# World Economic Situation and Prospects 2010

# Executive Summary


United Nations

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# Executive Summary

## The global economic outlook

### *The global economy is on the mend …*

The world economy is on the mend. After a sharp, broad and synchronized global downturn in late 2008 and early 2009, an increasing number of countries have registered positive quarterly growth of gross domestic product (GDP), along with a notable recovery in international trade and global industrial production. World equity markets have also rebounded and risk premiums on borrowing have fallen.

### *… but recovery is fragile*

The recovery is uneven and conditions for sustained growth remain fragile. Credit conditions are still tight in major developed economies, where many major financial institutions need to continue the process of deleveraging and cleansing their balance-sheets. The rebound in domestic demand remains tentative at best in many economies and is far from self-sustaining. Much of the rebound in the real economy is due to the strong fiscal stimulus provided by Governments in a large number of developed and developing countries and to the restocking of inventories by industries worldwide. Consumption and investment demand remain weak, however, as unemployment and underemployment rates continue to rise and output gaps remain wide in most countries.

In the outlook, global economic recovery is expected to remain sluggish, employment prospects will remain bleak and inflation will stay low.

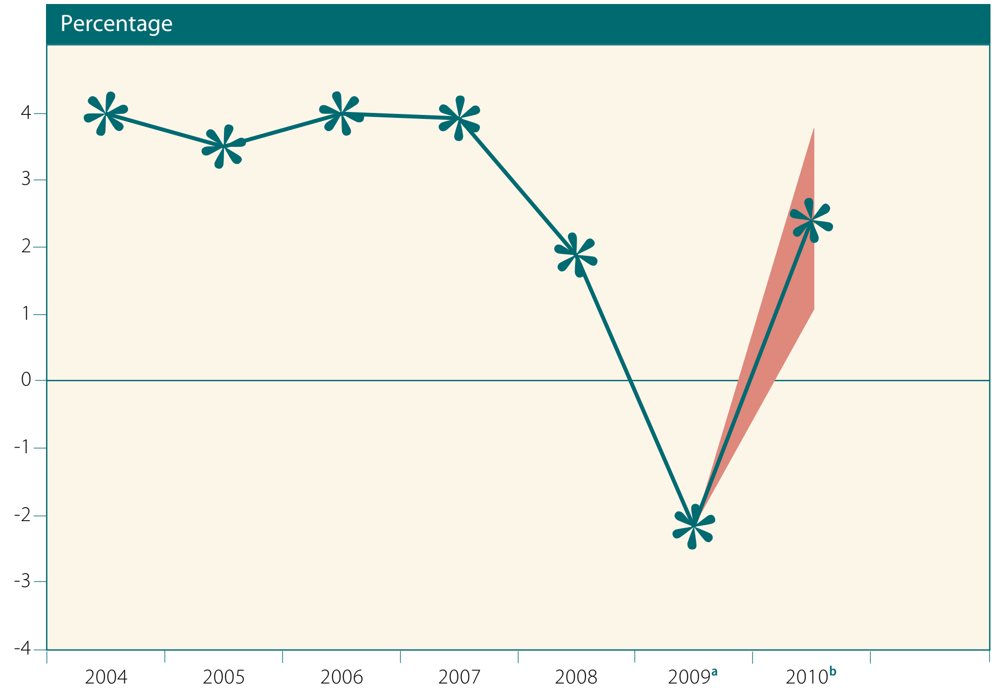
### *Global growth will be below potential …*

World gross product (WGP) is estimated to fall by 2.2 per cent for 2009, the first actual contraction since the Second World War. Premised on a continued supportive policy stance worldwide, a mild growth of 2.4 per cent is forecast in the baseline scenario for 2010. According to this scenario, the level of world economic activity will be 7 per cent below where it might have been had pre-crisis growth continued.

### *… with little impetus from developed economies*

In developed economies, consumer and investment demand remains subdued as a result of a continued rise in unemployment rates, efforts by households to restore their financial balances following the wealth losses incurred during the crisis, and the reluctance of firms to invest while capacity utilization rates are low and credit supplies remain tight. Furthermore, the impetus from the stimulus measures and the turn in the inventory cycle are expected to diminish over time. The major developed economies are not expected to provide a strong impulse to global growth in the near term, growing at a moderate 1.3 per cent on average in 2010 (a nonetheless visible rebound from the decline of 3.5 per cent in 2009).

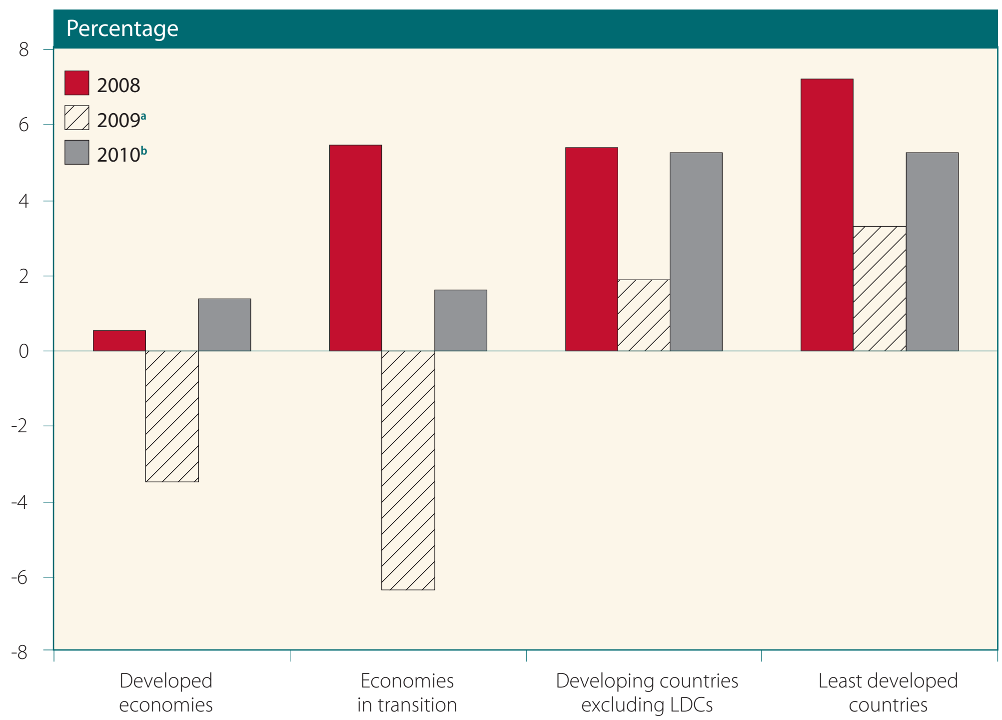
**World economic growth, 2004–2010**




Indicates the confidence interval at two standard deviations from historical forecast errors.

**Source:** UN/DESA.
**a** Partly estimated.
**b** United Nations forecast.

**Economic growth by region, 2008-2010**




**Source:** UN/DESA.
**a** Partly estimated.
**b** United Nations forecast.

### *The recovery is uneven among developing countries and the economies in transition*

Output growth in the developing countries, in contrast, is expected to recover at a faster pace but, at a projected 5.3 per cent in 2010, will remain well below the pre-crisis pace of more than 7 per cent per annum. Some developing economies have rebounded sooner than others. Fiscal stimulus and resumption of trade in manufactures pulled up economies in Asia in particular. Economies in transition are expected to see a turnaround from the steep decline (of 6.5 per cent) in 2009, but growth in the outlook for 2010 will be very weak, at 1.6 per cent.

Growth in most developing countries and economies in transition remains highly dependent upon movements in international trade, commodity prices and capital flows. These conditions have improved as part of the global recovery, but a further rebound will be strongly contingent upon the strength of the recovery in the developed countries. In the outlook, conditions for international trade and finance will remain challenging. This will affect the low-income countries in particular. While country-specific conditions differ markedly, the global crisis has undermined investments and, hence, the growth potential of their economies. Many of the least developed countries (LDCs) are expected to see a much slower economic performance in the years ahead compared with the robust growth they witnessed in the years before the crisis.

## The outlook for employment, poverty and inflation

### *Unemployment rates are still on the rise*

The number of unemployed is rising in most economies. Among developed economies, the number of unemployed has more than doubled in the United States of America since the beginning of the recession in December 2007. The unemployment rates in the euro area and Japan have also increased notably. The actual situation is even worse as it does not include unemployment data for discouraged workers who are unemployed but not currently looking for work because they believe no jobs are available for them. Unemployment rates in transition economies and developing countries have also moved higher, in particular in the Commonwealth of Independent States (CIS) and Central and South-eastern Europe.

### *Developing countries are seeing increases in vulnerable employment and working poverty*

In developing countries, while most job losses are in export sectors, a greater concern lies with the stark increase in vulnerable employment and working poverty. In East and South Asia, vulnerable employment affects about 70 per cent of the workforce and available data suggest that this share has increased significantly as a consequence of the crisis. Similarly, in sub-Saharan Africa, an important share of the region's labour force is engaged in subsistence agriculture and other low-productivity economic activities without any form of social protection. In the developing world at large, the share of working poor is estimated to have increased to 64 per cent in 2009, up from 59 per cent in 2007.

### *Social gaps in employment opportunities are widening*

The impact of the financial crisis on labour conditions is expected to aggravate social gaps in employment opportunities, in particular for women, who are more often involved in temporary employment and jobs in export-oriented manufacturing industries in developing countries. Worldwide, unemployment among youth (those 16-24 years of age) is expected to increase from a rate of 12.2 per cent in 2008 to about 14 per cent in 2009 on average. The rate of youth unemployment in the European Union (EU) increased by 4 percentage points in the past year, reaching 19.7 per cent, and in the United States it went up by 5 percentage points, reaching 18 per cent in 2009. In developed and developing countries alike, an increasing number of new college graduates continue to face enormous difficulties in finding employment.

### *Labour markets will remain weak in 2010*

Labour markets will remain weak in the outlook. The experience of previous recessions shows that employment recovery typically lags output growth by a significant margin, and this margin has been growing over time. The recovery from the present crisis has only just begun and large output gaps remain characteristic of the situation in most major economies. This will slow new hiring until output growth has become more robust.

The employment situation in developing countries is also expected to remain difficult in the outlook. In particular, jobs that were shed in export-oriented manufacturing sectors are expected to come back only very slowly. Workers who have shifted to informal sector jobs during the crisis in developing countries are expected to remain there for quite a long time. On top of vulnerable employment, social protection coverage is relatively limited in most developing countries, and working poverty levels will therefore increase. This will be difficult to reverse, as observed in previous crises.

### *The adverse impacts on poverty and human development could be long-lasting*

Between 47 and 84 million more people are estimated to remain poor or to have fallen into extreme poverty in developing countries than would have been the case had the crisis not occurred. Major setbacks in the progress towards the achievement of the other Millennium Development Goals (MDGs) are also to be expected, especially for the vulnerable populations in low-income countries. Despite the signs of economic recovery, many people are still facing declines in household incomes, rising unemployment and pressure on social services because of dwindling Government revenue. Where these adverse impacts cannot be countered because of weak social safety nets and lack of fiscal space to protect social spending and promote job creation, there are high risks of long-lasting setbacks in human development.

### *Inflationary pressures are expected to remain low*

The majority of countries have experienced significantly lower inflation rates (disinflation) in 2009, while a growing number of economies, mainly developed countries and a few emerging economies in Asia, actually experienced deflation as general price indices fell. The continued increase in unemployment rates and large output gaps suggest inflation is likely to remain low in the outlook despite continued expansionary monetary policies, as aggregate demand should be expected to fall short of output capacity for some time to come. With only a moderate recovery in global demand, further increases in the prices of primary commodities are expected to be limited, while high unemployment rates and continued efforts by the business sector to curb costs will keep wage pressures down. Inflationary pressures as a consequence of the ballooning government deficits and the ample liquidity injected during the crisis, if they emerge, will be more of an issue in the medium run, after the recovery has become more solid, and should not be of immediate concern.

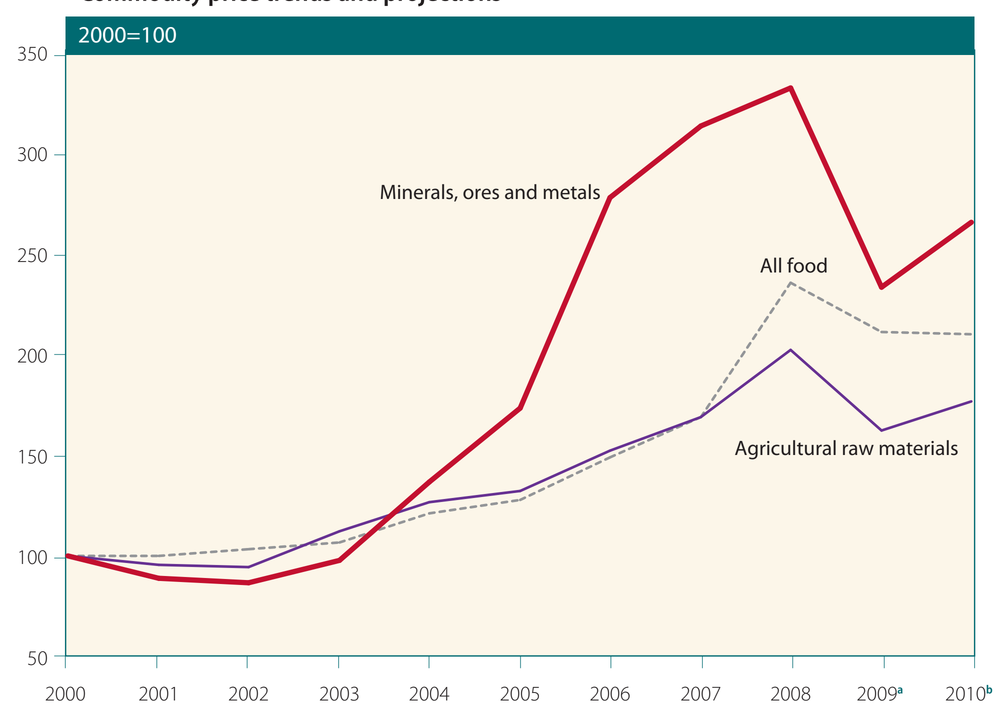
## Trade and financing conditions of developing countries

### *Trade volumes have rebounded after a free fall in early 2009*

The financial crisis caused a free fall in world trade volumes from the end of 2008 up to the second quarter of 2009, triggered especially by collapsing import demand in developed countries. Trade flows fell at annualized rates of between 30 and 50 per cent during that period, with Asian exporters being hit hardest. World trade rebounded somewhat thereafter, but for the year 2009 volume fell by almost 13 per cent. The severe decline in global aggregate demand was compounded by a considerable strain in global financial markets, resulting primarily in increased borrowing costs and a shortage of trade credits. Trade in services exhibited the same pattern as merchandise trade, with maritime transport and tourism being particularly hard hit.

A mild growth of 5 per cent in world trade volume is forecast for 2010 given the moderate recovery of global output.

**Commodity price trends and projections**




**Source**: UN/DESA, based on UNCTAD Commodity Price Statistics database.

a Partly estimated.

b United Nations projections.

### *Prices of commodities continue to be extremely volatile*

The financial crisis also caused a collapse in the prices of oil and non-oil primary commodities. By early 2009, oil prices plummeted by as much as 70 per cent from their peak levels of mid-2008 before rebounding to about $80 per barrel in November 2009 (which is still about 45 per cent below the high). During the same period, prices of metals declined even more sharply, to about one third of their peak levels. Prices of agricultural products, including basic grains, also declined significantly. The downward trend came to a halt in the first quarter of 2009 and rebounded thereafter. By mid-2009, real agricultural commodity prices were still high compared with the low levels sustained during much of the 1980s and 1990s. World food prices equally declined, then rebounded along with other primary commodities. With the measurable rebound in the prices of most primary commodities since March 2009, the room for further increase is limited in the outlook for 2010. The slack in supply of these commodities is not expected to close in the foreseeable future, and only a mild recovery in demand is likely. However, the close linkage between the prices of primary commodities and the financial markets, including the exchange rates of the United States dollar, will likely make these prices highly volatile.

### *Many developing countries experienced large swings in their terms of trade*

Many developing countries have suffered strong swings in their terms of trade. Net exporters of oil and minerals, in particular, felt very strong adverse export price shocks on top of the falloff in global demand as part of the recession, but some ground has been regained recently. Net importers of food and energy saw their import bills fall during the crisis, but, in general, the related terms-of-trade gain was more than offset by the steep drop in the demand for their exports at the height of the global recession. The more recent reversal in their terms of trade will slow their recovery. More generally, however, high terms-of-trade volatility makes macroeconomic management more challenging and enhances economic insecurity, all of which tends to be detrimental for long-term growth prospects.

### *Trade protectionism increased during the crisis*

In response to the current global crisis, many Governments have been tempted by sentiments of protectionism. Many fiscal and financial packages contain elements—such as direct State support to industries, bailouts, other subsidies and "buy/lend/invest/hire local" conditions—that favour spending on domestic goods and services. Several of these support measures may infringe upon fair trade practices, distort competitive conditions and influence decisions on the location of investment and production with implications for many years to come. Many developing countries that lack the capacity to engage such support measures may suffer undue losses in competitiveness as a consequence.

These protectionist measures were taken despite pledges, especially by the Governments of the Group of Twenty (G20) nations, to resist them. Thus far, however, these measures may be characterized as forms of "low-intensity" protectionism and remain far from the beggar-thy-neighbour responses that partly led to the Great Depression of the 1930s. In general, Governments have avoided resorting to widespread trade restrictions in their anti-crisis strategies.

### *New attempts are being made to revitalize the Doha Round*

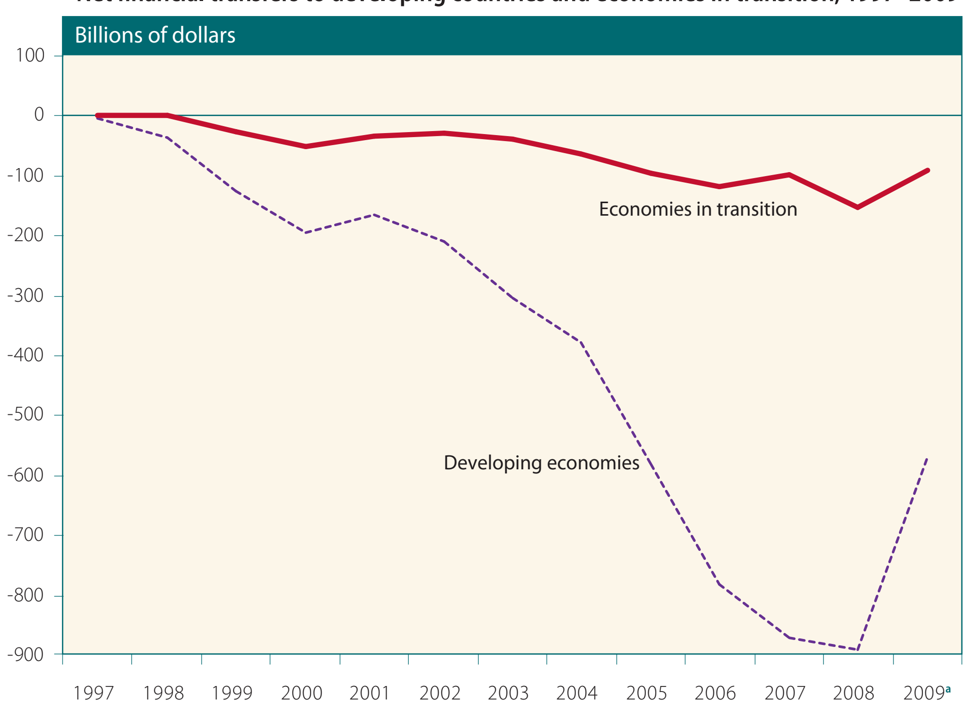
The attempts to re-energize the Doha Round of multilateral trade negotiations in mid-2008 failed over disagreements on various issues, especially on the special safeguard mechanism (SSM) for agriculture in developing countries. This preceded the financial crisis which sent global trade into a deep decline. In response to the crisis, countries have relied much more on safeguard mechanisms. Development-related deliverables that were originally expected of the Round (such as the SSM which aims to preserve the necessary policy space against adverse external shocks) should logically be accorded more focus in future negotiations.

G20 leaders at the Pittsburgh summit have promised they would pursue completion of the Doha Round in 2010 as part of their intent to strengthen concerted efforts towards a rebalancing of the global economy. But good intentions may not be enough. As the global economy starts to recover and the risks of proliferation of bilateral agreements re-emerge, trade negotiations in the context of the Doha Round should press ahead. However, a sustainable rebalancing of the global economy would require, inter alia, assurances that the outcomes of the new multilateral trading regime actually will be conducive to meeting the development objectives central to the conception of the Round. Furthermore, a shift to place greater focus on implementation, policy review and the enhancement of trade-related capacities would perhaps be necessary to avoid the risk of non-implementation and disputes.

### *Net financial resources continue to flow from poor to rich countries*

Developing countries as a group are expected to have continued to provide net financial transfers to developed countries in 2009 at a level of $568 billion. While still substantial,

**Net financial transfers to developing countries and economies in transition, 1997–2009**




**Sources**: UN/DESA, based on IMF, World Economic Outlook Database, October 2009; and IMF, Balance of Payments Statistics.

**Note:** Net financial transfers are defined as net capital inflows less net interest and other investment income payments abroad.

a Partly estimated.

this amount is notably lower than the all-time high of $891 billion reached in 2008. The estimated reduction in net transfers (defined as net capital flows less investment income payments) reflects the tentative narrowing of the global imbalances as a consequence of the ongoing global financial and economic crisis.

### *Private capital flows have declined sharply*

Private capital flows to developing countries declined sharply from the second half of 2008. The sharpest drop was in international bank lending, with a substantial net inflow to emerging and developing economies turning into a net outflow in 2009. The economies in transition experienced the most dramatic reversal, having been heavily dependent on bank financing and feeling the consequences of worldwide deleveraging as a consequence of the financial crisis. All other forms of private capital flows also declined, including foreign direct investment (FDI), which fell by 30 per cent in 2009. Countries with large current-account deficits, and therefore the most dependent on foreign capital, were hardest hit by the substantial tightening of credit conditions in international markets. But even middle-income countries with current-account surplus positions were substantially affected by the global financial crisis, since a sell-off in assets triggered a marked depreciation of exchange rates in a large number of economies.

These flows have recuperated markedly since March 2009, however, along with the rebound in stock markets in both developed and most emerging economies. In the outlook for 2010, FDI flows are expected to grow by about 20 per cent. Access to bank lending, however, is expected to remain limited for most developing countries and economies in transition in 2010 as global credit supply conditions are expected to remain tight. Given the sluggishness in the recovery of global output, there is also a fear that returning portfolio flows could reflect a renewed appetite for riskier assets. The speculative motives associated with this could become a source of increased volatility in exchange rates and assets prices and, hence, of renewed macroeconomic instability.

### *Delivery on development aid commitments continues to fall short*

Net official flows to a number of emerging and other developing countries have increased in 2009, especially after the International Monetary Fund (IMF) and other multilateral financial institutions significantly expanded their lending capacity and started to disburse lending. Emerging Europe received the lion's share of these additional resources in the form of emergency financing. Meanwhile, bilateral official, non-concessional flows also increased as central banks arranged foreign-exchange swaps to deal with the lack of international liquidity. Yet, in the aggregate, net official flows to developing countries are expected to remain negative in 2009 and 2010, continuing the trend of the past decade. Much of the outflow comes from developing Asia, while Africa and Latin America and the Caribbean are expected to be net recipients with positive inflows of about $14 billion and $27 billion, respectively, in 2009; in both cases substantial increases from 2008 levels.

Net official development assistance (ODA) to developing countries increased in 2008, but aid delivery still fell well short of international commitments. Net aid flows are expected to fall in absolute terms in 2009-2010 as the global crisis has put pressure on the aid budgets of major donors, several of which target ODA as a percentage of their gross national income (GNI). For low-income countries with weak fiscal space, in particular, more limited access to aid would not only make it more difficult for them to meet the MDGs, it could also leave them with insufficient resources to address the crisis with counter-cyclical policies. This is recognized by the international donor community, which has pledged at various platforms during 2009 to honour existing commitments to substantially increase development assistance.

### *New challenges have presented themselves after notable progress on debt relief*

Since the adoption of the Monterrey Consensus in 2002, the international community has made notable progress in reducing the external debt burden of developing countries. The ratio of debt-service payments of the 35 post-decision-point heavily indebted poor countries (HIPCs)—those qualified for debt relief—declined from 3.2 per cent of GDP in 2001 to 1.1 per cent of GDP in 2008. Nevertheless, owing to the global financial crisis, a large number of developing countries are facing renewed fiscal stress and challenges: external financing conditions from public and private sectors tightened, revenues declined and currencies depreciated. All these factors pose serious risks to the debt sustainability of developing countries and their capacity to service or roll over external debt.

## Uncertainties and risks

Even the mild recovery, as projected in the baseline outlook, is subject to high risks and uncertainties, mainly on the downside.

### *A premature exit from the stimulus measures could cause a double-dip recession*

The first risk is associated with a premature exit from the strong stimulus measures that helped halt the free fall of the global economy and that are supporting the incipient rebound. A premature withdrawal of the stimulus and financial sector support measures could cut short the still feeble recovery. The stronger-than-expected rebound in equity prices worldwide may belie the fact that there are still problems remaining in financial sectors in major economies which continue to constrain credit availability and could lead to more failures of financial institutions in the near future. Furthermore, policymakers should be cautious in supposing that the recent rebound in trade and industry is sufficient evidence that strong recovery is on its way. In fact, levels of trade flows and industrial production are still well below the pre-crisis peaks and, as analysed in the present report, the rebound is related more to a turnaround in the global inventory cycle than to a recovery of private consumption and investment.

Understandably, there is increasing concern that the substantial widening of fiscal deficits and mounting public debt could become a drag on future growth, and fiscal consolidation may therefore be needed sooner rather than later. Such concerns are present particularly in developed countries, where the average public debt-to-GDP ratio is expected to exceed 100 per cent in 2010 and to move even higher thereafter.

While such concerns are justified, a premature withdrawal of the stimulus could prove to be counterproductive. The immediate concerns of policymakers should be focused on addressing the continued weakness in financial sectors, stimulating demand in order to reduce the persistent large output gaps and reversing the upward trend in unemployment rates. If, instead, there were an early phasing out of stimulus measures during 2010, these weaknesses in the global economy could be exacerbated and a double-dip recession could emerge, leading equally to a rise in public debt ratios and further declines in GDP and tax revenue.

### *Renewed widening of the global imbalances could cause a hard landing of the dollar*

There is also a risk of a return to widening global imbalances. The global financial crisis and the worldwide recession have led to a recessionary adjustment of imbalances in current accounts across countries, with imports falling steeply in deficit countries (led by the United States) and export earnings collapsing in most surplus countries. However, as the financial crisis is abating and global growth tentatively recovers, the imbalances could widen again substantially. In most surplus countries, especially in developing Asia, growth continues to rely heavily on exports and high savings rates, leading to relatively weak domestic demand and high reserve accumulation. In the major deficit countries, particularly the United States, private savings have increased as consumers have become more cautious, but not by a sufficient margin to cover widening fiscal deficits and prevent mounting public indebtedness. The external deficit is therefore expected to widen again.

The level of external indebtedness of the United States has increased substantially, reaching $3.8 trillion in 2009, and is expected to increase further in 2010. Strong downward pressure on the dollar is thus anticipated to continue in the outlook. The value of the dollar had been on a downward trend since 2002, but it rebounded in the second half of 2008 through the end of the first quarter of 2009. This sharp appreciation of the dollar was mainly driven by flight to safety effects as the global financial crisis heightened risk aversion and caused a massive move of financial assets worldwide into United States Treasury bills. Since March 2009, however, the dollar has resumed its downturn as a result of the stabilizing conditions in global financial markets. This moderated the deleveraging process of major financial institutions as well as the flight to safety effects. At the same time, investors started to become increasingly concerned about the rise in the budget deficit and the worsening of the net foreign investment position of the United States. If this were to cause a gradual depreciation of the dollar, it could form part of an orderly rebalancing of the global economy. In all probability, however, such an adjustment would not be gradual and eroding confidence in the world's major reserve currency would first lead to substantial exchange-rate volatility which could subsequently escalate into more abrupt declines and a hard landing of the dollar.

## Policy responses and challenges

### *The response to the crisis has been bold and unprecedented, but may not have been enough*

Since the intensification of the financial crisis, Governments worldwide have taken bold actions. Massive public funding has been made available to recapitalize banks, taking partial or full Government ownership of ailing financial institutions and providing ample guarantees on bank deposits and other financial assets. Worldwide, publicly guaranteed funding for financial sector rescue operations is estimated to amount to about $20 trillion, or some 30 per cent of WGP. Furthermore, monetary and fiscal policy stances have been strongly counter-cyclical in most major economies, as has been reflected in the drastic cuts in policy interest rates and massive liquidity injections and fiscal stimulus packages totalling about $2.6 trillion (or 4.3 per cent of WGP) to be distributed during 2008-2010.

These policies have been effective to the extent that they have helped to stabilize global financial markets, support global effective demand and alleviate the economic and social impact of the crisis. Yet, these unprecedented responses have not been sufficient to induce a self-sustained process of recovery. As indicated, global demand recovery is expected to remain weak in the outlook even if the present stimulus measures are kept in place. Important financial fragilities still need to be addressed and many developing countries have not been able to implement significant counter-cyclical policies on their own.

### *The policy responses have been concerted to some extent*

The policy responses have been concerted to some extent among major economies, in particular at the level of the G20. At their London and Pittsburgh summits in April and September 2009, respectively, the leaders promised to continue the stimulus and other extraordinary measures as long as necessary. They further pledged to deliver on all aid and other international development commitments and fight off protectionist tendencies. World leaders have also facilitated a significant increase in resources for countries with external financing problems. The G20 by and large lived up to its promise to provide $1.1 trillion for this purpose, including through tripling the resources available to the IMF, facilitating additional lending by multilateral development banks and supporting trade finance. The IMF and the World Bank have in effect significantly stepped up lending operations.

At the Pittsburgh Summit, leaders also agreed to establish a policy coordination framework for "strong, sustainable and balanced growth" of the world economy. As part of this framework, G20 members with significant external deficits, mainly the United States, pledged to pursue policies to support private savings and to undertake fiscal consolidation. Surplus countries, including China, Germany and Japan, agreed to strengthen domestic sources of growth. These could constitute important steps towards effective policy coordination and a more balanced recovery of the global economy. However, more concrete details with clear policy targets and time horizons have yet to be worked out and the policy actions that have been undertaken thus far have by no means been fully concerted.

### *Continued fiscal stimulus is needed in the short run*

The immediate challenge for policymakers will be to determine how much longer the fiscal stimulus should continue. Given the risk of a double-dip recession resulting from a premature withdrawal, the stimulus should continue at least until there are clearer signals of a more robust recovery. It may be difficult, however, to determine when and whether the recovery has become robust. Substantial improvements in employment conditions and a reduction of output gaps will likely be meaningful indicators for establishing the turning point. Moreover, the framework for policy coordination should ensure that the timing for sustaining or unwinding counter-cyclical policy stances is determined not merely as a function of country-specific conditions but also in the context of containing international spillover effects and promoting sustainable global growth.

### *Sustainable global rebalancing needs to take place*

To avoid a return to the unsustainable pattern of growth that led to the global crisis and to sidestep the risks of a double-dip recession and a hard landing of the dollar, three forms of rebalancing of the global economy would need to take place over time. First, the pressure on Governments to hold up global demand would need to diminish over time through renewed impulses from private demand. Second, the composition of aggregate demand would need to rebalance to shift greater weight to investment in support of future productivity growth and the transformation of energy sectors and infrastructure required to meet the challenge of climate change. Third, demand across countries will need to be rebalanced. These three rebalancing acts will require close policy coordination as they are strongly interdependent.

Rebalancing across countries is needed because one of the key drivers of pre-crisis growth, consumer demand in the United States, is expected to remain sluggish in the outlook. Moreover, from the perspective of the problem of global imbalances, it would be undesirable to have to rely on this source of growth again for the recovery. Private investments are also expected to remain sluggish in the near future in the United States (as well as in other major developed economies) as rates of capacity utilization are at historic lows. If fiscal stimulus is to be phased out, net exports of the major deficit countries would need to increase. Rising exports by these countries would need to be absorbed by major surplus countries, starting with China and other parts of developing Asia. This could be achieved in part through a further strengthening of domestic demand by way of fiscal stimulus, which, along with a weaker United States dollar, would push up import demand in that part of the world. Since not all Asian trade is with the United States, other countries would also need to contribute to the rebalancing. Germany and Japan, other major surplus economies, could seek to strengthen investment and productivity growth in domestic production sectors, while major oil exporters could further step up domestic investment plans to diversify their economies. Additional financial transfers to developing countries with weak fiscal capacity would be needed to complete the rebalancing process and would enable these countries to increase domestic investment in infrastructure, food production and human development so as to support growth, poverty reduction and sustainable development. They would also encourage global import demand.

Stepping up public and private investment to address climate change could well be an integral part of the process. Large-scale investments in energy efficiency and renewable energy generation will need to be made now in order to achieve the scale effects needed to lower the cost of green technologies and effectively achieve low-emission growth paths. Such investments will also be needed in developing countries, where energy demand should be expected to increase starkly along with their efforts to reach higher levels of development. By leapfrogging to green technologies, they could contribute to emission reductions while sustaining high-growth development trajectories. Substantial investments will need to be made for climate change adaptation, especially in developing countries which are already being affected by adverse effects of global warming. As developed countries currently possess a comparative advantage in the development of green technologies and related capital goods, the increase in world demand for these goods should thus contribute to reducing the aggregate external deficit of these economies.

### *Strengthened policy coordination is needed*

Such a sustainable rebalancing of the world economy will by no means be easy to achieve and will require enhanced international cooperation. In particular, the need for effective international policy coordination to manage risks of global economic instability and to promote development has been reiterated in previous issues of the *World Economic Situation and Prospects*. It was also emphasized in the outcome document of the Conference on the World Financial and Economic Crisis and its Impact on Development, held at United Nations Headquarters in New York in June 2009.

A successful framework for international macroeconomic policy coordination should consist of at least four components: developing a consensus on common goals through international consultations with outside mediation; addressing commitment problems by issuing multi-year schedules for policy adjustments; enhancing the context for mediation and the perceived legitimacy of the mediator; and initiating systemic reforms in the field of international monetary and financial affairs.

In this context, the framework proposed by the G20 is a first step towards international policy coordination—at least among the major developed and emerging economies—to prevent a recurrence of the large global imbalances. The success of this framework, however, will depend not only on how to institutionalize the mechanism delineated above (which so far is still carried out on an ad hoc basis), but also on progress in the broad reforms of the international financial architecture and global economic governance.

### *Global governance should be strengthened on four fronts*

To support the enhanced framework for policy coordination, further progress on global economic governance reforms will need to be made on four related fronts. First, multilateral surveillance by the IMF will need to be extended well beyond the traditional emphasis on exchange rates, to address broader macrofinancial surveillance and also to monitor the "sustainable rebalancing" process of the global economy as outlined. Second, more pervasive progress on governance reform of the IMF will be needed to add legitimacy to the institution's enhanced role in this respect and also for mediating multi-annual agreements. Mediation to achieve consensus on the main targets for policy coordination is unlikely to be successful where doubts exist about the impartiality of the mediator. In this context, the reform of the governance of and representation in the IMF has become all the more urgent and important so that seats in the Executive Board and votes in the Fund better represent developing country interests in the decision-making process that is under way. Third, while the ongoing crisis has given strong impetus to macroeconomic policy coordination, there is no guarantee that all parties will remain committed to agreed joint responses. Having clear and verifiable targets for desired policy outcomes will help make parties accountable, and the possible loss of reputation through non-compliance should be an incentive to live up to policy agreements. Fourth, sustainable rebalancing of the global economy will require close coordination with other areas of global governance, including those related to development financing and the multilateral trading system, as well as with the United Nations Framework Convention on Climate Change. No specific mechanism for such coordination exists at present, and the creation of such a mechanism would need to be considered.

### *Urgent progress is also needed in reforming the global financial system*

The global financial crisis has further exposed major deficiencies in the international financial architecture, as well as failures of regulation and supervision at national levels. As the global economy recovers, more, rather than less, urgent efforts will be needed to spearhead reforms of international and national financial systems so as to prevent a similar crisis from recurring. The effectiveness of any international policy coordination mechanism would greatly benefit from overcoming these deficiencies, as tendencies towards excess risk-taking in financial markets would be reined in and the inherent tendency of the current system towards global imbalances and an unstable value of the major reserve currency would be addressed.

The risk of exchange-rate instability and a hard landing of the dollar could be reduced by having a global payments and reserve system which is less dependent on one single national currency. One way in which the system could naturally evolve would be by becoming a fully multi-currency reserve system. The present system has already more than one reserve currency, but the other currencies remain a secondary feature in a system where most reserve assets by far are held in dollars and where most of the world's trade and financial transactions are affected in the major reserve currency. The advantage of a multi-reserve currency arrangement is that it would provide countries with the benefit of diversifying their foreign-exchange reserve assets. However, it would not solve the problems of the tendency towards the emergence of important global imbalances and the related deflationary bias in the macroeconomic adjustment between deficit and surplus countries.

Such deficiencies could be more readily overcome by pursuing the transition to a reserve system based on a true form of international liquidity, such as by expanding the role of special drawing rights (SDRs). Doing so would, in fact, fulfil the objective included in the IMF Articles of Agreement of "making the special drawing right the principal reserve asset in the international monetary system" (Article VIII, Section 7, and Article XXII). The G20 decided, in April 2009, on a general SDR allocation equivalent to $250 billion in recognition of the need to boost international liquidity using an international reserve unit. Further advances could result from making SDR issuance automatic and regular, and linked to the demand for foreign-exchange reserves and the growth of the world economy. A key criterion for SDR issuance, withdrawal and allocation would be the provision of counter-cyclical finance. Thus, both key deficiencies of the present system—its deflationary bias and the inherent instability of the value of the reserve currency—could be overcome. An SDR-based reserve system would also provide a basis for a better pooling of international reserves, as international liquidity would be made available on a counter-cyclical basis, reducing the need for individual countries to hold costly amounts of reserves on their own.

There will be important practical hurdles to be overcome en route to such a system, and they will need to be discussed and addressed in conjunction with other reforms. A sustainable rebalancing of the world economy will not be possible without addressing the systemic flaws in the international financial architecture.