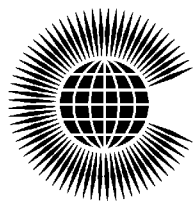


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CURRENT WORLD ECONOMIC SITUATION AND PROSPECTS

Paper by the Commonwealth Secretariat

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CURRENT WORLD ECONOMIC SITUATION AND PROSPECTS

EXECUTIVE SUMMARY AND ISSUES FOR CONSIDERATION

Executive Summary

Economic growth performance: The global economy recorded robust growth of 5 per cent in 2007, roughly similar to 2006 and above the long run average. Developing economies – driven by China and India - grew much faster (8 per cent) than advanced economies (2.7 per cent). Developing country growth was broadly based, with no major group (except small states) recording less than 5 per cent. Developed country growth is projected to decelerate to 1.7 per cent in 2008 as the effects of the financial sector crisis are fully felt. Growth of developing economies is projected to decelerate in 2008 to 6.9 per cent in response to the spreading of the financial sector crisis and the anti inflationary policy response to higher energy and food prices. Small states growth does not match that of other developing economies.

2. **External financial flows to developing countries:** Net private flows (private debt and equity) to developing countries in 2007 increased by 35 per cent to US\$1,029 billion. Net non-concessional official flows continued being negative in 2007, mainly on account of pre-payments to the IMF and the Paris Club. Official Development Assistance (ODA) levels at 0.25 per cent; ODA in relation to GNI are not consistent with meeting ODA targets in 2010. The target ODA volume of US\$50 billion to Sub-Saharan Africa by 2010 is also at severe risk of being missed.

3. **Effects of financial sector crises in developed countries:** After initial resilience, developing economies have started to feel the effects of the financial crisis as the cost of credit is rising and volumes available falling.

4. **Rising energy prices:** High energy prices look set to continue into the medium-term. Managing these higher prices globally will require promotion of energy-saving measures; hedging by oil importing countries against future price increases; adoption by oil exporting countries of prudence in managing oil windfalls and the attendant macroeconomic challenges; and allowing the transmission of world energy prices to consumers. The international community too should provide technical assistance to developing countries in policy design and should also increase concessional resource transfers – from the developed world and oil producers - to oil importers. The role of financial market movements in higher prices also needs examination.

5. **Rising food prices:** A mix of domestic and international response to raise food production to deal with high food prices. Internationally, developed world biofuel policy and trade policy need reconsideration. Food exporting and importing countries should refrain from export and import quotas, tariffs and subsidies. Domestically, developing countries should adopt anti-inflation measures that need not reduce growth; and adopt targeted measures to protect the poor. The international community can provide support in policy formulation, technical assistance and financial assistance (preferably, in the form of budgetary support) as well as by augmenting contribution to the World Food Programme to facilitate emergency assistance to countries in need of food.

6. ***Global inflation, global macroeconomic imbalances, and multilateral trade negotiations:*** Firstly, there is global inflation pressure, particularly in developing countries, due to rising domestic demand pressures and rising costs of food and energy. Secondly, global macroeconomic imbalances remain despite a depreciating US dollar and slower US growth. Thirdly, the Doha Round of talks have finally collapsed raising concerns about bilateral and regional trade agreements as well as protectionist measures intensifying, to the disadvantage of poorer developing countries, including small states.

7. ***Risks to the global economy:*** Notable among downside risks to good performance of the global economy are:

- The possible disorderly unwinding of the global macroeconomic imbalances.
- The extension of financial turmoil in developed countries beyond the period anticipated.
- Inflationary pressures, particularly in developing countries, which may reduce the freedom to manoeuvre in response to slowing output.
- The rising food and energy prices which could threaten the loss of gains in macroeconomic stability achieved in recent years in developing economies.

Issues for Consideration

8. In light of the above developments, Ministers may wish to consider the following issues:

- The need for developing countries to address the challenges of financial crises in advanced countries.
- The feasibility/modality of guarding against the risks of surging inflation pressures in developing countries without compromising economic growth.
- The need for collective policy actions in advanced countries to address the financial crises.
- The desirability of collective actions by global economy major players in the provision of coordinated fiscal stimulus in their respective countries to stem global economic downturn, should the financial crises in advanced countries get worse.
- The need for China, and some other emerging economies with substantial current account surpluses, to permit real appreciation of their exchange rates to assist in bringing about an orderly unwinding of the global macroeconomic imbalances.
- The need for donor countries to scale up international development assistance in line with pledges they have committed to, including to Sub-Saharan Africa.
- The need for host developing countries of international banks to be vigilant through vetting the soundness of international banks being licensed to operate,

including soliciting of requisite information from the banks' home countries.

- The need for key stakeholders in the Doha Round trade negotiations to muster necessary political will to achieve an early conclusion of the negotiations and for cessation of the emerging tendency to resort to trade protectionism.
- Desirability of a concerted international effort aimed at identifying and remedying the causes of the relatively poor growth performance of small states, in view of the fact that growth rates of **Commonwealth** small states fall short of the growth of other groups of developing countries.

I. OVERVIEW OF GLOBAL ECONOMIC PROSPECTS AND CHALLENGES

Global Growth Performance

Global economic growth was robust in 2007 despite the rise in commodity prices. As indicated in **Appendix Table 1**, the world economy grew at 5 per cent, just below the level of the previous year. Growth was broadly based among different regional groups of the developing countries, with no group (except small states) recording less than 5 per cent growth. The advanced economies, as a group, recorded 2.7 per cent growth. In the US, the slowing was the result of the sharp downturn in the housing market and consequent financial turmoil. Growth also lost some momentum in both Japan and the Euro area. Developing countries recorded 8 per cent, partly driven by the continuing high growth of China (11.9 per cent) and India (9.3 per cent). Developing country growth has been supported by higher commodity prices and exports, strong momentum from the productivity gains from the continuing integration into the global economy and stabilisation gains from improved macroeconomic frameworks.

2. The IMF projects lower global growth in 2008 and 2009 of 4.1 and 3.9 per cent. This reflects slower than anticipated growth of 1.7 per cent and 1.4 per cent in the developed world in those two years. The continuing turmoil in the financial sector is anticipated to lead to a further deceleration of growth in the US to 1.3 per cent in 2008 and 0.8 per cent in 2009. A similar loss of momentum is expected in the Euro Area and Japan. Slowing in developing economies reflects the spreading impact of the financial crisis in the developed countries on financial and trade flows and stronger anti-inflationary policy. As a result, their collective growth is projected to decline to 6.9 and 6.7 per cent in the next two years.

Growth Performance of Commonwealth Economies

3. The **Commonwealth Developed (OECD) countries** (made up of Australia, Canada, New Zealand and United Kingdom) collectively recorded in 2007 a growth rate of 3.1 per cent and are projected to record lower growth of 1.8 and 2.0 per cent in 2008 and 2009 respectively. Growth for the remaining Commonwealth countries is mainly driven by Indian growth which ran at 7.8 per cent in 2007 and is projected to remain fairly robust at 6.8 per cent in 2008 and 7 per cent in 2009. For the Commonwealth Small States group, a less robust growth of 4.1 per cent was recorded in 2007 and 4.3 and 4.1 per cent growth rates are projected for 2008 and 2009 respectively. Overall, the Commonwealth grew at 5.7 per cent for 2007 and 4.6 and 4.9 per cent for 2008 and 2009 respectively.

Growth Performance in Developing Economies of Asia and the Pacific

4. **Appendix Table 2** shows growth for developing Asian and Pacific economies. These economies recorded a robust collective growth of 9.9 and 10 per cent in 2006 and 2007 respectively and they are projected to grow at a slightly less robust rate of 8.4 per cent in each of 2008 and 2009, reflecting growth in China and India. The Commonwealth countries in the ASEAN 5, Malaysia and Singapore, have both continued to grow rapidly in the last two years although both are projected to slow to still relatively high growth levels in 2008 and 2009.

5. The economies of **Commonwealth South Asian** countries (comprising Bangladesh, India, Maldives, Pakistan and Sri Lanka) recorded growth rates of 9.2 and 8.6 per cent in 2006 and 2007 respectively while they are projected to grow by 7.5 per cent in 2008 and 7.7 per cent in 2009. On the whole, this group has the most impressive growth rates of all regional groups of Commonwealth countries.

6. The growth performance of the **Commonwealth Pacific countries** (comprising Fiji, Kiribati, Papua New Guinea, Samoa, Solomon Islands, Tonga, and Vanuatu) is less robust at 2.2 and 4.4 per cent in 2006 and 2007 respectively while the projected growth of 4.2 per cent for 2008 is even anticipated to fall to 3.4 per cent in 2009. This suggests, like last year, that these Commonwealth countries are facing growth challenges that prevent them from realising fast growth, unlike their Commonwealth South Asian counterparts.

Growth Performance in Sub-Saharan African Economies

7. Sub-Saharan Africa recorded a growth rate of 6.8 per cent in 2007, up from 6.4 per cent in 2006. Broadly the same growth rates of 6.6 and 6.7 per cent are being projected for 2008 and 2009 respectively. Growth in most of these economies is being driven by the rise in oil and non-oil commodity prices in the world market.

8. **Commonwealth Sub-Saharan Africa**, however, recorded slightly lower group growth rates (of 5.9 per cent in both 2006 and 2007) than for the region as a whole and is also projected to grow (5.9 per cent in 2008 and 5.8 per cent in 2009) at a similarly slower pace. This is mainly due to the slower growth rates recorded by the **Commonwealth Eastern and Southern Africa**, as the **Commonwealth West African** countries recorded about the same as the overall growth for the Sub-Saharan Africa as a whole and are even projected to grow faster. While the **Commonwealth Eastern and Southern Africa** grew by 5.8 per cent and **the Commonwealth Indian Ocean** by 4.6 per cent in 2007 (and are respectively projected to grow 4.6 and 6.8 per cent in 2008), **Commonwealth West Africa** grew 6.4 per cent in 2007 and is expected to grow 8.8 per cent in 2008. Growth of **Commonwealth Eastern and Southern Africa** is driven by South African growth just as Nigerian growth drives that of the **Commonwealth West Africa**.

Growth Performance of Latin America and the Caribbean

9. The economy of this region expanded 5.6 per cent in 2007, just above the 5.5 per cent recorded in 2006, while the growth is projected to decelerate to 4.4 per cent in 2008 and further to 3.6 per cent in 2009, mainly on account of its vulnerability to reduced financial and trade flows from the US, its main economic partner.

10. The growth of **Commonwealth Caribbean** economies sharply fell from 6.3 per cent in 2006 to just 3.6 per cent in 2007 and it is projected to be 4.1 and 4.0 per cent in 2008 and 2009 respectively. Although Trinidad and Tobago is a particular exception, overall the growth performance of this group of countries is not robust. This reinforces the conclusion that all **Commonwealth small states** are facing growth challenges that prevent them from realising fast growth rates of the type being experienced by other developing countries in the broader region.

Growth Performance of Emerging Europe, CIS, Middle-East and North Africa

11. For completeness, **Appendix Table 5** shows growth in the rest of the world, the economies of this composite region. They grew by 6.8 and 6.7 per cent in 2006 and 2007 respectively and they are projected to grow 5.9 and 5.7 per cent in 2008 and 2009. For oil producers in particular, it is surprising that growth is not higher.

II. EXTERNAL FINANCIAL FLOWS TO DEVELOPING COUNTRIES

Private Capital Flows

12. **Appendix Table 6** shows global net private capital flows (i.e., private debt and equity) to developing (defined here as non-OECD) countries increased by 35 per cent, breaking the trillion dollar mark, a new record (although depreciation of the US dollar may overstate the impact in destination countries), compared with about 17 per cent growth a year earlier. This is a continuation of the upsurge that started in 2001-02. But, as global liquidity has now tightened, it is projected by the World Bank that private flows would decline modestly in the short term and stabilise at levels above previous peaks (as a share of GDP of the destination countries) over the medium term.

13. Considering the components of this flow, net equity flows increased by about 30 per cent to \$616 billion (with FDI rising by 28 per cent to US\$471 billion and net portfolio equity by 38 per cent to US\$145 billion). Net private debt flows increased by about 43 per cent in 2007 to US\$413 billion. The bank lending component increased by about 25 per cent from US\$172.4 billion in 2006 to US\$214.7 billion in 2007 while the bond issuance component increased by about 213 per cent from a low base of just US\$25.3 billion in 2006 to US\$79.3 billion in 2007. The level and increase of other forms of net debt flows, including flows of short-term debts, were modest.

14. These aggregate figures concealed concentration of private capital flows with Brazil, Russia, India and China receiving 75 per cent of the total. The same is also the true of private debt flows with 20 countries receiving about 90 per cent of the flows, although a few low-income countries including Ghana and Nigeria have recently gained access to private debt markets, including bond markets.

15. The internationalisation of banking that started in recent years has continued to gather momentum, despite the financial turmoil in the developed countries. While this confers some benefits on the host countries, as warned in the World Bank's *GDF (2008)*, international banks can transmit adverse financial shocks to these countries, whose monetary and credit control capacity can also be constrained by the ability of those banks to raise funding from their parent banks abroad. Safeguards should therefore be put in place by both the host and source countries against these risks.

Current Account Balances and Foreign Reserves

16. According to the review in the World Bank's *Global Development Finance*, the external financial position of many developing countries has deteriorated, leaving them more vulnerable to subsequent adverse shocks. The position is worse than that shown in **Appendix**

Table 6, since China accounts for US\$367 billion surplus and five major oil exporters account for US\$280 billion. The remaining developing countries, as a group, recorded a US\$221 billion deficit. According to the GDF (2008), current account balances deteriorated in two-thirds of developing countries. The dramatic increase in energy and food import bills was clearly a major factor for this deteriorating current account balances. Foreign reserves rose by 72 per cent (US\$1,091 billion) in 2007 but only four countries (Brazil, Russia, India and China) account for over two-thirds of this.

17. Optimal management of foreign reserve holdings is a challenge facing a number of developing countries, and in practice led to a flow of capital from developing to developed countries. In this regard, as reported in the GDF (2008), several developing countries have shifted a higher proportion of their foreign currency earnings from official foreign currency reserves to sovereign wealth funds (SWF).¹ While this alternative vehicle for foreign reserve management has its own inherent challenges, some variants of it deserve being considered for adoption by other developing countries that have yet to explore this option: especially those whose export earnings are being boosted by the ongoing boom in global commodity prices.

Official Resource Transfers, Including Official Development Assistance (ODA)

18. Reflecting the ease of global credit markets at the time, pre-payments of debt obligations to the Paris Club creditors and international institutions meant that there was a negative net official lending of US\$4 billion in 2007. Although negative for the fourth year since 2003, the reflow was at a much lower scale than the last two years.

19. Official Development Assistance (ODA) from the 22 DAC donors (including debt relief) totalled US\$103.7 billion in 2007, compared with US\$104.4 billion in 2006 and US\$107.1 billion in 2005. Excluding debt relief, the volume in 2007 was US\$87.4 billion, an increase of 2.4 per cent in real terms (i.e., after adjusting for inflation and exchange rate movements) over US\$85.4 billion recorded in 2006. This equates to 0.25 per cent of donor countries' GNI, the same percentage as in 2006. This is just slightly above 0.23 per cent recorded in 2002 when the Monterrey consensus was agreed, well below the 0.33 per cent attained in early 1990s, and far below the long-standing UN target of 0.7 per cent. To reach the 2010 intermediate targets on aid levels of 0.35 per cent of GNI, ODA levels would have to increase by an annual growth, in real terms, of 14 per cent in each of 2008 to 2010, compared to 4.6 per cent annual growth recorded in the five years since 2002. It seems unlikely that this target will be reached.

20. For Sub-Saharan Africa, while the share of aid (excluding debt relief) to the region increased from 34 per cent of total ODA in 2006 to 37.5 per cent in 2007, the commitment to increase the annual aid volume in real terms to US\$50 billion by 2010 requires an 18 per cent increase in the average annual aid volume to the region in each of 2008 to 2010. This seems unlikely in view of the fact that aid volume has increased by only 9 per cent over the 4-year period, 2002-2006.

¹ See also Information Paper, FMM(08)(INF)1

Financial Market Turmoil: Its Effects on Capital Flows to Developing Countries

21. The genesis of financial market turmoil in many developed countries, starting with the US around August 2007, is now well-known. Forceful policy responses in the developed countries, including injection by their central banks of more liquidity into the financial system, have failed to prevent a credit crunch and an economic down turn in the US and Europe, with some evoking comparisons with the impact of the 1930s depression.

22. The effects of this turmoil were not felt immediately in developing countries, in contrast to previous episodes of global financial crises. This reflected stronger growth fundamentals in developing economies (including productivity gains from their continuing integration into the global economy; rising prices of commodity exports in the global market; and stabilisation gains from improved macroeconomic policy frameworks in many countries).

23. However, this initial resilience of developing countries has eroded, as the effects of the financial crises on the developing countries started to emerge from late 2007, when lending by foreign banks and offshore borrowing by domestic banks in developing countries started to be adversely affected by the tightening liquidity conditions. Costs of debt also went up. In addition, due to reduced economic growth in the developed countries (partly as a result of the financial crisis), adverse impacts on exports of those countries that trade heavily with the US have been reported.

III. RISING COMMODITY PRICES

Factors Driving Oil Prices Higher

24. In addition to the financial crisis and the credit crunch, the key developments in the global economy over the past year have been the rising food and fuel prices which have had widespread macroeconomic, social and political implications. The *Special Theme* agenda item will present an opportunity to discuss these issues in further depth. This section provides just some highlights of the issues.

25. Since May 2008, prices have averaged around US\$130 per barrel, almost double the level a year before. This change reflected a mixture of factors. On the demand side, economic growth in emerging market economies, especially in Asia as well as subsidised prices in some markets, were significant contributory factors. This has coincided with tightening supply conditions, notably a lack of stocks and limited spare OPEC capacity. Finally, financial factors have played a role: the depreciating dollar has pushed up demand for oil as an inflation hedge and with falling US interest rates, commodities have become a more attractive investment.

26. Looking forward, most of these factors would continue to operate in the near term and the prices are, therefore, not expected to fall significantly below the existing high levels and there is even a possibility of an upside.

Factors Driving Agricultural Prices Higher

27. In agricultural markets, the largest price increases were recorded for grains and oilseeds which doubled during the first half of 2008. Substitution effects also led to increases in other agricultural commodities. These higher prices reflected increased demand particularly for biofuels reflecting subsidised production of ethanol from maize in the US and of biodiesel from vegetable oils in Europe. On the supply side, weather related reduction of crops, rising costs of production and historically low stocks contributed to a tighter market. These have been compounded by policy responses in both exporting and importing countries which has maintained demand and restricted global supply. Finally, financial factors have played a role in this area as well.

Policy Actions to Address the Causes and Consequences of Rising Oil Prices

28. Adjusting to higher oil prices requires price signals to produce responses on both the supply and demand side. In this:

- Oil importing developing countries, many of which have been running current account (and budgetary) deficits, should adopt fiscal restraint and introduce incentives to promote energy efficiency. In addition, hedging can be used as a way of managing the volatility of prices. There may be a role for the international community in assisting countries identify opportunities to use these instruments.
- Oil exporting developing countries should adopt prudent measures in managing the boom phase of the commodity cycle. As in the 1970s, there are questions about how to recycle high levels of earnings from buoyant oil prices and whether they can be used to support developing oil importing countries.
- In both oil exporting and importing countries, high energy prices should pass through to consumers to reduce demand, with targeted social measures to cushion the effects on the poor and the vulnerable.
- International development partners, bilateral and multilateral, should assist oil importing countries through concessional resource transfers.
- There is a role for enhancing dialogue between producers and consumers with a view to finding ways to overcome production bottlenecks, especially through promoting the conditions for investment.

Measures to Address the Causes and Consequences of Rising Agricultural Prices

29. To tackle higher food prices, action is required by both individual countries and the international community. At the international level, there are a number of international policy measures which could be taken:

- re-consideration of biofuel policies, especially subsidies, in the US and Europe and the import restrictions placed on Brazilian ethanol;

- seize the opportunity provided by the current high agricultural prices to prevail on the affected countries to reduce agricultural market distortions;
- food exporting countries should avoid policy responses that increase international prices by reducing supply to world markets and importing countries should refrain from import subsidies and tariff reductions; and
- encourage, through both financial and technical support, domestic policy actions and initiatives in developing countries that boost agricultural supply in the medium- to long-term.

30. Changing food prices lead to lower levels of resource transfers across borders than rising fuel prices. But there are greater consequences on consumer price inflation rates as food accounts for a larger share in consumption than energy; the lower a country's income level and, within a country, the lower the income level of an individual. For this same reason, food price spikes may impact more on low-income countries and, within a country, on the poor or more vulnerable segment of the (mainly, urban) population than a similar spike in energy prices.

31. In the long term, developing countries, in particular, should adopt policies suitable to each country's circumstances, for boosting agricultural output in the medium to long-term. In this context, some measures that can be considered are:

- A macroeconomic framework should be adopted that would strike an appropriate balance between the objectives of inflation reduction and promotion of economic growth.
- Measures should be adopted to protect the poor and vulnerable (particularly in the urban areas) against the rising food prices – if feasible, targeted income transfers or similar social safety net devices should be considered, instead of generalised price subsidies.
- At the same time, pass through of high prices to farmers (mostly, poor peasants in many developing countries) should not be hindered to allow an effective supply response. The goal of reducing urban poverty by cushioning urban poor against the rising prices should not be achieved by correspondingly impoverishing peasant farmers in the rural areas. For farmers, to some extent current prices are, arguably, a market correction of the deteriorating agricultural terms of trade they have been experiencing since the 1970s and early 1980s.
- Refraining from export quotas and tariff introduction on the part of exporting countries and from import subsidies and tariff reductions on the part of importing countries. This would permit suitable responses to world market prices and assist in redressing urban-rural income inequality.
- International development partners should provide assistance through suitable financial instruments to enable low-income countries protect their vulnerable

groups against the adverse effects of high food prices and also provide technical assistance in formulating the suitable policies identified above.

IV. INFLATION, GLOBAL IMBALANCES, AND THE DOHA ROUND TALKS

Global Inflation, Particularly in Developing Countries

32. Despite the slowdown in the growth of the global economy, high inflation rates prevail, particularly in developing countries. According to the IMF's World Economic Outlook (WEO, July 2008 update), in advanced economies, headline inflation rose to 3.5 per cent in May 2008 while core inflation remained at 1.8 per cent. On the other hand, the headline and core inflation rates in developing economies have risen to 8.6 and 4.2 per cent, respectively. These are the highest rates since the beginning of the current decade. Inflation is higher in developing than in developed economies since energy and food – where prices have been rising – account for more of household expenditure than in developed countries. Also, developing economies are witnessing a greater increase in domestic expenditure coupled with accommodative macroeconomic policies. Looking forward, the WEO (2008 update) projects that inflation pressures in developed economies are likely to be reversed in 2009, but in developing economies inflation is expected to be 9.1 per cent in 2008, and is expected to decelerate to 7.4 per cent in 2009.

Global Macroeconomic Imbalances

33. While the slowdown in the US domestic demand and depreciation of the US dollar in real terms has narrowed the country's current account deficit (from 6.2 per cent of GDP to 4.9 per cent in the last quarter of 2007), the problem of imbalances still remains. The Multilateral Consultation on Global Imbalances organised by the IMF in 2007, involving China and Saudi Arabia, in addition to the major advanced economies, set out policy measures for making progress in reducing imbalances. But the fundamental inconsistency at the heart of the International Monetary System is hampering the implementation of these policy actions. Currently, the burden of exchange rate adjustment needed to correct the imbalances is placed largely on the currencies of those major players with flexible exchange rate regimes while exchange rates of countries like China and the major oil exporters, because they are either fixed or heavily managed, have not appreciated sufficiently in real terms.

Multilateral Trade Negotiations

34. The collapse of the Doha Round, in July 2008, raises questions about the fate of the multilateral trading system. As pointed out in the 2007 version of this paper, a result of the failure to conclude the negotiations on time would be a proliferation of bilateral and regional trade agreements, which have already been in vogue. This would not be in the interest of all parties concerned vis-à-vis trade liberalisation based on a "most favoured nation" basis. In particular, they would be to the disadvantage of poorer developing countries and small states that are not well-placed in taking an effective part in such agreements. Moreover, the lack of progress in the multilateral trade negotiations could give impetus to the already rising protectionist forces, including a tendency to resort to anti-dumping policies that has now started to gain ground.

V. RISKS TO THE GLOBAL ECONOMY

35. Future performance of the world economy, particularly the projected deceleration of global economic growth, from 5 per cent in 2007 to 4.1 per cent in 2008 and 3.9 per cent in 2009, is still subject to a number of risks, many of which could tilt the projections to the downside. As discussed in the IMF's *WEO* (2008) and World Bank's *GDF* (2008), notable among the downside risks are the following:

- There remains a risk of possible **disorderly adjustment** of continuing global imbalances. This would particularly be so if the sources of financing the US current account deficits start to dry up as the sentiments of investors (including foreign reserves and sovereign wealth fund managers) shift away from assets in the US financial markets, in response to the prolonged weak returns.
- The still unfolding **financial market challenges in the advanced economies** are surrounded by uncertainties, many of which can prove to be more serious than projected. Should these uncertain conditions turn out to be worse than anticipated, the adverse effects on the growth of advanced economies and the consequential spillover effects on the developing economies via the financial and trade channels can substantially reduce global growth.
- Monetary policy may need to be tightened for longer in response to **inflationary pressure**. This is particularly the case if tight markets in both oil and food persist.
- Higher **food and fuel prices** would also act as a direct drag on global growth and put at risk macroeconomic stability.

VI. POLICY RECOMMENDATIONS

Policy Measures on the Part of Policymakers in Individual Countries

36. **Financial turmoil in advanced economies:** Developing countries should be prepared for the spillover effects from the financial turmoil in the advanced economies, including likely reversal of previous financial flows from abroad by strengthening regulation and supervision to reduce currency mismatches. Countries with large short-term foreign debts should monitor foreign borrowing by banks and risk management strategies of corporations that have external debt exposure.

37. **Global inflation:** Policy makers need to put in place anti-inflationary policy responses. The policy mix depends on the state of a country's economy: where growth is above trend, countries can embark upon tight monetary policy and fiscal restraint, together with more flexible exchange rate management. Others should strike an appropriate balance between policies aimed at inflation reduction and mitigating against the downside risk to economic growth arising from cross-border spillover of financial turmoil and the downward phase of the economic cycle in the developed countries.

38. The policies needed from individual countries to tackle *rising oil prices* and *rising food prices* have been set out earlier.

39. *Rising activities of international banks*: In view of challenges posed by increasing activities of international banks in developing countries, including vulnerability of these countries to transmission by international banks of adverse financial shocks from abroad and loss of the countries' monetary control ability, these countries should exhibit vigilance through vetting the soundness of international banks being licensed to operate. They should coordinate their surveillance with home country supervisors, including soliciting of requisite information from them.

Policy Measures Requiring Cross-Country and Global Community Actions

40. *Financial turmoil in advanced economies*: Addressing the challenges of the financial sector turmoil requires coordinated global policy responses, including cross-country coordination of financial regulation. It is also necessary to pursue the recent recommendations from the Financial Stability Forum, including raising capital requirements for certain structured credit products, increasing oversight of bank's risk management practices, and improving credit rating agencies' safeguards against conflicts of interest. These would address many of the factors that either caused or aggravated the current financial turmoil.

41. *Global downturn*: The current global deceleration of growth, should it intensify, may warrant multilateral policy responses in the same manner as the developed country central banks' cooperative response through provision of liquidity in their respective economies. A coordinated fiscal stimulus could also be appropriate.

42. *Global macroeconomic imbalances*: Implementing the agreed road map by participants in the IMF-sponsored Multilateral Consultation on Global Imbalances should continue. Particularly, China and some other emerging economies should allow their exchange rates to move more in line with their external balance positions (although major oil exporters should be alert to the risk of aggravating the Dutch Disease phenomenon that would result through further appreciation of their exchange rates).

43. *Doha Round talks*: The deadlock in the Doha Round trade negotiations should be brought to an end, with all key stakeholders mustering sufficient political will to advance and conclude the trade negotiations. Meanwhile, as previously recommended in this paper last year, countries should refrain from trade protectionism and, also, the existing bilateral and especially regional trade arrangements should be such as to minimise costs to third countries from trade diversion; accord greater voice to and address concerns of low-income countries and small states.

44. *Lagging growth in Commonwealth Small States*: As reviewed earlier and highlighted last year, growth performance of the **Commonwealth Small States** does not match (and is not projected to match) the growth performance of any other group of developing countries identified in this paper. This below-average growth performance is, in all probability, applicable to other small states that are not Commonwealth members. This observation suggests the need for international efforts aimed at identifying and addressing the

reasons why these small economies are not performing as well as larger developing economies.

45. ***Shortfalls in pledged aid volumes:*** Aid volumes substantially fall short of donor commitments made at various multilateral fora. This is so globally and for Sub-Saharan Africa, in particular. The donor community should increase its aid efforts forcefully and ambitiously so as to close the gap between their existing aid performance and the pledged aid targets for 2010. Increased proportions should also be in the form of budget (as opposed to project) support.

46. The international response to ***rising oil and food prices*** is outlined in the relevant sections.

STATISTICAL APPENDIX

Table 1: GDP Growth Performance and Outlook for the World and Regional/Economic Groups, 2006 - 2009 (in percent)

	Actual		Projection	
	2006	2007	2008	2009
World	5.1	5.0	4.1	3.9
A. Advanced Economies	3.0	2.7	1.7	1.4
United States	2.9	2.2	1.3	0.8
Japan	2.4	2.1	1.5	1.5
Euro Area	2.8	2.6	1.7	1.2
Commonwealth Developed Countries	2.8	3.1	1.8	2.0
of which: Australia	2.8	3.9	3.2	3.1
Canada	3.1	2.7	1.0	1.9
New Zealand	1.5	3.0	2.0	2.1
United Kingdom	2.9	3.1	1.8	1.7
Newly Industrialised Economies	5.6	5.6	4.2	4.3
of which: Singapore	8.2	7.7	4.0	4.5
Other Advanced Economies	4.5	4.6	3.3	3.3
of which: Cyprus	4.0	4.4	3.4	3.5
B. Other Emerging Market & Developing Economies	7.9	8.0	6.9	6.7
Sub-Sahara Africa	6.4	7.2	6.6	6.8
of which: South Africa	5.4	5.1	3.8	3.9
Nigeria	6.2	6.4	9.1	8.3
Central & Eastern Europe	6.6	5.6	4.6	4.5
Commonwealth of Independent States	8.2	8.6	7.8	7.2
of which: Russia	7.4	8.1	7.7	7.3
Developing Asia	9.9	10.0	8.4	8.4
of which: China	11.6	11.9	9.7	9.8
India	9.8	9.3	8.0	8.0
ASEAN-5	5.7	6.3	5.6	5.9
of which: Malaysia	5.9	6.3	5.0	5.2
Middle East & North Africa	5.6	5.6	6.0	6.0
Western Hemisphere (Latin American and the Caribbean)	5.5	5.6	4.5	3.6
of which: Brazil	3.8	5.4	4.9	4.0
C: MEMORANDUM: Commonwealth Countries	5.7	5.7	4.6	4.9
of which: Four Developed Commonwealth Countries	2.8	3.1	1.8	2.0
Commonwealth countries other than the four developed ones	8.1	7.8	6.8	7.0
Commonwealth Small States	4.8	4.1	4.3	4.1

Source: Computed from IMF's April 2008 World Economic Outlook (WEO) online Data Base and Its July 2008 Update.
Note: Purchasing Power Parity GDP-weighted average growth is used for each group of countries.

Table 2: GDP Growth Performance and Outlook for the Emerging/Developing Asia and Pacific, 2006 - 2009 (in percent)

	Actual		Projection	
	2006	2007	2008	2009
Emerging/Developing Asia & Pacific	9.6	9.7	8.2	8.4
of which: China	11.1	11.4	9.3	9.5
ASEAN-5	5.7	6.3	5.8	6.0
of which: Malaysia	5.9	6.3	5.0	5.3
Commonwealth South Asia	9.2	8.6	7.5	7.7
of which: Bangladesh	6.4	5.6	5.5	6.5
India	9.7	9.2	7.9	8.0
Maldives	19.1	6.6	4.5	4.0
Pakistan	6.9	6.4	6.0	6.7
Sri Lanka	7.4	6.3	6.4	5.6
Commonwealth Pacific	2.2	4.4	4.2	3.4
of which: Fiji	3.6	-4.4	2.0	2.8
Kiribati	2.4	2.0	3.7	2.5
Papua New Guinea	2.6	6.2	5.8	4.7
Samoa	1.8	6.0	4.5	4.0
Solomon Islands	6.1	5.4	4.2	2.8
Tonga	1.3	-3.5	0.8	1.3
Vanuatu	7.2	5.0	4.0	3.5

Source: Computed from IMF's April 2008 World Economic Outlook (WEO) online Data Base.
Note: Purchasing Power Parity GDP-weighted average growth is used for each group of countries.

Table 3: GDP Growth Performance and Outlook for Sub-Saharan Africa, 2006 - 2009 (in percent)

	Actual		Projection	
	2006	2007	2008	2009
Sub-Saharan Africa	6.4	6.8	6.6	6.7
Commonwealth Sub-Saharan Africa	5.9	5.9	5.9	5.8
Commonwealth West Africa	6.2	6.4	8.8	8.2
<i>of which: Cameroon</i>	3.2	3.3	4.5	4.6
<i>The Gambia</i>	6.5	7.0	6.5	6.5
<i>Ghana</i>	6.4	6.4	6.9	7.5
<i>Nigeria</i>	6.2	6.4	9.1	8.3
<i>Sierra Leone</i>	7.4	6.8	6.5	6.5
Commonwealth Eastern & Southern Africa	5.7	5.8	4.6	4.7
<i>of which: Botswana</i>	3.6	5.4	5.0	4.3
<i>Kenya</i>	6.1	7.0	2.5	3.4
<i>Lesotho</i>	7.2	4.9	5.2	5.4
<i>Malawi</i>	7.9	7.4	7.1	6.2
<i>Mozambique</i>	8.0	7.0	7.0	7.0
<i>Namibia</i>	4.1	4.4	4.7	4.5
<i>South Africa</i>	5.4	5.1	3.8	3.9
<i>Swaziland</i>	2.8	2.4	2.0	2.0
<i>Tanzania</i>	6.7	7.3	7.8	8.0
<i>Uganda</i>	5.1	6.5	7.1	7.0
<i>Zambia</i>	6.2	5.3	6.3	6.3
Commonwealth Indian Ocean States	3.8	4.6	6.8	5.8
<i>of which: Mauritius</i>	3.6	4.6	7.0	6.0
<i>Seychelles</i>	5.3	5.3	4.6	4.2

Source: Computed from IMF's April 2008 World Economic Outlook (WEO) online Data Base and Its July 2008 Update.
 Note; Purchasing Power Parity GDP-weighted average growth is used for each group of countries.

Table 4: GDP Growth Performance and Outlook for Western Hemisphere, 2006 - 2009 (in percent)

	Actual		Projection	
	2006	2007	2008	2009
Western Hemisphere	5.5	5.6	4.4	3.6
<i>Brazil</i>	3.8	5.4	4.8	3.7
<i>Mexico</i>	4.8	3.3	2.0	2.3
Commonwealth Western Hemisphere	6.3	3.6	4.1	4.0
<i>of which: Antigua & Barbuda</i>	12.2	6.1	2.1	4.0
<i>The Bahamas</i>	3.4	3.1	4.0	3.8
<i>Barbados</i>	3.9	4.2	2.7	2.5
<i>Belize</i>	5.6	2.2	3.0	2.3
<i>Dominica</i>	4.0	0.9	3.5	3.0
<i>Grenada</i>	-2.4	3.1	4.3	4.0
<i>Guyana</i>	5.1	5.4	4.6	4.5
<i>Jamaica</i>	2.5	1.4	2.4	2.8
<i>St. Kitts & Nevis</i>	6.4	3.3	3.5	2.7
<i>St. Lucia</i>	5.0	3.2	4.4	4.4
<i>St. Vincent & The Grenadines</i>	6.9	6.6	5.0	4.9
<i>Trinidad & Tobago</i>	12.0	5.5	5.9	5.6

Source: Computed from IMF's April 2008 World Economic Outlook (WEO) online Data Base and Its July 2008 Update.
 Note; Purchasing Power Parity GDP-weighted average growth is used for each group of countries.

Table 5: GDP Growth Performance and Outlook for Central/Eastern Europe, CIS, Mid-East & North Africa, 2006 - 2009 (in percent)

	Actual		Projection	
	2006	2007	2008	2009
Central/Eastern Europe, CIS, Mid-East & North Africa	6.8	6.7	5.9	5.7
Central/Eastern Europe	6.647	5.777	4.427	4.328
Commonwealth of Independent States (CIS)	8.164	8.524	6.978	6.511
<i>of which: Russia</i>	6.4	6.7	7.0	6.8
Middle East & North Africa	5.6	5.6	6.0	6.0

Source: Computed from IMF's April 2008 World Economic Outlook (WEO) online Data Base and Its July 2008 Update.

Note: Purchasing Power Parity GDP-weighted average growth is used for each group of countries.

Table 6: Net Capital Flows to Developing Countries, 2002-07 (US\$ billion)

	2002	2003	2004	2005	2006	2007e
Net Equity Flows	166.2	186.0	265.9	357.4	472.3	615.9
Net FDI Flows	160.7	161.9	225.5	288.5	367.5	470.8
Net Portfolio Equity Flows	5.5	24.1	40.4	68.9	104.8	145.1
Net Debt Flows	8.9	72.8	128.8	152.4	217.5	409.1
Official Creditors	4.9	-11.7	-26.1	-71.7	-70.5	-3.9
World Bank	-0.4	-0.8	1.4	2.5	-0.7	3.0
IMF	14.0	2.4	-14.7	-40.2	-27.1	-4.7
Others	-8.7	-13.3	-12.8	-34.0	-42.7	-2.2
Private Creditors	3.8	84.4	155.2	222.7	288.0	413.0
Net Medium- and Long-term Debt Flows	0.7	30.9	87.7	133.1	193.8	283.3
Bonds	8.8	19.6	41.1	52.6	25.3	79.3
Banks	-1.7	15.2	50.4	85.3	172.4	214.7
Others	-6.4	-3.9	-3.8	-4.8	-3.9	-10.7
Net Short-term Debt Flows	3.1	53.5	67.5	89.6	94.2	129.7
Balancing Item	-70.6	-83.2	-156.6	-417.5	-481.9	-391.0
Change in Reserves (- = increase)	-166.5	-292.4	-402.4	-390.8	-634.2	-1,090.7
Memo Items:						
Current Account Balance, as % of GDP	1.0	1.7	2.0	3.2	3.8	3.1
Net Private Flows (Debt + Equity)	170.0	270.4	421.1	580.1	760.3	1,028.9
Net Private and Official Capital Flows (Net Private Flows + Official Debt Flows)	174.0	262.4	386.4	479.7	689.8	1,025.0
Workers' Remittances	115.8	143.4	160.7	191.0	221.0	240.0

Source: World Bank's Global Development Finance, 2008 (Table 2.1)

"e" = estimate