United Nations

World Economic Situation and Prospects, 2005 – 2009

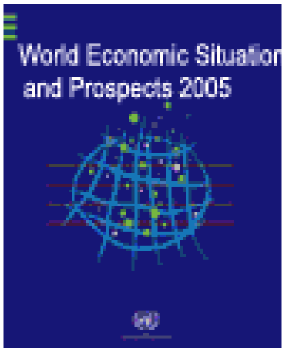
On the Global Financial and Economic Crisis

The *World Economic Situation and Prospects* is the United Nations annual report (with mid-year updates) on the state of the global economy. The report has been published since 1948, originally as the *World Economic Report*. All reports since then are available on line from http://www.un.org/esa/policy.

WESP is a joint publication of the Department of Economic and Social Affairs (DESA), UNCTAD and the UN's five regional commissions (ECLAC, ECA, ECE, ESCAP, and ESCWA).

In recent years, from 2005, but also in earlier editions, WESP has warned against the dangers of the unsustainable pattern of global growth that emerged about a decade ago and which was characterized by strong consumer demand in the United States, funded by easy credit and booming house prices. Far-reaching financial deregulation facilitated a massive and unfettered expansion of new financial instruments, such as securitized sub-prime mortgage lending, sold on financial markets worldwide. This pattern of growth enabled strong export growth and, eventually, high commodity prices benefiting many developing countries, but also led to mounting global financial imbalances and overleveraged financial institutions, businesses and households. In the context of a highly integrated global economy without adequate regulation and global governance structures, the breakdown in one part of the system thus easily leads to failure elsewhere, as we are witnessing today.

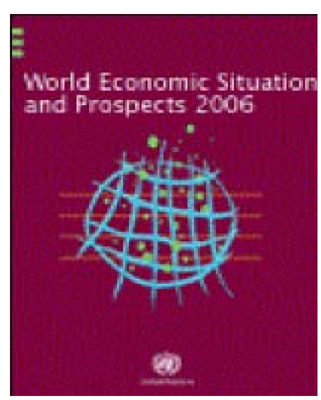
This framework of analysis allowed detecting the core causes of the present crisis early on. WESP also sustained, on the same grounds, that the problems in the US housing and financial markets could easily spread around the world and severely affect economic and social progress in developing countries, even if many of these were not directly exposed to the risk of sub-prime lending and the related derivatives markets. The hypothesis, sustained by many analysts, including at the Bretton Woods institutions, that developing country growth would somehow have become "decoupled" from growth in developed economies was always rejected by WESP. We know now for a fact how misguided this hypothesis was and unfortunately led to many developing countries to be taken by surprise by the consequences of the financial crisis after it intensified in September 2008, despite all warning signals.



Such early warning signals were sent out, for instance**,** in **WESP 2005** (published in January 2005) which warned in particular about the unsustainable global imbalances that were mounting. Among other things it analyzed that:

- The **global imbalances** may have reached a stage where they pose a **potential threat** to sustained growth in the world economy because international markets may react in a precipitous or excessive fashion. The various structural and institutional differences between the deficit and surplus countries suggest that it is unlikely to be possible to reduce the imbalances to a sustainable level in the short term (WESP 2005, p. 19).
- The over-riding need is not to focus directly on correcting the trade imbalances but rather to rebalance the **global pattern of growth and of savings and investment**. The efforts to reduce the deficits of the United States will have a contractionary effect on the world economy unless complemented and offset by complementary expansionary measures in surplus countries. To ensure that the necessary actions are taken by all concerned in a timely and effective manner, an enhanced degree of **international macroeconomic policy coordination** is necessary (WESP 2005, p. 20).
- The report further warned that the **inertia of policy makers** in addressing the global imbalances would be one of the factors causing volatility in international financial markets (WESP, p. 21).

The analysis of this report was deepened in the ***World Economic and Social Survey*** (WESS) ***2005*** on *Financing for Development*, which laid out, among other things, many of the flaws of the present international financial architecture and proposed directions of reform which have come high on today's policy agenda, including: reform of the Bretton Woods institutions, reform of regulatory frameworks, new and improved mechanisms for international liquidity provisioning, as well as reform of the global reserve system (WESS 2005, chapter VI).



The analysis was followed through with renewed early warning signals given in **WESP 2006** (published in January 2006), which emphasized as major downside risks that:

- The strong expansion of financial sectors and capital flows worldwide had not translated in higher productive investment, suggesting global growth was driving on a bubble. There was not so much a "savings glut" in the world economy, as some analysts contended, but rather "**investment anaemia**" (WESP 2006, pp. 14-17).

- The **ever-widening global imbalances**, with the country issuing the world's major reserve currency – the United States – accumulating increasing deficits financed in no small part by trade surpluses in developing countries, would eventually prove unsustainable and could risk volatile global currency markets and a hard landing of the dollar A disorderly unwinding of these imbalances could well upset financial markets and bring down the global economy (WESP 2006, pp. 17-22).
- The **bubble in the US housing market** could come to an end. As this bubble was fuelled by lax monetary policy and innovative, but poorly regulated financial instruments, a deflation in house prices could easily lead to financial sector problems and given the "inextricable linkage" between the house market bubble in the US and the global imbalances, this could bring down the world economy (WESP 2006, pp. 23-24).
- Given these global risks, the WESP called for urgent **international macroeconomic policy coordination** to redress the global imbalances, including policy corrections to stem the exuberance in housing and financial markets (WESP 2006, pp. 25-28).

In **WESP 2007** (published in January 2007), a further decline in house prices in the United States was once again singled out as the key risk for the global economy:

- The possibility of a more severe downturn in **housing markets** represents a significant downside risk to the economic outlook. A number of economies have witnessed substantial appreciation of house prices over the past decade, and the associated wealth effects have contributed to relatively strong economic growth rates. A reversal of the process may thus lead to **significant negative fallout for world economic growth** (WESP 2007, page v, and Box I.2, pp. 3-4).
- For the global economy, the **risks** associated with the **housing sector** are serious, not only because of the sheer size of the economies concerned, but also because of an **inextricable linkage** between the increase in **house prices** and **global imbalances**. A number of economies that have seen substantial appreciation in house prices are also running large external deficits (including, of course, the United States) and experiencing a decline in household savings to very low levels. In this regard, the housing booms in those countries have been indirectly financed by borrowing from the high-savings countries running external surpluses. Therefore, a **collapse in house prices** in major economies would provoke a **contractionary** and **abrupt adjustment** of global imbalances (WESP 2007, page 18).
- The current and envisaged **macroeconomic policy** stances appear **poorly designed** to deal adequately with the problem of the widening global imbalances (WESP 2007, page 23).

- Both the need and feasible mechanisms for effective **international macroeconomic policy coordination** along with broader reforms of the international financial architecture are detailed in ten pages of chapter one (WESP 2007, pp 24-34, as well as in chapter III of the report).

In **WESP 2008** (published in January 2008), the risk of a recession in the United States and a hard landing of the global economy as a whole, was highlighted and quantified:

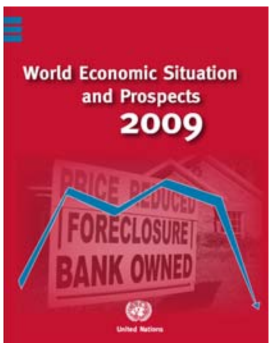
- The combination of a deep housing slump in the United States, continuous devaluation of the United States dollar and related increased financial turmoil could trigger an **abrupt adjustment of the global imbalances**, which would not only send the economy of the United States into a recession, but would also lead to a hard landing for the global economy as a whole. In the pessimistic scenario, global growth for 2008 was forecast to be 1.6 per cent, as it turned out to be in reality by close approximation (WESP 2008, p. 3).

- The **major drag** on the world economy continues to be a notable slowdown in the **United States**, driven by the slump in the **housing sector**. The deteriorating housing downturn in the United States, accompanied by a meltdown of sub-prime mortgages, eventually triggered a full-scale credit crunch that reverberated throughout the global financial system during the summer of 2007. Central banks of the major economies consequently injected a large amount of liquidity into money markets and, in the case of the United States Federal Reserve Bank (Fed), lowered interest rates. These **measures** have largely attenuated the immediate financial stress, but they **did not address the more fundamental problems** rooted in the global financial system and the world economy (see below for a more detailed discussion). The **housing recession** in the United States will likely continue in 2008, remaining one of the major downside risks for the growth prospects of the United States and the global economy (WESP 2008, p. 5).

- The extremely low levels of the **risk premiums** on lending to this group of countries [**emerging market economies**] might suggest a considerable degree of **complacency** on the part of international investors. Should the financial market conditions in major developed economies worsen and/or the large global imbalances undergo a disorderly adjustment, the **international economic environment for developing economies** and economies in transition would also face a significant risk of **deterioration**. Both **policymakers** in the emerging market economies and international investors stand reminded of the **risky** and **volatile** nature of these markets (WESP 2008, p. 12).
- Despite robust growth and increasing importance in the generation of global welfare, **growth cycles** in developing countries remain closely **correlated** with the ups and downs of the United States economy. It is therefore not correct, therefore, to speak of a **decoupling** of economic growth in the rest of the world

from that of the United States, and the robust growth of developing countries in recent years should not be seen as a sign that they could readily avoid the occurrence of a **worldwide recession** (WESP 2008, p. 26).

- More **global demand stimulus** will be **needed** to prevent the slowdown in the United States economy from slipping into a recession and spilling over to the rest of the world (WESP 2008, p. 32).
- Lessons need to be learned from the recent financial turmoil to reduce vulnerabilities to future financial stress. Responses by the central banks of the major economies have focused on liquidity injections to restore financial market confidence and avoid a credit crunch. These measures have had some temporary effect, but have also raised questions regarding the quality of **financial regulation** and financial safety nets, both nationally and internationally. More fundamental regulatory reforms are needed, next to reform of the global reserve system (WESP 2008 p. 34).



The latest **WESP 2009** (published in January 2009) addresses all these issues once again, but no longer discussing these as downside risks, but as the root causes of a financial and economic crisis that already had emerged and was rapidly deepening and spreading around the world. With even greater urgency than previously, the report calls for massive, globally coordinated fiscal stimuli and details the far-reaching reforms of international financial system needed to safeguard against future recurrence of events.