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Report on the Project LINK Meeting

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1. Introduction and opening of the meeting

The Fall 2008 Project LINK Meeting was held from October 23-24 in New York, hosted by the United Nations Department of Economic and Social Affairs (DESA). Around 80 participants from 30 countries attended the meeting, whose agenda comprised the following main themes: the global and regional economic outlook; the current global financial crisis; and developments in the global commodity markets. This document summarizes the content of the presentations and discussions.

The LINK Global Economic Outlook prepared for this meeting by the Global Economic Monitoring Unit of DESA, the LINK country reports prepared by country participants, an most of the documents presented at the meeting are available on the United Nations website (http://www.un.org/esa/policy/) and the Project LINK Research Centre website at the Institute for Policy Analysis at the University of Toronto (http://www.chass.utoronto.ca/link/).

Mr. Rob Vos (UN-DESA) welcomed the participants, highlighting the current changes in the financial landscape that lend a particularly urgent dimension to the LINK meeting.

Mr. Peter Pauly (University of Toronto) also welcomed the participants, expressing his thanks to the UN for arranging the meeting. He pointed out that the number of participants exceeded expectations, which testifies to the important phase the world economy currently finds itself in as well as to the strength of the LINK group.

Mr. Lawrence Klein (University of Pennsylvania) highlighted that the current turmoil is not the first economic crisis, although this one appears to be worse than the economic difficulties during the oil embargo.

2. Economic outlook

Mr. Rob Vos (UN-DESA) presented the UN-DESA / LINK projections, forecasts and downside risks for the world economy against the backdrop of the international financial crisis as outlined in DESA's Global Economic Outlook. After providing an overview of the causes and key events of the crisis and the policy responses in various countries, he shed light on the likely consequences for the global economy. He then highlighted major downside risks to the outlook and presented a set of reform proposals for the international financial architecture.

Mr. Vos stressed that the global financial crisis, which is increasingly affecting the global economy, is rooted in the sub-prime mortgage debacle in the United States. Monetary easing in the United States and liquidity injections by central banks in major developed economies have failed to restore confidence and prevent the crisis, which has manifested itself in a global credit crunch and rapidly declining stock and commodity markets. In September 2008, the spread between the LIBOR and United States treasury bills increased sharply and inter-bank lending virtually dried up. Financial institutions in developed countries faced massive write-downs of assets, which eventually resulted in the collapse of several large financial firms. Non-financial firms also started to have difficulties in obtaining bank loans. Mr. Vos pointed out that initial piecemeal responses to the crisis were largely unsuccessful and Governments in developed economies have therefore turned to more comprehensive and coordinated approaches, including the issuance of state guarantees on bank deposits and other assets, the recapitalization of financial institutions, and the continuing provision of liquidity. The financial crisis is quickly spreading to emerging markets, with many of them facing a sudden increase in bond spreads and massive outflows of foreign portfolio investment. He indicated that risk aversion among investors and, thus, bond spreads are likely to remain high for some time.

Mr. Vos then stated that the financial crisis will result in a severe economic slowdown in both developed and developing countries. According to the UN-DESA / LINK baseline forecast, growth of world gross product is expected to slow from 3.7 per cent in 2007 to 2.6 per cent in 2008 and 1.6 per cent in 2009. Most developed economies are heading for recessions and there remains the risk of a global recession as outlined in the pessimistic scenario of UN-DESA's Global Economic Outlook. Mr. Vos emphasized that a synchronized global downturn is taking place, which implies that emerging markets have not decoupled from trends in developed economies, in particular the United States. He then presented the UN-DESA / LINK regional growth estimates and forecasts.

Turning to the major consequences of the crisis, Mr. Vos pointed out that growth in world trade is expected to decelerate rapidly as import demand across the globe weakens. The Baltic dry index, a benchmark for commodity shipping costs, plunged by 85 per cent between May and October 2008, indicating a sharp slowdown in the volume of global trade. At the same time, the prices of oil, basic grains, and other commodities dropped sharply over recent months. The slowdown in global demand is expected to adversely affect all developing countries.

Mr. Vos highlighted the fact that Asian and Latin American countries are generally better placed to weather the current storm than previous crises. In stark contrast to the situation before the Asian crisis in 1997, almost all countries in East and South Asia have maintained current account surpluses for several years and accumulated significant levels of international reserves, mostly in excess of 20 per cent of GDP. However, especially in the more vulnerable Latin American countries, international reserves may shrink rapidly as net financial transfers from developing countries continue to increase. In general, middle-income countries will be hit especially hard by the financial crisis, with liquidity constraints likely to emerge in a growing number of economies.

Mr. Vos then identified two major downside risks to the global economic outlook. First, there remains the danger of a large-scale financial meltdown, which would lead to a prolonged credit crunch in the large economies and a worldwide recession as outlined in the pessimistic scenario. In this case, world gross product is forecast to shrink by 0.5 per cent in 2009, with contractions in all developed regions and Latin America. A more severe global crisis would imply massive capital reversals from emerging markets and lower flows of official development assistance to low-income countries. The second risk emphasized by Mr. Vos relates to a hard landing of the dollar. Global imbalances have narrowed over the past year, but remain large, with the United States net foreign debt position continuously deteriorating. The fast appreciation of the dollar between July and October 2008 primarily reflects a flight to safety among investors and is likely to be only a temporary phenomenon. If investors lose confidence, a rapid slide of the dollar may occur, possibly resulting in a second round of financial crisis.

Mr. Vos concluded his presentation by pointing to the way ahead. The primary objective of restoring stability in financial markets can only be achieved through globally coordinated policy responses. Avoiding similar crises in the future requires a fundamental reform of the international financial architecture. The agenda for such a reform includes the following elements: establishing a credible and effective mechanism for international policy coordination; reforming the existing systems of financial regulation and supervision; reforming the provisioning of global liquidity, and reforming the international reserve system. Mr. Vos noted that a deep and comprehensive reform will require substantial time to be developed and accepted by UN member countries.

Mr. Hans Timmer (World Bank) said that the economic outlook is deteriorating rapidly. He argued that it was now necessary to make a major adjustment to the forecast and start from scratch. September saw the failure of some significant institutions, and the financial turmoil in the United States had spread to Europe and then to the rest of the world.

He highlighted three messages:

(1) Developing countries can no longer rely on their resilience and domestic growth dynamic. There is no de-coupling. Looking at a decomposition of trend growth, previously there was a strong internal growth dynamic through investment and this could offset external developments. In addition, macro policies generated increasing reserves. But now this is weakening. Slowing exports are coupled with slowing investment due to the crisis and reserves are not relevant in the midst of a global meltdown.

(2) Private sector investment will be under heavy pressure and there will be impacts on governments.

(3) Extremely negative scenarios have now become more plausible, such as negative global growth. But at the same time, there is the opposite danger of too much stimulus and liquidity creation. Liquidity from central banks means the government taking on liabilities and if there were to be a sharp rebound, there could be significant inflationary pressure.

He then reviewed some of the salient historical features leading up to the present situation. Declining United States import volumes have been part of the story since 2006, and developing countries were able to cope. Exports within the region remained robust, particular in China, aided by strong internal growth dynamics.

There was a long boom in private investment. This was true especially in developing countries, but also in high-income countries. Domestic demand was slow but exports were strong, especially for capital goods exports to developing countries. High frequency data shows that at the beginning of 2008 industrial production was stalling, but this was after the adjustment process started in the United States, more than 2 ½ years ago.

This resilience has ended with the intensifying financial crisis. LIBOR has risen, corporate bond spreads have increased, more so in emerging markets, bank lending and bond and equity issuance has slowed dramatically, there is a reversal of capital flows, and much of this has intensified in the last few weeks. The forecast is now for a slowing of private capital flows, from about $1 trillion in 2007 to $800 billion in 2008 and $500 billion in 2009. This is a very sharp reduction, which is crucial to the investment process.

The speaker's group at the World Bank has developed a revealed vulnerability index, which is built up from components of the stock market index, spreads and high frequency capital flows. The score in the index has good predictive power for FDI flows. Looking at current readings, the index shows that Latin America is in trouble, despite the fact that current account balances and government deficits look adequate by the usual standards.

In the past, investment growth was greater than 12% in developing countries, but investment is losing momentum. In the forecast, they used a model to adjust investment downward for 2009 and then cyclically up for 2010. They also have an alternative scenario with investment much slower for 2010. Given this, growth is expected to be 0.3% for the advanced economies, with a recession in the United States, the EU and Japan, and 4.5% in the developing country region (versus 6% in the previous outlook). World trade growth will be much slower than the previously anticipated 3-4% growth for 2009, instead contracting by 2.5%. This comes from falling investment and the high import content of investment. They have worked on a trade channel downside scenario, which contains supply effects on trade, and a fall in trade credits (affecting countries such as Brazil) and trade insurance, a form of short-term financing rises (affecting India). This gives a negative demand side effect on trade and a negative supply side effect as well.

Looking at commodity prices, developing countries have seen a large rise. In the old forecast, prices were assumed to remain stable at a high level with some subsequent downward movement. The new baseline contains a much sharper decline. For oil, the equilibrium long-run price is estimated to be around $75, which is a function of marginal cost, so they assume that the price does not fall below this level. OPEC's share of world supply is larger now, so it is assumed that OPEC can defend this price, although this could be debated. With growth slowing, this implies that oil goes to $75 and stays there. Looking at other commodity markets, grains and foods have an association with oil price movements when oil is above $50 but not when below. So in the current case, commodity prices are likely to fall but still remain well above the levels of 2000.

In conclusion, the main changes to the forecast come through investment and commodity prices, and this implies that current account balances for developing countries will be very different.

In the aftermath of the crisis, there will be debates about a range of issues such as re-regulation of financial markets and re-thinking of financial integration; regional re-orientation of financial markets; and risks of continued booms and busts in asset markets because of savings and investment imbalances. It is likely that the United States will lose its dominance in financial markets in view of the rising importance of China and the Gulf states, resulting in a multi-polar world. Sovereign wealth funds will act differently and monetary policy in Asia will be another important element.

Looking at risks, it is important to ask what went wrong. There have been a lot of booms and busts in financial markets in the past. In the 1970s, there was the recycling of petro dollars (stemming from a surplus of savings) which led to an increase in debt in the LDC's and then the debt crisis. In the 1990s, it was capital flows to Asia which led to a crisis. Then there was the hi-tech boom, followed by the housing boom. It seems likely that there is a surplus of savings at the global or regional level and that the distribution of this is wrong.

Finally, one danger is that there is a rebound with a strong stimulus which would lead to price pressures. In the 1960s, inflation was low and growth was high, but in the 1970s, inflation shot up. A similar picture could emerge now, implying considerable upside risks.

Mr. Ray Barrell (NIESR) presented the prospects for the world economy based on the most recent estimates and forecasts of the NIESR. According to these forecasts, the global economy will be in recession in 2009 as purchasing-power-parity-weighted growth of world GDP falls below 3 per cent. OECD countries as a group will face their worst recession since 1982. Annual GDP is forecast to decline in the United Kingdom and the United States, whereas Germany, France and Italy are expected to register zero growth. Mr. Barrell emphasized that the outlook would be much worse if the ongoing bailout packages turned out to be unsuccessful. In all major developed economies, the likelihood of a recession has increased sharply since September 2008. Most worryingly, there remains a significant probability of negative growth of four or five quarters in both the United Kingdom and the United States.

Mr. Barrell then illustrated the recent sharp increase in corporate bond spreads across the globe, which is likely to have a severe adverse impact on real economic activity. In the United States, bond spreads have reached their highest level since the period 1931-33. As firms face significantly higher costs of borrowing, investment is expected to fall. Since at least 1930, a prolonged rise in corporate spreads of more than 250 basis points in the United States has consistently been associated with a decline in United States business investment.

Mr. Barrell then turned to major recent developments that have led to the global crisis. He noted that until early September, the NIESR - similar to the IMF - anticipated only a mild slowdown of the world economy. However, as several financial institutions in the United States and Europe collapsed and equity prices dropped sharply, levels of risk premia and credit rationing needed to be reassessed. The forecast was also affected by sharp changes in exchange rates between major world currencies, including a rise in the value of the dollar vis-à-vis the euro.

Mr. Barrell pointed out that the financial shock will affect economic growth through three main channels: First, credit will become scarcer for both firms and households. Second, firms and consumers will be more cautious and spend less. And third, lower equity prices will further reduce consumption and investment. The United States and Japan may face liquidity traps as low interest rates give little leeway for monetary policy. In both countries, there is a strong probability of deflation in the medium term as indicated by simulation exercises. Mr. Barrell emphasized that United States interest rates need to drop to zero per cent to have a significant impact on real economic activity. A globally coordinated interest cut of 250 basis points could partially offset the output decline in the United Kingdom and the United States next year. In addition, a coordinated expansion of 1 per cent of GDP could raise growth in major economies by 0.8 – 0.9 percentage points next year.

Mr. Barrell noted that before the wave of banking sector bailouts, global credit conditions were so tight that prospects for the world economy looked even worse. In early October, the NIESR forecasted two years of negative growth in the United Kingdom and a full year of recession in Japan, the euro area and the United States. The possibility that the United States would allow a large financial institution to go bankrupt constitutes a major downside risk to the current economic outlook. By contrast, if financial markets stabilize more rapidly than expected, the global economic downturn may be less severe.

Mr. Pete Richardson (OECD) said that the OECD forecast was not finalized yet and that he would make instead some general remarks. Investment is the core weakness; commodity prices and oil are still risks; and there are pressures emanating from the relative weakness/tightness of monetary policy in the EU and the United States. On the latter, it is still unclear why these relative stances occurred and it could seem as if the Fed knew more about the danger of an imminent crisis. He noted that the worst-case scenario in the past included higher oil prices, higher risk premiums, lower equity prices and a dollar crisis. The current situation contains all of these elements except a dollar crisis. The previous outlook did not anticipate the spread of the financial crisis, which became a banking crisis in September. Before September, there was a downside risk, but the banking crisis in September changed everything. Now the question is how deep the recession will be. The outlook is likely to contain four consecutive quarters of negative growth (with the worst in the fourth quarter). In 2009, there will be strongly negative growth in the OECD countries and the United States, followed by a return to normalcy in the second half of 2010. Monetary policy actions have been taken, but cannot do much more now. On the fiscal side, there may be some action in the United Kingdom, but there are long-term problems to this. Near-term multipliers are less than 1, so even a large concerted action cannot stop recession and there is a risk that with a return to normalcy there will be overshooting. In the OECD, Japan will experience low growth but no recession and, similarly, smaller OECD countries are not expected to have a recession. Overall, he expected 4 quarters of negative growth, with consumption, investment and exports all declining.

A key question will be whether non-OECD countries will be less affected. In the past, this was not the case, as usually exports fall more than in the OECD as a function of commodities, but there has been a change in structure due to the spreading and deepening of the international production chain. Consequently, the outcome seems less clear in the current situation. Two additional risks are a further depreciation of the dollar and the impact of the global slowdown on China, despite its considerable foreign exchange reserves.

Discussion

Mr. Sam Olofin (University of Ibadan, Nigeria) asked for more elaboration on the implications for developing countries. He asked Mr. Timmer whether robust growth in China and India could significantly dampen the downturn in the United States, and Mr. Vos whether there can be optimism concerning capital flow reversals.

Mr. Lawrence Klein (University of Pennsylvania) said that in interpreting the crisis, there was a tendency to say it all happened at once (except for Rob Vos), but that the dynamics suggest a sequence of events. First the economy of the United States decelerated, then the downturn spread, so there is the question of whether the crisis could have been prevented. He also noted that a big part of the problem has to do with the war and not paying for it. The massive market failure in the United States was facilitated by a lack of regulation especially from the U.S. Federal Reserve Bank, which largely assumed that markets can be left to their own devices.

Mr. Juan-Rafael Vargas (Universidad de Costa Rica) asked about the seemingly contradictory movements in currency markets, especially the recent rapid appreciation of the dollar against the euro and other major currencies. In addition, he raised a question concerning the possibility of a new Bretton Woods arrangement with perhaps a multi-polar currency world.

Mr. Wladislav Welfe (University of Lodz, Poland) asked about the channels through which the recession was operating. Was it consumers facing credit rationing, or slowing growth that led to higher unemployment and lower disposable income, or the drop in investment that are key to the recession?

Mr. Adolfo Castilla (Universidad Antonio de Nebija, Spain) said that while there was obviously a failure of markets, a key question is whether the government intervention would end in failure as well, given that there have been many in the past. He raised the question as to what policies are available, which ones should be advocated, and how similar crises can be prevented in the future.

Mr. Georgio Basevi (University of Bologna, Italy) asked why the dollar had appreciated and the euro depreciated. He noted that there had already been coordinated interest rate reductions. But the situation now is that future cuts can not be equal due to lack of room, so possibly euro area interest rates will fall more, putting downward pressure on the euro. He also pointed out that intervention in Europe is greater than in the United States, debt/GDP ratios are larger, and France’s behaviour has weakened the stability-and-growth pact. There is pressure on the ECB to cut rates more, and perhaps be more concerned about output growth in their policy making.

Mr. Ray Barrell (NIESR) referred to an article on policy architecture, “The great crash of 2008”, in which he looked at a large coordinated interest rate cut: 450 bps cut in the euro area and the United Kingdom, and less in the United States and other countries. He said that the Fed is more concerned about output is part of the problem. He was highly skeptical of the possibility of a new Bretton Woods. The previous version broke down because the Bundesbank did not want to import inflation from the United States. He went on to say that the NIESR is a proponent of a coordination of bankruptcy laws. In the United States, when a homeowner declares bankruptcy, the bank loses all. This has contributed to excessive risk-taking. This is not true in the EU. In addition, the Fed and the United States government pushed mortgages, which were then repackaged and sold to European banks. There was too much financial liberalization without regulation.

Mr. Rob Vos (UN-DESA) responded to Ray Barrel that fiscal stimulus does have long-term implications. But a key question is which form the stimulus takes. In addition, stimulus packages should be initiated in more than just the EU and the United States. He said that government spending needed to be ramped up anyway to deal with such challenges as climate change, food security and public investment, and these will have short and medium-term implications for growth. He emphasized that the fiscal stimuli should be concentrated where needed for global rebalancing, particularly in Asia. He pointed out that capital reversals were affecting countries differently, but generally ODA to the poorest countries was decreasing. He agreed with Lawrence Klein that it was a sequence of events, and that now the key was the structure of bailout packages. On currencies, he noted that there was a flight to safety and a lack of alternatives, but questioned how long that would last. Finally, he said that problems stemmed from poor regulation but he argued the entire approach needs to change. Poor regulation led to the sub-prime collapse and spillovers. He advocated an approach similar to the one taken by Sweden, and perhaps the deliberate segmentation of markets. There is also a need for more representation from developing countries.

Mr. Hans Timmer (World Bank) responded to Sam Olofin that he originally thought that Africa would be shielded from the crisis, as most countries are not integrated into financial markets (the extraction sector is usually financed with retained earnings) and generally commodity exports are not volume but price sensitive. But now he is more pessimistic on Africa. The impact on South Africa will be large and this will feed through to the rest of Africa. Large investment projects are being delayed and there will be a political backlash, from the perception that private finance is not reliable. Commodity prices have fallen and aid flows are down. He agreed that there was a sequence of events and that a possible solution had already been under way. It required reducing domestic demand in the United States, a depreciation of the dollar and an increase in United States exports to dampen the slowing of output, implying an unwinding of the imbalances. But this changed in September. Now, the adjustment is coming through the financial crisis, and this explains why the dollar has appreciated. All currencies are weak now and the phenomenon is not dollar strength but rather a weakening of all currencies. There is also a problem in the EU, as the banking crisis has reduced EU growth and required the ECB to lower interest rates, putting downward pressure on the euro. Other currencies face similar difficulties. There is also a technical argument: a huge demand for liquidity and not many avenues to access needed dollars. He said that there will be changes at the IMF, and also at the World Bank. In response to Wladislav Welfe, he pointed out that the mechanisms are the credit squeeze and a liquidity trap. The key is that firms cannot get financing, so unemployment is increasing and wage growth is hampered. In addition, consumers cannot get funding. Addressing Rob Vos's point on fiscal stimulus, he disagreed that long-term fiscal spending was appropriate. He argued that it was better to rely on automatic stabilizers or create stronger ones. The problem with increasing expenditure by large amounts was that it is a very blunt instrument, especially in the case of long-term spending, as the timing would inevitably be wrong. A key question is what a country's position will be after the rebound starts. On the other hand, strengthening automatic stabilizers through an improved social safety net would help the most vulnerable. It is dangerous to over-stimulate wage growth because it will trigger higher inflation. If long-term investment projects are the first choice, there is the need to first identify and then target infrastructure bottlenecks.

3. Commodity prices and economic implications

Mr. William Meyers (University of Missouri-Columbia) gave a presentation entitled "Where from and where to: FAPRI agriculture market outlook." The presentation discussed the evolution of grain prices since 1999 and gave the FAPRI wheat projections in comparison with other projections such as those of the OECD. The presentation began with a background discussion of how food prices got to such a high level. In the years prior to the price buildup, grain stocks were gradually declining because real prices were going down. In addition, land area and yields were also declining, while rates of growth of yields have been slowing from about 1980 onwards. Consumption growth was also slowing, but it was slightly higher than production growth. He noted that stocks had not had a chance to recover when the market was hit with the "perfect storm", triggered by the depreciation of the dollar and increased petroleum prices. This made biofuel demand shift upwards, increased export restrictions, led to shifts in acreage, and lowered stocks and the stocks-to-use ratio. There was also the effect of speculation in the commodity market that added a volatility factor. Because of resilient world demand, exports continued to grow despite higher prices. The main effect of the export restrictions was a rise in prices.

Mr. Meyers stated that on the demand side, ethanol use led to price increases. One effect is that the EU was a net exporter of vegetable oils in 2000-01, but became a net importer since 2004-05. Consequently, almost all of the biodiesel feedstock in the EU will need to be imported either as seed, oil or biodiesel. Mr.Meyers also showed the effect in the United States of removing all biofuel policies. This mainly has an effect at lower petroleum prices as there is a mandated quantity of production, which means production can not go below a certain level when oil prices fall.

Regarding the future direction of food prices, the recent price surge seems to have abated. In addition, good weather and yields in 2008/09 have led to favourable harvests. Biofuel growth has slowed, but policies are still unchanged. Major uncertainties are oil prices, the value of the dollar and the global economic slowdown. To project prices, Mr. Meyers ran a stochastic analysis, showing the relationship between gas and ethanol.

In conclusion Mr. Meyers stated that agriculture prices are highly influenced by oil prices, but the weaker macroeconomic outlook and stronger dollar could put prices at a lower range. He also notes that the food price surge has revealed flaws in the market/policy systems.

Robert Kaufman (Boston University) gave a presentation on "The forecast for world oil prices." He stated that last year's forecast was somewhat optimistic given the current situation and that he would first try to explain what happened last year, looking at the price discovery for crude, granger causality and how crude oil prices change. In his analysis he found that Dubai spot and WTI are gateway prices. By taking these two crude prices and calculating the simple spread, he finds the Dubai and WTI far-month spread, which is stable until 2004, when there was a structural break. The reason for this is that much of the analysis of world oil is built on a unified oil market and the law of one price. Crude oil prices started their increase in 2004 as non-OPEC production peaked and started to fall off. This was not a demand-driven crisis, but rather a supply-side phenomenon. At that point, OPEC stopped moving its quota up and down and began to operate close to its production limit. This change is partially responsible for the rapid run-up in prices, as the market expected oil prices to go higher because production was tight. In 2008, as prices increased steadily, monthly United States oil demand declined due to a significant slowing in economic activity.

Mr. Kaufman noted that oil as a commodity is interesting to track because there is weekly oil data available. Therefore, if one considers that oil is a leading indicator, then there is a lot to be worried about in terms of the economic slowdown. Regarding the short-term outlook for oil prices, he ran a crisis scenario, whereby world oil demand drops by 10 per cent. If this happens, then oil prices could end up in the $50 dollar range next year. There is, however, no reason to believe that prices will return to the level of the 1980s/90s. OPEC is cutting its quota by 1.5 mbd and the market will expect further reductions. This opens a big space between capacity and production, creating excess capacity, which could keep prices lower. At the same time, many oil-driven economies need high oil prices to balance their budgets.

As a final exercise, Mr. Kaufman analysed the relationship between oil prices and exchange rates. He found that there is a causal relationship, with crude oil driving exchange rates. His next step will be to develop co-integrating equations for oil prices.

Ms. Pilar Fajarnes (UNCTAD) gave a presentation based on the recent Trade and Development Report entitled "Uncertainty and instability in commodity markets." She stated that the presentation contained no projections and was derived from the analysis of the report that was published in September. Given the current economic situation, some of the conclusions of the report were still valid, however others required changes. Most notable was the impact of the change in commodity prices since the second half of 2008. The gloomy economic outlook is creating risks for developing countries, since all the instability in commodity markets is related to instability in financial markets.

As the monthly commodity price indices show, there has been a clear increase of commodity prices since 2002/2003 that seems to have come to an end in 2008 for all commodities. The major question is whether this is due to short-term factors and the financial crisis, or rather structural factors.

The recent uncertainty and instability in the global financial system has clearly affected the trend of increasing commodity prices. In particular, there is an increasing integration among commodity and financial markets and an increasing the role of speculation with respect to commodity price destabilization. However, the recent fall in prices is not only due to financial issues, but also structural factors. Lower demand for commodities is already observed in the context of the global economic slowdown, affecting the economic prospects for developing countries. The evolution of global demand is still uncertain, depending mainly on China, which is a major importer of several commodities. On the supply side, recent explorations of several commodities, such as metals and minerals, will reduce supply constraints and contribute to a decrease in commodity prices. There is also an increasing link between commodities, creating a co-movement in their prices. In recent times, for example, higher oil prices drove up the price of other commodities as well.

Developing countries remain highly vulnerable to commodity price fluctuations. In the last few years, significant terms of trade gains were reinvested in the same type of activities, perpetuating commodity income dependence. The current developments in commodity markets will affect developing countries negatively, although some countries will benefit from better terms of trade. Oil, minerals and metals exporters should be more negatively affected by recent trends, while manufacture exporters will improve their terms of trade. On the other hand, those countries that benefited from gains in their terms of trade in recent years also improved their current accounts and are now in a better position to face the financial crisis.

There are several policies that can help in dealing with the commodity problem in developing countries. Commodity price stability has to be achieved by strengthening existing measures and creating new ones. This includes stricter regulatory measures to contain speculation, which may also help to stabilize the world economy. Policies have to be implemented to increase the share of commodity rents in the long-run and to reinvest these rents in industrial upgrading and diversification. Industrial development and diversification is the best long-term strategy to move away from commodity dependence.

F. Gerard Adams (Northeastern University) gave a presentation on the actual situation in the world commodity markets. Since previous speakers had already raised the most important issues on commodity markets, Mr. Adams focused on market forces that can explain part of the actual trend in commodity prices.

Looking at IMF commodity price indexes from January 2005 to September 2008, he observed a trend of increasing prices with a peak in mid-2008, followed by an unprecedented decline. This is in particular the case for crude oil, but also for other commodities like copper, aluminum and tin, as well as for food products like rice, maize and cocoa.

He noted that it is a compliment to LINK that its forecasts were timely and took into consideration the last 2 weeks of information, which look very different from the previous weeks.

Although speculation has played an important role in recent trends, market forces can explain part of the situation. On the demand side, there was an increasing demand from emerging Asian economies, in particular from China, which explains for instance increasing prices, although economic activity was slowing down in developed countries. On the supply side, several commodities faced production constraints, which also had an important impact on prices. This was in particular the case for copper. In other cases, energy costs have driven up prices for other commodities, for example aluminum.

Discussion

Mr. Peter Pauly (University of Toronto) asked whether there was something that has made it harder for fundamentals to be seen in terms of driving prices.

A further set of questions referred to windfall oil revenue. When oil price reached $147 pb, what part of that profit was invested abroad (and into what)? Is it possible to observe any kind of Dutch disease? Moreover, the question was raised as to what could be expected from the combination of the decrease in production by OPEC with the consensus view that the global economy is in recession.

Mr. Carl Weinberg (High Frequency Economics) pointed out that China last week announced land reforms for farmers to consolidate properties and he raised the question as to the impact of this on prices.

Ms. Marva Corley (UN-DESA) pointed out that about a year and a half ago, Mr. Kaufman said that the price floor OPEC was willing to defend was $50 pb. She asked what the minimum price floor is now and what had changed in that short space of time to alter those expectations.

Mr. Keiji Inoue (UN-DESA) pointed to the celebration of World Food Day the day before and asked whether the food crisis was still a macroeconomic crisis considering that food prices have been decreasing and supply has recovered somewhat. However, he pointed out that it is still both a humanitarian crisis and a long-term development crisis. He asked for the speakers' advice on how to describe the present situation to the Secretary-General of the UN.

Mr. Robert Kaufman (Boston University) pointed out that prior to the 1930s when there was no financial influence in oil markets, prices fluctuated tremendously. He argued that this has to do with short-run elasticity and that a bubble can build quickly since it is hard to replace oil. Regarding the price floor, markets see a price and get used to it. In countries like Venezuela, Russia and Iran, those price floors are closely associated with what governments need to balance their budget. Floors are not set by fundamentals but by cash needs of producers.

Ms. Pilar Fajarnes (UNCTAD) agreed that profits and remittances come from transnational corporations. Regarding the Dutch disease, a currency may appreciate if it is not possible to recycle the gains or the country is not able to buffer the effects.

Mr. William Meyers (University of Missouri-Columbia) pointed out that in China, over a period of time, farms grew in size and diversity. The effect of any reform on prices will take some time to become clearer. Commodity prices are down, but still higher than in the middle of the decade. Rice seems not to be coming down as quickly.

However, price declines have occurred in individual markets and not in developing or low-income countries. He highlighted that short-run/emergency responses are needed to provide immediate relief. The problems raised in the context of World Food Day are still there and the recent price declines will not make them less important.

4. Regional outlook

United States

Mr. Lawrence Klein (University of Pennsylvania) presented the outlook for the United States, based on the high-frequency model of the University of Pennsylvania. He first stated that the analysis refers to the economy and not the stock markets. In both the baseline and the pessimistic scenario, he predicted a decline of GDP in the third quarter of 2008. He believed the first fiscal stimulus package adopted by the United States in the first half of 2008 had worked to keep GDP growing, but he called for a second stimulus package. Reviewing the performance of various economic sectors, he pointed out the strength in the external sector, as net exports in real terms had improved since 2007, contributing to GDP growth. He also noticed the weakness in domestic demand, particularly in household consumption, as indicated by very weak retail sales. He pointed out declining payroll employment, which had been trending downward since the beginning of 2008. He also noticed the drop in inflation expectations and believed the Fed would still cut interest rates further.

In analyzing some longer-term factors behind the current economic downturn, he believed the war in Iraq and the associated costs have weighted down the economy of the United States. He also criticized the tax policy of the current administration, stating that the tax cut for those at the top of the income cohort did not generate any trickle-down effects for the people at the middle and lower income levels.

Japan

Mr. Kanemi Ban (Osaka University) started his presentation on Japan by highlighting the link between the stronger yen and the weaker export outlook, which in turn has been a major driving force for the sharp fall in Japanese stock prices. Lower exports are feeding through into lower production, ultimately hitting economic growth, which has already been negative in the second and third quarter. Business confidence has also been falling, and he expects this downward trend to continue. CPI is running at around 2.5 per cent, while unemployment stands at 4.2 per cent, with an increase to 4.6 per cent expected in the wake of the current crisis. Investment will be one of the possible pillars for a recovery in growth, although this might not happen until 2010. In a reference to Japan's financial crisis in the 1990s, he pointed out that it took more than 10 years to resolve the problem of non-performing loans. However, a key difference in the current crisis is that policy actions have been taken more quickly, although the structure of the non-performing loans also seems to be more difficult to deal with.

Western Europe

Mr. Ray Barell (NIESR) first stated that growth in the EU was slowing. The financial crisis emanating from the United States has slowed external demand. Some support is generated by falling exchange rates while fiscal policy may be of some help. European banks hold a lot of toxic assets and the collapse of Lehman Brothers hurt British banks as many assets were trapped. As a consequence of this, credit conditions have worsened: B-AA spreads have increased in the EU, even more so than in the United States. Inflation is coming down as output slows, although it had been well above target.

Growth will be very slow over the forecast period. The probability of a recession (two consecutive quarters of negative growth) is greater than 50 per cent for all of the large countries as well as in Denmark and Ireland. 2006 and 2007 had been very good years for growth, but 2008 is sharply down: housing markets have fallen, with house prices declining (for 2 years in Spain and France). The run-up in oil prices earlier in 2008 was sufficient to generate a slowdown but then the credit crisis hit. Appreciating currencies were another negative impulse but have since turned around.

Expected growth is near zero for 2009, and negative in Spain, with 2010 and 2011 still very slow. The crisis is likely to leave permanent scars, because the user cost of capital will be permanently higher due to the realization that risk was higher than previously thought.

Germany will recover most quickly, as it is most export-oriented and is not so affected by the difficulties in housing markets. France is more affected by the latter and is likely to shrink despite various government policies. Italy is already weak and will slow further, making a recession likely.

The pre-crisis data base (end-of-September data) suggested some recovery in 2009. But since then, credit rationing and a higher user cost of capital have reduced growth substantially. The decline in equity prices is another downward force, while falling exchange rates help growth recover somewhat.

Euro area inflation has peaked but is expected to remain above 2 per cent for a few more quarters. Assuming falling oil prices and a recession, inflation will fall continuously over the forecast horizon. Interest rates can be cut a lot, but the ECB is unlikely to rush to action. Looser policy would not help banks to supply loans and would be unlikely to increase demand, although it might help to cause exchange rates to come down further. Deflation is possible in Italy, which has increasing spare capacity and is suffering from a lack of competitiveness.

Government borrowing in the euro area will reach 1.7 per cent of GDP, assuming that there are no tax increases or spending cuts. Coordinated fiscal policy could raise deficits and some countries are likely to run deficits greater than 3 per cent. The fiscal deficit in France and Italy will exceed 3 per cent, while Germany is expected to be in surplus. There is space for fiscal expansion in many countries, but this depends on debt stocks. Looking at long-term government bond spreads, it is clear that spreads have risen. The spread of Italian bonds over German bonds is now 80 basis points. This may be a sign that default risks have increased or that there is strain in the EMU.

House prices have started to fall in most countries in the region, but generally defaults are expected to be low. Spain is the most vulnerable to the ensuing wealth effects, but with prices falling, real devaluation will offset some of this. The current account will improve but imbalances are still a major problem. The banking sector is vulnerable to the wholesale market but has been rebuilding its retail depositor base. There is a 75 per cent chance of recession with a forecast of -0.3 per cent in 2009.

In the UK, the financial crisis has hit hard. The recession started in the summer, with the third quarter registering growth of -0.5 per cent. There could be four quarters of negative growth, and the forecast is for growth of -0.9 per cent in 2009. The CPI was running at 5 per cent but will come down sharply and the probability of a decline in the CPI is positive.

There are problems in the periphery countries. In the Baltic economies and Bulgaria, there are overextended banking systems. Exchange rates are falling and this is dangerous when banks are overextended. The Icelandic crisis exposed flaws in the European policy architecture. The EEA includes Norway, Iceland and Switzerland. Under this agreement, these countries implement most of EU market directives but there is a problem in the financial services area. Norway has the money to bail out its banking sector, but Iceland does not. Icelandic banks were taking deposits in the EU and the associated holding companies and hedge funds were making risky investments.

Economies in transition and new EU members

Ms. Malinka Koparanova (UN-DESA) presented an overview of the general trends in the economies in transition, which include the new EU member states, South-Eastern Europe and the CIS, and then turned to the economic outlook for the CIS. In her presentation, she focused on three key issues: (1) Growth patterns in the economies in transition in 2008 and 2009; (2) Inflationary pressures; and (3) Policies to mitigate weakening growth in the CIS. Ms. Koparanova analysed these three areas revealing the main drivers behind the current growth. She noted that despite limited direct financial contagion from the United States-borne financial crises in the first half of 2008, uncertainties and risks to economic growth have significantly increased in the second half of the year. Moreover, rapid changes in the financial market indicators of these countries since the summer of 2008 are pointing to a very rapid response of international investors' perceptions, leading to capital withdrawal from many economies in transition. As the global credit crisis unfolded, stock markets in the Russian Federation, Ukraine, Czech Republic, Poland and Hungary became highly volatile and spreads on credit default swaps soared. In the economies of the CIS, rapid and persistent declines of prices for oil, gas and metals have added to the downward pressure. In addition, some of the largest economies in this region such as the Russian Federation and Kazakhstan have shown signs of overheating, with corrections taking place in construction and investment. Ms. Koparanova noted that the transmission mechanism of the effects of the global financial crisis on the CIS varies across countries, although the negative impact is ubiquitous throughout the whole region. In regards to the macroeconomic policies ahead, in her opinion, growth-oriented policies will prevail at least until the middle of 2009, when a shift towards some tightening of the monetary policy stance is likely in most CIS. She concluded by summarising the main risks to the regional outlook, emphasising that a severe and more prolonged global recession could further weaken commodity prices and reduce external demand for many exports from the region. This, in combination with tightened domestic and external financial conditions, could lead to a marked slowdown of economic growth throughout the whole region.

Mr. Grigor Agabekian (UN-DESA) presented the outlook for the new EU member states and South-Eastern Europe. Following several years of buoyant growth, the new EU members exhibited a divergent growth pattern in 2008. While a number of economies, such as Bulgaria, Poland, Romania and Slovakia, sustained relatively high growth rates, the Baltic States, which used to be the fastest growing sub-region, witnessed a sharp slowdown. In general, the region faced a difficult economic environment in 2008, since growth in major export markets has decelerated, interest rates on external borrowing have moved up and the price of imported energy has increased. Some countries in the region, directly or indirectly, have also been affected by the global financial crisis. The slowdown in the Baltic States was caused by a noticeable drop in private consumption and a slowing of the real estate market. Strong growth in those countries in the earlier period was driven largely by domestic demand, underpinned by increasing real wages and expanding credit. However, this was accompanied by large current account deficits and growing indebtedness of the private sector, with much of the investment channeled into real estate. The drop in housing prices and worsened consumer and business sentiment has led to an adjustment in those economies and some reduction of their external deficits. However, the coinciding of their domestic business cycle with the global financial crisis may have serious repercussions for those countries given their need for a continuous inflow of capital. Inflation in 2008 picked up in the new EU members, since domestic inflationary pressures were amplified by the global food and energy price increases. The impact of those factors was asymmetric across the region and it was most pronounced in Bulgaria and the Baltic States. Confronting the inflationary surge posed a serious policy challenge and in order to prevent any second-round effects, it remains important to manage inflationary expectations. Exposure to the global financial crisis has been most pronounced in Hungary and in the Baltic States, but all countries with large external financing requirements are at risk. Most of the banking system of the new EU members is owned by EU-15 banks, and if those banks experience serious difficulties, this may create a liquidity squeeze in the interbank market of the new EU members, destabilizing the banking system and the real sector. In the outlook, since domestic demand is weakening and the original scenario of shifting to more export-led growth in Central Europe is probably not plausible, those economies will grow at slower rates of 3 to 4 per cent in 2009. All these forecasts were released in mid-October and could be optimistic. The Baltic States may experience stagflation. On a more positive note, the inflows of EU funds and FDI into those economies should continue. In South-Eastern Europe, high rates of economic growth are expected to decelerate in 2009. The region was not exposed to the global financial crisis, although in Serbia, the currency has depreciated recently.

The presentation was followed by comments from a number of country participants.

Poland will see a slowdown, in line with the LINK projections, but this has very little to do with the global financial crisis and reflects an adjustment of the domestic business cycle. The situation in the banking industry meanwhile deteriorates, creating credit constraints.

Bulgaria is an interesting case of an economy which, amid the financial crisis, is not suffering from liquidity problems. Credits to the non-financial sector increased in 2008 by 50 to 60 per cent, the currency board functions well, and the foreign exchange reserves cover about 6 months of imports of goods and services.

Slovakia is about to adopt the euro, as it fulfilled all necessary criteria. The government has a program to mobilize the labor force, since the country has a relatively high rate of unemployment. Growth was strong in the first and second quarter, but the current forecast may be too optimistic since it was released prior to the current situation.

Africa

Ms. Marva Corley (UN-DESA) gave a presentation on Africa's growth outlook. She noted that Africa's growth remained resilient in spite of the current global economic turmoil, but it is expected to decelerate in the outlook period. The main factors underpinning the continent's growth in 2008 were the relatively high commodity prices, particularly up to the third quarter of the year; the improved security situation in different parts of the continent, and a turnaround in agriculture from the poor harvests of 2007. She noted, however, that a slowdown of growth would occur in the outlook due mainly to the decline in commodity prices and external demand and weakened export revenues, as well as the impacts of inflationary pressure caused by higher food and fuel prices.

Ms. Corley displayed a graph showing growth in Africa, which is expected to decline from 5.9 per cent in 2007 to 5.0 per cent in 2008, with the slowdown fairly equitably distributed between two different groups of economies. For the fuel-exporting economies, the lower oil prices in the fourth quarter of 2008 are expected to continue into 2009 and lead to a further slowdown in growth, while in the non-oil economies, growth will be impacted by the slowdown in other sectors such as tourism and manufacturing. Although the current moderation in commodity prices will certainly improve the terms of trade of oil importers and lower their import bills, it comes at a time when export demand is weakened globally, so the growth effects will be offset.

Ms. Corley also noted that significant disparities in growth exist across the African region, but from looking at the top and low performers, peace and stability are important indicators of growth. Economies with the lowest growth rates in 2008 are mainly those embroiled in conflict and/or political turmoil.

Both oil-importing and exporting African countries experienced mounting inflationary pressures, as inflation in Africa excluding Zimbabwe was 10.7 per cent in 2008, up from 6.4 per cent in 2007, mainly due to high energy and food prices. Inflation is expected to moderate somewhat in 2009 as oil and other commodity prices recede. Ms. Corley emphasized, however, that inflationary pressures are not only a challenge to macro-stability, and a policy dilemma in many economies coping with slowing economic growth, but it is a humanitarian crisis for many countries that are facing rapidly rising food prices.

Ms. Corley noted that employment creation in Africa has generally been weak, in spite of the commodity boom. However, the expansion in services, construction and the public works sector has helped to boost employment creation in urban areas, especially in North Africa). This channel is, however, expected to weaken in 2008, pushing unemployment rates higher and forcing workers into the already large informal economy. The trade surplus in Africa is expected to peak in 2008 as the slowdown in 2009 will lower export growth and reduce the surplus of the oil exporters. An improvement in terms of trade, along with a decrease in trade volume in general will narrow the trade deficit of oil importers.

Regarding the current global financial turmoil, Ms. Corley stated that there have been no direct effects on the balance sheets of banks in the major economies in the region. However, some central banks such as in Nigeria took precautionary measures by injecting liquidity into the financial markets and lowering benchmark interest rates. For the region, the indirect effects of the crisis are of a larger concern. These risks include the threat of a commodity price collapse that would adversely affect the net fuel-exporting economies; a reversal of capital flows, which could have severe consequences for exchange rates and run down the large reserve accumulations in some economies; and the risk that donor countries will not live up to their aid commitments, which threatens the achievement of the MDGs and undermines the progress made so far.

East and South Asia

Ms. Tiziana Bonapace (ESCAP) presented the economic outlook for East Asia and South Asia. Ms. Bonapace pointed out that the banking sector in the Asia-Pacific countries did not appear to have invested as heavily in subprime-related debt instruments as the banking sector of the United States and the European Union. However, the impact on regional capital markets from the global turmoil has been large. Regional equity markets have also experienced severe capital reversals, while the direct linkages with failed institutions in the United States such as Lehman Brothers have caused losses for regional financial institutions. The bailout of AIG also further intensified fears among investors in the region.

Ms. Bonapace then reviewed the region's economic fundatmentals in the context of the post-1997 crisis phase. In general, the region's economies are relatively well prepared for the global turmoil. Many countries have moved explicitly toward inflation targeting rather than exchnage-rate targeting. Government budget deficits have declined from 1997 levels and, in some countries, have turned into surpluses. Public debt is at its lowest level since 2000 for most countries. Many countries in the region have accumulated significant amounts of foreign reserves. The banking sector's non-performing loan ratio has been low and capital adequacy ratios are well above the international standard. The development of local currency bond markets has created a channel for the reflection of perceived risk and implies less systemic risk than foreign-currency denomiated loans.

Nevertheless, the global financial turmoil has impacted the region, as it has caused capital outflows from countries that were preceived to have weaker fundamentals. Countries with high external debt obligations, a high current account deficit (relative to foreign reserves), high short-term foreign-currency debt and a high share of foreign investors in equities or local currency bonds are more subject to market risks. The outflow of capital has resulted in pressure on currencies as well as banking and corporate sector debt.

Ms. Bonapace then presented the ESCAP outlook for the Asia-Pacific economies. The growth of developing economies in the region will slow from 7.1 per cent for 2008 to 6.4 per cent in 2009. The slowdown will be caused by slower export growth and a slower expansion of domestic demand due to the monetary tightening introduced in early 2008. East and North-East Asia will see its growth rate reduced by 0.7 percentage points in 2009 to the level of 6.9 per cent, while the South-East Asian economies will see growth rate decline from 5.2 per cent in 2008 to 4.8 per cent in 2009. Growth rates will be lower for China, India, the Republic of Korea and Singapore in 2009. However, Malaysia and Indonesia will be less affected by the slowdown in manufacturing exports in 2008 as they have been benefiting from high commodity prices.

Regarding the impact of the slowdown in world trade, Ms. Bonapace explained that current account balances will be reduced across the region. The situation in the EU is of special importance to Asia-Pacific economies as the EU area has recently become as important an export market as the United States for many countries in the region. Ms. Bonapace saw the increasing intra-Asia trade as an encouraging trend as it will buffer the slowdown in extra-Asia trade.

Ms. Bonapace also argued that countries with a relatively high dependence on domestic demand have been less affected by weakness in global markets. Many South-Asian countries belong to this category. However some of these countries have been suffering from inflation problems. The monetary policy reaction to the inflation problem also caused the slowdown in the growth of consumption and investment.

High food and oil prices have pushed up inflation in all countries in the region in 2008. For many countries, the inflation rate for 2008 will be two or three times higher than 2007. Inflation is expected to fall in 2009, although price levels will remain high. In countries like the Philippines and the Republic of Korea, core inflation rates have started to climb in early 2008. Ms. Bonapace also emphasized that in some countries the demand-push factors have exacerbated the cost-push inflation.

Ms. Bonapace also presented the results of a simulation of lower growth in the developed economies. In the exercise, the growth rate for the United States in 2009 had been reduced from 0.4 per cent to -1.6 per cent due to lower investment and consumption. Growth for other developed countries (Japan and euro zone) was also reduced. Although the effects on each economy are not homogenous, the simulation showed that developing Asian economies as a group will see a reduction in growth by 0.7 percentage points, while inflation will be 0.3 percentage points lower than in the baseline scenario. The simulation also demonstrated that the impact will be greater for highly external-oriented economies in terms of both trade and financial linkage.

Discussion

Mr. Tongsan Wang commented that China's annual growth rate has been exceeding 10 per cent for several years. In view of the danger of overheating in 2003, the government took various measures to slow growth, which still remained high. In 2007 and 2008, policies have again been aiming to slow growth and inflation. However, the risk lies in causing too sharp a drop in economic growth.

Mr. Young Il Kim commented that in the Republic of Korea, growth was already slowing at the end of last year, especially due to higher oil prices. While the fundamentals of the economy remain sound, an additional problem is now the global financial crisis, in particular capital withdrawals and the ensuing downward pressure on the exchange rate. The economy will grow by 4.2 per cent in 2008, down from 5.0 per cent in 2007, and the pessimistic outcome for 2009 envisions a growth rate of 3.6 per cent.

Western Asia

Mr. Ingo Pitterle (UN-DESA) presented the economic outlook for Western Asia. After providing regional and subregional growth estimates and forecasts, he gave an overview of the key macroeconomic developments in the region in 2008. He then assessed the potential impact of the global financial turmoil on the region, highlighting the major risks and vulnerabilities of the Western Asian economies.

Mr. Pitterle noted that Western Asia enjoyed robust growth in 2008 on the back of high oil prices and strong consumption and investment demand. Average GDP growth in the region is estimated at 5.0 per cent, slightly above the rate in 2007. However, as global economic conditions deteriorate rapidly, growth in Western Asian economies is anticipated to slow down to 3.2 per cent in 2009, the lowest rate in seven years. The economic downturn is expected to be relatively synchronized as all countries in the region experience weaker growth. Mr. Pitterle emphasized that in Israel and even more so in Turkey, growth had already decelerated in the second quarter of 2008.

During the first half of 2008, the region continued to benefit from strong demand for crude oil, which resulted in increased production and soaring oil prices. Total oil exports of the countries of the Gulf Cooperation Council (GCC) are estimated to increase from $360 billion in 2007 to $520 billion in 2008. At the same time, the combined current account surplus of GCC is anticipated to reach a record level of $267 billion. Growth in many Western Asian countries was also underpinned by buoyant consumption and investment demand. Non-oil economies, such as Israel, Jordan, Lebanon and Turkey, reported strong growth in exports and tourism earnings during the first half of 2008. In Iraq and Lebanon, political progress and improved security conditions facilitated economic recoveries.

Mr. Pitterle indicated that inflation in Western Asian economies accelerated rapidly during the first half of 2008. Annual consumer price increases are likely to exceed 10 per cent in all economies in the region except Bahrain and Israel. In part, this resulted from trends on global markets such as the rise in commodity prices and the weakness of the dollar, to which most countries in the region peg their currencies. Yet, domestic factors and policies added to inflationary pressures as internal demand was fuelled by strong population growth, increased credit to the private sector, sharply negative real interest rates and salary hikes for public employees. Mr. Pitterle emphasized that the lack of monetary independence, which results from the combination of pegged exchange rates and open capital markets, has severely constrained the ability of most Western Asian central banks to fight inflation.

Mr. Pitterle concluded his presentation by illustrating the different channels through which the global financial crisis is expected to impact Western Asian economies. Growth in oil-exporting countries is forecast to slow significantly in 2009 due to a sharp decline in crude prices as well as lower production, especially in OPEC member countries. GCC countries have already begun to experience a contraction of liquidity as well as rising spreads on corporate debt. This is likely to lead to delays in large industry and infrastructure projects throughout the region. Dubai is arguably the most vulnerable economy in the GCC subregion due to its considerable level of debt and overheated property market. The non-oil economies in the region are expected to suffer declines in export and tourism earnings as well as in the inflow of workers remittances. Among the non-oil economies, risks are especially high in Turkey as the country faces a significant current account deficit that is increasingly financed through relatively short-term corporate debt.

Latin America and the Caribbean

Mr. Osvaldo Kacef (ECLAC) presented the economic outlook for Latin America and the Caribbean. In 2008, growth continued at a reasonable pace despite the worsening of the external environment and ECLAC expects a fifth consecutive year of relatively strong growth of around 4.6 per cent in 2008. Within the region, South America is leading in growth rates with 5.7 percent for 2008. Uruguay, Peru and Panama will register the highest growth rates in the whole region.

Macroeconomic balances are healthier and the region as a whole is better prepared to face difficulties than before. Among the salient characteristics of the recent period, current accounts, fiscal deficits and private savings have improved in recent years. However, the situation differs widely across countries and the current account performance, as well as public finances, depends heavily on the evolution of commodity prices. In 2008, the region as a whole might continue to achieve a current account surplus due to the performance of South American countries. There has been an improvement in the terms of trade in some South American countries, especially exporters of oil, metals and minerals.

However, the region is not immune to the current global economic slowdown and the macroeconomic conditions will become more problematic towards the end of 2008. Remittances will decline, affecting mainly Central American countries and Caribbean nations, where in certain cases the level of remittances is higher than FDI. Slower growth of manufacturing exports is to be expected in particular for countries like Mexico, whose exports are more sensitive to the performance of the United States economy. Lower commodity prices will negatively affect the region's economic performance and will reduce in particular the terms of trade for South American economies. The terms of trade in South America improved about 7.5 per cent between 2007 and 2008, but should face now a negative change of approximately 6 per cent between 2008 and 2009.

Inflation control will continue to be a challenge for the region in 2009. Although global inflation is tumbling in response to the plunge in commodity prices, currency depreciation will partially reverse the effect of lower external prices in some Latin American countries. In particular, inflation will continue to be particularly high in Venezuela, with an increase in the consumer price index of 35 per cent in August 2008, and in Nicaragua, with an increase by 24 per cent.

A financial contagion effect from the current global financial crisis is to be expected in the region as well. Price indexes of stock exchanges have decreased recently, reflecting already the effects of the financial crisis. In Brazil, the IBOV stock index registered a change of -35.3 per cent, on average, between December 2007 and the first half of October 2008. In Mexico during the same period, the MEXBOL index registered a change of -25.7 per cent. At the same time, risk perceptions towards emerging markets have increased abruptly since August 2008 and an acceleration of currency depreciation has been observed in the last months with upward pressure on inflation rates.

Although growth continued in 2008 and the region is better prepared to face these new difficulties, ECLAC forecasts that regional growth will slow down significantly in 2009. South America is expected to grow by 3.9 per cent in 2009, with Brazil growing at 3.5 per cent, B.R. of Venezuela at 4.0 per cent and Argentina at 4.5 per cent. Central America and the Caribbean are expected to register lower economic growth of 3.7 per cent and 3.5 per cent, respectively. Mexico is expected to face a slowdown in growth to 1.8 per cent in 2009.

Discussion

In the general discussion, **Ms. Camila Nunez (Fedesarrollo, Colombia)** pointed out the negative effects of the sharp deceleration of the United States and Venezuelan economies on the demand for Colombian exports. Lower consumption and investment growth is also expected due to the current monetary policy stance. **Mr. Juan-Rafael Vargas (Universidad de Costa Rica)** pointed out that major uncertainties still exist regarding the United States economy and world trade flows, but a complementary drive for economic growth in the case of Costa Rica will come from the domestic economy. **Ms. Cristina Rodriguez (Metro Economica S.C., R. B. of Venezuela)** mentioned that Venezuela is expected to face an economic slowdown in 2009, with growth dropping to 2 per cent from 6 per cent in 2008 due to external and fiscal restrictions.

5. The global financial crisis

Mr. Ray Barrell (NIESR) gave a presentation entitled "The crash of 2008". He started by analyzing the causes of the crisis and pointed out that one important factor were low real interest rates that had stimulated borrowing and financial innovation. Reasons for the low level of real interest rates were high savings, especially in Asian economies, as well as the low short-term policy rate in the United States. Meanwhile, new features of the market were not stress-tested for downturns. For example, new asset-backed securities hid risk rather than sharing or reducing it, and the reliance regarding mortgages on wholesale markets was unwise. The losses related to sub-prime loans in the United States could be $1.4 trillion, with half of this amount sold to European banks. Mr. Barrell also related the defaults of sub-prime loans to the United States bankruptcy law, which made defaulting too easy.

Mr. Barrell argued that the crisis has exposed deficiencies in risk management and prudential regulation. Regulation has three functions associated with market failure and externalities, namely to avoid monopoly power and aid competition; to regulate away toxic and dangerous products; and to reduce systemic risk and spill-over effects. Regulation can be regarded like a tax, where avoidance and incidence rates need to be balanced. Bank regulation increases the user cost of capital and reduces equilibrium output, while good regulation reduces default risks as well as equity and other risk premia. Costs and benefits need to be balanced. He pointed out that one needs to be careful not to fight the last war and respond flexibly in response to innovations, some of which are good, others bad.

Mr. Barrell concluded by saying that fiscal and monetary frameworks were not the source of the crisis. Instead, the missing arch in the framework was macro-prudential financial regulation. The origin of the crisis lies in lending by United States banks to consumers who do not or cannot pay back debts. A further problem in the case of Europe is that there is a single market, but each country has its own regulation. He emphasised the need for a single regulatory body.

Mr. Giorgio Basevi (University of Bologna) analysed the 'global financial crisis' from an European point of view and addressed in particular the implications for financial regulation and policy coordination.

When the crisis in the United States started to take on grave proportions and, particularly, when there was a lapse in the United States to approve a bailout plan, Europe could, to the surprise of many, act very quickly. It was also helpful that the EU was led by France and president Sarkozy had already for some time been calling for ways of taking preemptive action. The subsequent coordinated action of European countries was a success, considering the large number of countries and institutions involved.

The crisis seems to point to the possibility of greater financial and economic coordination in Europe, and perhaps to the creation of new institutions. In this context, an European-wide regulatory authority is most necessary.

Any blueprint for a European regulator would need to take into account the theory of optimal surveillance areas. A further problem is that for such surveillance to be effective, national authorities will eventually be captive of the multilateral authority. Moreover, some of the causes of systemic problems may reach beyond the region. There is also the possibility that the regulatory framework may endogenously contribute to a crisis. Despite all these considerations, a point of departure for the multilateral regulator could be the ECB.

Aside from the apparently positive role of European policy-makers in the way they addressed the crisis, the other positive aspect is that the confidence in the euro has strengthened Italy, Ireland and Hungary, for example, which until recently have been skeptical regarding the euro now think that it was thanks to the common currency that they could cope better with the turmoil.

Mr. José Antonio Ocampo (Columbia University) argued that the current global financial crisis should not surprise anyone who has studied H. Minsky.

Looking at the historic perspective, the United States and the world economy have faced banking crises before. The last crisis in the United States of a systemic character, in the 1980s, was exported to Latin America. Some lessons could be learned from these experiences:

1) The first essential point is the necessity of macro-prudential regulations with the ability of generating counter-cyclical patterns. The concrete mechanisms and capitalization processes for prudential regulations and countercyclical provisions to be in place are open to discussion and

will depend on the specific conditions of each country, but there should be no doubt by now that they must exist. Mark-to-market pricing is a problem as even if this adds transparency, it also tends to be pro-cyclical. There is an inherent tendency in an unregulated system to accumulate financial balance miss-matches which eventually cannot any longer be sustained. This should be corrected because the crisis that occurs when the system cannot be sustained any longer can be severe and lasting.

2) Another common characteristic in the build-up of all crises is the creation of shadow banking systems. That is why regulations need to be comprehensive.

3) Self-regulation does not work. Risk models actually increase instability.

Turning towards the present economic situation and some policy considerations, Mr. Ocampo argued that the worst is over, but that there is a tendency to underestimate the real impact of the crisis. Thus, looking at policy instruments still seems appropriate. In the current conditions, monetary policy may at best stop things from getting worse, but cannot help to improve the situation. Fiscal policy will be necessary, but the required mechanisms can be in place perhaps only in the United States, not in Europe and perhaps not sufficiently in China. It remains to be seen whether the countercyclical policies in China can help more than sustaining the country itself.

Apart from these general considerations, other aspects need to be contemplated when looking at the crisis from the perspective of developing countries. These countries will be affected via the following channels:

1) A fall in remittances. The evidence is still mixed but it is too early to make a final assessment.

2) Lower commodity prices. Copper for example is below the low-scenario contemplated by policy makers in Chile.

3) Finance, particularly as the corporate finance sector falls deeper into crisis. There is going to be a sharp credit contraction in developing countries. In addition, some countries are very vulnerable to capital reversals following massive capital inflows (Brazil, India).

In this context, there should be no doubt that self-insurance by reserve accumulation remains a reliable means to avert crises of this kind. Reserve accumulation was criticized for being too large. Mr. Ocampo thinks this has been very wise indeed.

Mr. Ocampo argued that the best hope is that developing countries would learn from this experience to create mechanisms of self-insurance and be able to run countercyclical policies. But the problem is that developing countries are generally forced, by the IMF among others, to undertake pro-cyclical policies.

Discussion

In reply to the question as to whether the crisis could have been prevented, Mr. Ocampo referred to Minksy, who argued that during booms agents take too many risks and these risks lead to excessive levels of debt that cause the crisis. It is therefore very hard to prevent a crisis because in reality one is also containing a boom which may not be very popular at that juncture.

On the question regarding the room of maneuver to cope with the crisis in Latin America, Mr. Ocampo argued that there is some room due to the large accumulation of reserves and the ability to intervene in foreign currency markets. Countercyclical policies, particularly fiscal policy, should be allowed to take effect.

A further question was raised as to whether the reversal of capital flows could erode foreign currency reserves. Mr. Ocampo pointed out that this is why recipient countries have accumulated large reserves. But together with containing the outflows, policy makers should as well be concerned with the management of the exchange rate to avoid sharp fluctuations.

The question was raised whether all the developing countries have the room of maneuver to contain the effects of the crisis by fiscal policy measures and the use of contingency mechanisms. Mr. Ocampo said that this is certainly the case for Chile, but not in Argentina, which has been running pro-cyclical fiscal policies for some time. The same holds true for Colombia. Consequently, what is most necessary and most likely to happen is that countries in the developing world are allowed and encouraged to activate counter-cyclical monetary policies.

Mr. John Walker (Oxford Economics) presented the outlook of Oxford Economics for the global economy and made a number of remarks on the global financial crisis. He stressed that although the ongoing financial crisis is a new development, it is a repetition of a long-term trend. In the past, United States banks used to lend to Latin American countries and to Mexico and could go bankrupt. Similar processes happened during the Asian financial crisis and eventually the bad financial system was to blame. During the last few years, capital flowed from China and the Gulf countries to the United States and Europe, which also was a mistake.

Currently, there are three uncertainties complicating the outlook for the global economy: the depths of the credit crunch, the behavior of commodity prices and the governments' response. The amount of banking losses has not been announced and it is difficult to make any estimate in this regard. But obviously the credit markets are in a crisis and there are a number of reasons for that, such as poor regulation and a shadowy banking sector, dubious activities in the financial sector and greedy consumers and, eventually, the exacerbation of all those factors by policy mistakes. The inflows from the rest of the world also played a part, as the United States received significant capital inflows, pushing long-term interest rates downwards. The surplus countries in Asia and the private sector invested into United States assets and the holders of United States debt have current account surpluses.

Mr. Walker then analyzed the stock of United States debt for households, the non-financial sector, the financial sector and government in the period from 1990 to 2008 He concluded that debt of the financial sector increased most of all in that period and contained a huge amount of leverage.

Turning to the higher level of commodity prices, Mr. Walker noted that these have prompted inflation in the industrial countries and weakened consumer confidence. Inflation was rising also in emerging markets, complicating the situation by creating pressure for monetary policy tightening.

Mr. Walker noted that household wealth declined in the United States (as both house values and financial wealth plummeted) in the third quarter of 2008, while the export performance was boosted by the weakening dollar. This makes the depreciating real effective exchange rate the only factor saving the United States from recession.

In the outlook, a recession is expected across the United States, but not as strong as the one in the early 1990s. Government actions should constrain the downside scenario. The level of interest rates is surprising against the backdrop of increased inflation and fiscal policy is expected to help consumers (including in terms of housing).

In Asia, China and India will increase their imports in dollar terms more than the rest of the world together, helping to support Asian exports. In Latin America, strong domestic demand, especially in Brazil, is helping to support growth. Still, there are a number of risks, as indicated by the increase in emerging market spreads and in the spreads of investment-grade corporate bonds.

Mr. Walker also noted that the pattern of the current recession is different from the recession in 2001, since it is driven by the housing sector and therefore affects consumers (as in the 1990s), while in 2001, only the corporate sector was affected. Meanwhile, a number of industries are performing well, such as the car sector and machine tools, and there are numerous export orders from China and the UAE.

Mr. Walker also mentioned possible alternative scenarios. A prolonged credit crunch may have a profound impact on both consumption and investment (in the downside scenario), while on the other hand, in the upside scenario, the impact of the credit crunch on the real economy may be less pronounced than expected.

Discussion

Following the presentation, the question was raised if econometric models should not include housing wealth and its impact on consumption, since houses will be transferred from generation to generation and inflation will eventually correct their value. Mr. Walker pointed out that the average person reacts to changes in house values even stronger than to changes in the value of pensions, and therefore econometrics does not support such an argument.

Mr. Carl Weinberg (High Frequency Economics) noted that his presentation covers two topics, one related to modeling and another one related to a systemic approach to the crisis. He first asked a number of systemic questions as to the causes of the crisis and whether this is a problem of banks or a problem of the real sector. He argued that if this is an issue related to banks, then regulation is the solution.

According to Mr. Weinberg's view, the crisis reflects a systemic failure related to human nature, and this should be incorporated into models. There is a core appetite for speculation, which is not constant, and the increased optimism created pressure to move away from prudential regulation. He agreed with Mr. Klein that those who wrote securities did not assess risk, which is understandable, but there is also the question regarding the perspective of the buyers. Some people also took mortgages without any proper assessment of their situation.

According to Mr. Weinberg, those buyers were driven by optimism, taking large risks relative to their portfolio. People invested in real estate as capital gains increased and this seemed better than keeping funds in cash. In addition, leveraging was widespread. There is an optimistic perception that if everybody does it, then it appears acceptable.

Mr. Weinberg referred to J. Tobin's article published in 1958, which describes the preferences to take on risky assets. Using the IS-LM framework, he explained that as demand for money declines, the LM curve shifts upward and to the right, equilibrium output increases and interest rates decline. Then, when the asset bubble bursts, the LM curve shifts downward and to the left and equilibrium output declines.

In the second part of his presentation, Mr. Weinberg suggested to assess when risky assets are preferred over holding cash and to include these parameters into models, trying to expect shifts.

On the current economic situation, Mr. Weinberg noted that there are two major problems in the United States and other major economies (the EU and Japan). One is economic (the global recession), while another one is that the financial system is broken and has to be fixed first. He suggested a four-point strategy that would pump liquidity into the financial system; support equity markets; cut interest rates and provide credit to the economy directly through the central bank; and use fiscal stimulus. He suggested implementing an equity buyback program to resolve liquidity problems.

Discussion

Mr. Pingfan Hong (UN-DESA) pointed out that the factors behind the recent dollar rebound are well-known and that a number of factors were mentioned explaining its medium-term decline. One factor, which was not mentioned, is that as housing prices and asset prices in the United States declined, resulting in dollar depreciation, the United States net investment position meanwhile improved, since United States holdings of foreign assets declined less. He asked whether this could lead to a clean-up of the United States foreign debt by dollar depreciation. Usually, foreign assets of the United States are in the form of FDI, while assets of foreigners in the United States are in the form of real estate.

In reply, Mr. Weinberg argued that asset markets are down everywhere, so there is no alternative "save haven".

A further question referred to the mentioned four-point program and the possibility that this could create a similar bubble in the next business cycle. Consequently, the answer to the current crisis might lie in more regulation.

Mr. Weinberg answered that business cycles are natural and that policy should minimize their lows instead of getting rid of them. On the issue of regulation, he pointed out that nobody knows what exactly to regulate. There are no measures on this matter, as there are no measures for rational expectations.

One conference participant argued that policy should not only minimize the lows of the business cycle, but also constrain its highs, and the four-point program suggested by the speaker, does not include this.

Mr. Rob Vos (UN-DESA) commented that as A. Greenspan acknowledged, there was not only a lack of regulation, but actually a period of ten years of deregulation. So the question refers not just to regulation, but also to managing internal reserves and creating room for a countercyclical policy.

Mr. Steven Hall (University of Leicester) commented that the current crisis is a confluence of several crises and the question is how responsible policy-makers are. In the United Kingdom, they denied that there is a housing price bubble.

Ms. Tiziana Bonapace (ESCAP) asked whether anything would have been different in terms of risk diversification if there had not been a rescue of LTCM ten years ago.

Mr. Weinberg replied that although it is possible to regulate institutions, it is impossible to regulate human behavior. Therefore, regulation is not a solution, since those people who want to create risky assets will create them anyway by going to places where there is less regulation. On the other hand, it is also possible to over-regulate good things. In fact, CDOs do not seem to be inherently bad in principle.

Regarding LTCM, Mr. Weinberg pointed towards the Bear Stearns rescue and argued that some lessons were learned, in particular that it was not a good idea to bail out Lehman Brothers.

Annexes

Project LINK Fall Meeting 2008
United Nations Department of Economic and Social Affairs
New York
23-24 October 2008

(Venue: The New York Helmsley Hotel, Knickerbocker Suite "D", 3rd Floor)

Thursday, October 23, 2008

9:30 – 9:45 **Opening and welcome**
(DESA and Project LINK)

9:45–11:15 **World Economic Outlook**
Chair: Lawrence Klein

LINK/UN DESA forecast (Rob Vos)
World Bank (Hans Timmer)

11:15–11:30 ***Break***

11:30–13:00 **World Economic Outlook (continued)**
Chair: Bert Hickman

Lead discussants: Ray Barrell (NIESR)
Pete Richardson (OECD)

General Discussion

13:00 – 14:00 ***Lunch***

14:30 – 17:30 **Panel discussion on the global financial crisis**
Chair: Stephen Hall (Leicester University)

Panel members:

Ray Barrell (NIESR)
Giorgio Basevi (University of Bologna)
Jose Antonio Ocampo (Columbia University)
John Walker (Oxford Economics)
Carl Weinberg (High Frequency Economics)

(16:00–16:15 ***Break***)

Friday, October 24, 2008

9:30- 11:30	**Global outlook: commodity prices and economic implications** *Chair: Charlotte du Toit (University of Pretoria)* Willy Meyers (University of Missouri-Columbia) Robert Kaufmann (Boston University) Pilar Fajarnes (UNCTAD) F. Gerard Adams (Northeastern University) Discussion
11:30–13:00	**Regional Outlook: developed regions** *Chair: Byron Gangnes (University of Hawaii)* United States (Lawrence Klein, University of Pennsylvania) Japan (Kanemi Ban, Osaka University) Western Europe (Ray Barrell, NIESR)
13:00–14:00	***Lunch***
14:30–17:30	**Regional Outlook: developing and EiTs** *Chair: Pingfan Hong (UN/DESA)* Africa (Marva Corley, UN/DESA) East and South Asia (Tiziana Bonapace, ESCAP) West Asia (Ingo Pitterle, UN/DESA) Latin America and the Caribbean (Osvaldo Kacef, ECLAC) Economies in Transition (Malinka Koparanova and Grigor Agabekian, UN/DESA) Each lead presentation is followed by comments from LINK country experts
17:30	**Business and closing**

Economic Outlook Reports Provided by Participants

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1. Austria
2. Brazil
3. Bulgaria
4. China
5. Colombia
6. Costa Rica
7. Greece
8. Hong Kong
9. Ireland
10. Italy
11. Korea
12. Malawi
13. Mexico (CKF)
14. Mexico (UNAM)
15. Philippines
16. Poland
17. Russia
18. Singapore
19. Slovak
20. Slovenia
21. Spain
22. Taiwan
23. Togo
24. Turkey
25. Ukraine
26. Venezuela

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