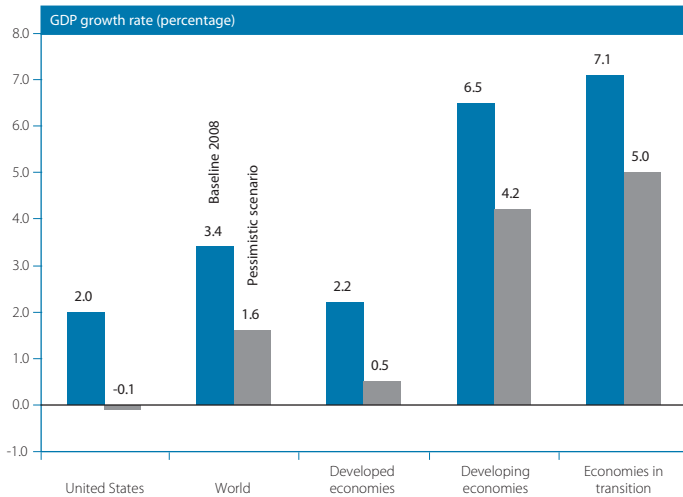




Concerted international policy action needed to tackle worsening global outlook

The global economic outlook has turned gloomy, very much along the lines of the pessimistic scenario in the most recent *World Economic Situation and Prospects (WESP) 2008*. If the US economy moves into recession this year, world economic growth could slow to just 1.6 percent in 2008 (figure 1), debunking the myth of its “decoupling” from the US. This is the consensus view. Policymakers there are trying to stave off a recession through aggressive monetary and fiscal policy action, but this is unlikely, by itself, to avoid global economic distress. The presence of persistently wide global macroeconomic imbalances complicates such unilateral responses and highlights the urgent need for internationally concerted policy action.

Figure 1: World growth prospects in view of housing crisis in the US and dollar depreciation



Sources: UN/DESA and Project LINK
a Partly estimated. b Forecast.

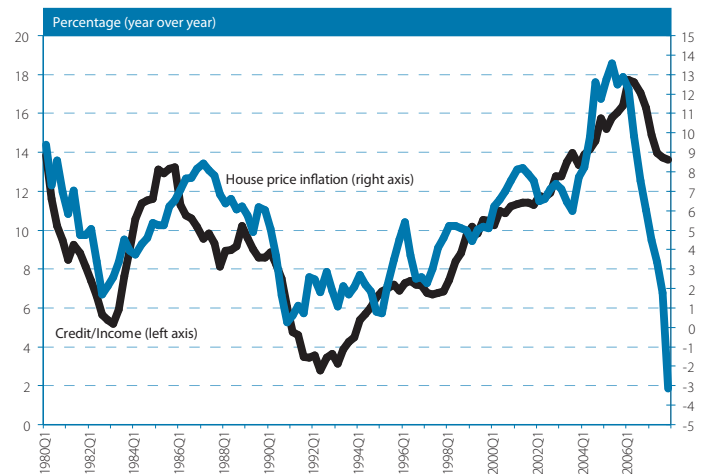
Follow the money

Robust growth in the developing world, which has been building momentum over the past five years, may cushion the world economy from a hard landing. Still, that performance has, in no small part, been based on strong consumer demand in the US and surging financial flows that produced a remarkable degree of monetary and exchange-rate stability. The growth prospects of developing countries are unlikely to be “decoupled” from the macro-financial weaknesses in the US.

Today’s financial system tends to respond to economic shocks in a pro-cyclical manner. Two such responses can be

traced from the ongoing housing recession in the US. First, the weakness in the real estate sector is putting pressure on credit availability and, hence, on household spending. After the dotcom crisis of 2001, rising housing prices and aggressive lending practices encouraged a sharp increase in household indebtedness to finance a surge in household spending (figure 2). This has now gone into reverse. In addition, credit tightening has been compounded by the crisis in the sub-prime mortgage market as banks adopt a much more cautionary lending stance, which has already spread from the household to the business sector.

Figure 2: Household borrowing relative to income, and house price inflation in the United States



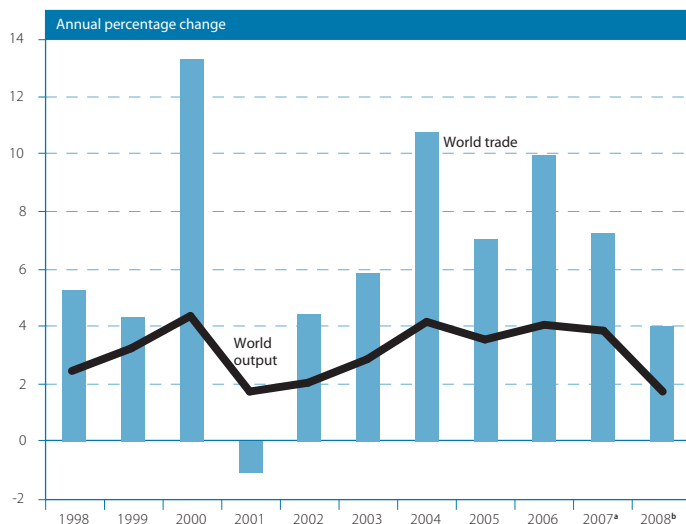
Sources: Federal Reserve Bank, Flow of Funds (Dec. 2007), NIPA tables and OFHEO price index. Figures for 2007Q4 are estimates derived from the last “Consumer Credit” report (Fed), “Personal Income and Outlays” (BEA) and Radar Logic RPX’ house price index.

Second, the strong depreciation of the dollar is adding to the economic woes by aggravating instability in financial markets. The persistent current-account deficit of the US, which still amounted to 2 billion dollars a day in the final quarter of 2007, has contributed to the 24 per cent depreciation of the dollar since its peak in February 2002. Foreign holders of US assets have, as a consequence, seen the value of their wealth decline. The stock of assets invested by foreigners in the US increased from \$9 trillion in early 2002 to more than \$15 trillion at present, but the dollar depreciation implies that, valued in their own currency, foreign investors have taken a \$2.8 trillion loss. The interest rate cuts by the Federal Reserve will create additional downward pressure on the dollar, adding to foreign investors’ concerns about continuing losses on

dollar-asset holdings. This could precipitate a much sharper drop in the value of the dollar. The global reverberations of such an outcome are difficult to foresee, but clearly, the credit mechanism that enabled the US economy to become a driver of global growth is now in jeopardy.

The impact of a slowdown in the US economy will also be felt through global trade. For several years, world trade has been growing twice as fast as output (figure 3), but this is unlikely to persist as import demand slows in the US. Most likely, the first economies to experience a deceleration of export growth will be in the industrialized world, not only because of lower US demand, but also because of the appreciation of their currencies vis-à-vis the dollar. However, since global trade growth has been significantly driven by demand from the industrialized world, exporters of manufactures in Asia and parts of Latin America will also be affected. Slower growth in emerging economies will, in turn, cool demand in primary commodity and energy markets, with weaker prices affecting growth prospects, particularly those of poorer commodity-exporting countries.

Figure 3: Trade flows and global growth, 1998-2008



Sources: UN/DESA and Project LINK.
 a Partly estimated.
 b Forecast under assumptions of pessimistic scenario of *World Economic Situation and Prospects 2008*.

The policy response has to be clear, decisive and internationally concerted

In January 2008, US policymakers put together a stimulus package to stave off a recession. Although the full details are still being worked out, it is unlikely that even the world's major economy can work out a lasting solution on its own. The problems are global, requiring a concerted multilateral response.

The management of global demand is particularly challenging, given the current macro-financial imbalances and the

continued importance of trade as a growth engine in many countries. A US stimulus package will further weaken the dollar, though by how much and how quickly is uncertain, and it could also rekindle asset-price bubbles, with attendant risks to growth recovery and financial stability. Moreover, a mix of monetary and fiscal policy, which would shift indebtedness from households towards the government sector, could end up contributing to a further increase in the US external deficit, thereby exacerbating global imbalances.

The current situation calls for measures that would induce a recovery of savings by US households and bring their debts to more sustainable levels. Achieving this adjustment without triggering destabilizing effects elsewhere in the world economy necessitates a multilateral policy consensus built around well-calibrated fiscal and monetary measures, allowing spending increases in other parts of the world and export growth to rebalance the US current account. As a matter of urgency, finance ministers of all major developed and developing countries should push for a more decisive and inclusive process of multilateral consultations at the IMF, along with a commitment to an agreed policy package oriented towards an expansionary global rebalancing.

To have a lasting impact, the policy response to the current crisis has to be unambiguously comprehensive in coverage, involving the participation of all countries, as well as tailored to their capacity to carry the burden of adjustment. More fundamental reforms include, especially, the creation of an officially backed multi-currency reserve system in which countries could accumulate reserves without exacerbating the US current-account deficit, as well as a more effective mechanism for providing adequate liquidity, especially to developing countries. In addition, the credit crisis has revealed systemic weaknesses hidden behind the complex web of financial derivatives and related instruments, necessitating a return to stronger regulatory measures. These should include higher capital requirements for financial institutions, and more effective surveillance of banks, intermediaries and credit rating agencies as well as controls to better deal with sudden surges and stops in capital flows. ■

Prepared by:

Rob Vos, Richard Kozul-Wright, Alex Izurieta and Matthias Kempf, DPAD

For further information please contact:

Rob Vos, *Director*, Development Policy and Analysis Division
 Department of Economic and Social Affairs, Rm. DC2-2020
 United Nations, New York, NY 10017, U.S.A.
 Tel: +1 212 963-4838 • Fax: +1 212 963-1061
 e-mail: vos@un.org • website: <http://www.un.org/esa/policy>