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Global Economic Recovery: Prospects and Challenges in the Post-Crisis Phase

The world economy has passed the most severe phase of the worst economic downturn since the Great Depression and a stimulus-led recovery is underway across the globe. Expansionary monetary policy, fiscal stimulus packages and efforts to introduce financial reforms all played an important role to lead the global economy out of the great recession of 2008-09. However, recovery is highly uneven among the regions and economic prospects are more promising in developing and emerging economies compared to the developed economies. The difference in pace of recovery across the regions and countries is mainly due to their relative exposure to the negative impacts of the crisis and their pre-crisis fiscal conditions. Therefore, countries which born the heavy output loss during the crisis are expected to recover slower than those which are marginally affected. Similarly, economies with pre-crisis huge fiscal imbalances are subject to little room for an expansionary policy and hence are experiencing sluggish recovery compared to those with sound pre-crisis fiscal base.



Being the epicenter of this downturn of historic magnitude, developed countries are still under great economic and financial stress. During the crisis, many countries were forced to recapitalize banks, take over a large part of the debts of failing financial institutions and introduce large stimulus packages to revive demand. As a result, there was an explosion of public debt across the globe in general and in developed countries in particular. Today, the majority of these economies are carrying huge public debts which could reach to over 100% of GDP in 2011. According to the IMF (WEO April 2010), elevated level of public debt could undermine the economic recovery and many developed countries are exposed to the challenge of debt sustainability and resulting sovereign default risk. Among the developed countries, euro zone economies already started experiencing negative impacts of emerging sovereign debt crisis. Provided the fact that in many developed countries unemployment is still very high, confidence of business sector is yet to recover and household demand will take some more time to rebound, emerging sovereign debt crisis could cause double dip recession.

During the crisis, many countries introduced fiscal stimulus packages to revive the economic growth and trillions of dollars have been injected in the ailing economies in the form of government spending increase, tax cuts, bank recapitalization and interest rate reduction. However, resulting fiscal imbalances are unsustainable and forcing many countries to roll back their supportive public policies in near future. According to the IMF and World Bank, a sudden pre-mature withdrawal of policy support could undermine the ongoing sluggish recovery especially in advanced economies while keeping supportive public policies for too long will lead to overheating and asset bubble especially in emerging economies. Therefore, appropriate timing and pace of withdrawal of policy support is very crucial decision which requires insight to



devise prudent exit strategies. Policy makers should keep a vigilant eye on the behavior of important economic indicators to figure out when is the right time to exit. Keeping in view the prospects for global economic recovery, IMF suggests that advanced economies must continue the expansionary measures till the end of 2010 while emerging economies in Asia and Latin America should start slower withdrawal of policy support.

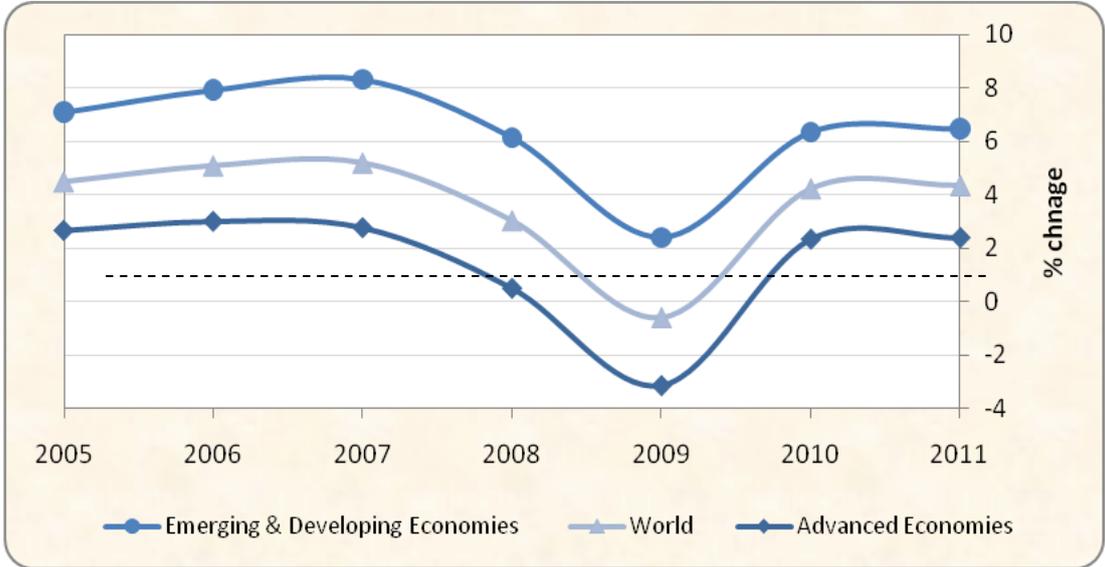
Against this backdrop, this short outlook report aims to shed light on the global economic prospects and investigates the potential challenges related to fiscal imbalances, emerging sovereign debt crisis and formulation of prudent exit strategies in the so called post-crisis phase.

Global Economic Prospects

Growth Rate

Economic recovery is underway across the globe and output growth rebounded better than expected in 2009. In most of the advanced economies, the recovery is expected to remain slow, whereas in many emerging and developing economies, economic activity is expected to be relatively vigorous, mainly due to the strong domestic demand and recovering external demand. According to the IMF WEO (April 2010), world output is expected to grow by 4.2 % in 2010, an upward revision of 0.3% from January 2010 forecast, and by 4.3% in 2011 (Figure1). Most of this improvement in global GDP is contributed by the emerging and developing economies which are expected to grow by the rate of 6.3% in 2010 and 6.4% in 2011. In contrast, advanced economies are expected to grow by the rate of 2.3% in 2010 and 2.4% in 2011.

Figure1: Global Real GDP (% change)

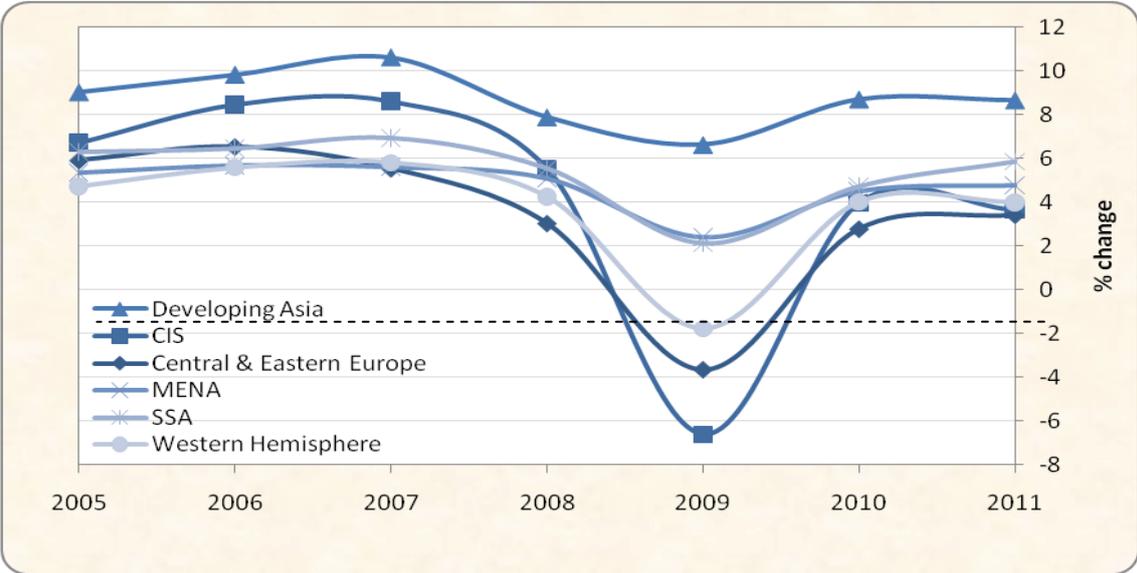


Source: IMF WEO, April 2010.

As a group developing and emerging economies suffered less during the down turn period of the crisis and, thus, their economic growth prospects are very promising in the coming years. Among the developing regions, developing Asia, Middle East & North Africa (MENA) and Sub-Saharan Africa (SSA) performed better than others and mostly withered the negative impacts of the crisis. According to the IMF WEO (April 2010), developing Asia is in the leading developing region

with an expected growth rate of 8.7% in 2010 and 8.6% in 2011 (Figure 2). There are many factors behind the outstanding performance of this region as export oriented Asian economies are benefiting from the normalization of global trade, capital inflows are increasing and domestic demand remained much stable. In SSA region, output is expected to grow with a rate of 4.7% in 2010 and 5.9% in 2011. Meanwhile, MENA region will experience a growth rate of 4.5% in 2010 and 4.8% in 2011. Other developing regions which suffered heavy output losses during the crisis and their growth rates dropped to negative; will also experience improvement in economic activity in near future. The worst affected developing region of Commonwealth Independent States (CIS) is expected to grow at 4.0% in 2010 and 3.6% in 2011. Similarly, Central & Eastern Europe will experience growth rates of 2.8% and 3.4% in 2010 and 2011 respectively. Meanwhile, in Western Hemisphere (Latin and Central America), economic activity is expected to rebound in 2010 and 2011 with a growth rate of 4.0%.

Figure 2: Developing Regions Real GDP (% change)



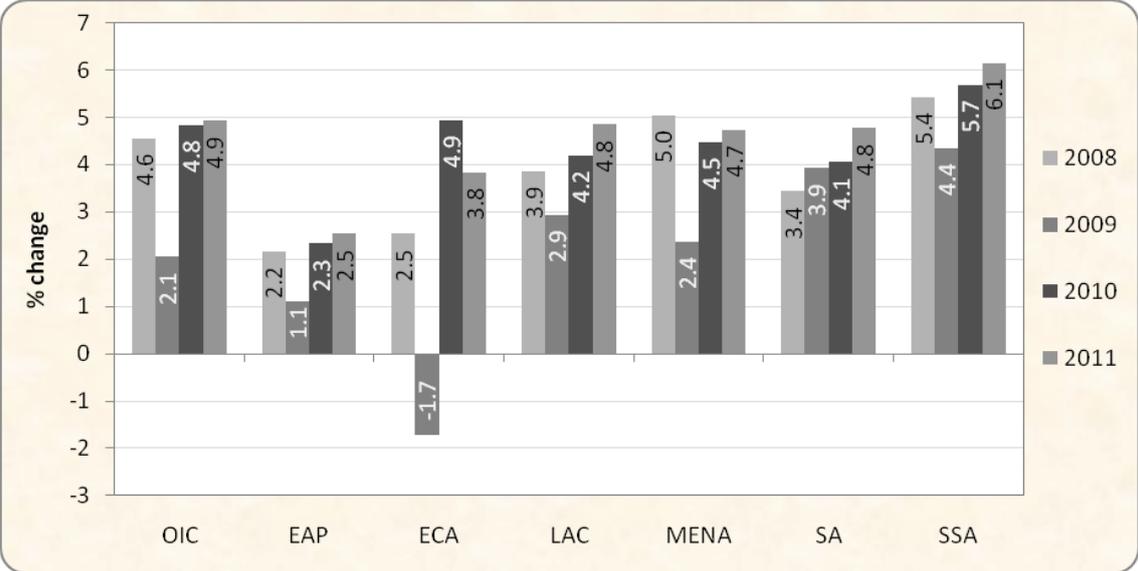
Source: IMF WEO, April 2010.

Growth Rates in OIC Member Countries

OIC member economies are also gradually recovering from the negatives impacts of the financial crisis and recession of 2008-09. Due to virtually non existence of sub-prime market in member countries, majority of them were only affected by the spillover effects of the crisis on their export earnings, remittances, aid and FDI. During the crisis, OIC real GDP growth declined from 4.6% in 2008 to 2.1% in 2009. However, after reaching the bottom in 2009, economic activity is expected to rebound across the OIC group and GDP is estimated to grow with a rate of 4.8% in 2010 and 4.9% in 2011 (Figure 3). Similarly, OIC regions are also expected to experience resurgence in economic activity in near future. As shown in the Figure 3, all OIC regions felt the pinch of the crisis and growth rates dropped during 2008-09 except in South Asia. Among the OIC regions, member countries in Europe & Central Asia (ECA) region experienced the highest decline in economic activity and their GDP growth declined to -1.7% in 2009 compared to 2.5% in 2008. However, in 2010, ECA will witness second highest GDP growth among

all OIC regions with a rate of 4.9%. Sub-Saharan Africa (SSA) region is expected to experience highest GDP growth rate among the OIC regions while lowest growth will be witnessed in East Asia & Pacific (EAP) region.

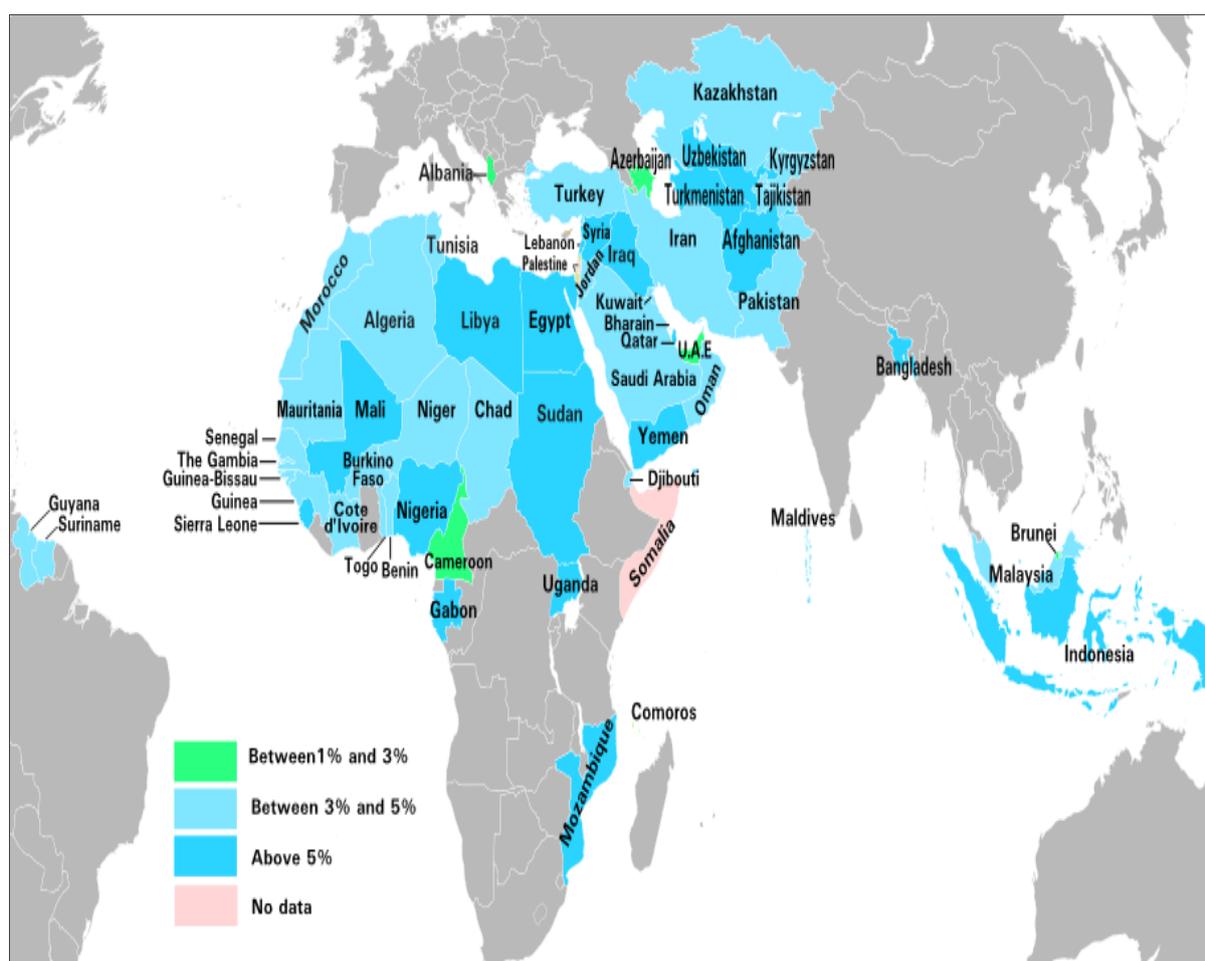
Figure 3: OIC Regions Real GDP (% change)



Source: IMF WEO, April 2010.

At the individual country level, growth prospects are promising in the majority of OIC member countries. As shown in the Figure 4, during 2010-2011, average GDP growth rate will be above 5% in 19 OIC member countries. Among these countries, Qatar and Turkmenistan will experience double digit growth rate of 16.4% and 12.1% respectively. On the other hand, 30 member countries will witness average GDP growth rate between 3% and 5% during 2010-2011. Among these member countries, Kirghizstan, Malaysia, Djibouti, Gambia and Mauritania will grow with 5% while Togo and Iran are expected to grow with just over 3%. Furthermore, average GDP growth rate will lie in between 1% and 3% for 6 member countries. In this group, Albania and Cameroon are expected to experience an average GDP growth rate over 2.5% while remaining member economies will witness average GDP growth rate higher than 1%.

Figure 4: OIC Member Countries Average Real GDP (% change) during 2010-2011

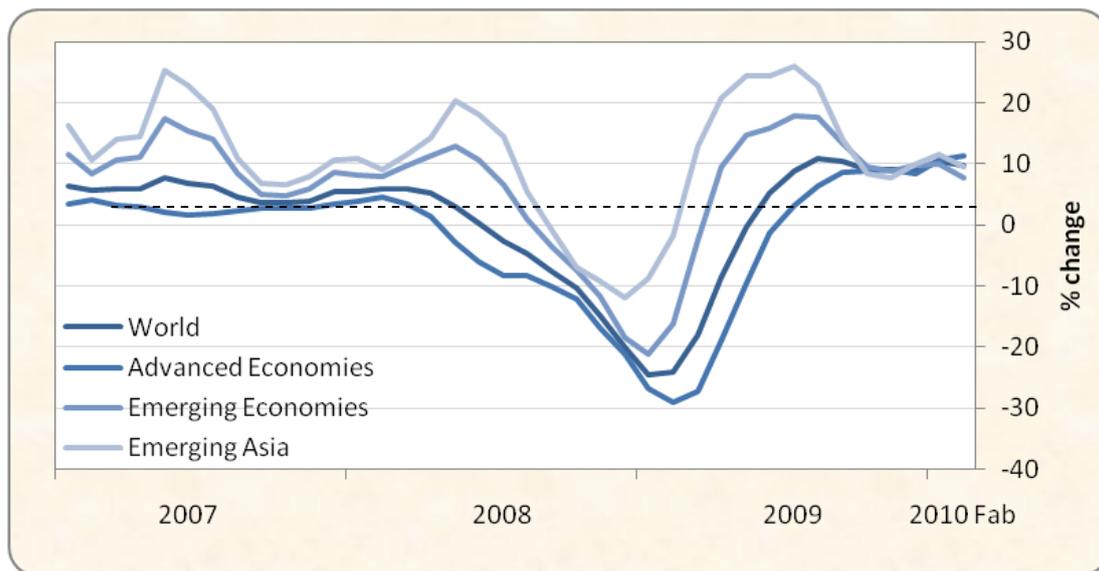


Source: IMF WEO, April 2010.

Industrial Production

During the crisis, industrial sector experienced dramatic decline and negative growth across the globe. Industrial sector in advanced economies experienced sharper and deeper decline compared to the developing and emerging economies. As shown in the Figure 5, industrial production rebounded during the second quarter of 2009 and at the end of 2009 entered into positive territory. Emerging economies especially in Asia experienced the least decline in industrial production and their pace of recovery also outpaced the other regions. According to the IMF latest estimates, industrial production will continue growing with a positive rate during 2010. As of February 2010, global Industrial production registered growth of 9.8%. Meanwhile, advanced economies experienced industrial production growth of 11.2% followed by emerging Asia, 9.6%, and emerging economies, 7.7%.

Figure 5: Industrial Production (% change)¹



Source: IMF WEO, April 2010.

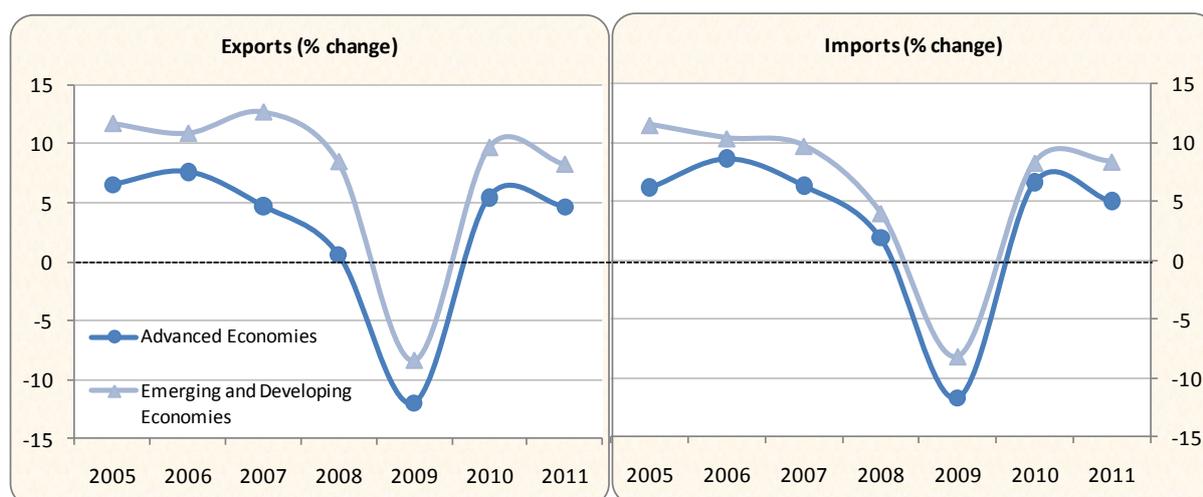
Trade Volume

During the financial crisis, world trade volume dropped significantly. According to the United Nations Department of Economic and Social Affairs (UN-DESA) World Economic Vulnerability Monitor (February 2010), global trade flows dropped at an annualized rate between 30% and 50% during the end of 2008 and second quarter of 2009. The export dependent economies especially in Asia were hardest hit and suffered significant output losses during this period. However, since the second quarter of 2009, world trade started to rebound and export dependent economies are benefiting from this improvement.

According to the IMF WEO (April 2010), world trade volume in goods and services experienced an average negative growth rate of 10.7% in 2009. However, there are increasing signs of improvement in world trade and IMF estimates show that the world trade volume will grow with a rate of 7.0% in 2010 and 6.1% in 2011. The expected improvement in the economic situation in 2010 will bring trade benefits to all regions. As shown in the Figure 6, after suffering a deep plunge in 2009, both imports and exports are showing upward trend across the world. Exports of emerging & developing countries are expected to grow with 8.3% in 2010 and 8.4% in 2011 while exports of advanced economies will grow with 6.6% in 2010 and 5.0% in 2011. Similarly, imports of emerging and developing countries will experience growth rate of 9.7% and 8.2% in 2010 and 2011 respectively while imports of advanced countries will grow with 5.4% and 4.6% in 2010 and 2011 respectively.

¹ Annualized % change of 3-month moving average over previous 3-month moving average

Figure 6: Trade in Goods and Services (% change)



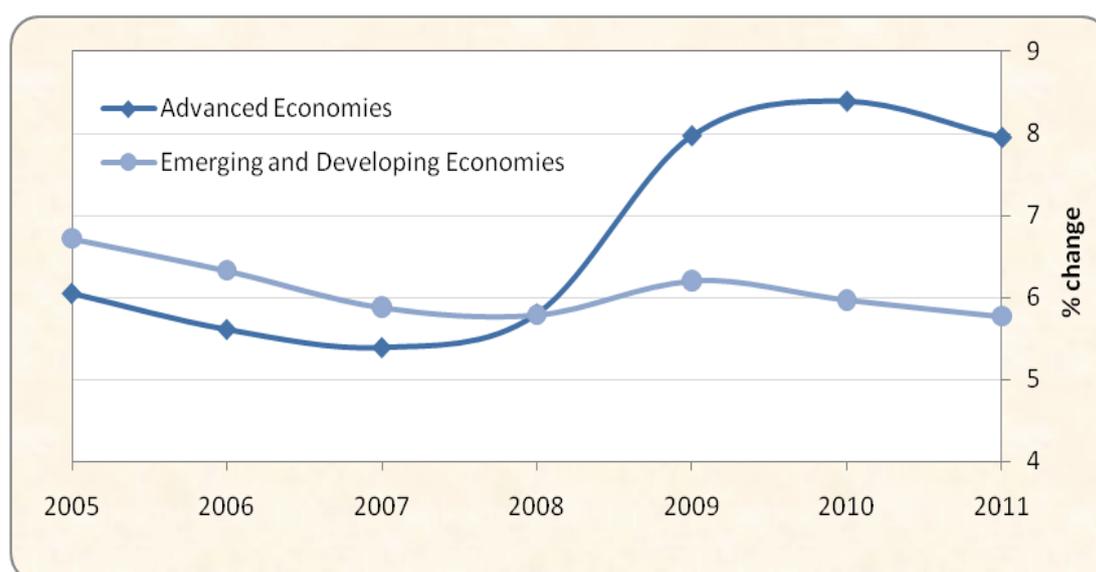
Source: IMF WEO, April 2010

Unemployment Rate

According to the International Labor Organization (ILO, January 2010) estimates, nearly 34 million more were added to the unemployed people during the crisis of 2008-09. As a result, the total number of unemployed people worldwide soared to 212 million at the end of 2009 (i.e. 6.6 percent of world total workforce). On the other hand, some 633 million workers and their families were living on less than \$1.25 per day in 2008 and some 215 million additional workers were at risk to fall in this bracket in 2009. The outlook for new jobs is not very promising in 2010 especially in the developed countries. Some 3 million more people are expected to lose their jobs in the EU and other developed countries in 2010 while unemployment will stabilize or decline slightly in other regions.

Despite positive developments in global economic activity, rebound in industrial production and increase in trade volume; unemployment remained high compared to the pre-crisis level of 2007, especially in the developed countries. During 2008-2009; the most acute phase of the crisis, unemployment rate soared up both in advanced and developing and emerging economies. However, developing and emerging economies witnessed marginal increase compared to the advanced economies. In 2008, unemployment rate was almost equal in both groups, however during 2008-09, it climbed up from 5.79% in 2008 to 7.97% in advanced economies while in the developing and emerging economies it increased from 5.79% in 2008 to 6.20% in 2009 (Figure 7). Due to slower output growth and higher prevalence of financial stress, advanced economies are expected to witness further increase in unemployment in 2010 and their unemployment rate is expected to climb up to 8.39% before declining to 7.95% in 2011. Meanwhile, in developing and emerging economies unemployment rate is expected to decline back to pre-crisis level in 2011.

Figure 7: Unemployment Rate (% change)



Source: IMF WEO, April 2010.

Major Challenges in Post Crisis Phase

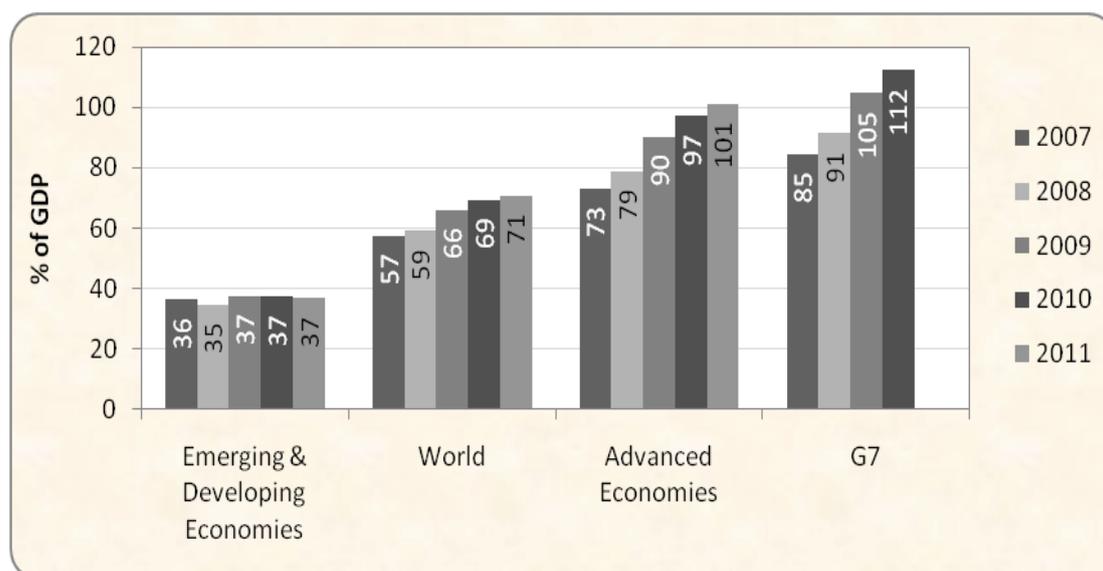
Emerging Sovereign Debt Crisis

Despite the fact that government intervention played an important role in the recovery of world economy from recent great recession, the sovereign default risk associated with unprecedented accumulation of public debts especially in developed world could undermine the recovery and extend the crisis to another phase. The majority of the developed countries were already running massive budget deficits and their fiscal positions are further aggravated due to stimulus spending, low tax revenues and support to the financial sector. According to the IMF (WEO, April 2010), mounting public debt pose serious challenges for the continuation of expansionary fiscal policies in developed countries and this could further slow down the already sluggish recovery in these economies. On the other hand, increasing sovereign default risk could also shatter the confidence of the investors leading to increase in financial stress in these economies.

Over the years, sovereign debt burden of the advanced economies, especially in the G7 countries, has shown significant increase. As shown in Figure 8, the debt burden of the advanced economies increased from 78% of GDP in 2008 to 90% of GDP in 2009. According to the latest estimates, public debt in these economies will reach 97% of GDP in 2010 and over 100% of GDP in 2011. The G7 countries are facing much higher debt burdens compared to the rest of the advanced economies. During the crisis, public debt in G7 countries increased from 91% of GDP in 2008 to 104% of GDP in 2009 and estimated to reach around 112% of GDP at the end of 2010.

Compared to the advanced economies, debt situation is much better in the developing and emerging economies. During the crisis, their debt increased from 35% of GDP in 2008 to 37% of GDP in 2009 and, with minor fluctuations, it is estimated to remain around 37% of GDP in 2010 and 2011.

Figure 8: Public Debt (% of GDP)



Source: IMF WEO, April 2010.

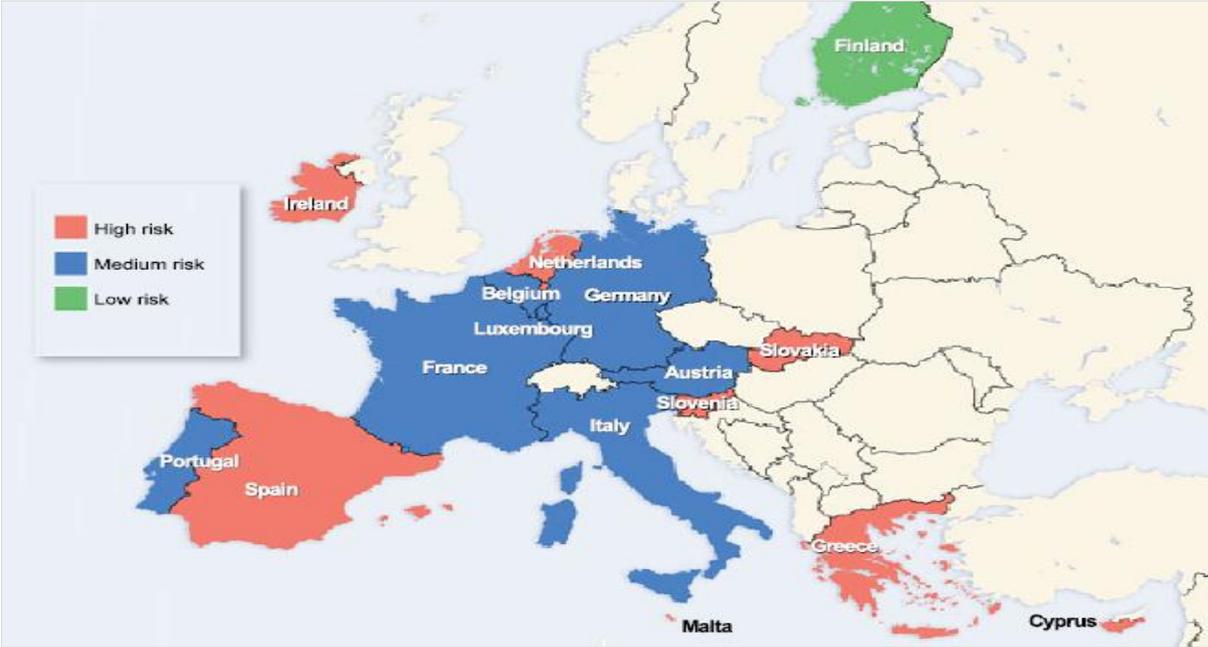
Due to increasing debt and fiscal deficit problem, Greece is at the epicenter of emerging sovereign debt crisis in the euro zone economies. In addition to Greece some other euro zone economies like Portugal, Italy, Ireland and Spain are also in danger. Massive budget deficits, huge public debts and muted prospects for recovery and growth are the common characteristics of these economies. As shown in Figure 9, half of the euro zone members are at high risk to sustain their public finances. There is an increasing consensus that these economies need to revise their social security model and rationalize public spending to wither emerging debt crisis. Moreover, the situation in these economies could also have severe negative implications for their trading partners and lenders both in Europe and other regions.

Considering the expected negative impacts of Greece default on other economies, the euro zone members along with IMF agreed to provide a US\$ 145 billion (€110 billion) three-year rescue package (The Economist print edition, 6th May 2010). This money will be used to finance Greece's budget deficit as well as repayment of maturing debts. However, due to the conditions of this bailout package, Greece government has to impose some strict austerity measures which aim to achieve budget cuts of €30 billion over three years. This will help to bring Greece public budget deficit to less than 3% of GDP by 2014 which currently stands at 13.6%. The planned austerity measures include cuts in bonus payments for public sector workers, no increase in their salaries and pensions in coming three years, increase in VAT from 21% to 23%, increase in taxes on fuel, alcohol and tobacco by 10% and bringing the illegal construction in the tax net.

Whether these measures will bear the expected fruits or not is yet to be seen, however Athens is already on a standstill due to widespread agitations against government proposed austerity plan. On the other hand, experts are of the view that if similar austerity measures are being introduced by other euro zone members as European Commission is planning to introduce strict fiscal discipline in coming days, there is no doubt that this will halt the already sluggish economic recovery and the euro zone may face a double dip recession. Following the footsteps of Greece, other euro zone economies like Spain, Italy and Ireland also announced budgetary cuts and

austerity measures to mitigate emerging sovereign default risk. On the other hand, European Commission also established a fund to provide financial support for EU members in trouble. Provided the level of integration of global financial markets, emerging euro zone sovereign debt crisis could have negative repercussions for other advanced economies like USA, Japan and UK which are suffering from similar fiscal imbalances. Keeping in view these developments, IMF advised governments to design credible medium-term fiscal consolidation plans to manage rising debt burdens and deteriorating fiscal balances (WEO, April 2010).

Figure 9: Public Finance Unsustainability Risk in the Euro Zone Economies



Source: The wall Street Journal, 30th December 2009.

Exit Strategies: Timing and Pace of Rewinding Policy Support

During the financial crisis 2008-09, governments across the globe especially in advanced economies introduced economic stimulus plans to revive their ailing economies through increasing government spending, tax cuts, buying toxic assets and interest rate reduction. According to the UN-DESA (Policy Brief No. 13, March 2009), since the outbreak of the crisis up to March 2009, the total government support is estimated at some \$20.8 trillion or 33.5 per cent of the estimated World Gross Product (WGP) for 2008. Most of these resources have been used to take financial measures like bank injections, buying toxic assets and loan guarantees. While, about \$2.6 trillion or 4 per cent of WGP is to be used for the fiscal measures like public spending on goods and services and tax cuts during the period between 2009 and 2011.



These expansionary macro policies paid off and helped the global economy to recover from one of the worst recessions in recent times. However, amid the emerging signs of economic recovery, there is an ongoing debate among the policy makers on what should be the 'Exit strategy' and when governments should start rewinding the policy support? Considering the deteriorating fiscal conditions and huge accumulation of public debts during the crisis, many advanced economies are exposed to sovereign default risk and want to withdraw policy support to mitigate this emerging threat. Nevertheless, their economic prospects are not very promising and a premature withdrawal can further delay the already sluggish recovery in these economies. On the other hand, many emerging and developing economies are doing very well and if they didn't withdraw supportive public policies in near future there are chances of overheating and asset bubbles amid the increasing flow of capital in these economies. Therefore, there is a genuine need to formulate prudent exit strategies to overcome post crisis challenges without compromising the current global economic recovery.

According to the IMF (WEO, April 2010), exit strategies should be tailored keeping in view the state of national economy and health of financial system. If economic conditions allow a government to wind up policy support even then it should be done slowly with the involvement of all stakeholders. In general, advanced economies must continue the expansionary measures till the end of 2010 meanwhile emerging economies in Asia and Latin America should start slower withdrawal of policy support. However, to overcome the problem of fiscal imbalances and increasing debt burdens, advanced economies, especially in the euro zone, need institutional and operational reforms without putting the recovery at risk. To achieve the goal of fiscal consolidation they should strengthen institutions to improve fiscal monitoring and reporting, budgeting practices and government assets and liabilities management. While, to curtail the government spending they should introduce health and pension reforms to stabilize entitlement spending.

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