand growth in Europe, Asia and the major oil exporters. Such a growth impetus is necessary to help reduce the US external deficit and to offset the contractionary effect on the

world economy of necessary corrections in the US, including strengthening demand for US exports.

Exchange rates should be realigned in a coordinated fashion to stimulate exports from the deficit countries and import demand from the surplus countries. This is not just a matter of revaluing the Chinese currency, as argued by some US policy makers, but requires gradual adjustment of most major currencies against the dollar in conjunction with concerted fiscal and monetary policy management to strengthen demand in the rest of the world.

Existing arrangements, such as the G-8 summits, are unsuitable for achieving the necessary course of action, mainly because key players from the developing world are not included. The multilateral surveillance mechanisms launched last year by the IMF are steps in the right direction, but only if they become part of a truly multilateral mechanism of surveillance and policy coordination.

To be a credible mediator of this mechanism, the IMF itself would need reform, including a more substantial change of voting power to bring the influence of developing countries in line with the weight they now carry in the global economy and thus better reflect the IMF's claim to operate as a cooperative, rather than a corporation.

Such new arrangements should be used to work towards more structural reforms of the international monetary system, away from its currently excessive reliance on the US dollar as reserve currency. Such reforms should work towards the development of a multilaterally agreed multi-currency reserve system or even a world currency based on the Special Drawing Rights issued by the IMF in the longer term.

Prospects of weaker growth in the US and the world economy at large, and the possibility of an imminent hard landing for the dollar should be alarming enough to mobilize concerted action by policy makers. Coordinated economic policies will surely deliver more satisfactory outcomes than what each country can achieve on its own. ■

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The full report can be downloaded from:

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

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