World Economic Situation and Prospects

Monthly Briefing Note to the Secretary-General

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Summary

In response to the intensified global financial crisis, a large number of countries adopted extensive emergency plans in October 2008, following a more comprehensive and internationally concerted approach. However, great uncertainties remain in global financial markets. The impact of financial strains on economic activity is deepening and the crisis is spreading rapidly towards a growing number of developing countries and the economies in transition.

Global economic issues

Extensive emergency plans

In the first week of October, several central banks cut policy interest rates in a coordinated fashion. On the second weekend of that month, a Summit of leaders of the 15 euro-zone countries adopted a package of more coherent policy measures to the tune of over $2 trillion. On the same weekend, at the joint meeting of the World Bank and the IMF, the International Monetary and Financial Committee, on behalf of the 185 members, endorsed the G-7 initiative, which laid out five principles for managing the crisis: to support systemically important financial institutions and prevent their failure; to unfreeze credit and money markets and ensure that banks and other financial institutions have broad access to liquidity and funding; to ensure that banks and other major financial intermediaries can raise capital from public as well as private sources; to ensure that national deposit insurance and guarantee programmes are robust and consistent; to restart the secondary markets for mortgages and other securitized assets.

Financial stress rapidly spreading toward emerging economies

There had been complacency about the limited impact of the global financial crisis on developing countries and the economies in transition, but since October, financial stress has shifted rapidly towards these economies. The broader international economic environment for developing countries and the economies in transition has deteriorated sharply. The cost of external borrowing has risen considerably and capital inflows are reversing. Both currency and commodity markets have become extremely volatile, with the exchange rates depreciating at an alarming pace in several countries and prices of primary commodities tumbling. Developing country export growth is decelerating and many countries are seeing a shift towards current account deficits.

Oil prices have fallen sharply

During October, crude oil prices declined sharply on expectations that the financial crisis would result in a severe global economic slowdown that would dampen the demand for oil. The price of Brent crude dropped from $94 per barrel (1 October) to $59 (28 October), its lowest level since February 2007. In response, OPEC decided to decrease production by 1.5 million barrels per day and indicated additional cuts in coming months. Nevertheless, there is likely to be more downward pressure on prices in the short run as further evidence of slowing growth in major oil-consuming countries becomes available. At the same time, concerns about medium-term supply shortages have increased since current price

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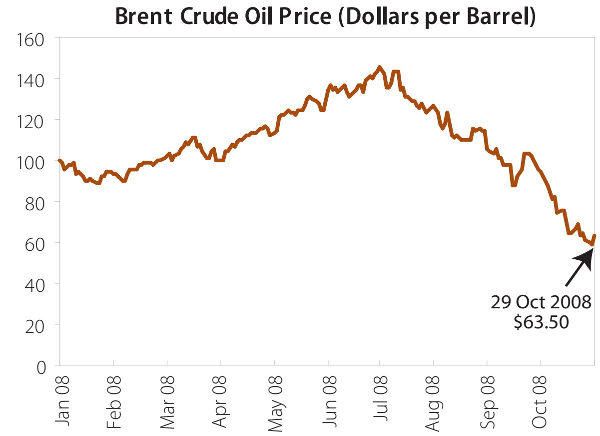
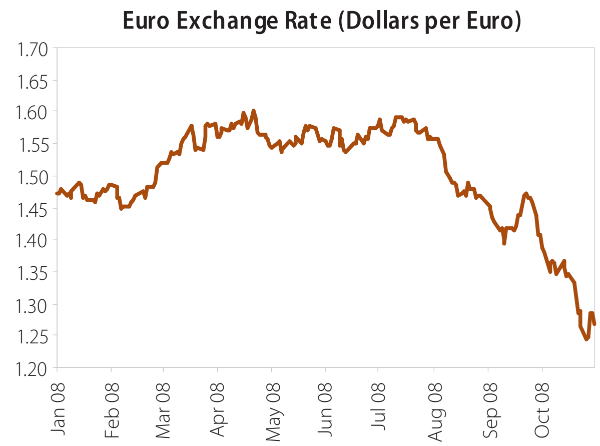
levels are close to or below marginal costs of production for many new projects.

The dollar has continued to appreciate

After a prolonged period of dollar depreciation, the dollar (as well as the Japanese yen) has rebounded against the euro and other major currencies. This has to do in part with expected lower growth prospects in the euro area. It is also caused by a continued 'flight to safety' in short-term dollar assets (especially US treasury bills) and high demand for dollars and yen to pay off bad short-term debts held in those currencies. This provides some comfort in addressing the financial woes in the United States, but at the same time a stronger dollar will weaken export competitiveness in the United States and deepen the recession.





Developed economies

United States: in a recession

The latest data show that real gross domestic product (GDP) decreased at an annual rate of 0.3 per cent in the third quarter of 2008, dragged down mainly by the largest decline in personal consumption expenditure in 28 years. Policy-makers increased their efforts to tackle the financial crisis. The Fed reduced the federal funds rate twice in October, by a total of 100 basis points. After passage of the Emergency Economic Stabilization Act (EESA) at the beginning of October, the Treasury started to buy stocks worth $250 billion in a number of banks, out of the $700 billion allocated to EESA.

Western Europe and the EU: activity continues to decelerate amidst turbulence in financial markets

The Economic Commission's (EC) economic sentiment indicator for the euro area deteriorated sharply in October to its lowest level since November 1993. This was mirrored by the German IFO index, which fell to its lowest level since May 1993. The United Kingdom released its first estimate of GDP for the 3rd quarter of 2008, with GDP contracting by 0.5 per cent (QoQ). In its latest economic outlook (with data through 23 October), the EC projected growth of 1.2 per cent in the euro area for 2008 and 0.1 per cent for 2009, and warned of the downside risks. Inflation continues to decelerate. In the euro area, it has now declined for 3 months in a row, from a high of 4.0 per cent to 3.2 per cent in October. Unemployment has drifted up from its low of 7.2 per cent in March to 7.5 per cent in September.

Central banks took significant action during the month. The ECB, the Bank of England, The Bank of Sweden and the Swiss National Bank, in concert with the Fed and the Bank of Canada undertook coordinated action, cutting their main policy rates by 50 basis points. The ECB also changed its operating procedure to supply unlimited liquidity at the fixed policy interest rate at its weekly auctions. Governments were also active with a number of bailouts of banks and mortgage lenders, and deposit guarantees were raised across the region. In the aftermath of the G-7 summit, EU governments agreed on a joint framework for national intervention plans that could possibly mobilize 1.8 trillion euro. The general worsening of the outlook led to a sharp decline in the euro and the British pound against the dollar, with both currencies reaching multi-year lows.

The Icelandic government requested a $2 billion loan from the International Monetary Fund (IMF), three weeks after the State was forced to take control of the country's three largest commercial banks. Iceland's financial system has seen the near collapse of its stock and foreign exchange markets. The IMF bailout package and accompanying economic stabilization programme are set to be agreed in early November.

The new EU member States: international confidence is weakening

In view of the unfolding global financial crisis, stock markets in the new EU member States continued to decline and currencies of the countries with flexible exchange rate regimes continued to depreciate, reflecting weakening international confidence in those economies. The most pronounced impact of the crisis occurred in Hungary, where domestic banks had to limit foreign currency lending. This complicated the financing of the country's large external deficit, against the backdrop of the large foreign debt of the private sector. In order to restore liquidity in the domestic banking sector, the Government and the central bank had to seek assistance from the ECB, which provided a 5 billion euro credit line. An agreement was also reached with the IMF on a possible 17-month stand-by loan of $15.7 billion, the first case of an EU member State asking the IMF for financial assistance. In addition, the European Commission expressed its willingness to lend 6.5 billion euro to Hungary, and another 1 billion euro could be provided by the World Bank. These moves should restore confidence in the economy, revitalize the bond market and enable the Government to roll over its external debt obligations. To protect the currency from further decline, interest rates in Hungary were increased by 300 basis points, which may have an adverse effect on the real sector. These events highlight the vulnerability of the EU-10 countries with large external financing needs, even if their banking sector is largely controlled by the parent banks in the EU-15.

Japan not spared from the effects of the crisis

The Bank of Japan cut its policy interest rate from 0.5 per cent to 0.3 per cent, the first reduction in seven years. Policymakers cited the slowing in economic activity for their decision, given the weakening of exports as well as the continued effect of higher energy and materials prices. Japan's exports suffer from weaker economic growth in global markets as well as the appreciation of the yen. The latter is due to a flight to safety and the closing of carry trade positions: traders who borrowed in yen to invest in higher-yielding currencies such as the Australian dollar are now affected by higher volatility and falling interest rate differentials, making them buy back the yen. The overall bleaker situation for Japan's exports has also led to a rapid fall in equity prices, with the leading Nikkei 225 stock index at times losing almost one third of its value in October.

Economies in transition

Concerns over the situation in domestic financial sectors have intensified

Driven by continued risk aversion of international and domestic investors, as well as falling prices for oil, gas and metals, share prices on the Russian stock exchanges plummeted, with trading having been suspended several times during the month. By 20 October, the RTS index had fallen 60 per cent from its peak in May. In response to the deepening financial crises, the Government introduced further measures to shore up State-owned banks, commercial banks and stock markets. Companies will be able to borrow up to $50 billion from the National Development Bank to finance foreign liabilities. A further $36 billion is to be allocated to key banks in subordinated loans for at least 5 years. In Kazakhstan, the Government used $10 billion from the National Oil Fund to boost banking sector liquidity. In Ukraine, parliament approved a legislative package which had been negotiated with the IMF as a condition for a loan of $16.5 billion to help stabilize the economy.

Developing countries

Africa is highly vulnerable to fallout from financial turmoil

Africa's lack of integration into the global financial system has so far kept it relatively immune from the direct effects of the global financial crisis; however recent events confirm that the region will not be unscathed. Growth in the region will be affected indirectly through slower global growth and credit tightening, which will impact on investment flows, export demand, commodity prices, and exchange rate vulnerability. For example, in South Africa, where there is no risk of bank insolvency, the rand has weakened by about 17 per cent against the dollar since September as a 'flight to safety' triggered a sell-off of equities and bonds, while in Nigeria the 2009 budget was revised downwards based on a price of $45 per barrel of oil, and there is growing concern about the currency's stability. Although the terms of trade in net fuel- and food-exporting countries are being impacted by the fall in commodity prices, recent data shows an easing of headline inflation in many economies in the region. However, high food and utility prices still remain a problem in countries such as Ethiopia, where inflation of 60 per cent is eroding incomes and putting downward pressure on demand.

East and South Asia: policy-makers take action to fight spreading crisis

The Republic of Korea has suffered a worsening credit crunch in terms of a drying-up of liquidity in both won and dollars in "on-shore" money markets. As a result, the won has depreciated to a level not seen in ten years vis-à-vis the dollar and the stock market has declined by more than 50 per cent over the past year. In response, the authorities have scaled up a number of policy measures, including a large cut in the interest rate by 75 basis points, a fiscal stimulus package worth the equivalent of $11 billion, the extension of government guarantees on the external debt of the country's banks, and the use of public funds to reduce the stock of unsold homes. On 31 October, the US Federal Reserve decided to include the Bank of Korea in a currency-swap agreement, causing the Seoul stock market to jump 12 per cent in a single day.

Four other monetary authorities in the region (China, Hong Kong Special Administrative Region of China, Taiwan Province of China and India) have also lowered their policy rates to stabilize their economies. On the other hand, the central bank of Indonesia has raised the policy rate to curb inflation.

Three countries released GDP data for the third quarter of 2008 and all of them show slowing growth rates. For China, the Q3 figure (9 per cent) is lower than the level for the first two quarters (10.4 per cent). The figure for the Republic of Korea (3.9 per cent) is also lower than the level for the first two quarters (5.3 per cent). The preliminary data for Singapore shows the output level shrank by 0.5 per cent in the third quarter year-on-year.

Inflation rates remained high but stable in most countries. However, the inflation rates for China, Hong Kong Special Administrative Region of China and Taiwan Province of China have fallen significantly from their peak levels. The fall in the price of oil will benefit a number of countries, India being a case in point. As one third of India's imports are petroleum and petroleum products, the lower level of oil prices will reduce some of the pressure on both inflation rates and fiscal balances, which had been suffering from higher oil prices in view of fuel subsidies.

Western Asia: weakening economic prospects

With the financial crisis spreading across the globe and oil prices tumbling, the economic outlook for Western Asia has deteriorated considerably. Stock markets in the region registered large declines, banks in GCC countries saw liquidity dry up, and Turkish bond spreads widened steadily, while the Turkish lira dropped sharply against the dollar. In Kuwait, the central bank halted trading in the shares of Gulf Bank, the country's second biggest lender, because of massive derivative losses. Central banks in Israel, Turkey, and several GCC countries responded to the financial turmoil by lowering benchmark interest rates and by injecting liquidity into domestic banking systems and foreign exchange markets. In addition, Kuwait and the United Arab Emirates issued guarantees of bank customer deposits. While GCC countries face a significant drop in export revenues, their financial positions remain strong, making it likely that they will weather the crisis. In Turkey, which faces a current account deficit and a rapid economic slowdown, market conditions improved significantly at the end of the month, reducing the risk of a deep financial crisis.

Latin America: currencies have seen a pronounced depreciation

In Latin America, although indications are that exposure to the global financial crisis is in part manageable and covered by existing levels of capital adequacy, signs of vulnerabilities emerged during October. A six-year-long appreciation trend for Latin American currencies has come to an end, with regional currencies having fallen about 23 per cent against the dollar since June. In order to boost the supply of dollars locally, the US Federal Reserve announced it would provide Brazil with $30 billion, an initiative led by the IMF to support key emerging markets. Latin American countries are increasingly faced with a negative impact of the international crisis on their domestic economies in the form of a more difficult external environment. This includes a slowdown in global demand for the region's exports, a sharp fall in commodity prices, as well as capital outflows.