World Economic Situation and Prospects

Monthly Briefing Note to the Secretary-General

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Summary

The world economy is facing the most severe financial crisis since the Great Depression of the last century. The risk for a global recession has heightened significantly and volatility of commodity prices has increased further. If the situation continues to deteriorate, the progress towards the achievement of the MDGs could be in great jeopardy.

Global economic issues

The global financial crisis has intensified

The global financial crisis intensified significantly in September 2008: liquidity dried up in many financial markets, equity prices fell sharply worldwide, and a number of large financial institutions collapsed or came close to bankruptcy. These financial strains have increasingly led to downward pressure on economic activity worldwide. While a large number of developed economies are already in recession, growth in many developing countries is decelerating significantly.

The largest US financial institutions that came under intense pressure in September were Fannie Mae and Freddie Mac, Lehman Brothers, American International Group (AIG) and Washington Mutual.

Fannie Mae and Freddie Mac are the US government-sponsored enterprises holding about half of all the mortgage loans in the United States and issuing multi-trillion dollars of bonds bought by many other financial institutions worldwide, including the central banks of many countries and pension funds. As the failure of these two firms would most likely have led to unacceptably large disruptions in the functioning of financial markets at large, the US government took control of Fannie Mae and Freddie Mac.

AIG is the largest insurer in the world, with more than one trillion dollars in assets and operations in more than 100 countries. Given the size and composition of its obligations, a failure of AIG would also severely threaten global financial stability. The US Fed decided to provide an emergency credit line to AIG.

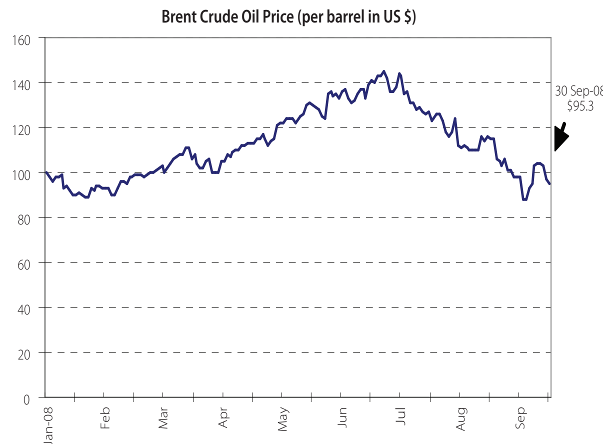
Lehman Brothers and Washington Mutual filed for bankruptcy, with the former being the largest firm to collapse in US history and the latter representing the largest bank to fail. Along with the failure of other investment banks, which have either gone bankrupt or been converted into commercial banks, September 2008 marked the end of independent investment banks in the US.

The central banks in major developed countries, including the US Federal Reserve, have taken a number of actions to increase liquidity and stabilize markets, but stresses in financial markets remain extremely high. In late September, the US Government stipulated the Emergency Economic Stabilization Act (EESA), which includes, among other measures, a plan to make available up to $700 billion for the purchase of troubled assets from beleaguered financial companies in the hope of reviving bank lending. The initial draft of the Act, however, failed to pass in Congress, sending global stock markets into a plunge.

Early October 2008, the financial crisis escalated further. Many countries experienced the worst sell-off in their equity markets. Facing the ever-heightening systemic risks for an imminent interruption of the global financial system, policymakers in the developed countries embarked on more coordinated rescue plans. Finance ministers of the G-7 decided on a farther-reaching bailout package based on a number of common principles: to recapitalize banks with public funding, to seize partial government ownership of banks, and to provide blanket government guarantees on inter-bank loans and deposits. The plan was endorsed by the IMFC at the annual joint meeting of the World Bank and the IMF and by government leaders of the Euro zone countries. Compared with the earlier piecemeal approach, which failed to prevent the crisis from spreading, these new plans are more comprehensive and more coherent. The immediate objective of the concerted action is to unfreeze the credit markets and to prevent failure of major financial institutions.

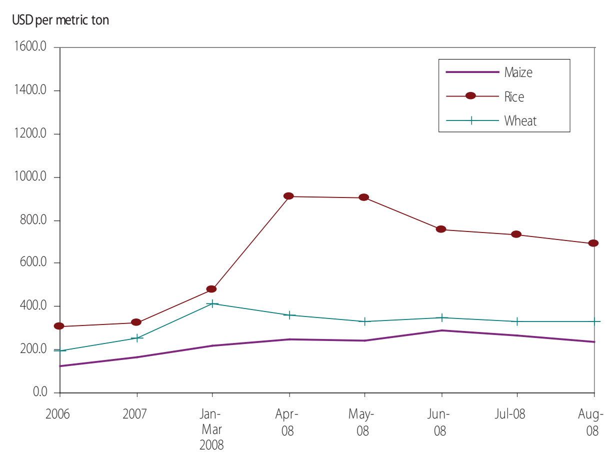
Oil prices have retreated, but remain volatile

Amid the global financial turmoil, oil prices showed extremely high volatility in September 2008. By the end of the month, Brent crude was at about $99 a barrel, 30 per cent below its peak of July, but still 30 per cent higher than the average price of 2007. The deteriorating global economic outlook is likely to put further downward pressure on crude oil prices, which are expected to remain highly volatile.



Food prices have decreased recently

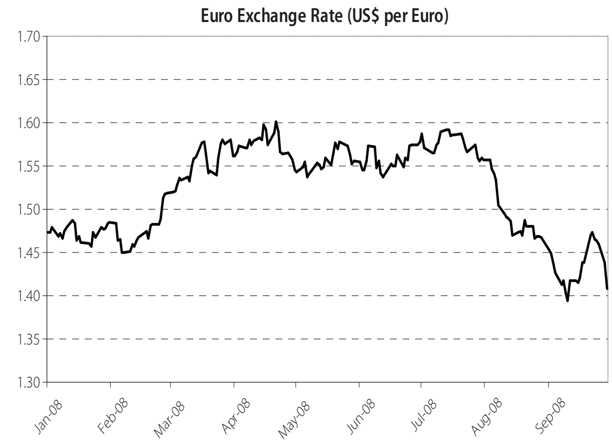
After a substantial surge in the first half of 2008, most world market prices for food commodities have decreased since June. While supply conditions have improved somewhat, the dimmer global economic outlook has slowed growth in demand. The average food prices so far in 2008 are, however, still significantly higher than in 2007.



Foreign exchange markets: The US dollar has appreciated

After hovering around $1.55-1.60 to the Euro since March 2008, the US dollar started to appreciate in July to reach about $1.40 per Euro in early October 2008. The recent deterioration of conditions in European financial markets has further increased the pressure on the Euro.

Developed economies



United States: a recession seems inevitable

The latest data indicate that the US economy grew by 2.8 per cent in the second quarter of 2008. Growth was mainly driven by exports, while domestic demand was weak. Many indicators point to a recession in the months to come: house prices continue to slide; employment has declined in every month during 2008, with the unemployment rate rising notably; demand from the rest of the world is slow; and these factors combined with the severe tightening of credit conditions are expected to lead to retrenchment of household consumption and business spending. With or without the EESA, a recession seems inevitable.

Western Europe and the EU: financial markets experience turbulences

The EU economies have come under increasing pressure. The banking sector saw a number of emergency measures, for example with the Benelux states intervening through the (partial) nationalizations of the Dutch-Belgian bank Fortis and the French-Belgian bank Dexia. In the UK, the British mortgage lender Bradford & Bingley failed and was nationalized, while in Germany, Hypo Real Estate made a loan deal with a consortium of banks for its solvency. The impact of the crisis on the real economy is deepening, with GDP declining in a number of economies.

The new EU member states: a slowdown, but financial conditions are sound

Bulgaria, Poland and Romania reported a robust expansion for the second quarter, but underlying indicators point to a slowdown. Banks in Central Europe and the Baltic States have not been exposed directly to US sub-prime loans and financial systems are generally in good shape. The Baltic States are experiencing a noticeable and broad-based slowdown. The Baltic economies have built large external imbalances, financed by borrowing from abroad, and channeled buoyant investment into their real estate markets. These imbalances are now facing an adjustment.

Japan: affected less directly by the financial crisis, but more from weaker exports

Japan suffers from weaker export demand from the United States, which is its biggest export market, as well as slowing economic activity in Europe. On the financial side, Japan has been relatively detached from the current turmoil. Japanese financial institutions had been more cautious in their investment and lending practices, helping them largely avoid any exposure to sub-prime loans.

New Zealand: falling into recession

New Zealand has technically entered into recession, as its economy contracted both in the first and the second quarter of this year. Economic activity is suffering from tighter global credit markets, the negative effect of rising food and energy prices on consumers' purchasing power, and lower agricultural output due to drought conditions.

Developing countries

Africa: so far insulated from direct effects of the financial crisis

The direct impact of the financial crisis on the African economies has thus far been limited as most commercial banks in the region refrained from investing in the troubled assets from the US. Stock markets in the region showed some volatility, driven by a sell-off by foreign investors. A stronger concern, however, is the indirect effect of volatile and falling commodity prices, particularly crude oil, on export revenue and the inflow of capital into the region. In a precautionary move, the central bank of Nigeria reduced its benchmark interest rate to boost liquidity, although the country continues to receive significant FDI inflows and has built up a large foreign reserve position.

East and South Asia: the effects of the financial turmoil are intensifying

Many Asian economies are experiencing a more adverse impact of the global financial crisis. After the bankruptcy of Lehman Brothers, it was noticed that many Asian countries had held significant amounts of financial assets related to that company. Also, the problems encountered by the American International Group (AIG), which runs insurance operations in a large number of Asian countries through subsidiaries, have reinforced investors' pessimism in the region. The recent fall in oil and food prices has reduced the upward pressure on inflation in many Asian countries such as China, Hong Kong SAR and the Republic of Korea. However, in many countries, food prices remain at a very high level relative to last year's record.

Western Asia: strong financial positions to counter the effects of the crisis

Along with the global credit crunch, Kuwait, Saudi Arabia, and the United Arab Emirates experienced a severe contraction of inter-bank liquidity and rising spreads on corporate debt. However, as both the governments and the central banks remain in very strong financial positions, tighter credit conditions are likely to have only a moderate effect on investment activities in the region. In Israel and Turkey, recent economic data also indicate a significant slowdown in economic growth as both domestic and foreign demand is weakening. On a positive note, inflationary pressures appear to have moderated slightly in the majority of countries during the past two months.

Latin America: prospects still positive amid growing challenges

Prospects continue to be positive for Latin America, although the financial and economic crisis in the US heightened uncertainties in many countries. In particular, higher unemployment in the US has led to falling remittances, especially in Central America. In Mexico, for example, remittances fell by 6.9 per cent year-on-year in July. The region is also facing higher inflation, which is eroding households' purchasing power. This has led to monetary policy tightening in a number of countries such as Brazil and Chile. A further concern is the volatility of oil prices, with oil exporters like Venezuela, Mexico and Ecuador being particularly exposed to the effect of any further retreat of crude prices on fiscal balances.

Economies in Transition

Growth is slowing

Recent data show that economic growth in the CIS region is moderating. This slowdown is driven by a combination of factors such as the financial crisis in the US, the global slowdown, increased geopolitical tensions in the region (as a consequence of the military conflict between Georgia and the Russian Federation in August), and weakening commodity prices, in particular for oil. A case in point is the Russian Federation, where growth is set to slow to about 7.0 per cent by the end of 2008 due to growing concerns about declining oil prices and the instability of the banking system.