Financing for Development

PRESS RELEASE

Coordinated, massive and swift economic stimulus required to counteract synchronized global downturn, new UN report asserts

- **world per capita income is expected to decline next year**
- **falling export growth and capital inflows and higher borrowing costs for developing countries, as contagion spreads from the major economies**
- **dollar set to resume its decline, with possibility of a hard landing in 2009**
- **deep reforms of global financial system called for to prevent crisis recurrence**

(DOHA, QATAR, 1 December) UN economists are recommending massive economic stimulus packages that are coherent and mutually reinforcing on a global basis, and linked with sustainable development imperatives. These should come on top of the liquidity and recapitalization measures already undertaken by countries.

The 2007 sub-prime mortgage debacle spread into a global financial crisis in 2008, and since has turned into a calamitous economic downturn that will last into 2009 and likely beyond, says an advance edition of the UN annual economic report, issued today at the international Financing for Development review taking place in Doha.

Also recommended are stronger regulation of financial institutions, adequate international liquidity provisioning, an overhaul of the international reserve system and a more inclusive global economic governance, to prevent against any future repetition.

According to the baseline scenario of *World Economic Situation and Prospects 2009*, world output will reach a meagre 1 per cent in 2009, compared to 2.5 per cent in 2008 and global growth rates of between 3.5 and 4 per cent in the preceding four years (*see Table I.1*). The 2009 projection includes a decline in output of 0.5 per cent in developed countries, along with growth of 5.3 per cent in the transition economies and 4.6 per cent in the developing world.

This global growth trajectory points to a drop in income per capita for the world in 2009.

Under a more optimistic scenario -- factoring in fiscal stimulus of between 1.5 and 2 per cent of gross domestic product (GDP) of the major economies, and further interest-rate cuts -- the developed economies could post a 0.2 per cent rate of growth, and the developing world would surpass 5 per cent growth, UN economists calculate.

Given the great uncertainty prevailing today, the unfolding of a more pessimistic scenario is possible.

If the present credit squeeze prolongs and confidence in the financial sector is not restored in the coming months, the UN warns, the developed countries could enter into a deep recession in 2009, causing world output to fall and GDP growth in the developing world to drop to 2.7 per cent, dangerously low for the ability of countries to sustain poverty reduction efforts and social and political stability.

Harsh development environment

Developing country policy makers spent the third quarter of 2008 tracking inflationary threats, acutely felt through the rising cost of basic commodities such as food and fuel. They were caught by surprise in October, when the financial crisis and economic downturn hit economies with the speed and strength of a tropical storm.

The cost of external borrowing has since risen sharply for developing countries and capital inflows are reversing. Stock markets have dropped further on the back of a difficult year, while currency and commodity markets have become extremely volatile, with the exchange rate depreciating at an alarming pace in several countries and prices of primary commodities tumbling since summer highs. Export growth is now decelerating and the current account balance of many countries has shifted back into the red.

Contagion from developed countries – with a majority of them already in recession – to the rest of the world entails a "globally synchronized downturn [that] may be the first of its kind in the post-war era," *WESP* says.

Crisis management has moved slowly . . .

Monetary policy in the United States during the first half of 2008 was aggressively expansive in attempts to stave off a recession, while European central banks maintained a tightening stance in the face of the inflation threat (*see Figure I.11*).

This policy mismatch typifies the lack of coordination during the boom years, when growth was strong and the over extension of credit in the United States and over-accumulation of savings in surplus countries could have been addressed with less pain and more room for manoeuvre. Along these lines, the UN's W*orld Economic Situation and Prospects 2007* and *2008* advocated consolidation in the US economy matched with stimulus in surplus countries such as China, Japan, and in Europe.

Finally by October 2008, response measures within countries took on a more comprehensive, less piecemeal approach, and unilateral national approaches gave way to increased international cooperation and coordination. About $4 trillion worldwide was invested in efforts to unfreeze credit and money markets. Interest rate cuts took shape rapidly in developed as well as some developing countries.

“But with consumer and business confidence seriously depressed and banks reluctant to lend, further lowering of interest rates by central banks will to little to stimulate credit supplies . . . and private spending,” UN economists caution.

With limited space for monetary stimulus, fiscal policy options are needed to reactivate the global economy.

China has already launched a $586 billion (15 per cent of GDP) fiscal package to be implemented in two years, which may contribute to reinvigorating global as well as domestic demand. In the US, fiscal stimulus equal to 1.1 per cent of GDP in the first half of 2008 probably kept economic growth afloat for an extra quarter. The Republic of Korea recently announced a package of roughly the same size relative to its GDP.

To stave off a much deeper recession, UN economists argue for greater fiscal stimulus, in an internationally coordinated fashion. In a globalized economy, fiscal stimulus in a single country is undercut by import leakage and other effects; when instituted across the board, a reinforcing multiplier effect can take hold.

. . . but bold reforms are needed to prevent future crises

There is, however, a lack of an institutionalized and credible mechanism for coordination of stimulus packages or monetary policies. With net indebtedness of the United States still growing -- to about $2.7 trillion at the end of 2008, up from $2.5 trillion in 2007 – a disorderly adjustment of global imbalances and a hard landing of the dollar remain major downside risks. In that case, investors might again embark on a “flight to safety”, but away from dollar-denominated assets instead of to them, pulling the US economy down further, and the global economy with it.

The UN sees an opportunity to align fiscal stimulus packages with long-term sustainable development goals. The massive resources required for fiscal stimulus can be applied in part to public investments in infrastructure, food production, education and health and renewable energy sources, helping developing countries to diversify their economies and meet their Millennium Development Goals.

To shore up weaknesses which led to the extraordinary damage brought on by the downturn and to prevent this from happening again, UN economists are advancing a broad range of steps, including the following:

- fundamental revision of the governance structure and functions of the IMF and the World Bank for enhanced international policy coordination and for more inclusive participation of major developing countries;
- fundamental reforms of existing systems of financial regulation and supervision to stem past excesses;
- reform of the present international reserve system, away from the almost exclusive reliance on the US dollar and towards a multilaterally backed multi-currency system;

- reforms of liquidity provisioning and compensatory financing mechanisms, backed, among others, by better multilateral and regional pooling of national foreign exchange reserves, and avoiding onerous policy conditionality.

The “Global Outlook” chapter of the UN *World Economic Situation and Prospects 2009* is released today in Doha. The full report, including regional overviews and detailed trends in global trade and finance, is due out in early January 2009.

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