

3 THE EXTERNAL ENVIRONMENT OF THE EURO AREA

1 The world economy in 2008

1.1 INTRODUCTION

A global financial crisis broke in 2008 and the world economy entered a recession whose scope, duration and consequences are difficult to predict

After progressive deterioration, the financial system teetered on the brink of collapse in September, prompting a contraction in activity worldwide

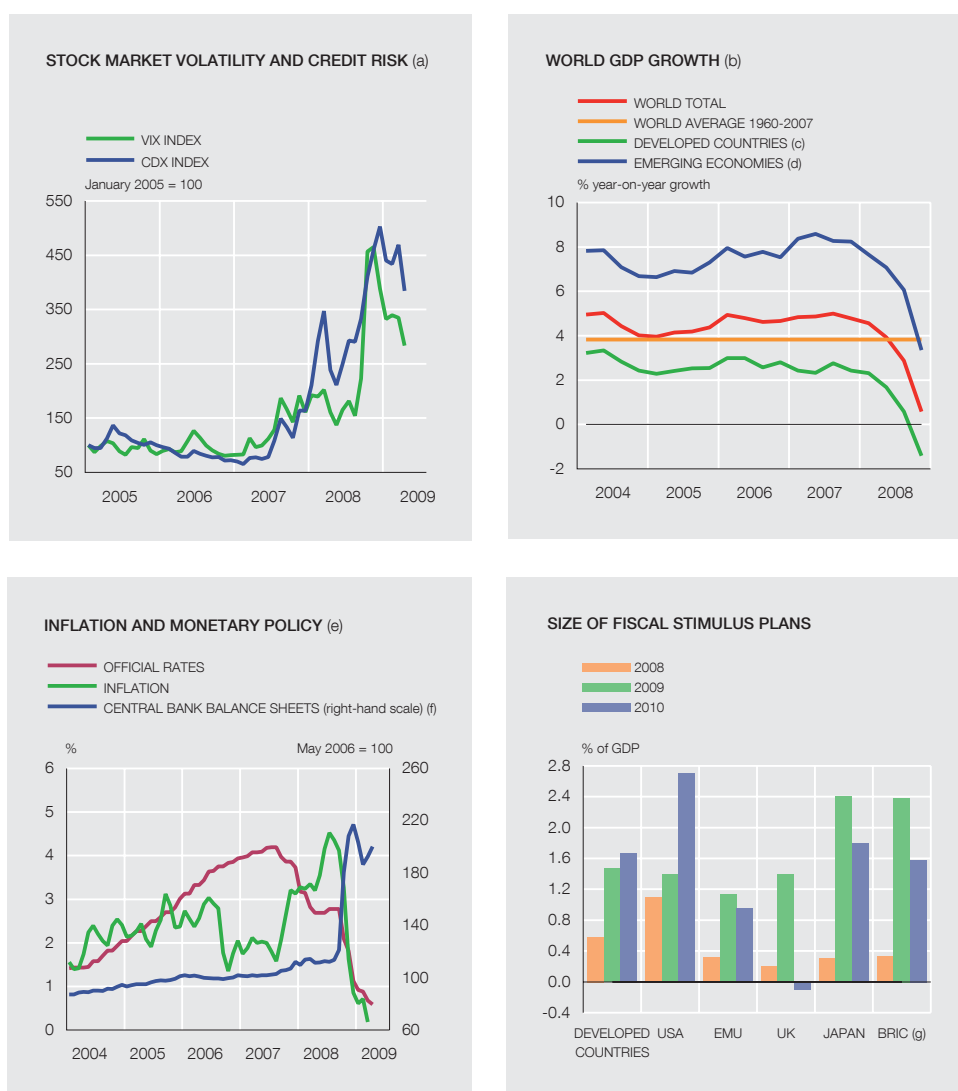
The economic authorities' response was emphatic, generalised and, to a certain extent, coordinated,...

The world economy is undergoing its most difficult period in recent decades. 2008 was marked by the gestation and subsequent eruption of a financial crisis, a corollary of the turbulence first seen in the summer of 2007. The crisis acquired global proportions, undermining agents' confidence and resulting in a worldwide economic downturn. The data available for the first half of 2009 signal an unfavourable outlook for the year, despite the intense economic policy response. The depth and scope of the crisis have brought about major changes, not only in how economies work but also in economic priorities and in the framework in which the authorities may act, raising uncertainties about how agents may respond and the effectiveness of economic policy. In short, the economic and financial situation has deteriorated significantly, with serious consequences that will make it difficult to return to a period of high sustained growth like that which was so abruptly interrupted in 2007. And not only because the present crisis has very probably lowered economic growth potential worldwide for a considerable time, but also because the bases for this renewed growth will necessarily be different from those that supported the last growth phase, which ultimately proved unsustainable.

The extent of the financial difficulties facing the developed economies acted as a growing restraint on real and financial activity in 2008, eventually spreading to the emerging economies. In this respect the year divides into two distinct parts, separated by the financial stress witnessed in September (see Chart 3.1). Until then, the financial turmoil first seen in the summer of 2007 when the subprime crisis broke had gradually eroded (with varying degrees of intensity) the solvency of a growing number of financial institutions, fomenting a process of generalised deleveraging, making it impossible for some markets to function and gradually reducing the international financial system's intermediation capacity. As from September, these developments evolved into a global financial crisis, marked by extreme market instability, the fall of systemic financial institutions, a credit market freeze and the collapse of agents' confidence, significantly heightening the interplay between the difficulties facing the financial sector and the real economy. Economic activity, whose slowdown had intensified and spread geographically up to the summer, contracted sharply on a global scale in 2008 Q4. The developed economies fell deeper into a recession that in many cases had already begun, as the signs of financial weakness multiplied, while the emerging economies, far from remaining immune to the adjustment process, were hit by the combined impact of a halt in external demand and in capital inflows towards these economies.

Nevertheless, the global economy still managed to grow by 3.2% in 2008, a relatively high figure, albeit considerably lower than the average of 4.9% of the previous four years (see Table 3.1). But average growth in 2008 masks the significant decline in the year-on-year rate (from 4.8% at end-2007 to 0.2% in 2008 Q4) and the low growth in the developed economies in the year overall (0.9%, in comparison with 2.7% in 2007). The emerging economies posted economic growth of 6.1% for the year, in comparison with 8.3% for 2007. The inflationary tensions that had peaked mid-year (when inflation in the industrialised economies reached 4.5%, the highest figure recorded since July 1991) disappeared in Q4, as economic activity collapsed and commodities prices, which had started to decline in the summer, rapidly corrected.

As from September 2008, this combination of circumstances prompted an emphatic, generalised and, to a certain extent, coordinated response by economic authorities worldwide, but most especially in the developed economies. As the lower half of Chart 3.1 shows, the economic response covered all fronts: monetary policy (in many cases including the adop-



SOURCES: Datastream, IMF and Banco de España.

- a. VIX Index (stock market volatility of the S&P 500) and CDX Index (5-year US investment grade credit default swap index).
- b. Compiled by the Banco de España, based on data from 57 countries representing 90% of world GDP. The aggregates have been calculated using the weight of the countries in the world economy in the previous year, in purchasing power parity (PPP), based on IMF data.
- c. Western Europe, United States, Canada, Japan, Australia, New Zealand, Israel, Slovakia and Slovenia.
- d. Latin America, emerging Asia, central and eastern Europe (except for Slovakia and Slovenia) and South Africa.
- e. United States, euro area, Japan and United Kingdom aggregates.
- f. Total assets as a percentage of GDP. Up to May 2006 the figures are for the United States, the euro area and Japan only.
- g. Aggregate of Brazil, Russia, India and China.

	2004	2005	2006	2007	2008
UNITED STATES					
GDP	3.6	2.9	2.8	2.0	1.1
CPI (a)	2.7	3.4	3.2	2.9	3.8
Current account balance (% of GDP)	-5.3	-5.9	-6.0	-5.3	-4.7
General government balance (% of GDP)	-4.4	-3.3	-2.2	-2.9	-6.1
JAPAN					
GDP	2.7	1.9	2.0	2.4	-0.6
CPI (a)	0.0	-0.3	0.3	0.0	1.4
Current account balance (% of GDP)	3.7	3.6	3.9	4.8	3.2
General government balance (% of GDP)	-6.2	-5.0	-4.0	-2.5	-5.6
UNITED KINGDOM					
GDP	2.8	2.1	2.8	3.0	0.7
CPI (a)	1.3	2.0	2.3	2.3	3.6
Current account balance (% of GDP)	-2.1	-2.6	-3.4	-2.9	-1.7
General government balance (% of GDP)	-3.3	-3.3	-2.6	-2.6	-5.4
CHINA					
GDP	10.1	10.4	11.6	13.0	9.0
CPI (a)	3.9	1.8	1.5	4.8	5.9
Current account balance (% of GDP)	3.6	7.2	9.5	11.0	9.8
General government balance (% of GDP)	-1.3	-1.2	-1.0	0.6	-0.4
LATIN AMERICA (b) (c)					
GDP	6.3	4.7	5.6	5.7	4.2
CPI (a)	6.3	6.4	5.2	5.4	7.9
Current account balance (% of GDP)	1.6	1.9	2.0	0.8	-0.3
General government balance (% of GDP)	-0.8	-0.6	-0.6	-0.1	-0.3
NEW EU MEMBER STATES NOT IN EURO AREA (b) (d)					
GDP	5.9	4.8	6.6	5.9	4.1
CPI (a)	5.3	3.7	3.3	4.4	6.5
Current account balance (% of GDP)	-6.1	-4.5	-6.6	-8.2	-7.9
General government balance (% of GDP)	-3.8	-3.5	-3.4	-1.9	-3.3
PRO MEMORIA: GDP GROWTH					
World	4.9	4.5	5.1	5.2	3.2
Euro area	2.2	1.7	2.9	2.7	0.9

SOURCES: Banco de España, IMF and national statistics.

a. Year-on-year percentage change in average CPI index.

b. The aggregate for the different areas has been calculated using the weight of the countries making up such areas in the world economy the previous year, in PPP, based on IMF data.

c. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.

d. Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Bulgaria and Romania.

... but it failed to lift the uncertainty overshadowing the global economy

tion of unconventional measures), financial sector support policies and fiscal policies. The steps taken were designed to uphold liquidity and keep credit flowing, to strengthen financial institutions' solvency and to sustain activity, aiming to restore agents' confidence and break the increasingly powerful negative spiral between economic and financial deterioration.

The scale of the response, which has involved committing a very substantial volume of public funds, halted the collapse that threatened some of the world's key financial systems. However, the global outlook remains highly uncertain, in light of the persistent financial fragility (especially due to the lack of sufficient progress in financial system restructuring) and extreme economic weakness, all of which means that it may be some time before confidence returns and the outlook stabilises.

1.2 THE FINANCIAL MARKETS:
FROM TURMOIL TO CRISIS

The financial turmoil first seen in 2007 intensified throughout 2008, posing a serious threat to global financial stability

Far from abating, the financial turmoil first seen in 2007 gained in strength in 2008, setting the scene for what would become a global financial crisis. One of the underlying elements of this crisis, in addition to ample global liquidity and highly accommodating financial conditions, was the complex web of risk transfer from credit originators to investors worldwide, via complex financial products which, in turn, helped increase leveraging opportunities even further. The serious implications that these risk transfer mechanisms held for financial stability were revealed when the subprime mortgage crisis broke in the United States. Many mortgage credit risks – which had supposedly been passed on – returned to the banks' balance sheets via the liquidity commitments assumed when the loans were refinanced. Throughout 2008, as the losses associated with these complex products emerged and mistrust between banks grew in light of the lack of transparency and the lack of data on exposure to these products, risks were reappraised and stress in the money and credit markets heightened. All this gradually undermined credit institutions' solvency, and tensions spread to a growing number of financial agents and market segments. In September, the situation evolved into a global financial crisis whose depth and duration remain far from certain.

Up to mid-September, high financial volatility and the deteriorating economic outlook compounded the pressure on financial institutions...

Up to mid-September, against a backdrop of high market volatility, the deteriorating financial climate gradually eroded agents' confidence and effective credit conditions for firms and households in the main developed economies tightened, meaning that the financial difficulties began to pass through to the real economy. This progressive deterioration of the economic outlook was accompanied by further house price declines in the United States, which heightened the underlying mortgage securitisation problems, prolonging the uncertainty over the value of troubled assets in individuals' and financial institutions' investment portfolios and fuelling distrust between institutions. The growing losses recorded by financial institutions deriving from their more traditional portfolio assets and from some assets with a high credit rating which, in origin, appeared to represent no risk, added to these difficulties. All these factors blocked market recovery, and a growing number of firms went into liquidation or faced State intervention.

... and some systemic institutions experienced severe difficulties,...

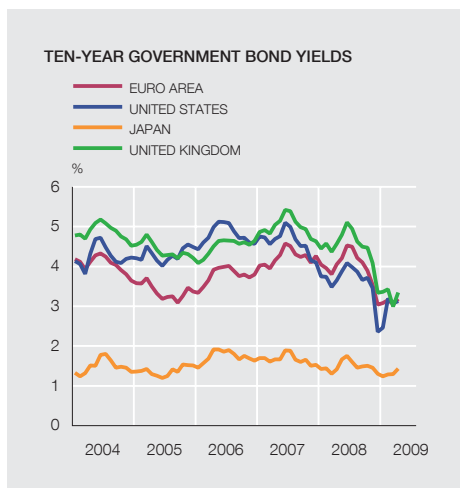
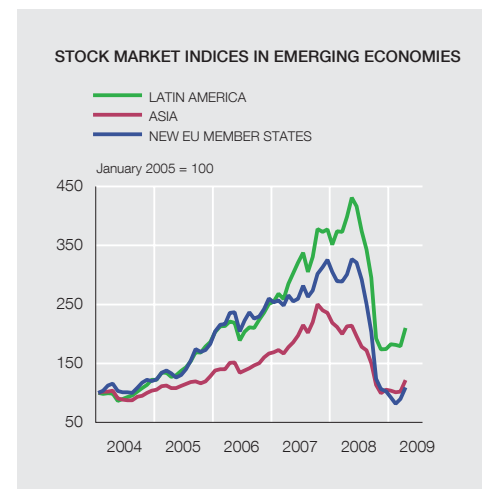
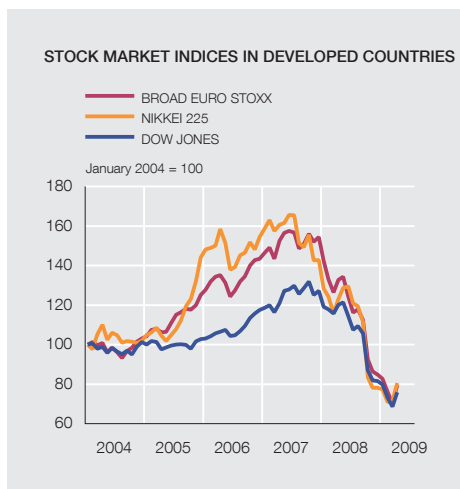
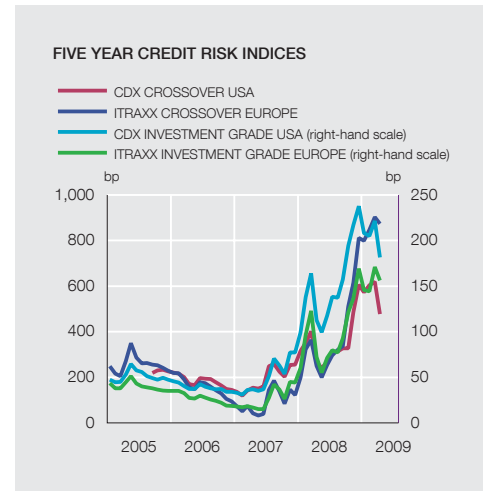
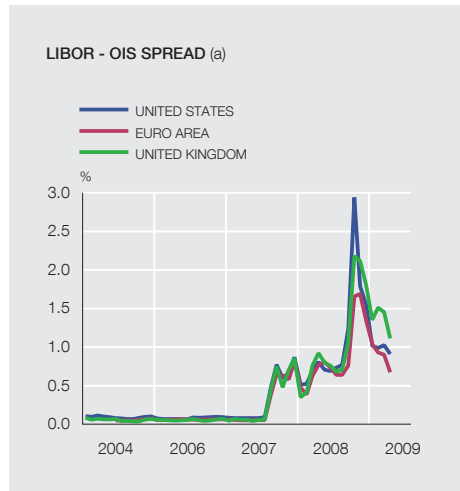
This phase was thus marked by the problems seen at a number of systemic institutions, such as the investment bank Bear Stearns, which was acquired by JP Morgan in mid-March, and the government-sponsored enterprises Freddie Mac and Fannie Mae. More generally, the high losses emerging at various financial institutions in the United States and Europe, and the credit rating downgrades seen at the main monoline bond insurers in June, contributed to a further deterioration of the financial situation. In particular, these credit rating downgrades triggered uncertainty about possible valuation problems relating to the insured instruments and gave rise to large-scale sales of a wide range of assets.

... while liquidity remained in short supply

Liquidity had been in short supply at banks since the beginning of the financial turmoil and remained so throughout this period, obliging central banks to maintain extensive liquidity provision. Nevertheless, as the LIBOR/OIS spread shows (see Chart 3.2), the interbank markets failed to return to normal, as counterparty credit risk continued to rise. On the stock markets, the bearish trend that began in 2007 continued, in light of the poor corporate earnings performance and the lower economic growth outlook, while on the foreign exchange markets the dollar depreciated, to stand at almost \$1.60/euro in mid-July.

The emerging economies' markets coped relatively well in the first half of the year,...

The emerging economies' financial markets coped relatively well with the financial turbulence in this period, although market sentiment gradually deteriorated as the economic situation worsened. Sovereign spreads widened moderately and, in general, the stock markets outperformed those of the developed economies, while currencies appreciated in the first half of the year. But the emerging markets began to deteriorate over the summer, in a scenario dominated by inflationary pressures.



SOURCES: Datastream and Bloomberg.

a. 3-month spread. US: LIBOR-effective Fed Funds rate OIS; UK: LIBOR-EONIA swap; euro area: EURIBOR-EONIA swap.

b. EMBI+ for Latin America and Global EMBI for Asia and central and eastern Europe.

... but everything changed in mid-September as the financial situation deteriorated further

In mid-September 2008, following the takeover by the US administration of Freddie Mac and Fannie Mae, the collapse of Lehman Brothers – the first large firm not to be bailed out – marked a radical change in events in the financial system. The failure of this major US investment bank revealed its systemic nature, given the volume of securities issued and of the derivatives contracts in which it acted as counterparty, significantly raising the counterparty risk in the clearing and settlement of these contracts. The fall of Lehman Brothers further reduced confidence and paralysed the credit and money markets, placing the entire financial system on the brink of collapse.

A series of highly adverse developments followed, prompting large-scale State intervention: the bail-out of the insurance firm AIG; significant corporate consolidation moves in the United States, with the takeover of Merrill Lynch, another investment bank, and other commercial banks (Washington Mutual and Wachovia); and support for other smaller institutions, in Europe also.

Stress spread rapidly, driving down the prices of all but the safest and most liquid assets

Stress spread rapidly to the different financial market segments and the flight to quality drove down the prices of all but the most liquid and safest assets which acted as a safe haven. The world's stock markets recorded the highest losses since the crash of 1929, and volatility soared in all markets; the VIX index, for example, which measures the implied volatility of the S&P 500, hit new all-time highs. Lower credit-rating corporate and sovereign credit spreads widened dramatically and, in general, the cost of non-bank lending to firms, irrespective of their credit rating, rose significantly. Moreover, higher counterparty risk gave rise to a sharp rebound in credit default swaps (see Chart 3.2).

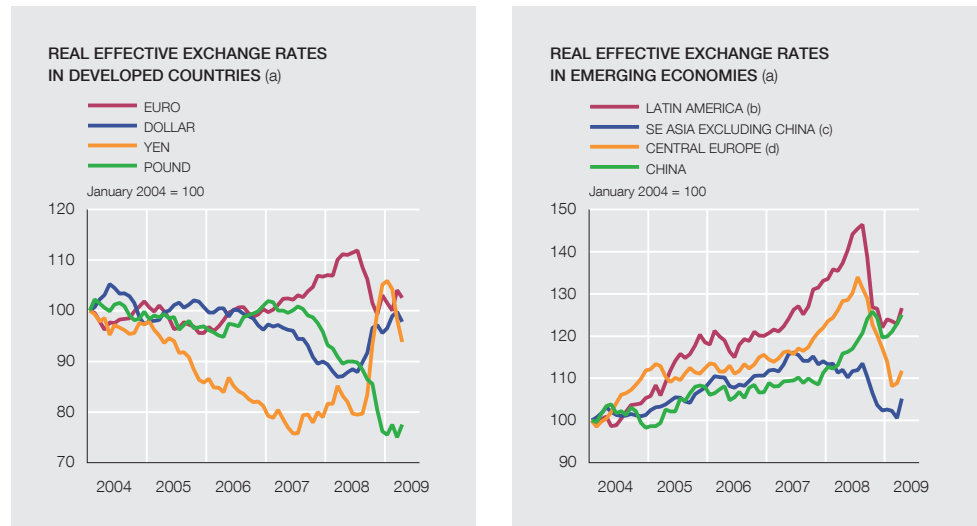
Government debt – especially US government debt – came to act more and more as a safe haven, accentuating the downward trend in long rates in the United States in this part of the year. This was also due, albeit to a lesser extent, to the poorer economic outlook and the lower inflationary pressures in the long term. Subsequently, as the flight to quality abated and the authorities' fiscal and financial efforts revealed the need for larger debt issues in the future, government debt yields rebounded somewhat, while at the shorter end of the yield curve rates fell, in step with the successive interest rate cuts seen in numerous countries as the economic and financial situation deteriorated.

The foreign exchange markets were extremely volatile in the period

As from September, the foreign exchange markets became extremely volatile. The dollar acted as a safe-haven currency, appreciating against most other currencies (see Chart 3.3) to stand at around \$1.25/euro. The yen also appreciated significantly against the main currencies as a result of growing risk aversion and unwinding of carry-trade positions (in which investors borrow currencies with low interest rates to invest in others, mainly in emerging economies, with high interest rates). Sterling fell to all-time lows against the dollar and the euro, due to the severe deterioration of the UK economy and the difficulties facing the financial system.

The relative resilience displayed by the emerging economies' markets up to September subsequently crumbled and capital inflows fell sharply

The relative resilience exhibited by the emerging markets since the start of the financial turmoil crumbled in mid-September, as external credit conditions deteriorated and investor confidence collapsed. The extensive deleveraging and reduction in capital flows from the developed markets – specifically in portfolio and banking flows – had a profound and sudden impact on the emerging markets. The initial effect was indiscriminate, despite the reduced vulnerability and relatively widespread improvement in the fundamentals of some of the emerging economies, especially in Latin America, in recent years. The external origin of the financial crisis explains why, at first, it was precisely the economies with more liquid and deeper capital markets that were most affected by the lack of external credit. This explains the sharp stock market falls and the currency depreciations seen in Brazil, Mexico and South



SOURCE: Datastream.

- a. CPI-based. An increase (decrease) denotes an appreciation (depreciation) of the currency.
 b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
 c. India, Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines.
 d. Czech Republic, Hungary and Poland.

Korea. Gradually, however, these effects passed through to countries or regions with higher financial vulnerability, including, in particular, the countries of eastern Europe and, within this region, some of the new EU Member States. These countries rely on external credit flows in foreign currency, and a growing number of them have needed external financial support. Reflecting the general deterioration of the emerging economies' markets, sovereign spreads, measured by the EMBI+, widened considerably and stock markets recorded losses (higher, in many cases, than in the developed economies, especially in eastern Europe and commodity exporting countries). Moreover, on the foreign exchange markets, the deterioration in the financial situation and the need for dollar liquidity meant that the local currencies depreciated against the dollar.

Net private capital inflows to the emerging economies fell dramatically in 2008, interrupting the upward trend seen since the start of the decade. The decline from the all-time high recorded in 2007 (\$93 billion, in comparison with \$638 billion) was due to the combination of lower capital inflows and high capital outflows, affecting mainly portfolio investments and international bank loans.

A wide range of measures was quickly taken to shore up the financial system,...

Once the financial crisis broke in September, a wide range of measures was quickly taken, aiming to stabilise the financial systems of the developed economies. In addition to the supply of unlimited liquidity by the central banks, these measures initially took the form of State guarantees for bank deposits, up to a certain limit, public capital injections to restore the solvency of the main financial institutions and State guarantees for bank debt issues. Subsequently, other measures were introduced, aimed at restructuring bank balance sheets and managing assets that had become impaired as a result of the crisis (see Box 3.1 and section 1.3 below). In the emerging markets, where the problems related mainly to foreign currency funding, measures were adopted to alleviate the pressure on exchange rates and facilitate foreign currency borrowing, through domestic credit swap facilities with the main central banks and multilateral organisations.

Numerous initiatives designed to provide support to financial institutions in difficulties were instigated throughout 2008 and early 2009. These rescue plans were implemented fundamentally at a national level, although with a certain degree of international coordination, and grew in number as the financial crisis worsened. To date, the authorities' response has prevented a collapse of the financial system, although the situation is still far from normal. Moreover, the global nature of the crisis, the urgency in the rescue of some systemic institutions, the scale of the losses seen and the uncertainty surrounding the final extent of these losses have resulted in some improvisation and emulation in the different countries' responses. This box offers a brief summary of the key financial rescue initiatives launched internationally, focusing particularly on the United States and the United Kingdom, classifying these initiatives and endeavouring to explain the reasons behind them at each different stage¹.

Up to September 2008, the authorities had responded to financial institutions in difficulties on an ad hoc basis, providing support to those that were considered systemic² and intervening in the others³. However, as the year progressed, the number of institutions in difficulties increased, as did the size of the losses receiving public sector backing. This trend heightened sharply in the wake of the collapse of Lehman Brothers on 15 September, following the breakdown of negotiations to find a private-sector solution for the investment bank. This bankruptcy raised global instability levels significantly, revealing the complexity and interconnectedness of the international financial system.

From then on, the authorities' rescue plans began to target the entire financial system, which was facing a serious risk of collapse, rather than specific financial institutions. The type of measures adopted gradually changed, as the crisis heightened and amplified and as crisis management became more and more difficult. On 3 October the US Congress approved the Troubled Asset Relief Program (TARP), originally designed to alleviate institutions' financing pressures and restore price formation mechanisms for illiquid assets, via Treasury purchases of troubled assets. However, these measures proved difficult to implement in the short term, and this, together with the heightening of the crisis and the emergence of other initiatives in other countries, meant that this strategy was abandoned before it was implemented.

1. The box focuses exclusively on the financial rescue measures seen in the period, thus excluding, inter alia, the unconventional monetary policy measures implemented by some central banks. A summary of these initiatives may be found in the Banco de España's Financial Stability Report of May 2009. 2. Up to mid-September, the public authorities backed rescue operations coordinated with the private sector in institutions such as Bear Stearns, Countrywide, Merrill Lynch and AIG; they also provided credit facilities and injected public capital into Fannie Mae and Freddie Mac. 3. The takeovers of Northern Rock and IndyMac, in addition to interventions in some small banks, stand out.

In this setting, on 8 October a financial sector rescue plan was announced in the UK, aimed at helping credit institutions win deposits. The plan envisaged capital injections in the form of preference shares, subject to fulfilment of certain conditions, and State guarantees for bank debt. Soon several countries – including many in Europe – were introducing similar plans. Moreover, on 14 October, just 11 days after approval of the TARP, the US Treasury announced a change in this programme, to permit capital injections. It also established a programme to guarantee bank debt, backed by the Deposit Guarantee Fund. Although these measures proved effective in halting the rapid and serious deterioration of the financial situation, they failed to bring market operations back onto a normal footing and restore agents' confidence, not only because of the new losses that began to emerge, linked to complex assets, but also because of the significant deterioration in activity as from the end of 2008. At the same time, signs of restrictions in credit available to the private sector began to appear, even though one of the objectives of the rescue plans was to preserve the availability of credit for households and firms, thus increasing the risk of a feedback loop between the deterioration of the financial and the economic situation.

Thus, between the end of 2008 and early 2009, the financial rescue plans entered a new more ambitious phase, with higher volumes of funds committed and a broader scope. Several countries included a series of public sector initiatives, aimed at directly encouraging private sector credit, and measures were approved to limit losses and to remove impaired assets from banks' balance sheets, with a view to restoring confidence in these institutions. Nevertheless, these measures were not uniformly implemented. Thus, in the United Kingdom, an asset protection scheme was announced, establishing a system for distribution of portfolio losses between banks and the public sector. Meanwhile, in the United States, the new administration announced a new rescue plan, including, inter alia, the creation of several funds for the purchase of troubled assets, permitting their removal from banks' balance sheets. These funds will be managed by the private sector but will be primarily funded by the public sector, which will also assume the bulk of the risks assumed by the funds. Initially, these funds will be able to purchase assets (loans and financial assets) worth up to \$500 billion, extendable up to \$1 trillion if and when necessary.

Recently, government influence on the decisions adopted by the institutions that have received a significant volume of funds has increased, as the number of conditions included in these programmes has increased, without this implying any transfer of management to the public sector. In this respect, in some cases the authorities have replaced the preference shares they held in banks' capital with ordinary shares, granting them, in principle, enhanced voting rights in these institutions.

... bringing temporary relief to the markets, but normalisation remains a distant prospect

Although the financial system has by no means normalised, the relative market stability seen from mid-October to the time of this report going to press is, above all, a reflection of the wide range of extraordinary measures that prevented an even greater loss of confidence. Nevertheless, this extensive State support has not prevented the deterioration in the financial situation from passing through to the real economy: the markets have become dominated by the prospect of recession and the scale and effective implementation of the financial policies announced is still shrouded in uncertainty. This explains the continued tensions on the money and credit markets, the lack of clear signs of recovery on the stock markets, the high volatility levels and the continuing deterioration of indicators in some emerging markets, all of which signify that the financial system is still in a very delicate position. However, as State support gradually restores confidence among investors and the financial institutions, the first signs of recovery should start to emerge.

1.3 THE SHARP ADJUSTMENT IN THE WORLD ECONOMY

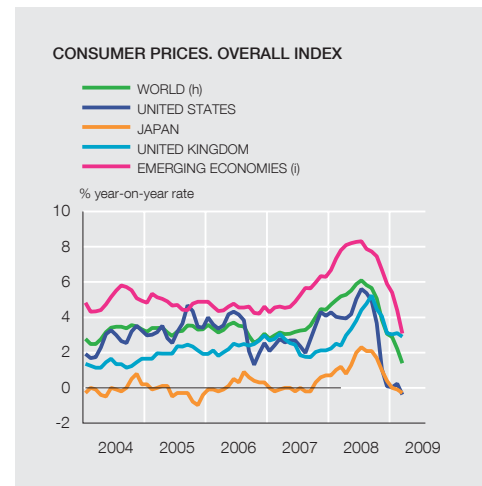
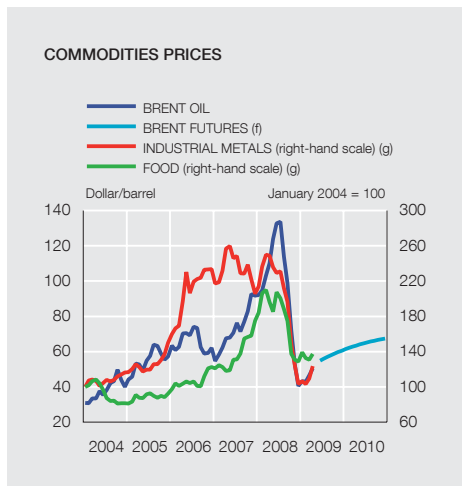
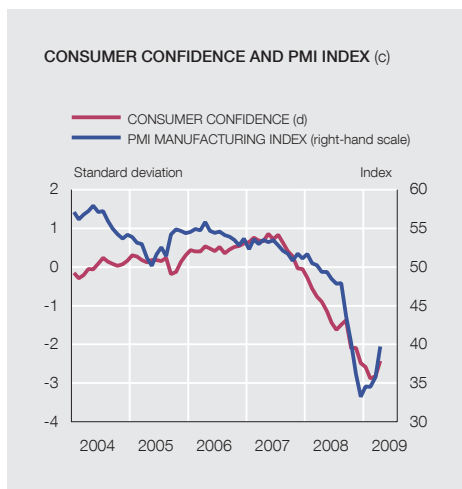
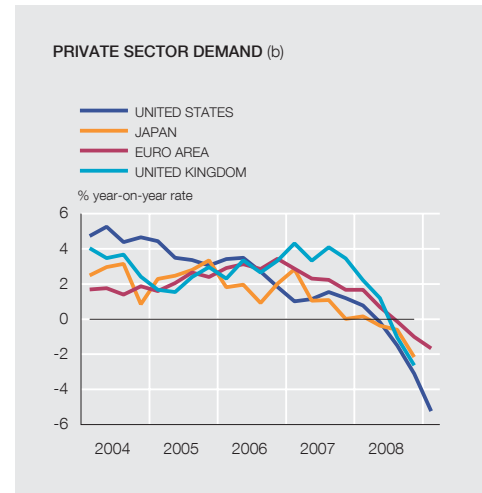
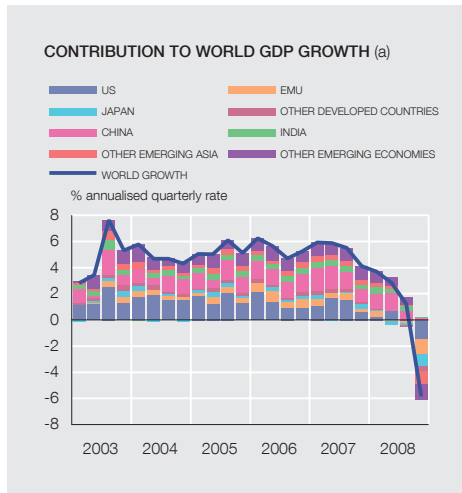
In 2008 the world economy grew by 3.2%, 2 pp less than in 2007, fundamentally due to the contribution of the emerging markets

The financial stress of mid-September marked the turning point between a gradual slowdown, albeit intense in the more developed economies, and a severe and generalised slump in global activity. The global economy decelerated considerably in 2008, growing by 2 pp less than in 2007, although it still managed to record positive growth (3.2%). The negative quarterly growth rates seen in a rising number of developed economies over the year reflect the intensity of the adjustment; in fact, by year-end, many of these economies were in recession (see Chart 3.4). The emerging countries were, once again, the main growth drivers, posting growth of 6.1%, in comparison with 8.3% in 2007. China, in particular, with growth of 9%, contributed 1 pp to world growth, while the rest of emerging Asia contributed 0.6 pp and Latin America 0.4 pp. The industrialised economies, where the rate of growth was very low in 2008 (0.9%, in comparison with 2.7% in 2007), contributed just 0.5 pp to global GDP growth. In the United States, growth fell from 2% in 2007 to 1.1% in 2008, due to the severe adjustment in residential investment and private consumption. In the United Kingdom, the decline in investment, especially residential investment, was a key factor in the significant deceleration in activity (from 3% to 0.7%), while the generalised contraction in Japan, where the growth rate fell from 2.4% to -0.6%, was due to the structural fragility of the Japanese economy since the 1990s.

To September, activity in the industrialised countries gradually weakened, through various channels, while the emerging economies saw a moderate slowdown,...

Activity gradually weakened in the industrialised economies in the first three quarters of 2008, bearing the brunt of the significant financial deterioration and its effect on the determinants of private sector demand. In particular, the deepening of the adjustment in the real estate sector in some countries fuelled the negative spiral between the decline in house prices, the deterioration of the quality of collateral held by financial institutions, the tight credit supply and the economic slowdown, although the impact of the financial deterioration on the real economy also intensified in other areas. Effective credit conditions tightened, even though official interest rates remained relatively stable, and were even cut in the United States. Consumer confidence fell as the economic outlook deteriorated, unemployment rose and consumer wealth diminished, against a backdrop of high household indebtedness in many countries. Business confidence also declined, as the demand and profit outlook deteriorated. All this weakened private sector demand in the industrialised economies (see Chart 3.4) and led to a gradual adjustment in activity. As a result, the year-on-year rate of growth went from 2.4% in 2007 Q4 to 0.6% in 2008 Q3 and a number of countries went into recession.

By contrast, in the emerging economies the relative strength of domestic demand, together in some cases with high commodities prices, helped sustain the pace of activity. Nevertheless, there was some deceleration, as these economies were not completely immune to the fall in external demand or the decline in consumer purchasing power as a result of rising inflation.



SOURCES: Datastream, Goldman Sachs, JP Morgan, PMI Premium, CPB Netherlands Bureau for Economic Policy Analysis and Banco de España.

- a. Contribution, in percentage points, to the annualised quarterly change in global GDP.
- b. Year-on-year growth in private-sector demand (consumption + investment) in real terms.
- c. Aggregate of United States, euro area, Japan and United Kingdom.
- d. Normalised variable, measured as the difference between the indicator and its historic average, expressed in standard deviations.
- e. Year-on-year growth in export volume.
- f. Brent futures from the week of 1 - 7 May 2009.
- g. Goldman Sachs indices.
- h. Aggregate calculated drawing on the data from 47 countries representing 86% of world GDP.
- i. Aggregate of 21 emerging countries of Latin America (5), central and eastern Europe (8), emerging Asia (7) and South Africa.

... but from then on, activity contracted on a global scale

As from September, the situation of extreme financial instability saw household and business confidence collapse. This, together with even tighter credit conditions, the sharp decline in wealth due to the intense stock market correction and job destruction, led to a collapse in private sector demand and a generalised contraction in economic activity of an intensity and scale unprecedented in recent decades. Against this backdrop, the main industrialised economies moved further into recession, recording year-on-year growth rates verging on -1.7% at end-2008. The crisis quickly spread to the emerging economies, as a result of the collapse in global demand, which contributed to a notable decrease in international trade flows, and the significant decline in capital flows, in light of the heightened financial stress, all of which added to the sharp drop in commodities prices first seen in the summer, with most impact on the economies that were in most need of external financing and most dependent on external demand. Thus, in 2008 Q4, global GDP contracted by 1.5% in comparison with the previous quarter and only a few countries – including China – managed to continue to post positive growth rates in the period. On the data available as at the date of this report going to press, global GDP growth is estimated to have contracted by a further 1.5% in quarter-on-quarter terms, also on a generalised basis, in 2009 Q1.

International trade was particularly affected by the fall-off in demand and the credit freeze

As indicated above, international trade was particularly dented by the slump in demand and the financial crisis (see Chart 3.4). The volume of trade fell dramatically between October and February: by some 15% in the developed economies and 19% in the emerging economies. This collapse in trade (see the analysis in Box 3.2), which has been much more intense than would normally be warranted by the decline in global activity, could have been fuelled, to a certain extent, by the scarcity and the rising cost of trade credit, especially in the emerging economies, caused by the funding difficulties on the wholesale markets. In 2008 as a whole, the volume of world trade decelerated to 3.3%, almost 4 pp less than in 2007; in February 2009 it recorded a year-on-year contraction of 15%. Accordingly, world trade could well decline in 2009, for the first time since 1982.

Commodities prices reflected the decline in demand and the global growth outlook...

Inflation rates reflected the rise and subsequent fall in commodities prices and the deteriorating global demand conditions. In fact, the developments on the commodities markets largely mirrored the change in the demand outlook, although supply disruptions and the dollar exchange rate also played an important part. Prices continued to climb in 2008 H1, in light of persistently high demand prospects for the emerging economies and a number of factors conditioning supply. In particular, the price of Brent oil rose by 54%, in dollar terms, between January and June (in euro terms, by a slightly lower 44%) to over \$145/barrel, an all-time high in both nominal and real terms. In the same period, metal prices rose by 19% and food prices by 34%. In July, however, commodities prices turned sharply downward, coinciding with a general deterioration in global growth expectations, which intensified when the financial crisis broke in September. Thus, despite successive production cuts, the price of oil fell by 66% in dollar terms, to around \$50/barrel at end-April 2009. Dollar appreciation against the euro halted the drop in price in euro terms, which amounted to 58% in the same period. Prices of metal commodities also fell substantially (by 38% between July 2008 and April 2009, in dollar terms), as did food prices and prices of agricultural commodities, reflecting not only demand factors but also good harvests. Lastly, prices of precious metals, such as gold, rose as from September, in light of their role as a safe haven. In any case, since the start of 2009 Q2, the main commodities prices have picked up.

... and were largely behind the major fluctuations in inflation rates

Against this backdrop, since early 2008 global inflation has fluctuated between record highs for the last decade, seen in the summer, and record lows since March 2004 (2.5%), seen in February 2009 (see Chart 3.4). In the first half of the year, inflationary pressures heightened considerably, as oil and food prices rose, although in the industrialised economies these pres-

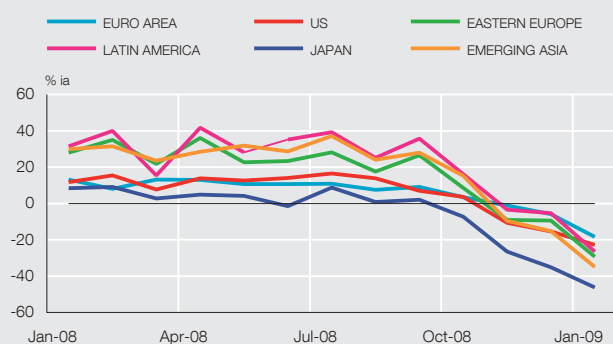
International trade has undergone a sharp correction since 2008 Q4: the volume of trade fell by some 6% in monthly terms in November and December 2008 and in January 2009 (see Chart 3.4). This decline in trade, although generalised, has been most intense in Asia (see Panels 1 and 2), where it is comparable with the decline seen in the 1998 crisis. Accordingly, the volume of world trade growth in 2008 was significantly lower than the average of the last 20 years (3.3% against 7%) and the main international organisations are forecasting a contraction of around 10% in 2009, which would be the first since 1982 and much more intense than the figure recorded in that year.

Much of the collapse in international trade is a direct result of the sharp decline in global economic activity as from 2008 Q4 (estimated at 5.9% in annualised quarterly terms). Nevertheless, although trade tends to be more volatile than activity, Panel 3 shows that the decline in the volume of trade in 2008 Q4 was significantly greater than that which was to be expected on the basis of the historical relationship between trade and global GDP growth. The high level of outsourcing and segmentation of production processes across countries, as a result of the integration of global production chains seen in recent decades, may explain why the decline in demand has had a greater

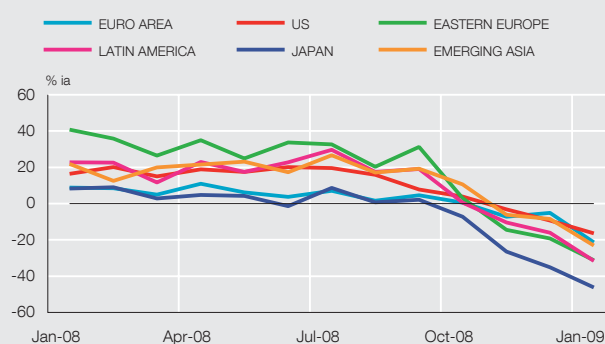
impact on trade than in the past. Moreover, the fact that this decline in demand has been most severe in durable goods, especially automobiles, whose production chains tend to be more internationally fragmented, may also explain the extraordinary decline in trade in relation to activity. However, even bearing in mind these considerations, this decline continues to seem disproportionate.

A further factor that may have contributed to the sharp contraction in trade flows in 2008 Q4 is the drought in trade finance stemming from the problems on the financial markets, which intensified thereafter. Trade finance, through direct or indirect finance, insurance or guarantees, is behind 80% to 90% of the approximately \$14 trillion worth of goods exported every year and is recognised as a fundamental factor in the growth of trade in recent decades, especially for the emerging countries which face more restrictions on financing. The most usual forms of trade finance are documentary credit (especially letters of credit), trade credit and, increasingly, syndicated loans (especially for commodities) and structured financing through securitisations (forfaiting and forwarding). In addition to providing finance for import and export transactions, these products facilitate hedging of risks (commercial, exchange rate or political-institutional risks) and supply of working capital.

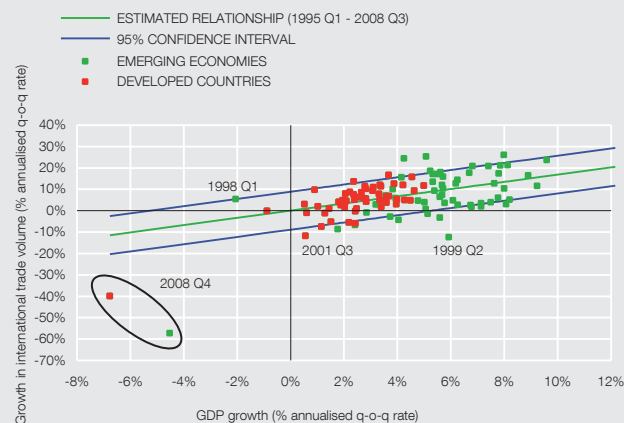
1 IMPORTS



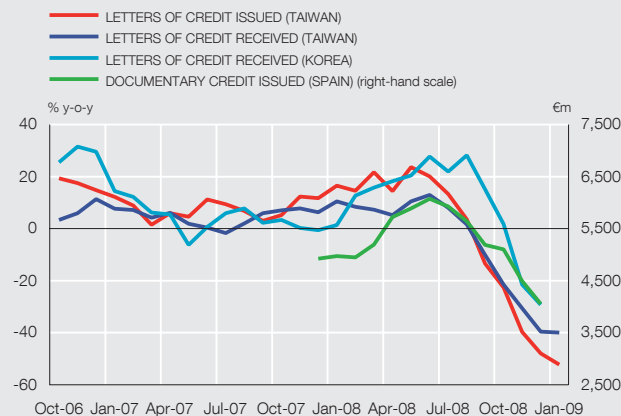
2 EXPORTS



3 WORLD GROWTH AND VOLUME OF INTERNATIONAL TRADE (1995 Q1 - 2008 Q4)



4 LETTERS OF CREDIT AND DOCUMENTARY CREDIT IN KOREA, TAIWAN AND SPAIN



SOURCES: JP Morgan, CPB Netherlands Bureau for Economic Policy Analysis, Datastream and Banco de España.

Trade finance is primarily short term, it requires high collateral and extensive documentation and it is normally low risk. All these factors probably explain why this market weathered the financial turmoil of the closing months of 2007 and the first half of 2008 relatively well, despite warnings by the World Trade Organization during this period of rising costs and liquidity restrictions for some countries. Nevertheless, there is some evidence that the heightening of the financial crisis as from September 2008 has had a particularly harsh impact on this market, which continues to face serious difficulties. Since September it has become more difficult to obtain letters of credit, especially in Asia, and the few firms that have managed to do so have seen how these letters of credit have been rejected owing to mistrust of the issuing banks: Panel 4 depicts the sharp decline since October in letters of credit issued in Taiwan (for imports and exports) and Korea (exports only) and in documentary credit issued in Spain. Lastly, it seems likely that unintermediated finance (direct credit between firms) will also have been severely hit, judging by recent trade credit patterns in most countries.

Although this fragmented evidence points to a decline in trade finance as from 2008 Q4, it does not indicate how much is due to a decline in supply and how much to a decline in demand. Recent surveys conducted among the main finance providers in the banking sector¹ point to restrictions in the supply of trade finance. These restrictions would appear to be most severe in the emerging economies (especially in Asia, which would be consistent with the sharp contraction seen in trade flows in this region in comparison with others), and as yet non-existent in the developing countries. The surveys

1. The first survey was conducted jointly by the International Monetary Fund and the Bankers Association for Finance and Trade (BAFT). The subsequent survey carried out by the International Chamber of Commerce reinforces the idea that there are supply-side problems in trade finance.

also reflect the notable rise in the cost of trade finance, from an average of 10 to 20 bp over LIBOR to 250 to 300 bp. Moreover, the banks surveyed expect these costs to continue to climb throughout 2009.

Trade finance is in short supply for the same reasons as other types of credit, but its very nature may hinder its recovery. First because, as they have deleveraged, credit suppliers have tended to withdraw funds from these markets, which involve mostly short-term credit, having committed these funds to other more long-term credit segments. Second, because the trade finance sector is highly concentrated and many players are among those most affected by the financial crisis, meaning that they have withdrawn from this market segment or have disappeared altogether. And third, because the financial sector support plans launched have focused on keeping domestic credit flowing, to the relative detriment of trade credit.

All in all, although to date there is no clear evidence of the extent of the contribution of the trade finance drought to the decline in international trade, if it fails to recover it could hamper global economic recovery in the short and long term. In the short term, restrictions on the supply of trade finance could hinder a return to normal for global production chains and trade flows. The first stage of many of these production processes is in Asia, where the shortage of trade finance appears to have been most acute. In the medium term, if the restrictions continue, international production chains may tend to relocate to their home territories, or to countries which, although not the most efficient in production terms, offer a competitive edge in terms of access to finance. This would signify a considerable efficiency loss in the utilisation of global resources and a step backward in globalisation. The recent G20 agreement to earmark \$250 billion to reactivate trade finance is an acknowledgement of the importance of these considerations for recovery from the crisis (see Box 3.3).

sure were barely passed through to core inflation. In July, the global inflation rate stood at 6.1% year-on-year, 1.4 pp more than at the start of the year. In the emerging economies, inflationary pressures were even higher (the year-on-year rate stood at 8.3% in July), due to the greater weight of prices in the consumption basket, the higher relative contribution of commodities to products' final prices and, in some countries, domestic demand pressures, and these were passed through in part to core inflation, prompting monetary policy tightening, in contrast to the situation in most of the developed countries.

In the second half of the year, as commodities prices corrected and demand collapsed, inflation fell rapidly to very low rates, undershooting monetary policy targets in some of the developed economies. At the end of 2008, average global inflation stood at 3.1%, substantially below the figure one year earlier and close to zero in the United States and in Japan. Inflation rates have remained very low in the opening months of 2009, helped by the favourable base effect stemming from the increases seen in commodities prices in early 2008, and have turned negative in some developed countries. Nevertheless, in the main industrialised economies, long-term inflation expectations remained well-anchored throughout the year.



SOURCES: Datastream and IMF (WEO).

- a. OPEC countries plus Russia and Norway.
- b. Country aggregates based on the IMF (WEO) definition.
- c. Data as a percentage of GDP. (+) surplus; (-) deficit.
- d. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
- e. India, Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines.

Global imbalances lessened slightly in the second half of 2008 and accumulation of external assets by the emerging economies slowed

Global imbalances, measured in terms of external balances, remain significant, but there were some signs of a correction as from the second half of 2008. The global current account surplus amounted to \$1.3 trillion in 2008, unchanged at 2.1% of world GDP (see Chart 3.5). In the second half of the year, weakening domestic demand in the United States and the lower energy bill prompted a decline in the US trade and current account deficits, while the deceleration in world trade and falling commodities prices reduced surpluses in some regions (Latin America, emerging Asia – excluding China – and the oil exporting countries). The most striking exception is China, whose current account surplus continued to grow, albeit at a lower rate than in previous years.

Thus, the correction in real effective exchange rates between January 2008 and March 2009 was not, in many cases, consistent with the correction in global imbalances (see Chart 3.3). Albeit with significant fluctuations in the period considered, the US dollar appreciated, while

the emerging market currencies generally depreciated, with the exception of the Chinese renminbi. The intense process of accumulation of reserves and assets in sovereign wealth funds by some of the emerging economies concluded in 2008, as oil prices fell sharply in the second half of the year and some countries delved into their international reserves to maintain exchange rates or limit exchange rate volatility in Q4.

1.4 THE ECONOMIC POLICY RESPONSE

The economic policy response has grown in scope and strength as the economic situation has deteriorated

The economic policy response has grown in size, strength and geographical scope, with a qualitative and quantitative leap as from September 2008. Initially, following the onset of the financial turmoil in 2007, the authorities in the developed economies responded by supplying liquidity to banks, to alleviate the shortage in the interbank markets, cutting interest rates in some cases and sporadically bailing out financial institutions. However, as from 2008 Q4, the economic policy response stepped up a gear, as a wide range of complementary and interconnected financial, monetary and fiscal measures were introduced in many more countries, aimed at stabilising the financial markets and halting the collapse in aggregate demand, to restore private agents' confidence and sever the interplay between the problems facing the financial sector and the real economy.

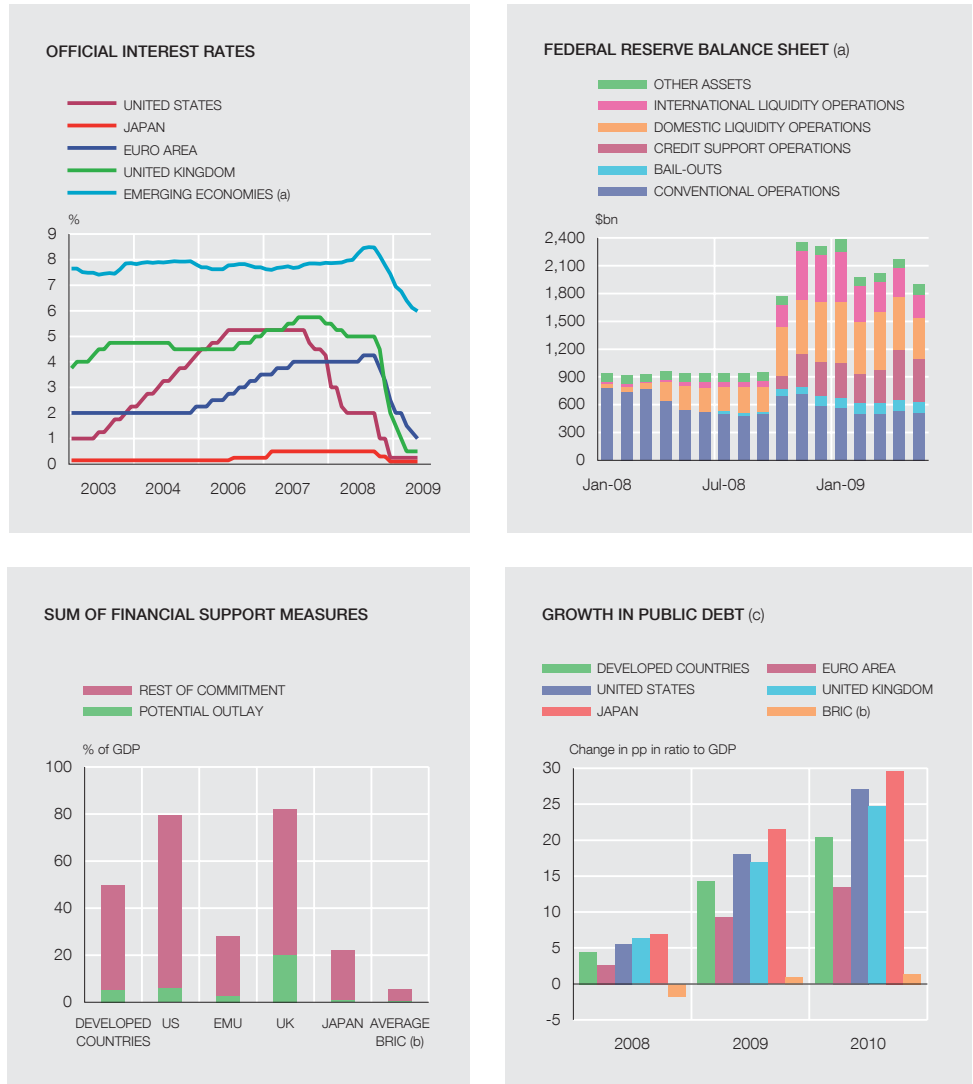
Official interest rates were conditioned by inflation developments

As regards monetary policy, official interest rates were conditioned by price developments throughout 2008. During the first half of the year, the generalised rise in inflation posed difficulties for most monetary authorities in the developed economies, which were facing growing inflationary pressures on the one hand and the risk of economic slowdown and financial instability on the other. The initial response varied from country to country. The United States cut its official interest rates quickly and substantially as from the end of 2007, with a brief pause in mid-2008, against a backdrop of severe financial market instability. By contrast, official interest rate moves were less intense in other industrialised economies, and some countries even raised rates. In the emerging economies in general the monetary policy stance tightened.

The rapid decline in commodities prices as from July, and the heightening of the financial crisis in September, altered the scenario facing the monetary authorities dramatically, as the risks to financial stability loomed larger, amidst clear signs of economic slowdown and even recession. This prompted substantial interest rate cuts, including an unprecedented coordinated 50 bp rate cut by the main central banks – with the exception of the Bank of Japan – in October 2008 (see Chart 3.6). Most of the emerging economies also cut their official interest rates, although this monetary easing came in differing degrees of pace and intensity and was, in some cases, initially limited by the risks of exacerbating exchange rate depreciation and encouraging capital outflows. However, the rate cuts had only a limited impact on financing conditions: the generalised decline in inflation offset the impact on real interest rates, which nonetheless remained substantially below the levels seen before the start of the financial turmoil in 2007; and the pass-through of these lower rates ran counter to the tight credit conditions that continued to be applied to firms and households.

The sharp decline in inflation brought rates close to zero in most industrialised economies, giving rise to the use of unconventional instruments and increasing the size of central banks' balance sheets

These dramatic rate cuts brought official interest rates very close to zero in most industrialised economies, meaning that the monetary authorities were obliged to use other less conventional measures to ensure that monetary easing passed through to agents' effective credit conditions. Thus, in addition to continuing to provide almost unlimited liquidity to financial institutions, the main non-euro area central banks began to intervene directly to support the credit markets, purchasing private assets and granting credit and guarantees to intermediaries in certain markets. They also began to purchase government bonds, aiming to drive down long rates. As a result, the central banks' balance sheets, which were stable in terms of size up to September, even though their asset composition may have changed, expanded significantly (see Chart 3.6). In the United States, other measures directly associated with support



SOURCES: National statistics, IMF and Banco de España.

- a. Conventional operations: includes T-bonds, primary credit and repos. Bail-outs: support given to Bear Stearns and AIG. Credit support operations: purchase of GSE debt, mortgage securitisation assets issued by the GSEs, the TALF, AMLF and CPFF. Domestic liquidity operations: includes the TAF, TSLF and PDCF. International liquidity operations: currency swaps with other central banks.
- b. Aggregate of Brazil, Russia, India and China.
- c. Expected increase in debt in each year in comparison with 2007.

for certain financial institutions also added to the Federal Reserve's balance sheet. Accordingly, by early 2009, the balance sheets of the Federal Reserve and the Bank of England had more than doubled since September, and although in recent months they have declined slightly, the measures approved in March could double them once again. This package of measures underlines the key role that the central banks are playing in support of the financial sector and the erosion of the dividing lines between monetary and financial policy. Thanks to the direct support received by certain credit market segments, yield spreads have corrected somewhat from the levels seen at the beginning of 2008 Q4.

The financial sector support measures are wide-ranging and include guarantees, capital injections and asset purchases

The financial sector support measures first introduced when the financial turmoil erupted in mid-2007 continued through the first half of 2008. The central banks continued to inject liquidity into the system, against a backdrop of considerable mistrust between financial institutions, to alleviate the credit freeze, while a number of firms facing particular difficulties were bailed

out, either by State intervention (Northern Rock in the United Kingdom) or by State support for private-sector transactions (Bear Stearns and Countrywide in the United States).

Once the financial crisis broke in September, the authorities' response became more emphatic, more generalised and more coordinated, encompassing a wide range of measures, including extended State guarantees for bank deposits, injections of public capital and purchase or guarantee of assets, it being assumed, in the last two cases, that the public sector would bear the bulk of any losses (see Box 3.1). Moreover, considering how difficult it was, in these circumstances, for the financial sector to play its role of financial intermediary satisfactorily, the authorities also took direct measures to stimulate credit in certain strategic sectors, such as the automobile industry and SMEs. Two aspects of the economic policy response are particularly noteworthy: the huge volume of funds involved in the financial support plans; and the appearance of certain mechanisms coordinating the national authorities' response, in light of the global nature of the problems faced. In this respect, the emergence of the G20 as a crisis-response discussion and coordination forum, not only at a financial level but also in terms of economic policy in general (see Box 3.3), should be highlighted.

Fiscal policy has generally been the last tool to be used, and to a different extent from country to country

With the notable exception of the United States, until 2008 Q4 no country had introduced discretionary fiscal stimulus measures in response to the worsening economic and financial situation. However, as a result of the economic slowdown (with the consequent activation of the automatic stabilisers) and the difficulties facing the financial sector, together with the real estate sector adjustments seen in some countries (reducing tax revenue, as real and financial asset values diminished), fiscal positions gradually deteriorated from the start of the year in most of the developed economies. Once the crisis broke in September, fiscal expansion became one of the most potentially effective economic policy instruments to stimulate activity and staunch private agents' loss of confidence, considering, in addition, the scant or non-existent upward pressure that fiscal expansion would exert on interest rates in the short term in the present circumstances. Accordingly, fiscal stimulus plans, of very different sizes, were introduced in numerous countries in the last quarter of 2008 and in early 2009. The overall fiscal stimulus in the developed economies is estimated at around 0.6% of their GDP in 2008, rising to 1.5% in 2009 and to 1.7% in 2010 (see Chart 3.1), with the United States playing a leading role.

In the emerging economies the fiscal impulse has also been considerable, although it was introduced rather more belatedly

In some emerging economies, rising commodities prices and their social impact inspired consumer support measures which had an adverse effect on fiscal balances in the first half of the year. The decline in commodities prices as from the summer halted revenue growth for commodities exporters. Although the fiscal impulse was introduced later than in the industrialised economies, it is expected to be more intense in the emerging economies in 2009, and similar in 2010, with China, Russia and Saudi Arabia leading the way. Specifically for the G20 member countries, the fiscal impulse should amount to 0.4% of their GDP in 2008, 2.3% in 2009 and 1.6% in 2010. The initial caution may have been due, in part, to possible difficulties funding these fiscal plans, in light of the abrupt decline in external financial flows.

The fiscal impulse has leant heavily on public spending measures, especially infrastructure

Fiscal plans have leant heavily on public spending measures, especially infrastructure. On the revenue side, tax cuts have targeted personal and, to a lesser extent, corporate income tax, while indirect tax cuts have been only symbolic. This bias towards public spending measures is due to the private sector's lower marginal propensity to consume and invest, against a backdrop of economic and financial fragility and an adverse economic outlook, thus making tax cuts, in general, less effective. Nevertheless, delays in implementing spending plans, at a time when urgent demand momentum is needed, may limit their effectiveness in the short term.

The international crisis is having a profound impact on the global economic and financial system, giving rise to a review of the three key pillars of the international financial architecture: the coordination of economic policy decisions, granting the G20 a key role; the supranational aspects of the financial regulatory and supervisory framework; and the international financial institutions. This box analyses the main elements of this review and the role played by Spain in this process.

One initial element of the reform process is the key role assumed by the G20. The global nature of the crisis and the extent to and speed at which it has spread across national boundaries have revealed the limitations of the G7 as a decision-making forum and the need for greater international concertation, to include not only the developed economies, but also the emerging countries, in decision making. The G20's new leading role became evident at the first summit of Heads of State and Government of the G20 countries held on 15 November 2008, and was reaffirmed at the second summit, held on 2 April 2009, both preceded by meetings between ministers and central bank governors. These sessions directly approached the subject of coordination of macroeconomic and financial policies, designed to facilitate recovery from the crisis, with special emphasis on establishing a coordinated fiscal effort and financial sector support plans, to bring the market situation back to normal and restore credit flows.

The guidelines for reforms in financial regulation and the international financial system were also set at these summits and meetings. In this respect, detailed work programmes were established and four working groups were created within the G20, on regulation, international cooperation and integrity in financial markets, the International Monetary Fund (IMF) and development banks. Each working group has been co-chaired by two officials, one from an emerging market and one from a developed economy, and has involved international financial institutions in their work. Each group has progressed in the design of reforms and responses to the global crisis and has taken the technical discussions directly to the G20, parallel to the executive bodies of the international financial institutions.

Spain is not a G20 member but it was invited to take part in the summits of Heads of State and Government, in recognition of its economic weight and financial system, which place it among the world's ten leading economies. In addition to participating in the summits, Spain has made a notable contribution in various European and international fora, working to achieve convergence on common positions for the reform process. In this respect, in addition to taking part in the European Council sessions and ECOFIN meetings, Spain also played an important role in the meeting of European leaders held in Berlin on 22 February and in the meeting of Ibero-American ministers held in Oporto on 2 March, and, on a more technical level, in the work conducted from the chairs of the ECB's International Relations Committee and the Economic and Financial Committee's Working Group on Procyclicality.

As regards the changes in the financial regulatory and supervisory framework, it is commonly agreed that they should envisage the higher degree of interconnectedness between the different national economic and financial systems. The G20 is promoting multiple re-

forms in this field, to meet this aim and to strengthen international coordination. In general, the challenge these reforms face is to strike a correct balance between preventing excessive regulation, a difficulty parallel to determining the limits of the fiscal impulse or of public sector intervention in the financial system, and securing effective implementation of the measures proposed, which requires a high degree of international coordination to standardise guidelines and basic rules and ensure monitoring and control of the measures adopted.

In this respect, the creation of the Financial Stability Board (FSB) to succeed the Financial Stability Forum (FSF) is one pillar of the reform. The FSB was founded with expanded membership to include the G20 countries that were not FSF members¹, Spain and the European Commission. It is the reference forum in international financial regulation, to the extent that it has been described by some authoritative voices as the fourth institution of the international financial system, together with those established at Bretton Woods (the IMF, the World Bank and the WTO). The FSB aligns the reality of a global and highly interconnected financial system with a more coordinated and inclusive regulatory framework, updating obsolete structures that excluded the emerging economies. Once again, Spain's membership of the FSB is the recognition of its weight in the international financial system.

The areas of review of financial regulation and supervision include: (i) enhancing market transparency and extending the scope of the regulatory and supervisory framework to all institutions and markets that are relevant for the stability of the financial system (understood in a wide sense, this includes the various initiatives to strengthen or include in the regulatory framework tax havens, credit rating agencies and hedge funds, or the need for transparency in exposure to off-balance-sheet products); (ii) reducing the procyclicality of the financial system and solvency standards, to ensure that capital requirements and accounting standards help safeguard the solvency of the financial system instead of amplifying the effects of crises (in this area, with special priority given to the dynamic provisioning system of the Banco de España); (iii) introducing a macro-prudential approach in supervision, to ensure that an institution's potential systemic risk is taken into account in addition to its accounting and financial position; (iv) strengthening international coordination of supervision and surveillance of the financial system, including the introduction of colleges of supervisors for transnational banking groups and creation, jointly by the IMF and the FSB, of an early warning system for financial risks; and (v) adopting principles for executive remuneration schemes in financial institutions, to bring them more in line with the time horizon of the risks assumed.

Regarding reform of the international financial institutions (IFIs), the G20 has promoted a significant increase of up to \$1.1 trillion in their funds: an additional \$500 billion for the IMF, as described in detail below, as well as a \$250 billion SDR allocation by this institution; an extra \$100 billion in development bank loans; and \$250 billion to bolster international trade finance. It has also promoted a policy over-

1. Argentina, Brazil, China, India, Indonesia, South Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey.

haul, to enable the IFIs to face up to the new challenges posed by the crisis with more guarantees. The rapid response from the IFIs reflects the recognition of the need for a multilateral approach to what is a global crisis and the need to provide financial support to the emerging and developing economies, which are bearing the brunt of a crisis that originated in the developed world. In this respect, the proposals to adapt governance of the IFIs to better reflect the economic weight of the different countries and raise the weight of the emerging and developing economies (changing representational criteria determined by past inertia), represent another common element of reform.

In connection with the IMF, three key reforms stand out: increased funding, review of lending policies and enhanced surveillance.

The international community has resolved to triple the resources for IMF loans, granting \$250 billion immediately (via bilateral contributions) and up to a further \$250 billion in the short term via extension of the New Arrangements to Borrow (NAB). Moreover, the option remains for the IMF to assume debt on the open market. As regards the bilateral contributions, Japan took the first step, contributing \$100 billion in February 2009; it was followed by the European Union, after approval by the European Council on 19 and 20 March of voluntary

contributions by the Member States totalling €75 billion (the Spanish contribution is estimated at €4.1 billion).

As regards lending policies, the IMF, adapting its lending framework, is widening access limits and reviewing the conditionality of its programmes, strengthening the principle of ownership and reducing the number of performance criteria, focusing on those that are critical for crisis resolution. The IMF has also approved a new lending facility, the Flexible Credit Line (FCL), with preventive nature, which enables rapid access to a large volume of funds, with ex-ante conditionality, granting countries access to IMF funds in accordance with pre-set qualification criteria, based on the implementation of sound economic policies and the existence of solid fundamentals.

Lastly, on surveillance, the IMF has progressed in including financial supervision in countries' Article IV, in fomenting analysis of the links between the real economy and the financial sector and in early detection of risks, through activation of a new early warning system in co-ordination with the FSB. It is also considering making the Financial Sector Assessment Programs (FSAPs) more regular, undertaking to conduct them at least in all the G20 countries, and using them for peer reviews within the FSB.

The automatic stabilisers and the fiscal stimulus and financial bail-out plans have led to a significant and generalised deterioration of public finances

This fiscal activism and the economic slowdown have pared down present and future fiscal balances. Moreover, the financial support plans, and even some aspects of the unconventional monetary policy measures, also entail a high level of commitment of public funds, amounting to more than 50% of GDP in the industrialised economies (see Chart 3.6). Although only some of these funds will require disbursement at the time of use (9% of GDP in this group of countries), and much of the total invested is expected to be recovered, these measures may raise the public debt/GDP ratio by more than 20 pp in 2010. They could also result in substantial losses, due to guarantees or purchases of assets whose value at maturity is far from certain.

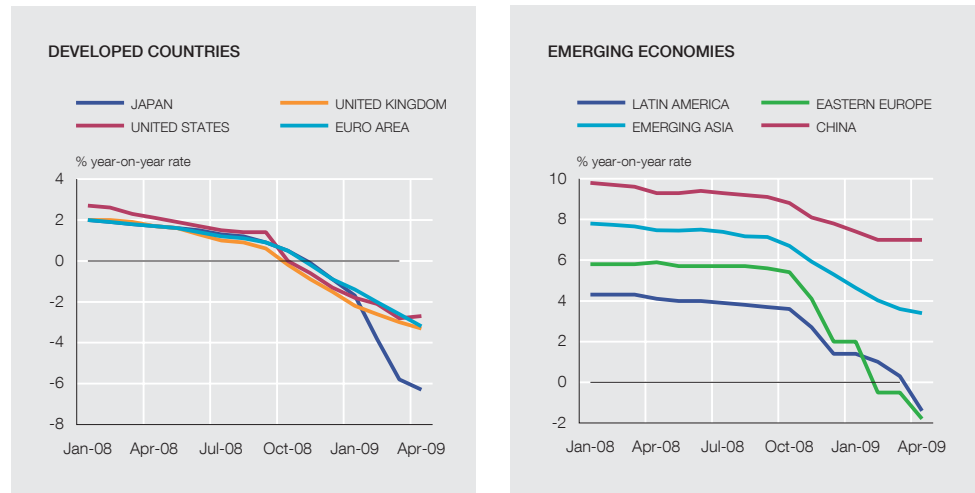
Despite the efforts made, a return to normal is still a long way off

In any case, these wide-ranging economic policy measures, which brought the global financial system back from the brink of collapse at the end of 2008, are still a long way from achieving their aim to stabilise the situation on the financial markets, restore agents' confidence and improve the global economic outlook.

2 Outlook and risk factors

The outlook for 2009 points to a sharp decline in activity in the developed economies and to an abrupt slowdown in the emerging economies, followed by a very gradual recovery towards the end of the year...

Throughout 2008 Q4 and 2009 Q1, growth forecasts for 2009 for the developed and the emerging economies were revised down dramatically (see Chart 3.7). This reflects the intense adjustment in activity seen in 2008 Q4, which has had a significant impact on average growth in 2009, and the weak economic situation at the start of the year, as a result of the continued adverse interplay between the deterioration of the financial sector and the real economy. Thus, according to the leading international organisations' growth forecasts, world GDP will shrink by some 1.3% in 2009, the largest decline, at least, since the Second World War. This contraction is expected to be most profound in the developed economies, where it is estimated that GDP will fall by more than 3.5%, to be only partially offset by some of the emerging Asian economies (especially China and India), which should continue to post positive growth rates,



SOURCE: Consensus Forecasts.

a. Growth forecasts for 2009 issued as at the dates indicated on the horizontal axis.

albeit well short of those seen in 2008. The developed economies should start to see a timid recovery in activity by the end of 2009 or early 2010, recording positive quarter-on-quarter growth rates marking the start of a gradual recovery from the crisis. Nevertheless, these forecasts are shrouded in uncertainty and many risks remain.

... as the financial markets stabilise and private sector demand recovers

This outlook points to a gradual recovery in business and household confidence in financial institutions and to a severing of the interplay between the deterioration of the financial sector and the real economy. For this to happen, two conditions would seem necessary. First, that as a result of the financial sector support measures, progress is made in the reshaping, resizing and restructuring of financial institutions, and market stability enhanced. A sustainable recovery is most unlikely if no decisive steps are taken to reorganise the financial system on a solid base. Moreover, to trigger a recovery in activity, credit conditions will have to gradually improve and real estate market adjustment processes will have to be completed (in the United States, the real estate market adjustment was at the source of the deterioration of the bank balance sheets which began now more than three years ago). The second condition is that the economic stimulus measures taken be effective in sustaining demand and activity.

In any case, given the harm inflicted on the economy and the financial system, the recovery in growth is likely to be a very gradual process. This is generally the case when recessions are accompanied by a financial crisis, exacerbated, in this case, by the virtually global scale of the downturn. Moreover, the adverse effect of the crisis on growth potential worldwide is likely to be felt for a considerable time, not only because credit conditions will foreseeably be tighter than in the past, but also because of the possible decline in production capacity and productivity, as a result of the prolonged decline in investment and the long-term unemployment situation.

If the negative spiral between the financial sector and the real economy were to intensify, or the policy response were to prove less effective than expected, the outlook for recovery would be jeopardised

In short, the main risks to economic recovery in the developed countries in the short term are, first, that the above-mentioned negative spiral between the financial system, the real estate sector and the real economy becomes more acute again; and second, that the effectiveness of the support measures is impaired, due to adverse collateral effects on effective financing costs or market mechanisms, or if their impact on confidence ultimately disappears as they absorb more and more public funds.

In the case of the emerging economies, the recovery will hinge on a return to normal access to external financing

In the case of the emerging economies, there is a risk of a higher-than-expected decline in capital inflows, due to higher public sector borrowing in the industrialised countries (as a result of the bail-out plans and fiscal impulse measures), along with the generalised deleveraging process and the increase in home bias among investors. This risk is especially high in the economies that are most reliant on external financing, which have high external deficits and whose financial or corporate sectors have high borrowing requirements, as it would exacerbate the effects of the adjustment already under way in many of these countries.

More protectionism and fewer capital inflows are additional risk factors

More globally, the main risk is that the economic and financial adjustment, and in particular the measures taken from the different national perspectives, result in greater segmentation of the product and financial markets, marking a step backward in the process of economic and financial globalisation seen in recent decades. In this respect, it is important to reaffirm and put into practice the commitments assumed at the G20 summit meetings, to adopt a concerted approach to the crisis and to recovery from the crisis and to continue along the free trade road under the Doha round (see Box 3.3).

Global capital flows pose a further risk, since although global imbalances are diminishing, many countries still need to borrow extensively, and they may find it difficult to meet these needs against a backdrop of higher volatility on the financial markets and tighter credit conditions than in the past. This could affect not only the emerging economies but also the United States, where borrowing requirements are high, investors have suffered very substantial capital losses and the net international investment position has deteriorated significantly.

But there is no imminent risk of deflation

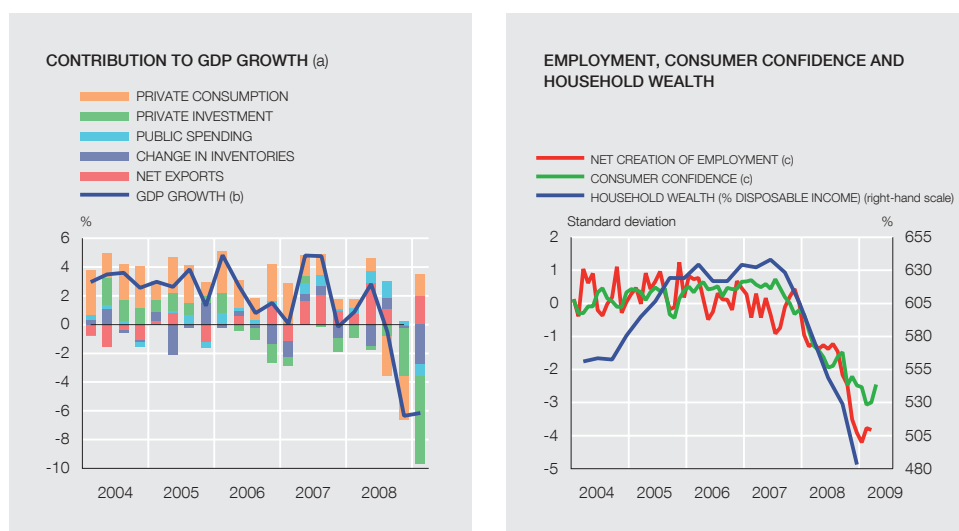
Lastly, as commodities prices and capacity utilisation decline, there is a possibility that some industrialised economies may post negative inflation rates in 2009. Nevertheless, this would not imply deflation, even if economic activity were to continue to contract for some time, provided that it was temporary and that medium- and long-term inflation expectations remained anchored around central bank targets, as has been the case up to the date of this report going to press.

The policies implemented to combat the crisis could have adverse effects in the medium term, if the monetary impulse is not withdrawn in time...

The scale of the economic and financial policies adopted may have undesirable consequences when the world economy recovers from the crisis. Accordingly, the implementation and subsequent withdrawal of the significant monetary impulse, which has helped limit the recession and sustain the financial markets, must be carefully calibrated, to prevent the risk of it being passed through to future inflation rates, undermining the anti-inflationary credibility of the central banks, or to real and financial asset prices, sowing the seeds for a new cycle of future financial excesses.

... or if public sector indebtedness proves unsustainable in the medium term

In addition, the substantial rise in public sector borrowing underlines the need to make fiscal discipline a priority in the medium term. In the short term, the fact that government bonds act as a safe haven in times of high uncertainty, the decline in wealth and the increase in the propensity to save in the private sector have meant that the growing fiscal imbalances are being funded at relatively low cost. But the huge increase in public debt depicted in Chart 3.6 generates concern as regards its sustainability, especially in economies with high debt ratios and whose public finances are under pressure due to population ageing. As the financial situation returns to normal, the increase in debt will eventually drive up long rates, thus adding to the pressure on the debt position.



SOURCES: National statistics, Datastream and Federal Reserve.

- a. Contributions to annualised quarterly GDP growth.
- b. Annualised quarterly rate of change.
- c. Normalised variable, measured as the difference between the variable and its historic average (since 1952 for employment and since 1969 for consumer confidence), expressed in standard deviations.

Growing State involvement in the functioning of some sectors may affect efficiency in the allocation of resources; this support should be withdrawn as and when circumstances permit

Growing State involvement, largely driven by the circumstances, in economic activity and in the financial sector also entails risks. In the medium term, State involvement beyond its traditional role could lead to efficiency losses in the allocation of resources. Moreover, public support for sectors in crisis may delay or even prevent necessary restructuring and resizing. Accordingly, when it comes to withdrawing public support, the economic policy response must be equally rapid, timely and decisive. Clearly the scale of the monetary stimulus measures will hinder their withdrawal, as will the difficulty in establishing precisely the right time for this withdrawal, in a situation in which potential growth rates may have declined, making it more difficult to assess the cyclical position, and in which the policy transmission mechanisms have changed significantly. The withdrawal may also be hindered by considerations unrelated to the economy, which means that it is important to design an exit strategy well in advance. In any case, the withdrawal of the current stimulus measures cannot signify a return to the situation prior to the crisis, as one of the essential lessons to be learnt from this crisis is that there must be much closer monitoring of financial imbalances – both national and global – and that the perimeter and scope of financial regulation and supervision must be extended and enhanced.

3 The main industrialised countries

3.1 UNITED STATES

The US economy went into recession as a result of the profound adjustment in both the financial sector and the real economy

The US economy has deteriorated significantly since the end of 2007 (according to the National Bureau of Economic Research, it officially went into recession in December that year), despite recording positive quarter-on-quarter growth rates in 2008 Q1 (see Chart 3.8). Growth in 2008 overall amounted to 1.1% (the lowest annual rate of growth since 2001), down from 2% in 2007. The real estate sector adjustment, which has proved deeper and longer-lasting than was first expected, heightened the adverse interplay between house prices, financial asset quality and economic activity. In addition, consumer confidence and, consequently, private consumption have deteriorated in the face of declining consumer wealth and the weakening labour market (a net total of three million jobs were destroyed in 2008, half of these in Q4 alone, followed by two million more in 2009 Q1).

The signs of weakness became increasingly evident in 2008 H1, although the impact of the first fiscal stimulus plan – launched in February – and external demand support helped foster seemingly robust growth in this period. In 2008 Q3, however, GDP declined in quarter-on-quarter terms, before contracting sharply in 2008 Q4 (–6.3% in annualised terms) and in 2009 Q1 (–6.1% in annualised terms, on the preliminary estimate), as the deterioration of both the real economy and the financial sector heightened. While residential investment contracted throughout the year, consumption and non-residential investment weakened in 2008 H1, before collapsing in 2008 H2. External demand offset the fall in domestic demand up to the third quarter, but was subsequently dragged down by the sharp slump in international trade. As a result, the trade deficit narrowed to 4.8% of GDP in 2008 and the current account deficit closed the year at 4.7%, 0.6 pp less than in 2007.

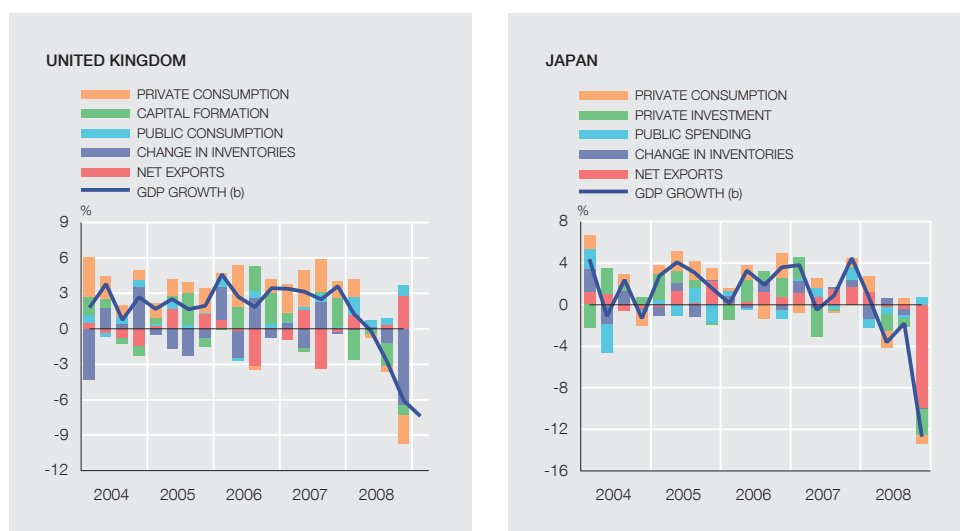
Inflation decelerated considerably in the second half of the year, posting negative rates by March 2009

Consumer prices rose by 3.8% in 2008 overall, in comparison with 2.9% in 2007, but the breakdown for the year reflects two very distinct halves. Thus, inflation rose gradually up to July, to peak at 5.6%, driven by energy and food prices, before declining sharply thereafter, as commodities prices collapsed, to negatives rates in March 2009. Core inflation remained relatively stable in 2008, at 2%-2.5% year-on-year, although it declined slightly at the beginning of 2009.

The economic policy measures adopted to halt the serious deterioration of the financial system and of economic activity were increasingly determined and decisive

The economic policy measures adopted to halt the serious deterioration of the financial system and of economic activity were increasingly determined and decisive and were closely coordinated between the Federal Reserve and the US Treasury, especially following the events of September. The Federal Reserve gradually eased its monetary policy stance, cutting the target federal funds rate from 4.25% at the beginning of the year to 2% in April, when it paused in light of the inflationary pressures. It then made further rate cuts in response to the severe financial crisis, down to a target range of 0%-0.25% in December 2008. Moreover, throughout the year the Federal Reserve gradually extended its liquidity-providing measures to a growing number of financial institutions. As from September, it began to use the asset side of its balance sheet to keep credit flowing in the economy and to keep the financial markets, including the money, commercial paper and mortgage securitisation markets, functioning. And in March 2009, in line with the new monetary policy approach, it began to purchase Treasury bonds to help reduce long-term borrowing costs.

The Treasury responded decisively to the deteriorating situation in the financial system. At the beginning of September, it took control of the government-sponsored enterprises Freddie Mac and Fannie Mae, recapitalising them. And then in October, faced with the risk of financial system collapse, it secured approval for the \$700 billion Troubled Assets Relief Program (TARP), originally designed to purchase toxic assets but whose funds were subsequently earmarked for recapitalisation and bail-out of financial institutions. This was followed, in 2009, by an integral plan to guarantee assets, recapitalise institutions and restructure banks' balance sheets, via a public-private initiative for purchase of problem loans and assets (see Box 3.1). State support targeted not only the financial sector, but also other economic sectors, fundamentally automobile manufacturing. Initiatives were also taken to facilitate the renegotiation of doubtful and impaired mortgage loans and the supply of mortgage credit. Lastly, in early 2009, a \$787 billion fiscal stimulus package was approved (representing 5.5% of GDP, of which 1.3% will be disbursed in 2009). As a result of the measures taken and of the deterioration in economic activity, the fiscal position worsened significantly in 2008: the budget deficit reached 6.1% of GDP in the year, against 2.9% in 2007, and gross public sector debt amounted to 70.5% of GDP, an increase of 7.4 pp on the previous year.



SOURCES: National statistics and Datastream.

a. Contributions to annualised quarterly GDP growth.
 b. Annualised quarterly rate of change.

The economic outlook for 2009 has worsened significantly; recovery would need to be preceded by stabilisation of the real estate market and recovery on the financial markets

The economic outlook for 2009 has worsened significantly due to the severe deterioration of the real economy, presaging not only a profound contraction but also a slow recovery that is not expected to start until H2. As at the date of this report going to press, the main international organisations expect GDP to shrink by more than 2.5% in 2009. A return to growth would need to be preceded by stabilisation of the real estate market and by a partial recovery in the functioning of the financial markets, although there is uncertainty regarding the effectiveness of the policies implemented. The risks remain on the downside, given the possibility of further difficulties in the financial system, or of a deeper adjustment in the residential sector or the labour market.

3.2 UNITED KINGDOM

The UK economy decelerated considerably in 2008, weighed down by domestic demand

The UK economy decelerated considerably in 2008, growing at a rate of 0.7%, in comparison with 3% a year earlier. Following low growth in Q1, activity contracted sharply as from Q2 (see Chart 3.9), to fall by 6.1% in annualised quarter-on-quarter terms in Q4 and, on the preliminary estimate, by 7.4% in annualised terms in 2009 Q1. There was a sharp deceleration in domestic demand, with a notable decline in gross capital formation and inventories. Private consumption was also weak, against a backdrop of credit market restrictions and falling property and financial asset prices. The intensity of the financial crisis in the United Kingdom, and the weight of this sector in the UK economy overall, also had an adverse impact on activity. By contrast, the contribution of external demand improved, as sterling depreciated and imports declined. As a result, the current account deficit fell back from 2.9% of GDP in 2007 to 1.7% in 2008.

Inflation rose for much of the year, and subsequently evidenced considerable downward stickiness, which conditioned the monetary policy response

Inflation rose for much of the year, to peak at 5.2% year-on-year in September, and subsequently evidenced considerable downward stickiness due, inter alia, to the depreciation of sterling. During the first half of the year, the rise in inflation conditioned official interest rates. However, as financial stress heightened as from September, the Bank of England launched a series of successive and far-reaching rate cuts which brought the base rate down from 5% to 0.5% – an all-time low – by March 2009. It also decided to pursue monetary expansion through higher liquidity provision and purchases of private financial instruments and Treasury bonds. Moreover, since October 2008, the UK government has introduced vari-

ous rescue measures for the banking sector, via guarantees for debt issues and bank assets, asset purchases by the Bank of England and recapitalisations of credit institutions facing grave solvency problems (see Box 3.1). As a result, the State has gained control over most of the capital of a growing number of banks. As regards fiscal policy, the 2009-2010 budget contained a fiscal stimulus package for households and SMEs worth 1.4% of GDP. This included a VAT rate cut, distinguishing it from the packages announced in other countries.

Activity is expected to contract notably in 2009

The outlook for 2009 points to a sharp contraction in GDP (around 4%), reflecting continued deterioration of domestic demand and the external economic climate. As regards policy measures, there is little room for manoeuvre, as the budget deficit will already be high in 2009 and further base rate cuts are virtually impossible. The main risks are on the downside, if the financial crisis proves deeper and longer-lasting than initially expected.

3.3 JAPAN

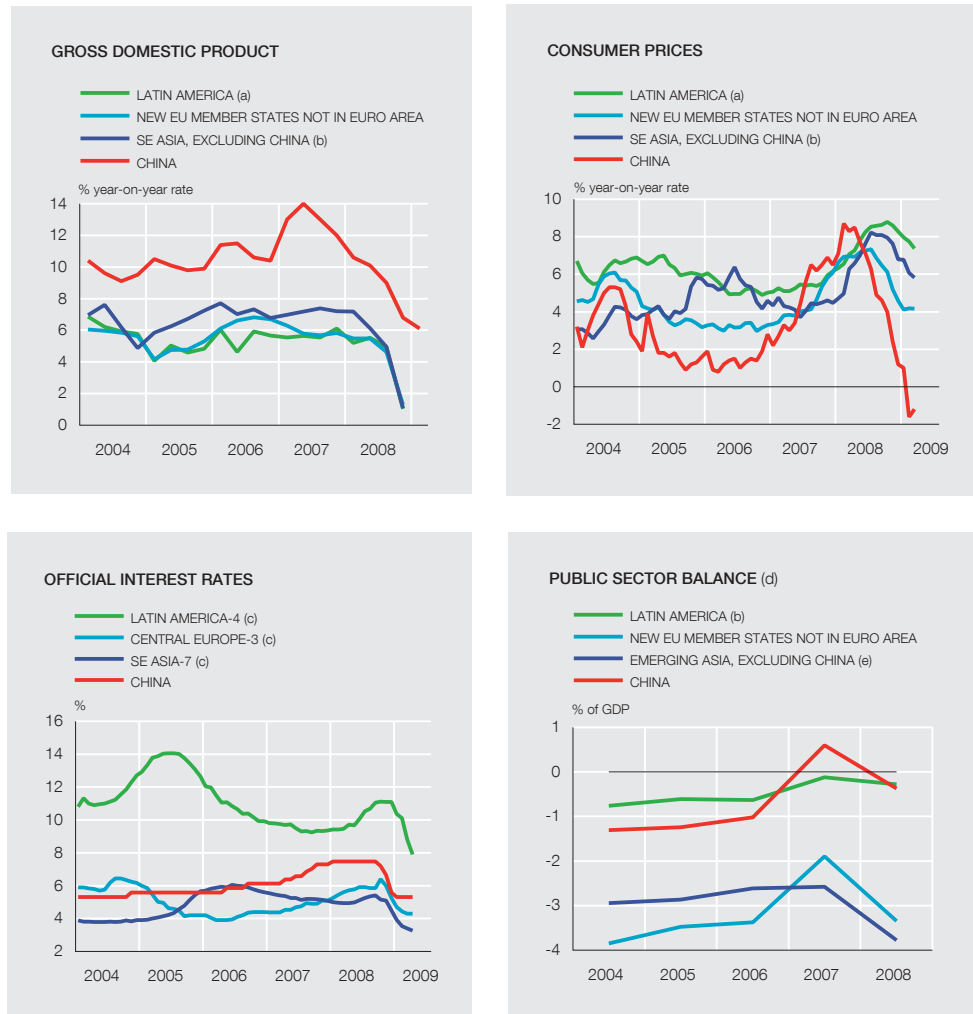
GDP contracted in Japan in 2008, dragged down by all its components and by the growing financial difficulties

The Japanese economy contracted by 0.6% in 2008, after growing by 2.4% in 2007, reflecting the sharp drop in private investment, sluggish private consumption and growing external demand weakness. Activity recorded negative rates of growth in quarter-on-quarter terms in 2008 Q2 and declined abruptly to 12.1% in annualised quarter-on-quarter terms in Q4 (see Chart 3.9), the sharpest fall in any of the developed economies. The progressive deterioration in financial conditions was particularly intense towards the end of the year, as the stock markets slumped, the yen appreciated and credit restrictions heightened. That prompted a loss of confidence and a sharp fall in expectations, which had an adverse impact on domestic demand. Moreover, by 2008 Q4 the sharp deceleration in the export sector had become an intense contraction and, as a result, the current account surplus declined to 3.2% of GDP in 2008, 1.6 pp lower than in 2007.

Inflation fluctuated in line with commodities and food prices and with developments in domestic demand. In July 2008, inflation peaked at 2.3% year-on-year; by March 2009 it had fallen to -0.3%. The GDP deflator and core CPI displayed latent deflationary tensions throughout the year. Up to September, the Bank of Japan held its interest rates unchanged at 0.5%, and monetary policy was marked by the dilemma between inflationary pressures in the overall index and the decline in activity. When the financial crisis intensified, spreading quickly to the real economy, the central bank made two rate cuts as from October, so that by December 2008 the official interest rate stood at 0.1%. At the same time, the Bank of Japan introduced measures to increase liquidity in domestic and foreign currency in the money markets, followed by initiatives designed to facilitate corporate financing, including purchases of debt and shares by the central bank. As regards fiscal policy, the economic and financial crisis put an end to the correction of the fiscal imbalance and the path of adjustment of public debt, which stood at -5.6% and 196.3% of GDP, respectively, at end-2008. Since September, the Japanese government has announced various economic stimulus plans, including mainly initiatives to support financial institutions and supply credit to SMEs, as well as smaller-scale fiscal measures (representing some 2.5% of GDP) designed to sustain household income and promote public investment and employment.

The outlook for 2009 points to a notable contraction in activity

The outlook for 2009 points to a profound contraction of around 6% in GDP. Considering the sharp deceleration in world trade, the high weight of the external sector hinders recovery, while the loss of confidence and the weak labour market make a recovery in investment and private consumption more difficult. The risks to this central scenario are on the downside, if the global slowdown were to intensify and, in particular, if it were to have a knock-on effect on China.



SOURCES: Datastream, IMF (WEO) and Banco de España.

a. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.

b. India, Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines.

c. Areas analysed: SE Asia-7 (Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines), Central Europe-3 (Czech Republic, Hungary and Poland) and Latin America-4 (Brazil, Mexico, Chile and Colombia).

d. Percentage of GDP. Surplus (+) or deficit (-).

e. Country aggregate based on IMF (WEO) definition.

4 The emerging economies

4.1 CHINA AND THE REST OF ASIA

China proved relatively resilient in the face of the crisis, despite the deterioration in international trade and the real estate sector adjustment

The pace of economic growth decelerated to 7.7% in emerging Asia in 2008, in comparison with 10.6% in 2007, with a relatively strong performance in particular from China and India.

China's GDP grew by 9% in 2008, in comparison with 13% in 2007. Activity decelerated slightly in the first half of the year and then sharply in the second half, bringing year-on-year growth in 2009 Q1 to 6.1% (see Chart 3.10). This was attributable to sluggish domestic demand that was due, in turn, to the real estate sector adjustment and the effects of the deterioration in world trade. Nevertheless, external demand made a direct positive contribution to growth in 2008 (albeit smaller than in 2007), and the current account surplus rose to \$426 billion (9.8% of GDP), as imports adjusted to a greater extent than exports.

The rate of growth moderated in the other Asian economies, especially in those most reliant on external demand and international borrowing

The other main Asian economies recorded growth of 4.8% on average in 2008, in comparison with 7.2% in 2007. After a very strong Q1, economic growth decelerated gradually in Q2 and Q3, before slowing abruptly to a rate of 1.1% in Q4. The adjustment was especially intense in South Korea and in the more open and smaller economies, which went into recession as a result both of external and domestic demand (especially investment and private consumption), in a setting of weak employment and declining consumer and business confidence. This situation was exacerbated in 2008 Q4 by the sharp correction in trade flows (to which this region is particularly vulnerable as it is highly export-gearred), the collapse in confidence and tightening credit conditions.

Monetary policy responded to the sharp fluctuation in inflation, before being oriented, as from September, towards sustaining activity and mitigating the impact of the financial tensions

Monetary policy in the region tightened up to the summer to combat the growing inflationary pressures stemming from the rise in food and energy prices. As from September, the deterioration in activity and the decline in inflation – which was especially notable in China – prompted significant and generalised official interest rate cuts. Some countries, such as China, also reduced the bank reserve requirement and eliminated credit controls. Among the unconventional measures taken, some central banks introduced liquidity-providing instruments in local currency and dollars (in the case of South Korea and Singapore, with the backing of the Federal Reserve). As regards exchange rate policy, in July the Chinese authorities tacitly suspended the policy of sustained renminbi appreciation against the dollar, in light of the more unfavourable external demand outlook. In other countries, as repatriation of investments by non-residents in the closing months of 2008 and scant dollar liquidity prompted significant currency depreciation, a number of central banks intervened on the foreign exchange markets. Fiscal policies became expansive in 2008 H2, and were strengthened with support measures for the financial sector, albeit with varying degrees of scope and intensity from country to country. The Chinese and South Korean plans are the most extensive, representing an estimated 5.8% and 5.1%, respectively, of GDP in the period 2009-2010.

The outlook for 2009 envisages a sharp deceleration in growth

The outlook for 2009 envisages a contraction in many of the region's economies, especially in those that are most reliant on trade, with closer financial links and in most need of funds. China, which is expected to post growth in the order of 6.5%, and to a lesser extent India, could put up more resistance if the authorities manage to sustain domestic demand momentum. China's capacity to isolate itself from the external conditions will be key in the global scenario.

4.2 LATIN AMERICA

Activity also decelerated in Latin America as from the summer; the turnaround in commodities prices was an added adjustment factor

In Latin America, aggregate GDP rose by 4.2% in 2008, in comparison with 5.7% in 2007. After three quarters of very strong and even higher-than-expected growth, activity decelerated sharply in Q4, placing some economies on the brink of recession. This was due, in part, to commodities prices – which continued to provide strong support for activity up to the summer, before subsequently heading downwards – and, as from September 2008, to the slump in external financing and global demand. In this setting, the trade surplus decreased considerably, initially as a result of strong imports and subsequently due to lower export prices, resulting in a current account deficit of 0.3% of GDP.

On average, consumer prices in the region accelerated up to October 2008, rising well above central bank targets, save in Brazil, so that inflation expectations eventually deteriorated. The monetary policy response was marked by significant interest rate hikes, in some cases in the wake of alternative measures taken to mitigate currency appreciation pressures. Inflation peaked at 8.9% in October, and began to decline gradually in the closing months of 2008, prompting most of the region's central banks to make successive sharp interest rate cuts – rather belatedly in comparison with the rest of the world – between December 2008 and April 2009. As from September the central banks were quick to react, providing dollar liquidity

to bring the money and foreign exchange markets back onto a normal footing and prevent the risk of a credit freeze. This response was possible, in many cases, due to the volume of international reserves built up in recent years, in addition to the dollar credit facilities granted to a number of countries by the Federal Reserve in October and subsequently by the IMF. In this setting, most of the region's economies tried to introduce counter-cyclical fiscal policies, although these varied from country to country and were generally quite small in scale. The decline in State revenue as a result of the correction in commodities prices and external financing conditions limited the fiscal room for manoeuvre.

The outlook for 2009 points to a contraction in activity throughout the region

The outlook for 2009 points to a contraction in activity of around 1.5% throughout the region. In the present circumstances, the difficulties in covering net borrowing, which will grow due to the prospect of a higher current account deficit, may act as a constraint on economic growth.

4.3 THE NEW EU MEMBER STATES

The impact of the global financial crisis was particularly intense in the new EU Member States, due to their high exposure to external financing

In the new EU Member States, GDP decelerated sharply in 2008. On average it grew by 4.1%, in comparison with 5.9% in 2007, as a result of the adverse impact of the global financial crisis on the availability and the cost of financing. This was especially the case in these countries and in some of their neighbours, such as Russia and Ukraine, due to their high exposure to external financing in foreign currency. That led to a significant adjustment in domestic demand, just as external demand – especially from the euro area – was also deteriorating. In 2008 the Baltic States and Hungary went into recession, while the rest of the region's economies slowed more gradually. On average, the current account deficit declined slightly, to 7.9% of GDP, with a particularly significant adjustment in the Baltic States.

Inflation rose to 6.5% on average in 2008, in comparison with 4.4% in 2007, but it declined across the board as from July, as a result of the drop in commodities prices and the economic slowdown, prompting gradual monetary easing throughout the region. In the fiscal sphere, public finances deteriorated – save in Bulgaria and Hungary – due to the impact of the slowdown, while the budget deficit for the region overall rose from 1.9% of GDP in 2007 to 3.3% in 2008.

The policy response was constrained by external financing restrictions and some countries resorted to international financial aid packages

In response to the financial crisis, the authorities adopted a series of support measures for the banking sector, including extended deposit guarantees and, in some cases, recapitalisations and guarantees for bank debt. Moreover, in light of their foreign currency liquidity problems, Hungary, Poland and Latvia had to apply to other central banks for help (via swap facilities with the Swiss National Bank and the Swedish and Danish central banks, and repo transactions with the ECB), while some of the countries in greater need of external financing had to apply for financial aid packages – conditional upon fiscal adjustment and financial sector restructuring plans – from the international financial organisations and the European Union.

Slovakia joined the euro area on 1 January 2009. Within the Exchange Rate Mechanism (ERM II), the Latvian lats underwent intense depreciation pressure, especially as from September, trading at the lower limit of its fluctuation band of $\pm 1\%$. Exchange rates in Lithuania and Estonia, both with pegs to the euro, remained stable, despite the financial tensions. The currencies not participating in ERM II depreciated considerably against the euro in 2008 H2 and, more intensely so, in the opening months of 2009.

The outlook points to a decline in activity and high risks in the financial sphere

The outlook for 2009 has deteriorated substantially and the region faces particularly high risks associated with possible financing difficulties. GDP will foreseeably decline significantly in the Baltic States and in Hungary, while activity in the other economies is expected to slow considerably.