1 Introduction

In 2010, the world economy made progress in emerging from the crisis and grew by 5%, underpinned by the buoyant emerging economies, whereas the recovery in the advanced economies was more gradual

In 2010, as a whole, the world economy continued the process of recovery and financial normalisation with which it had ended 2009 and grew by 5%, following the contraction of 0.5% posted in the previous year. The emerging economies, whose fundamentals had scarcely been affected by the crisis, recovered more strongly and grew by 7.3%, which accounted for more than three quarters of world growth. The more gradual upturn of 3% experienced by the developed economies varied notably across countries, the United States and Japan being the most buoyant economies in this group. However, in most cases – the United Kingdom, the euro area and Japan – activity has still not returned to its pre-crisis levels as seen in Chart 3.1.

In the developed economies the recovery was subject to fluctuations and uncertainties throughout the year. The sovereign debt crisis in the euro area and doubts about the soundness of the upturn in the United States seriously affected confidence and markets around the second quarter. It was only with the support from fresh monetary and fiscal stimuli in the United States that confidence in the recovery was restored in the last four months of the year. Notwithstanding this, the risks to the recovery remained high and included, most notably, the upward trend in commodity prices, triggered by the strong growth of the emerging economies, and the ongoing sovereign debt problems in Europe. Furthermore, at the beginning of 2011 major shocks occurred – there was a wave of instability in the Arab world and an earthquake with grave consequences in Japan – which have exacerbated certain of these risk elements.

Inflation rates have risen from very low levels, driven higher by the upswing in commodity prices

During 2010, ongoing wide output gaps, weak labour markets and the process of reorganisation of public and private balance sheets constrained the expansion of domestic demand in the developed economies and eased inflationary pressures. However, increases in commodity prices, which intensified in 2011, have lifted inflation from average rates of approximately 1% in mid-2010 to the present level of more than 2%. In the emerging economies, inflationary pressures have been stronger and in certain cases – mainly in Asia – inflation rates have exceeded their pre-crisis levels.

International trade returned to a normal footing and international capital flows picked up

The recovery was accompanied by the normalisation of international trade, which in 2010 increased by 12% in volume and exceeded its pre-crisis levels. Noteworthy were the buoyancy of the trade of (and between) emerging countries and the fact that global imbalances once again widened, albeit moderately. The return of financial flows towards emerging economies has been very strong, accentuating the risks of some of them overheating. The reorganisation of international financial flows reflects the adjustment of the global financial system to a situation in which the outlook for emerging economies is better than that for advanced economies, while the latter continue to correct the excesses which led to the crisis.

Economic policies continued to play an essential role as a support for activity

Economic policies continued to play an essential role as a support for activity. In fact, uncertainty about the recovery and the financial situation led to the postponement of the exit strategies from expansionary monetary policies, which were anticipated at the beginning of the year, and there was even some further loosening in the United States and Japan. In the fiscal arena, there was a pronounced difference in behaviour between the fiscal consolidation in Europe - prompted by sovereign debt problems in the euro area - and fresh fiscal stimuli in Japan and the United States.

MAIN MACROECONOMIC INDICATORS

TABLE 3.1

	2008	2009	2010	2010 Q1	2010 Q2	2010 Q3	2010 Q4
UNITED STATES							
GDP (a)	0.0	-2.6	2.9	2.4	3.0	3.2	2.8
CPI (a) (f)	3.8	-0.4	1.6	2.4	1.8	1.2	1.3
Current account balance (% of GDP)	-4.7	-2.7	-3.2	-3.0	-3.4	-3.4	-3.1
General government balance (% of GDP)	-6.3	-11.3	-10.6	-10.7	-11.1	-10.4	-10.3
JAPAN							
GDP (a)	-1.2	-6.3	3.9	5.6	3.1	4.9	2.2
CPI (a) (f)	1.4	-1.4	-0.7	-1.2	-0.9	-0.8	0.1
Current account balance (% of GDP)	3.2	2.8	3.1	3.3	3.4	3.5	3.6
General government balance (% of GDP)	-4.1	-10.2	-9.6	-7.4	-7.1	-7.3	-7.5
EURO AREA							
GDP (a)	0.3	-4.1	1.8	0.8	2.0	1.9	2.0
CPI (a) (f)	3.3	0.3	1.6	1.1	1.5	1.7	2.0
Current account balance (% of GDP)	-0.7	-0.4	0.2	-0.4	-0.3	-0.4	-0.6
General government balance (% of GDP)	-1.9	-6.3	-6.5	—	—	—	—
UNITED KINGDOM							
GDP (a)	-0.1	-4.9	1.3	-0.3	1.6	2.5	1.5
CPI (a) (f)	3.6	2.2	3.3	3.3	3.4	3.1	3.4
Current account balance (% of GDP)	-1.6	-1.7	-2.5	-2.6	-2.1	-2.4	-2.9
General government balance (% of GDP)	-3.6	-8.6	-8.9	-7.3	-9.5	-7.9	-10.7
CHINA							
GDP (a)	9.6	9.2	10.3	11.9	10.3	9.6	9.8
CPI (a) (f)	5.9	-0.7	3.3	2.2	2.9	3.5	4.7
Current account balance (% of GDP)	9.3	4.9	5.2	4.5	5.4	7.2	5.3
General government balance (% of GDP)	-0.8	-2.8	-1.6	6.5	4.6	-1.0	-11.8
LATIN AMERICA (b) (c)							
GDP (a)	4.3	-2.0	6.3	5.9	7.9	6.0	5.3
CPI (a) (f)	7.8	6.4	6.4	6.1	6.6	6.3	6.7
Current account balance (% of GDP)	-0.6	-0.3	-0.7	-0.1	-0.4	-0.6	-0.7
General government balance (% of GDP)	-0.5	-2.9	-2.2	-2.7	-2.5	-2.1	-2.0
NON-EURO AREA EU MEMBER STATES THAT JOINED EU IN 2004 OR 2007 (b) (d)							
GDP	4.4	-3.4	1.9	0.6	2.0	2.1	2.8
CPI (a) (f)	6.4	3.6	3.1	3.0	2.7	3.1	3.7
Current account balance (% of GDP)	-7.4	-2.7	-2.6	-1.0	-2.0	-4.4	—
General government balance (% of GDP)	-3.6	-6.9	-6.4	—	—	—	—
PRO-MEMORIA: GDP GROWTH (e)							
World	2.5	-1.0	5.0	5.1	5.3	5.0	4.6
Developed countries	0.1	-3.5	2.6	2.1	2.7	3.0	2.4
Emerging countries	5.7	2.1	7.9	8.7	8.6	7.3	7.1
PRO-MEMORIA: INFLATION (e)							
World	4.5	2.9	3.3	3.0	2.8	3.0	3.6
Developed countries	1.6	0.1	1.5	1.6	1.1	1.3	1.7
Emerging countries	8.1	5.2	6.2	4.7	4.8	5.1	5.7

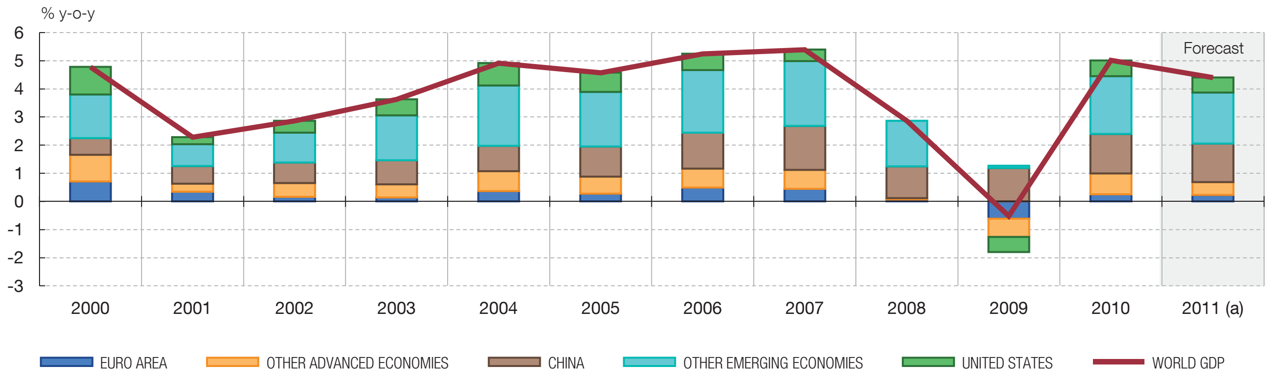
SOURCES: Banco de España, IMF and national statistics.

a Annual percentage change.
b The aggregate for the different areas has been calculated using the weight of the countries making up such areas in the world economy in the previous year, in PPP. Based on IMF information.
c Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
d Latvia, Lithuania, Czech Republic, Hungary, Poland, Bulgaria and Romania.
e Quarterly data based on a sample of countries representing 90% of world GDP.
f Quarterly CPI corresponds to the average for the quarter.

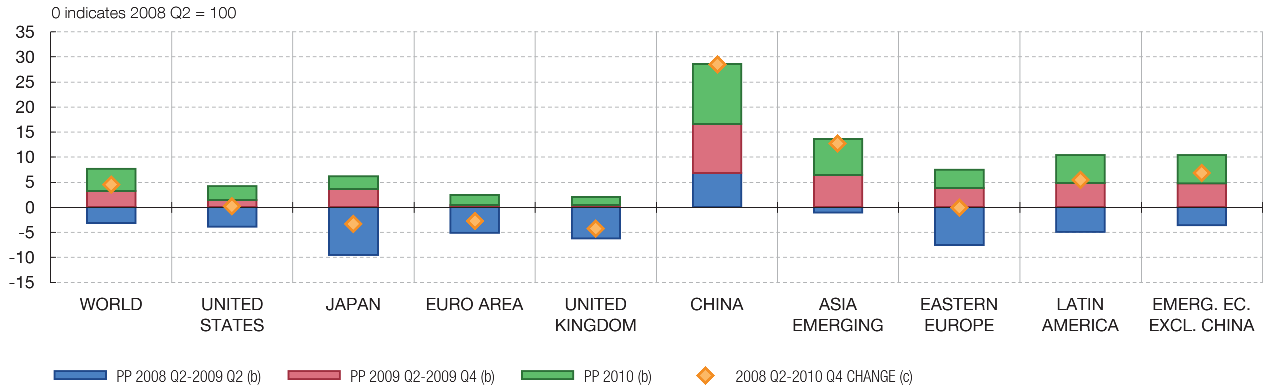
GDP

CHART 3.1

CONTRIBUTIONS TO YEAR-ON-YEAR WORLD GDP GROWTH



CHANGE IN LEVEL OF GDP AFTER THE FINANCIAL CRISIS



SOURCE: IMF World Economic Outlook, April 2010, national statistics, Datastream and JP Morgan.

a IMF forecasts.
b Contribution in pp to the change in GDP for the period.
c Rate of change of GDP between 2008 Q2 and 2010 Q4.

Emerging from the crisis will be a slow process and inflationary risks will become more important

The outlook for the global economy is one of a gradual recovery, although it will be hampered by the adjustments which are still pending in the developed economies and subject to notable uncertainty. The deterioration of public finances and the upward trend in commodity prices will reduce the authorities' margin for manoeuvre and may undermine confidence again. In parallel, the global economy remains immersed in a process of profound structural change characterised by the increasingly important role of emerging economies as engines of economic growth (see Box 3.1) and a new framework of international cooperation in the formulation of economic policies.

2 Economic and financial developments

In 2010 Q1, global economic activity continued to pick up, more sharply in the emerging economies...

At the beginning of 2010 global economic activity continued to recover against a backdrop of moderate inflation, carrying on the trend that began in the second half of 2009. World GDP increased at a year-on-year growth rate of 5.1% in Q1, boosted mainly by the emerging economies, which grew by 8.7% year-on-year (see Chart 3.2). For their part, the advanced economies expanded by 2.1% year-on-year (3.1% in annualised quarter-on-quarter terms), supported by stockbuilding and private consumption; the external sector's contribution to growth was negative despite the recovery of exports. The upturn was more robust in the United States and Japan, which posted annualised quarter-on-quarter growth of 3.7% and 6%, respectively, and more moderate in the United Kingdom. In any event,

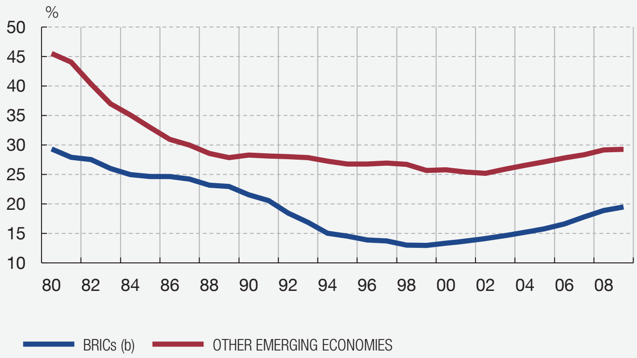
THE GROWING WEIGHT OF EMERGING ECONOMIES IN THE GLOBAL ECONOMY[1] BOX 3.1

The emerging economies have become increasingly important actors in the global economy, raising their share of world GDP, trade and financial flows. This process strengthened from the turn of the century and intensified further during the financial crisis. Also as a result of the crisis, there have been significant changes in the governance of international economic institutions, which have crystallised into greater participation by the emerging countries, more in line with their relative weight in the world economy. Within the group of emerging economies, these trends have been particularly strong in the most systemically important countries (Brazil, Russia, India and China, collectively known as the BRICs).

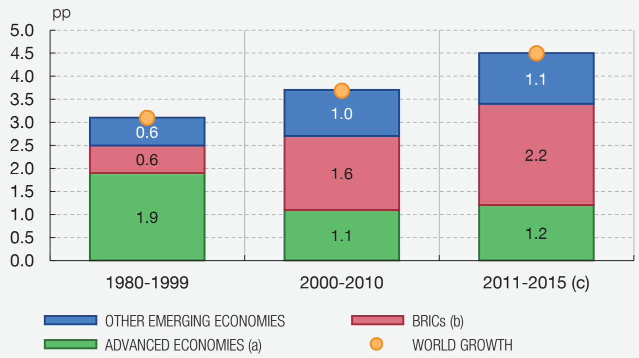
Traditionally, the medium- and low- income economies (included here in the category emerging economies), which account for most of the world's population, have recorded similar growth rates to the advanced countries, which has limited real convergence between these two groups of countries. However, in the last decade the advanced economies have grown by about 2% and the emerging economies by somewhat more than 6%, a disparity that, according to IMF long-term forecasts, will be sustained over the period 2011-15. This progress has enabled these countries to improve their living standards significantly, and has been reflected in an increase in the human development index and in a sharp rise in per-capita GDP (of 28.3% between 2000 and 2009). Within the emerging economies, the four BRIC countries are among those that have grown most (by 8% on average between 2000 and 2010, a rate that is expected to be sustained between 2011 and 2015), and those that have converged most rapidly with the developed countries (see Chart 1). This strong growth over the last ten years has led to a significant increase in the share of the emerging economies in world output, from one third in 1980 to almost one half now, a level that will be clearly exceeded in 2015 (53% of world GDP). The BRICs' share of world GDP rose from 12% in 1980 to 25% in 2010, and could reach 29% in 2015, with China accounting for the largest part of the increase. Given their strong relative growth rate and the increase in their share of the world economy, the contribution of emerging economies to world growth

1 See, for more details, "El creciente peso de las economías emergentes en la economía y gobernanza mundiales: los países BRIC", *Documentos Ocasionales*, No. 1101, Banco de España.

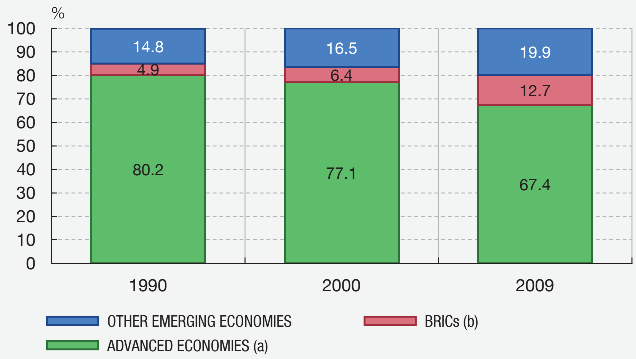
1 GDP PER CAPITA
(100 = advanced economies)



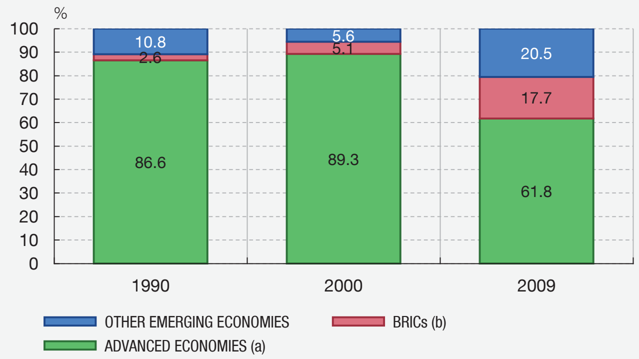
2 CONTRIBUTIONS TO GROWTH



3 SHARE IN WORLD TRADE
(EXPORTS PLUS IMPORTS)



4 SHARE OF DIRECT INVESTMENT INFLOWS



SOURCES: IMF, World Bank and UN.

a Current IMF definition
b Brazil, Russia, India and China.
c IMF estimates in WEO, October 2010.

has also increased substantially; in the last decade these countries have accounted for more than half of world growth (see Chart 2).

This progress has been made against a background of greater integration in the world economy of the emerging economies, which have also become the main beneficiaries and engines of globalisation. This process has been accompanied by a gradual improvement – albeit uneven across countries – in the institutional and macroeconomic framework of these economies, which has helped them to avoid the most negative effects of the crisis and to draw a dividing line from their own past.

The integration has taken place in both the trade and financial spheres, although it has been more pronounced in the former. The emerging economies increased their degree of openness to trade significantly from 2000 and are playing an increasingly important role in world trade (see Chart 3). The higher degree of openness of the developing economies largely reflects greater trade between the emerging regions themselves. Such trade increased from 25.1% of the total external trade of these economies in 1990 to 37.6% in 2009. The foreign trade of these countries is basically centred on raw materials, the BRIC countries being particularly important here, either as net exporters (Brazil and Russia) or as net importers (China and India). Notwithstanding the bias towards trade in raw materials, China (in manufacturing), India (in services) and other emerging economies (in particular in Asia) are rapidly increasing the technological content of their exports.

As in the case of trade, the financial integration of the emerging economies has intensified in recent decades. Direct investment has played a notable role in this process. While in 1990 direct investment flows were practically confined to the advanced economies (99% of outflows and 87% of inflows), in 2009 the developing economies received 38.2% of all direct investment inflows (see Chart 4) and were responsible for 15% of all outflows. Around half of the inflows and outflows of direct investment in the emerging economies correspond to the BRICs, with China standing out as the second largest recipient of direct investment inflows. The increase in the share of other capital flows has been less pronounced, partly due to the restrictions on the openness of the capital account that persist in some important countries, although Brazil and other Latin American and Asian countries play an important role in international flows of portfolio and fixed income investment. Moreover, the favourable outlook for growth in the short and medium-term and lower macroeconomic volatility have reduced the perception of risk traditionally associated with the emerging economies and may contribute to a reorientation of international capital flows towards these economies in the coming years. This process is not risk-free, given the volatility and institutional fragility that still characterise many of these economies.

The growing weight of the emerging economies on the international stage means that the main actors are no longer limited to the G7 countries. Indeed, the financial crisis has led to an increase in the weight of these economies in global financial institutions. Factors contributing to this change have been the relatively favourable behaviour of the emerging economies during the crisis and the need to involve them in the economic policy responses required to overcome it. The changes in world economic governance over the last three years have taken place in numerous spheres: the G20's acquisition of pre-eminence over the G7, the creation of the Financial Stability Board, with the participation of the emerging G20 countries, and the increase in their weights and voting power in the World Bank and IMF in 2010. Furthermore, the summits of heads of state of the so-called BRICs have begun to become institutionalised, reflecting the greater institutional links between emerging economies, with the aim of presenting a common front at the global level.

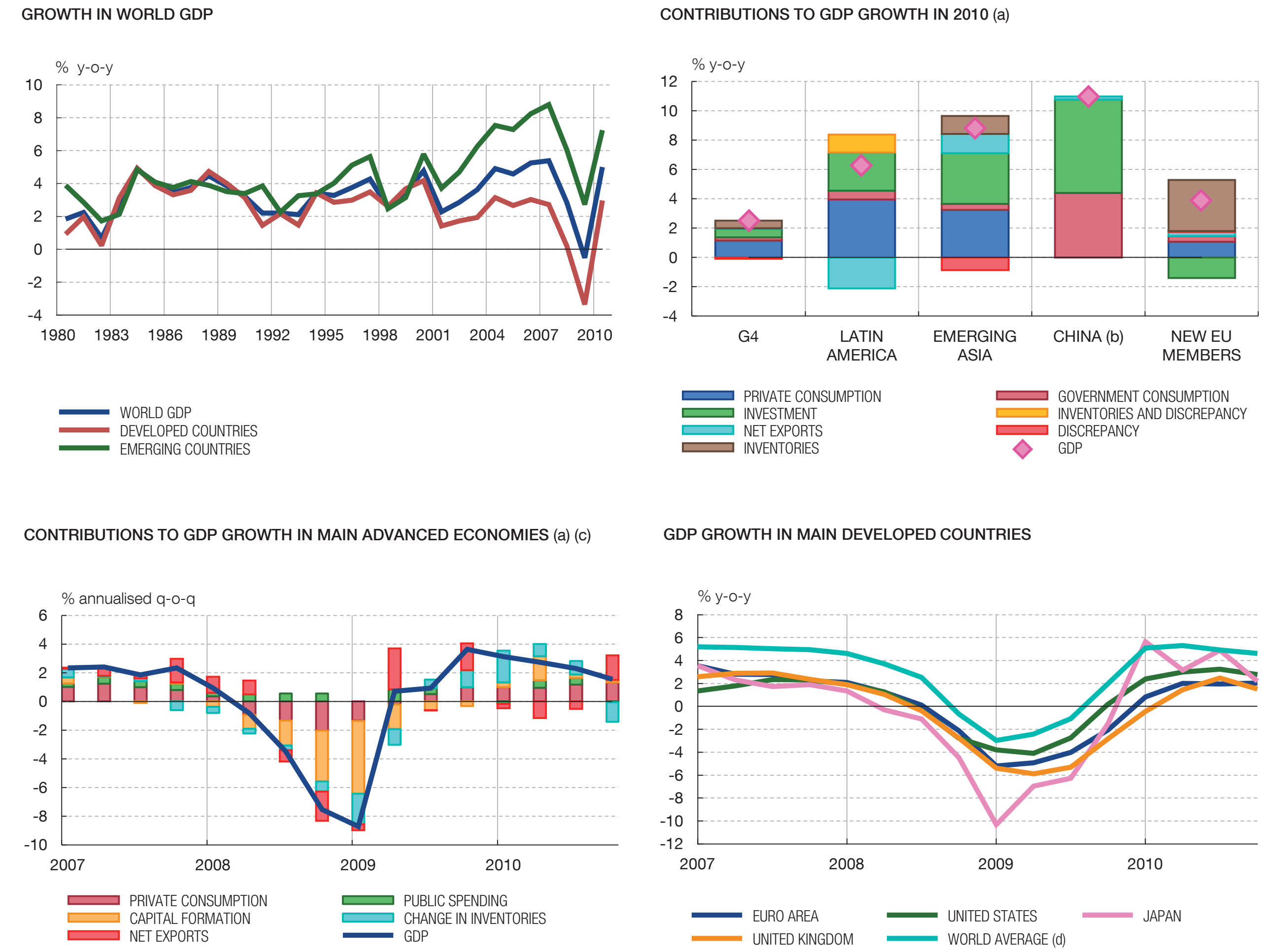
The result of these macroeconomic, trade and financial developments will be a world economy that is increasingly more globalised, multipolar and independent than it was at the end of the 20th century. Global governance structures, in which the emerging economies have acquired greater prominence, are adapting to this new situation, and mechanisms are taking shape to coordinate all the important actors, so as to ensure that growth in the world economy is more balanced and sustainable. However, this reshaping of global governance structures is neither free of difficulties nor of challenges, starting with the active and constructive involvement of the systemic emerging countries in the most important areas of international economic relations, such as global imbalances, financial reform, trade agreements and efforts to combat climate change.

growth in the developed economies continued to be underpinned by stimulus policies and its foundations remained fragile: employment was weak and unemployment rates were high (see Chart 3.3); indebtedness was still excessive in the non-financial private sector; restructuring was still needed in financial systems and activity in real estate markets was minimal.

In the emerging economies the recovery was gaining momentum in early 2010, particularly in China, which posted growth of approximately 10% year-on-year in Q1, and in the rest of emerging Asia and Latin America, which expanded by rates of around 8.5% and 6%, respectively. This buoyancy was driven by strong domestic demand and, in particular, by investment, a growth pattern that indicated a certain independence from developed econo-

GLOBAL ECONOMIC ACTIVITY

CHART 3.2



SOURCES: IMF, Datastream, JP Morgan, Eurostat, national statistics and Banco de España.

a G4: United States, Japan, United Kingdom and euro area. Latin America: Argentina, Brazil, Chile, Colombia, Venezuela, Peru and Mexico. Emerging Asia: India, Hong Kong, South Korea, Thailand, Indonesia, Philippines, Taiwan and Singapore. New EU members: Poland, Hungary, the Czech Republic, Latvia, Lithuania, Bulgaria and Rumania.
b In China, the government consumption component represents total consumption (government and private).
c Contribution, in percentage points, to the annualised quarterly change in GDP.
d In-house calculations based on data for 57 countries that represent 90% of world GDP. The aggregates have been calculated using the weight of the countries in the world economy in the previous year, in PPP, according to IMF information.

mies, in the absence of fresh shocks (see Chart 3.2). In Eastern Europe, by contrast, where the crisis had hit harder, the expansion was more moderate. The increase in trade between emerging economies, especially the Asian economies, was also faster (see Chart 3.3).

… and was accompanied by an improvement in the financial environment, which was not without weaknesses

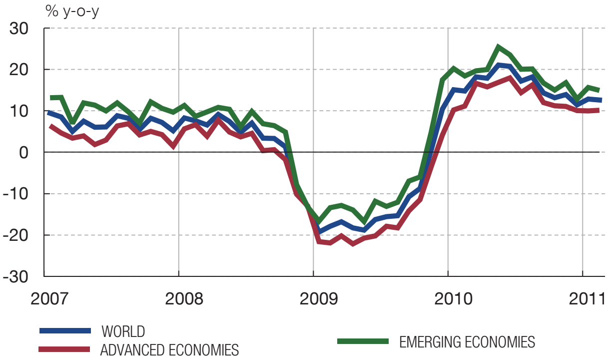
The performance of financial markets continued to improve at the beginning of 2010, in line with the trend that began half way through the previous year (see Chart 3.4). The early months of the year were marked by the recovery of the appetite for risk and lower volatility, which returned to its levels prior to the bankruptcy of Lehman Brothers. This favourable environment gave rise to stock market gains, a rise in long-term interest rates and a narrowing of the spreads on corporate and emerging sovereign bonds. The increase in profits and the notable level of issuance on capital markets improved the corporate sector's financial capacity despite weak bank lending (see Chart 3.5).

However, there were underlying weaknesses behind this favourable performance. The advanced economies' financial systems – still immersed in restructuring processes – had not

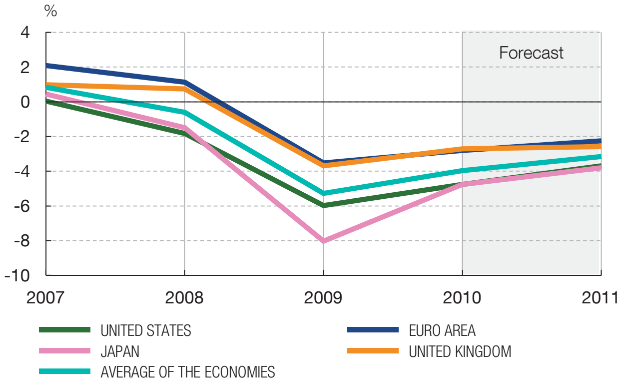
ACTIVITY INDICATORS

CHART 3.3

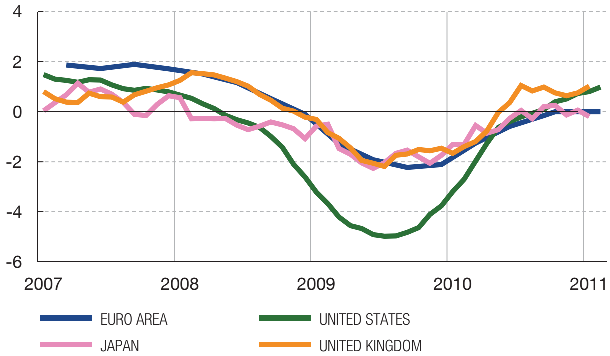
VOLUME OF EXPORTS



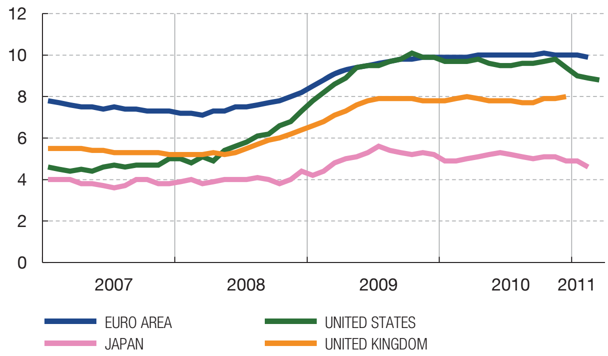
OUTPUT GAP IN THE MAIN DEVELOPED ECONOMIES (a)



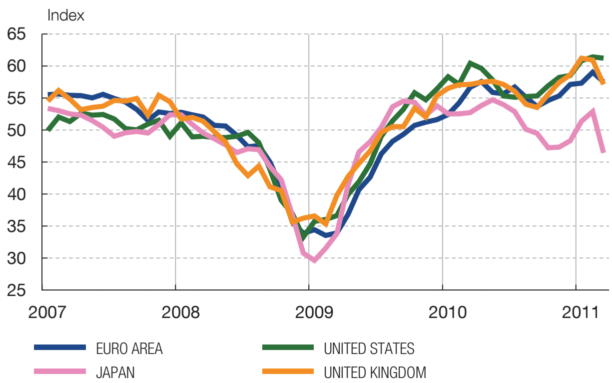
EMPLOYMENT CREATION IN DEVELOPED ECONOMIES



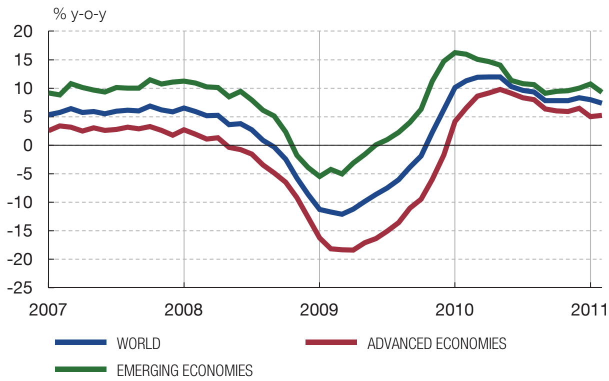
UNEMPLOYMENT RATE (b)



PURCHASING MANAGERS' INDICES



INDUSTRIAL PRODUCTION



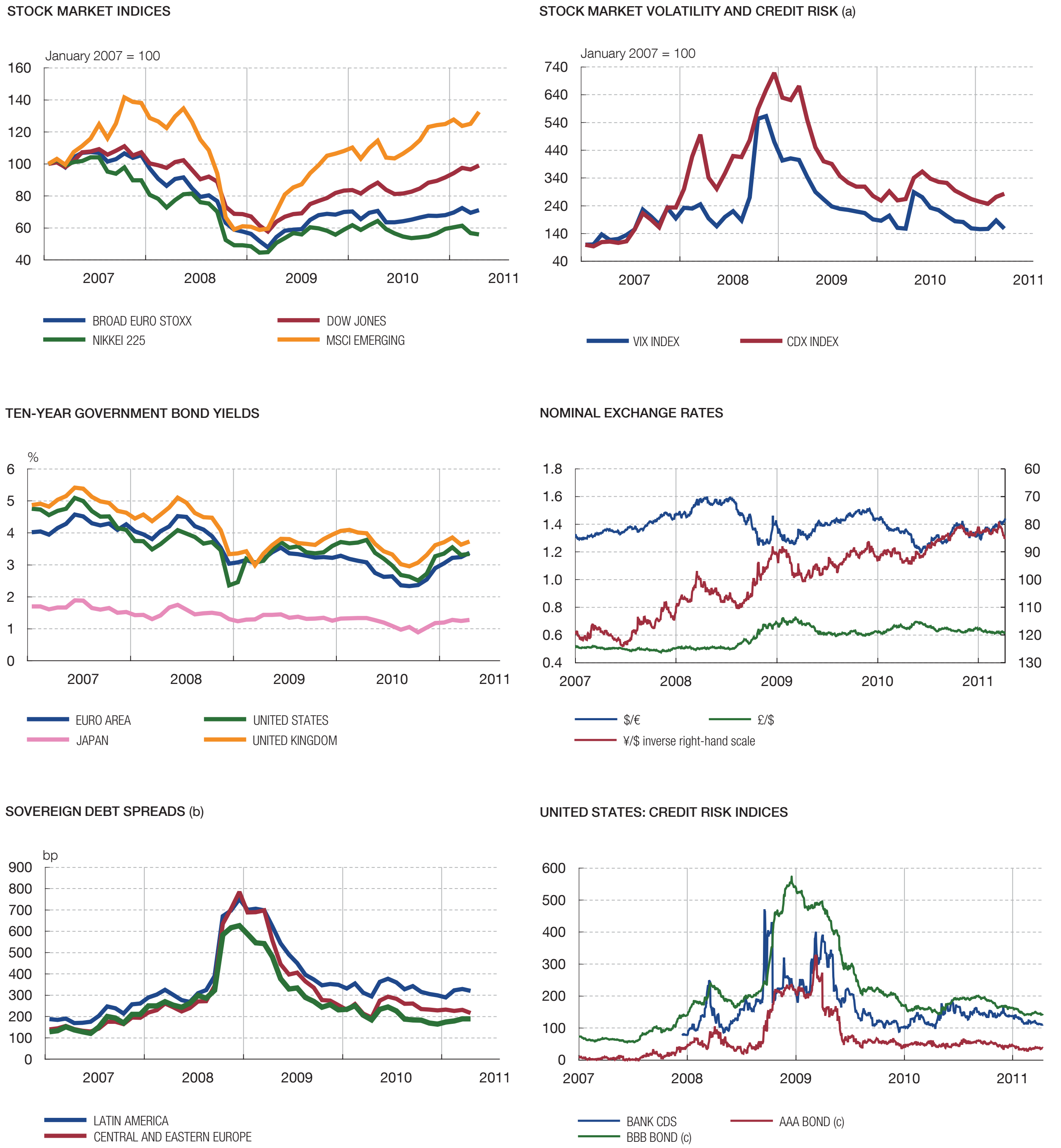
SOURCES: Datastream, CPB Netherlands Bureau for Economic Policy Analysis, IMF (WEO) and Banco de España.

a IMF forecasts.
b Percentage of labour force.

resumed their role as intermediaries in the financing of firms and households, and credit continued to adjust. As for the bank deleveraging and recapitalisation processes, vulnerabilities remained on the liabilities side, with substantial volumes of short-term financing, and there were still troubled segments in the financial system in some countries. Furthermore, since end-2009 problems had been incubating on the sovereign debt markets, which would ultimately affect confidence in banking systems.

INTERNATIONAL FINANCIAL MARKETS

CHART 3.4



SOURCES: Datastream and Bloomberg.

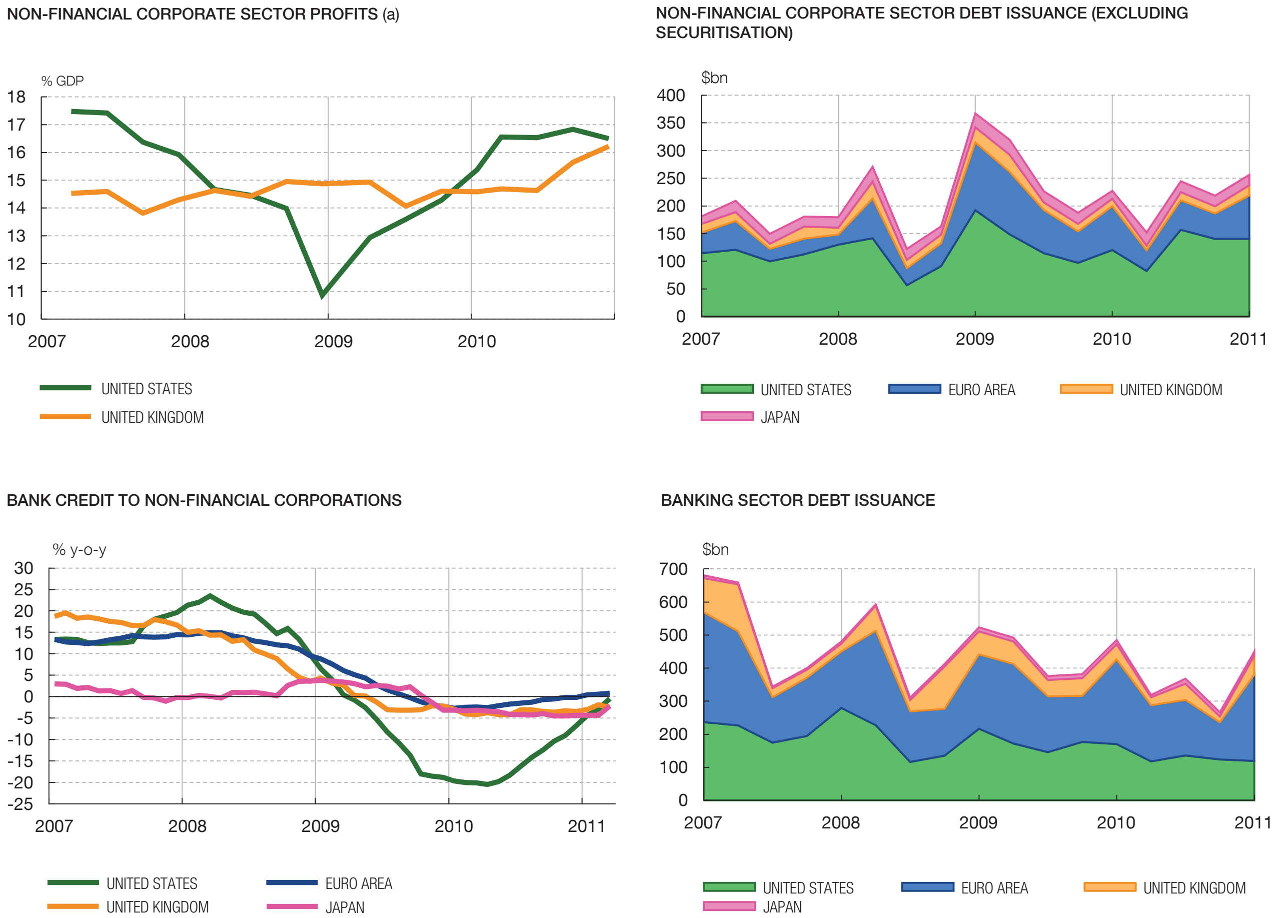
a VIX index (volatility of the Standard & Poors 500 index) and 5-year US CDX investment grade credit risk index.
b EMBI+ for Latin America and EMBI Global for Asia and Central and Eastern Europe.
c Industrial corporate bonds. Differentials vis-à-vis swaps.

In May, the European sovereign debt crisis unleashed a bout of instability on global markets and activity in the advanced economies began to show signs of weakness

Growing instability on certain European sovereign debt markets peaked in May when the turmoil associated with fiscal difficulties in Greece, after spreading to the euro area, affected global markets, including emerging ones, which had been the most resilient until that time. World stock markets recorded considerable losses and there was a sharp increase in volatility, although not as extreme as that in September 2008. Furthermore, the process of issuance returning to normal on fixed-income markets came to a halt. Investors' search for

FINANCING CONDITIONS

GRÁFICO 3.5



SOURCES: Datastream, Bureau of Economics, Federal Reserve, ECB, Bank of England, Banco de España, Bank of Japan and Dealogic.

a Pre-tax corporate earnings + fixed capital consumption.

safe havens resulted in a fresh decrease in US bond yields – and in those of other advanced economies – with the result that the ten-year yield dropped to levels of around 2.5% in summer, approaching the lows recorded after the bankruptcy of Lehman Brothers. The dollar and yen also appreciated strongly; at the beginning of June the dollar traded against the euro at its highest levels since 2006 ($1.21/€), as shown in Chart 3.4. In this scenario, banks' financing conditions tightened at the same time as their credit risk deteriorated.

The unfavourable impact on financial markets was accentuated by the signs of a slowdown in the US economy, which emerged during the second quarter of the year. This change was determined largely by the downturn in the housing market, which occurred when part of the tax relief it enjoyed ended. Furthermore, on the labour market, employment showed signs of renewed weakness, while the unemployment rate reached levels of approximately 9.5% and the labour force fell owing to a discouragement effect.

Throughout the summer markets stabilised, while uncertainty about the economy prompted a fresh round of monetary and fiscal stimulus in the United States…

The response of the European authorities to the Greek crisis, the results of the stress tests of European banks released in July and the publication of business and bank profits, mainly in the United States, contributed to the stabilisation of financial markets over the summer, although doubts remained about the recovery. US GDP growth in Q2 (1.7% in annualised quarter-on-quarter terms), which was published in July, confirmed the loss of economic momentum and the weakness of private consumption. The lack of vigour spread to other economies such as Japan's, while the United Kingdom recorded a recovery (that turned out to be temporary) following several quarters of sluggishness, which was led by buoyant private consumption.

The signs of economic weakness prompted an expansionary turn in the economic policy stance in the United States. Following the gradual (and passive) withdrawal of support for liquidity and financing during the first half of the year, the Federal Reserve pre-announced at the end of August a fresh phase of non-conventional monetary expansion, which began to be implemented in November. In addition to the monetary impulse, in December a new substantial fiscal stimulus package was introduced. Japan also implemented a new fiscal programme in that period, albeit on a more modest scale. These two cases contrast with the fiscal adjustment introduced in Europe, including the United Kingdom, as a result of the sovereign debt crisis in certain countries in the euro area (see Section 3.1).

... which contributed to improving the economic outlook and anchoring the confidence of financial markets, although it triggered strong movements in exchange rates

The stimulus measures in the United States prompted a notable improvement in the economic outlook at the same time as they contributed to anchoring the confidence of the financial markets, despite representing a serious setback for fiscal consolidation. The easing of financial tensions was reflected in a stock market rally and an improvement in credit and financing markets in the last stretch of the year. This trend was particularly pronounced in the emerging markets, where capital inflows notably stepped up at the end of summer, coinciding with the new expansionary turn in US monetary policy. This situation unleashed strong tensions in exchange rates due to the dollar's tendency to depreciate against most currencies; in particular, the euro returned to levels of approximately $1.40.

The new strains which appeared in autumn in the euro area did not have a significant impact on international markets

Coinciding with the fresh stimulus in the United States, US long-term bond yields increased to around 3.5% at end-2010, mainly reflecting better expectations for growth. This rise in long-term rates contributed to easing strains in exchange rates and capital flows to emerging economies, alleviating monetary policy dilemmas in these countries at a time when inflationary pressures were increasingly evident. In this context, the triggering of a new episode in the sovereign debt crisis in the euro area in November, caused by problems with banks in Ireland, had a very limited impact on international financial markets in comparison with the episode in May.

In the final stretch of 2010, world growth moderated slightly, although the US economy picked up

Overall, the world economy ended 2010 with a growth rate that was slowing slightly (close to 4.5% in annualised quarter-on-quarter terms) and a favourable outlook. The emerging economies remained notably robust, growing by 7.1% year-on-year in that period. For their part, the developed economies also experienced a slight deceleration and expanded by 2.4% year-on-year (with an annualised quarterly growth rate of 1.5%), partly owing to the fall in inventories. In the United Kingdom and Japan growth decelerated and negative quarter-on-quarter growth rates were recorded on account of the fall in private demand. However, in the United States activity rose in the last part of the year and GDP increased by 3.1% in annualised quarter-on-quarter terms in Q4, supported by private consumption and the favourable contribution from the external sector. In any event, output gaps in the major developed economies were still negative at the end of 2010 and unemployment rates held at historically high levels (see Chart 3.3).

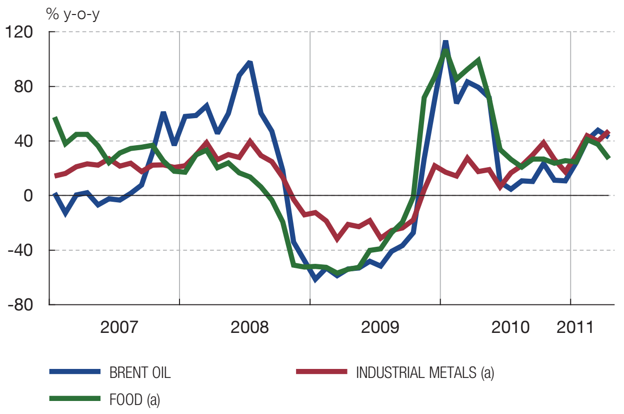
Despite the substantial negative shocks in the early months of 2011, the outlook remains favourable

In the early months of 2011, the main trends discussed have firmed: the recovery in the United States, strengthened by the revival of the labour market and the normalisation of financial markets. The ongoing problems in the euro area – with the bailout of Portugal in April – have not significantly affected global markets, while the political crisis in the Arab countries and the earthquake in Japan are having a global impact, since they contribute to

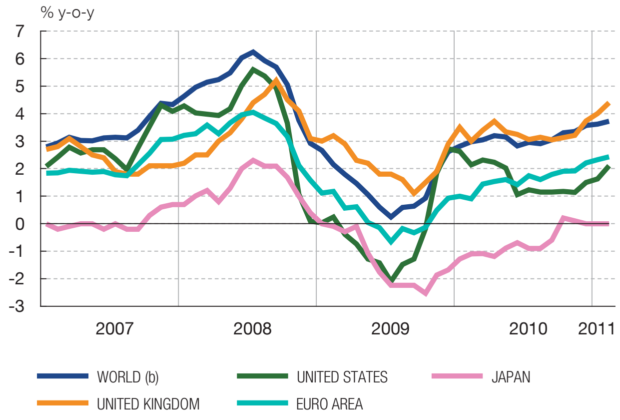
INFLATION AND COMMODITIES

CHART 3.6

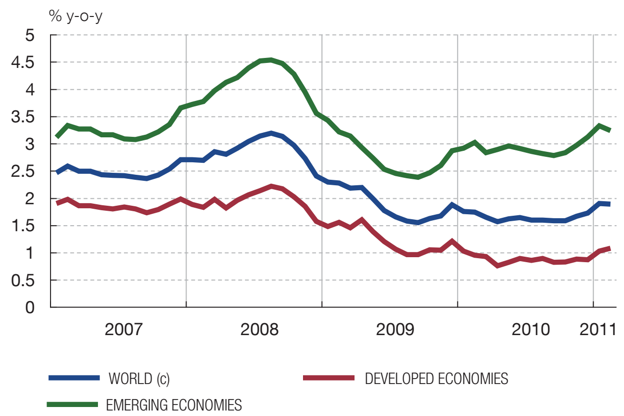
COMMODITY PRICES



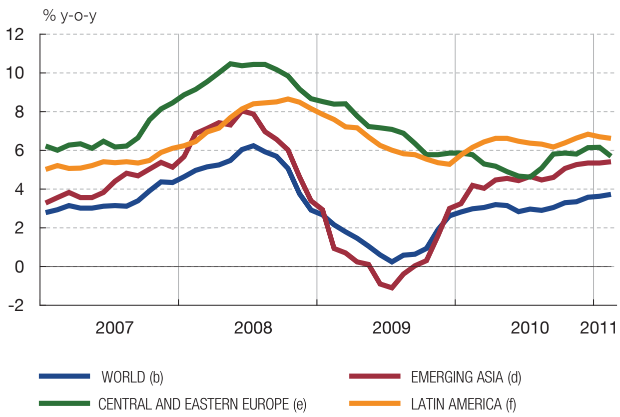
CONSUMER PRICES IN DEVELOPED ECONOMIES. OVERALL INDEX



CONSUMER PRICES: CORE INDEX



CONSUMER PRICES IN EMERGING ECONOMIES: OVERALL INDEX



SOURCES: Datastream, Goldman Sachs, national statistics and Banco de España.

a CRB indices.
b Aggregate calcuated on the basis of data for 57 countries representing 90% of world GDP.
c Aggregate calculated on the basis of data for 45 countries representing 83% of world GDP.
d India, China, Hong Kong, Indonesia, South Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.
e Russia, Ukraine, Turkey, Poland, Czech Republic, Hungary, Estonia, Latvia, Lithuania, Bulgaria and Croatia.
f Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

the rise in commodity prices but without having seriously compromised the confidence in the recovery.

Inflationary pressures only began to become widespread towards the end of the year, driven by the notable rise in commodity prices

Price developments remained contained in the first half of 2010, but inflation posted widespread rises after the summer (see Chart 3.6). The main factor behind this increase was the rise in commodity prices (agricultural products, metals and oil), which held on a rising trend throughout the year, that was only briefly interrupted in Q2, and gained strength in the final quarter (see Chart 3.6). In 2010, as a whole, the overall index increased by 24%, with notable rises in food (28%) and oil (23%) prices. This trend, which was the result of growing demand from emerging countries, continued in the early months of 2011 and was strengthened in certain cases by cyclical supply factors (see Box 3.2).

Inflationary pressures were more pronounced in the emerging economies than in the advanced economies. In the United States inflation reached 1.5% year-on-year at end-2010, which was lower than in the euro area (2.2%), whereas in Japan it held at negative

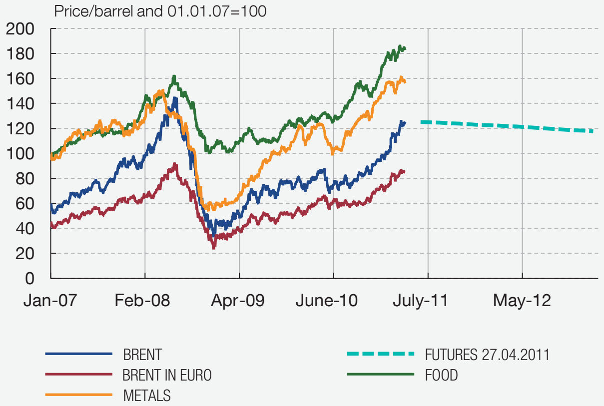
Commodity prices rose sharply from mid-2010 and in many cases were higher in early 2011 than in 2008 (see Chart 1). This general rise poses significant challenges for the developed economies, owing to the potential impact on inflation and the risk to the economic recovery.

The dominant factor in the general rise in commodity prices is the increase in world demand, stemming principally from the emerging economies (in particular, from China) and, to a lesser extent, from the recovery in the developed economies. As a result of this increase, the world demand for many commodities (including foodstuffs) is at an all-time high. Behind these developments lie cyclical factors, and also structural ones, relating to changes in consumption habits. In the case of oil, the International Energy Agency (IEA) expects the demand for oil in 2011 to be more than 89 million barrels per day (mbd), as compared with 86 mbd in 2008. The emerging economies are responsible for the increases in the demand for oil in recent years, given that energy efficiency improvements and the severe economic crisis in the advanced economies have significantly reduced their demand (see Chart 2).

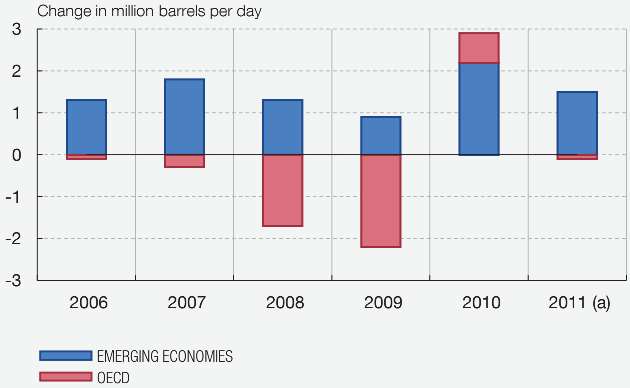
At the same time, various supply-side factors have also temporarily affected the prices of some commodities. Notable in the case of foodstuffs have been poor harvests, primarily due to adverse weather conditions, which have led to export restrictions in some countries. In the case of oil, since the beginning of the year, political tensions in various producing countries in North Africa and the Middle East have generated fears of a significant reduction in production.

Moreover, the upward trend in prices may have been exacerbated by an increase in financial flows into commodity markets, against

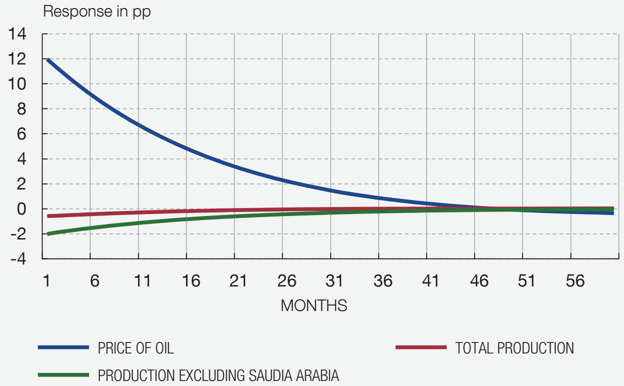
1 OIL AND OTHER COMMODITY PRICES



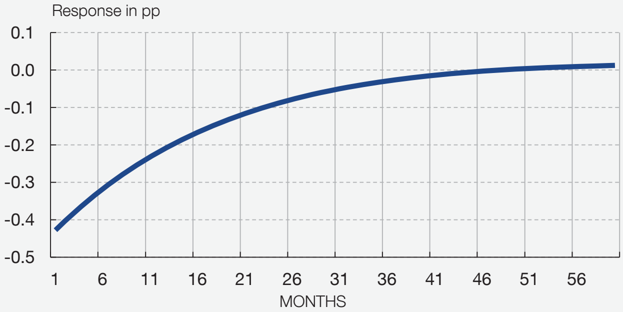
2 CHANGE IN DEMAND FOR OIL



3 RESPONSE OF OIL PRICES AND OF TOTAL OIL PRODUCTION TO A SUPPLY SHOCK (b)



4 RESPONSE OF GDP IN THE DEVELOPED ECONOMIES TO A SUPPLY SHOCK (b)



SOURCES: International Energy Agency, Bloomberg, Datastream and Banco de España.

a Forecast according to the International Energy Agency.
b The shock simulated relates to a 2% reduction in global production excluding Saudi Arabia.

a background of abundant liquidity at the global level and of a higher relative preference on the part of investors for this type of assets. However, the evidence on the causality between flows and prices in these markets is not conclusive. The question is even more complex in the case of those commodities that have relatively high storage costs, such as oil, in which investments are made in futures and options markets. The channels through which the prices of these financial instruments may affect spot prices are not clear.

Higher commodity prices have effects on inflation and activity. As regards inflation, the pass-through of the rise in international prices for commodities to their domestic prices depends on exchange rate fluctuations against the dollar (the reference currency for most commodity prices), duties and taxes, the ability of importers to mitigate the increase by lowering their margins and transport and distribution costs. For their part, changes in domestic commodity prices may affect consumer prices through various channels. First, an increase in commodity prices has direct effects on the CPI, which will be all the larger the greater their weight in the representative consumption basket. Second, there will be indirect effects, in the form of increases in production and distribution costs, which are more important in the case of energy. Finally, the so-called "second-round effects", which reflect the incorporation of the initial rise in prices into price and wage formation processes, so that the original shock is eventually passed through to inflation expectations and underlying inflation. The various studies that have analysed the impact of a rise in oil prices on inflation in the developed economies generally find relatively moderate effects, which principally stem from the direct impact of the higher cost of commodities on inflation. Thus, a 10% increase in the price of oil would involve a rise in the euro area CPI of some 0.2-0.4 pp.[1]

At the same time, higher commodity prices have a contractionary impact on the net importing economies via three main channels. First, relative prices change, causing households and firms to spend a higher proportion of their income on goods derived from such commodities, to the detriment of other products. Second, firms' production costs rise. And third, they may give rise to a contractionary monetary policy response. In the net exporting economies, by contrast, the impact is expansionary, through the increase in the terms of trade. However, it should be pointed out that the impact on activity will be very different depending on whether the rise in commodity prices is due to a sudden reduction in supply or to an increase in demand, owing to higher global economic growth.[2]

The recent tensions in the Arab countries make consideration of a scenario of reduction in the world supply of oil pertinent. The model used includes the consumption and production decisions of oil importers and exporters, taking into account, in particular, the different and strategic role of Saudi Arabia as the "dominant producer", i.e. the only country with surplus production capacity.[3] The results show that, given a fall in the supply of a producer equivalent to 2%[4] of the world market, the oil price would increase by 12% (see Chart 3). In response to this rise, Saudi Arabia would increase its oil production to make up for part of the fall in supply, so that the fall in world production would be smaller (0.5%). The initial impact on the GDP of the developed economies would be -0.4 pp, a fall that would be progressively absorbed and disappear after three years (see Chart 4). Accordingly, the effects on the activity of the developed economies of an oil supply shock would be moderate, in line with the results in the literature.[5]

1 See, for example, Rolf Strauch et al. (2010), "Energy markets and the euro area macroeconomy", *Occasional Paper Series,* No. 113, ECB or Luis J. Álvarez et al. (2011), "The Impact of Oil Price Changes on Spanish and Euro Area Consumer Price Inflation", *Economic Modelling*, No. 28, pp. 422-431.

2 For an in-depth discussion of the different responses of the economy and oil prices to changes in world supply and demand, see Anton Nakov and Galo Nuño (2010), "Un modelo sencillo para analizar las causas y consecuencias de las variaciones en el precio del petróleo", *Boletín Económico*, February, Banco de España, pp. 67-78.

3 For a technical description of the model used, see Anton Nakov and Galo Nuño (2009), "Oilgopoly: a general equilibrium model of the oil-macroeconomy nexus", *Documentos de Trabajo*, No. 0932, Banco de España.

4 As a reference, Libya represents 1.8% of the world oil market and during the crisis its market share fell by 75%.

5 The cited paper by Strauch et al. (2010) presents values of 0.2-0.4 pp, for a broad range of models, in response to a rise of 10% in oil prices. Some authors also stress that the impact of oil price shocks on GDP has been diminishing on account of the lower rigidities in labour markets, lower oil consumption per unit of GDP and the improvement in the conduct of monetary policy. In this connection, see O. Blanchard and J. Gali (2007), "The Macroeconomic Effects of Oil Shocks: Why are the 2000s So Different from the 1970s?", *NBER Working Paper* No. 13368.

rates, although in the closing months of the year it moved into positive territory. By contrast, in the United Kingdom, it climbed to 3.7%, and breached 4% at the beginning of 2011. The performance of core inflation was more stable and moderate, in line with the persistently wide output gap and surplus capacity. Similarly, inflation expectations remained firmly anchored. By contrast, in the emerging economies inflation rose to 5.6% at end-2010, reflecting the higher weight of food and energy in their consumption baskets (although subsidies tend to mitigate fluctuations in final prices), strong private demand and narrower output gaps, which in Asia and certain Latin American economies had already closed. By region, inflation at end-2010 stood at 6% in Eastern Europe, 6.9% in Latin America and 5.1% in emerging Asia. Core inflation also showed a slight upward trend (in China and Brazil, in particular) and inflation expectations rose in some economies. The rising trend in inflation continued into the early months of 2011, as a result of the continuous upswing in commodity prices: in February inflation was 2.1% in the advanced economies and 5.7% in emerging economies, and in many Asian and some Latin American countries it has breached its pre-crisis rates. This situation has prompted a notable change in the monetary policy outlook, in particular in the developed economies, as described below.

3 Economic policies

At the beginning of 2010, gradual economic recovery and financial normalisation presaged a progressive withdrawal of the support given as a result of the crisis, albeit at different paces in the developed and emerging countries (more gradually in the former and more decisively in the latter). However, several events altered these prospects and contributed to accentuating the differences in the conduct of economic policies between emerging and developed countries, and also among the latter.

3.1 ECONOMIC POLICY DIVERGENCE IN THE DEVELOPED ECONOMIES

The main developed economies began the year with the intention of exiting their extraordinarily expansive policies, which were implemented in response to the crisis. The challenge they faced consisted of reducing public support, which was leading to inflationary risks and doubts about the sustainability of fiscal positions, without harming the recovery.

At the beginning of 2010, a progressive exit from non-standard monetary policy measures in the developed economies was anticipated, against a backdrop of withdrawal of the stimuli introduced as a result of the crisis

In the monetary policy area, the debate centred on how and in what sequence non-standard measures would be withdrawn and when official interest rate rises would begin. The improvement in the financial and banking situation led to a natural unwinding of the use by financial institutions of certain assistance. Thus, in Q1, most of the extraordinary liquidity facilities in the United States and in the United Kingdom expired and the asset purchase programme of the Federal Reserve and the Bank of England was completed. In the euro area too certain measures, such as the covered bond purchase programme and special longer-term refinancing operations, came to an end. In contrast, the Bank of Japan continued to introduce new measures, against the backdrop of persistent deflation. Nevertheless, uncertainty about the strength of the recovery and the absence of inflationary pressures led to the postponement of when interest rate rises were expected – even in the United Kingdom, despite its higher inflation – a trend that was to continue throughout the year. Official rates were raised in other developed economies that were further ahead in the cycle (Sweden, Australia and Canada).

The sovereign debt crisis in the euro area and uncertainty about the recovery in the United States opened up a widening gap between the economic policies of the developed economies

In spring the uncertainty surrounding the euro area sovereign debt crisis and doubts about the strength of the recovery in the United States delayed the withdrawal of monetary stimulus and led to divergence in economic policy stances. Overcoming the sovereign debt crisis became a necessary priority in the euro area, whereas in the United States – and in a slightly different context, in Japan – concerns centred on avoiding a possible double-dip in activity and, even, the risk of deflation.

FISCAL POLICY IN DEVELOPED ECONOMIES

CHART 3.7

SOURCES: IMF, Datastream, Bloomberg, Federal Reserve Bank of Cleveland and Banco de España.

a Percentage of GDP. Surplus (+) or deficit (-).
b IMF forecasts.
c Necessary adjustment of the primary structural balance in 2010-2020, to stabilise the debt-to-GDP ratio in 2030 at 60% (200% in Japan).

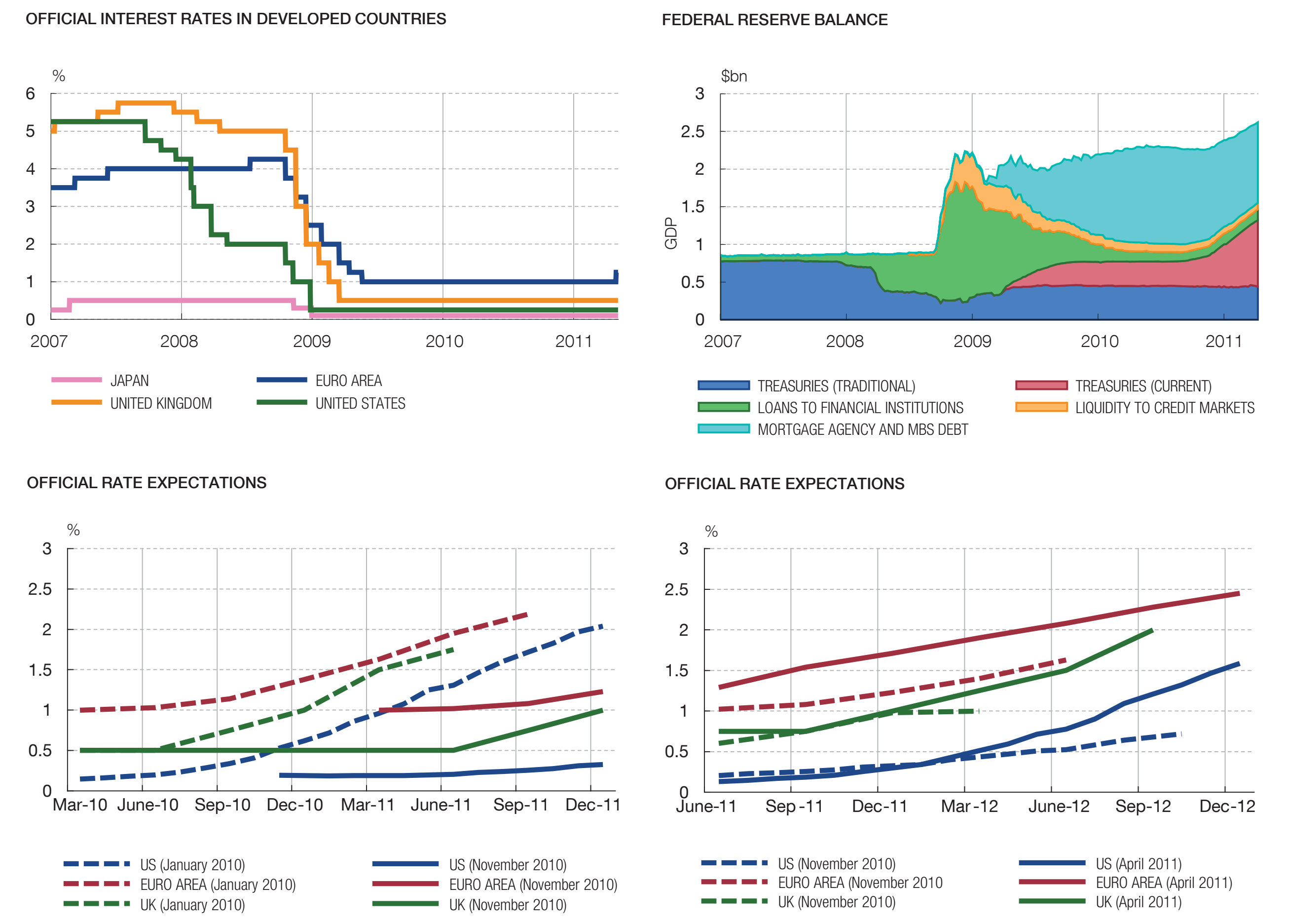
In the fiscal sphere, the euro area sovereign crisis accelerated the adjustment in Europe, while in the United States and Japan new fiscal stimulus plans were introduced towards the end of the year

The notable deterioration in fiscal variables in 2009 called for a gradual, but decisive, withdrawal of the fiscal stimulus (see Chart 3.7). However, public debt increased further in 2010 (by around 8 percentage points (pp) of GDP in the advanced economies as a whole), while fiscal deficits barely declined, standing at around 10% of GDP in the United States, Japan and the United Kingdom, and 6% in the euro area. The tensions prompted by the sovereign crisis in May led to an acceleration of fiscal adjustment in the euro area countries (see Chapter 4) and also in the United Kingdom (see Chart 3.7). In the latter country, the new government introduced a drastic fiscal adjustment (based on spending cuts and tax measures, including an increase in VAT of 2.5 pp and a new tax on banks), which will reduce the structural deficit by more than 8 pp of GDP over the next five years.

In marked contrast, activity doubts in the United States and Japan led to fresh fiscal expansion plans towards the end of the year. The main measure in the United States was the approval in December of a new fiscal package, of more then $800 billion (almost 6% of 2010 GDP) for the next 10 years, notable being the extension of tax cuts that were due to expire and of unemployment benefits. This plan may raise the structural deficit by between 1.5 pp and 2 pp of GDP, in 2011 and 2012, and delay the start of fiscal consolidation. For its part, Japan introduced a new fiscal package of around 1% of GDP in October and fol-

MONETARY POLICY IN DEVELOPED ECONOMIES

CHART 3.8



SOURCES: Bloomberg, Reuters Survey, Datastream and Federal Reserve Bank of Cleveland.

lowing the earthquake in March 2011 approved a supplementary budget of a similar amount for the reconstruction work.

As regards monetary policy, there was a new phase of quantitative easing in the United States

In the monetary policy sphere, the weakening of activity led to the possibility of new non-standard monetary policy easing in the United States and in the United Kingdom in the summer. This was not the case in the euro area, which did however continue to provide ample liquidity to the financial system and put in place a government bond purchase programme for the countries most affected by the sovereign tensions, to restore the transmission mechanism. Official interest rates remained unchanged in all cases during 2010, although in the first few months of 2011, in the face of the rise in inflation, the date on which the markets expected official interest rate rises to begin moved forward (see Chart 3.8). In fact, the upward cycle in the euro area began in April, with a rise in interest rates of 25 basis points (bp), to 1.25%.

The second phase of quantitative easing in the United States (known as QE II) was announced in August and commenced in November. It consists of the staggered purchase by the Federal Reserve System of $600 billion of Treasury bonds, to be completed in June 2011, along with the reinvestment of another $300 billion of balance sheet assets reaching maturity. The intention was to ease monetary and financial conditions, by reducing long-term interest rates and increasing the prices of a range of financial assets, in order to improve the outlook for agents and to increase their inflation expectations. Notwithstanding the debate on the effectiveness and risks of QE II, subsequent developments appear to indicate that it has contributed to this objective, although long-term interest rates rose sharply following the start of the programme, the initial downward movement having occurred in advance. For its part, in October the Bank of Japan extended its lending facilities and its programme for the purchase of financial assets (including government securities), with a new fund equivalent to 1.1% of GDP. After the earthquake in March, it doubled the volume of purchases and injected massive amounts of liquidity. In the United Kingdom, the possibility of an extension of non-standard measures eventually disappeared, owing to the risk that agents' expectations would become unanchored, given that inflation has been standing at more than one percentage point above target for the last two years.

The economic policy divergence reflects both differences in the economic situation and in the assessment of medium and long-term risks

There are many reasons for the divergence in the economic policies of the main developed economies: differences in diagnosis, strategy and priorities in the presence of inflationary risks and economic weakness, and different degrees of freedom to design policies. However, in an increasingly integrated global economy, in which the policies of the largest countries have implications for the rest, these divergencies may generate tensions and reactions by other countries, as has already happened in the monetary and foreign-exchange arena after QE II in the United States, undermining the international coordination efforts that were established after the crisis (see Section 4.3).

3.2 ECONOMIC POLICY DILEMMAS IN THE EMERGING ECONOMIES

Expectations of strong economic growth in the emerging countries were confirmed

The emerging economies avoided the impact of the crisis more successfully than the developed ones. Their recovery has been more rapid, assisted by robust economic fundamentals, less need to deleverage than in the developed economies and zero or low exposure of their financial systems to problematic assets. The situation in the EU Member States that joined the EU in 2004 and 2007 has been different. Most of them were hit hard by the crisis and their recovery has been weaker, owing to the larger imbalances and financial vulnerabilities accumulated during the years leading up to the crisis, as well as their close economic links to the euro area.

2010 saw sizeable capital inflows, that were especially large in certain countries

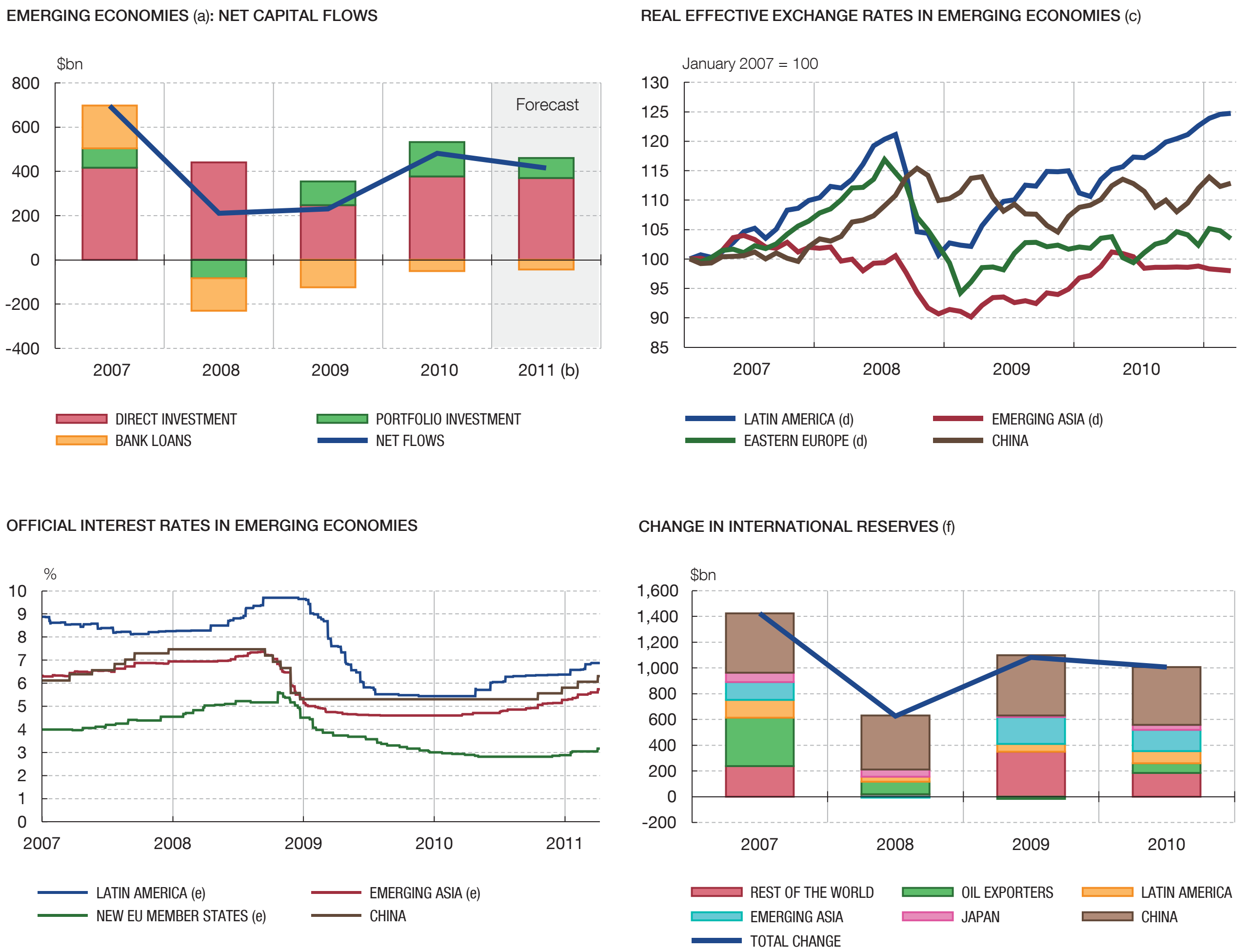
The combination of improved growth prospects in the emerging economies, renewed appetite for risk in global financial markets and the persistence of very low interest rates in the developed economies led to a resurgence of capital flows towards the emerging countries during 2010. In Asia and Latin America these flows exceeded their pre-crisis levels (see Chart 3.9). These flows intensified after the summer, given the expectations of further monetary stimulus in the United States, creating significant difficulties for macroeconomic management and the fear of excessive exchange-rate appreciation. A significant portion of these larger flows towards the emerging economies is possibly permanent in nature, being the result of a global reallocation of capital, associated with better growth prospects and reflecting the weight and growing importance of these regions in the world (see Box 3 .1). However, the capital inflows are perceived in these countries as having a temporary component – especially after their intensification at the end of 2010 – with the attendant risks of excessive exchange-rate appreciation or sudden reversal.

The capital inflows, combined with upward inflationary pressures, posed a dilemma for monetary policy

The sizeable capital inflows and appreciation pressures coincided with growing pressures on inflation, giving rise to a monetary policy dilemma in the Latin American and Asian economies. On the one hand, interest rate rises were desirable to contain the increase in inflation – against a background of closing output gaps and rising commodity prices – and to avoid the unanchoring of inflation expectations. On the other hand, interest rate rises might contribute to fuelling the capital inflows and increasing the pressure on the exchange rate. The emerging economies responded to this challenge

EXCHANGE RATES AND CAPITAL FLOWS IN EMERGING ECONOMIES

CHART 3.9



SOURCES: Datastream and IMF.

a Africa, Latin America and Caribbean, Central and Eastern Europe, Confederation of Independent States, Middle East and emerging Asia.
b IMF forecasts.
c CPI-based. An increase (decrease) denotes an appreciation (depreciation) of the currency.
d Areas analysed: Emerging Asia (India, Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines), Central Europe (Czech Republic, Hungary and Poland) and Latin America (Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru).
e Areas analysed: Emerging Asia (India, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines), Central Europe (Czech Republic, Hungary and Poland) and Latin America (Brazil, Mexico, Chile and Colombia).
f 2010: latest data available.

with a combination of measures: interest rate rises, controlled appreciation and accumulation of reserves, as well as administrative or macro-prudential measures, and even capital controls.

Interest rate rises were made in Asia and in most Latin American countries, although they were interrupted or toned down when capital inflows were at their strongest, following the summer. Many countries also used quantitative measures – primarily increases in reserve requirements – to tighten monetary conditions. With regard to exchange rates, larger appreciations were generally tolerated in Latin America than in Asia. In China the authorities announced a return to the pre-crisis exchange-rate regime and permitted some appreciation of the renminbi against its reference basket, but its extent was limited. There was also a generalised intensification of accumulation of reserves to mitigate exchange-rate appreciation, with the result that the holdings of these assets reached new historic highs (see Chart 3.9).

MAIN FINANCIAL FLOWS MANAGEMENT AND MACRO-PRUDENTIAL MEASURES

TABLE 3.2

MEASURE		COUNTRY (implementation date in brackets)
Financial flow restrictions (capital controls)	Tax on financial inflows	Brazil (Oct-10 and Mar-11), Thailand (Oct-10) South Korea (Nov-10)
	Establishment of minimum investment period	Indonesia (Sep-10)
Financial flow liberalisation	Liberalisation of capital outflows	Thailand (Feb-10 and Sep-10), Chile (Nov-10), Peru (various)
Macro-prudential measures	Restrictions on LTV (loan-to-value) and DTI (debt to income) in real-estate loans	China, Hong Kong, South Korea (Mar-11)
	increasing capital requirements	Brazil (Dec-10)
	Increasing reserve requirement (a)	China (various), India (Oct-10), Brazil (Dec-10), Indonesia (Dec-10), Malaysia (Mar-11), Turkey (various), Peru (various)
	Increasing reserve requirements for foreign-currency deposits	Peru (Jul, Sep and Oct-10)
	Limit on banks' short foreign-currency positions	South Korea (Jun-10), Brazil (Jan-11), Peru (Feb-11), China (Mar-11)

SOURCE: Banco de España.

a Cash ratios can also be considered to be an alternative monetary policy measure, although they are increasingly being used with macro-prudential objectives.

Notable among the measures adopted were those to moderate capital inflows

Many countries considered it necessary to resort to other kinds of measures (summarised in Table 3.2) to deal with the heavy capital inflows and their impact on exchange rates. In some countries measures were taken to liberalise financial outflows. In other cases, macro-prudential-type measures were adopted to moderate the effects of capital inflows, such as limits on the growth of real-estate lending or loan-to-value (LTV) ratios. Also, measures to hinder the financial movements of non-residents (capital controls) were adopted, with specific features depending on the country concerned, notable among them being taxes on portfolio transactions in Brazil and South Korea. Unlike in previous episodes, capital controls had greater international acceptance, albeit only as a last resort.

Fiscal policy stances did not help alleviate the economic policy dilemma

A contractionary fiscal policy stance in the emerging economies might have facilitated the management of exchange rate and monetary policies against a background of highly dynamic activity and, in some cases, of overheating. However, although the fiscal results were favourable, in marked contrast to the developed economies, the fiscal policy stance was not clearly restrictive in practically any country.

4 Towards a global environment of greater economic and financial stability

The achievement of greater global economic and financial stability requires strengthened multilateral coordination and the adoption of reforms

The seriousness of the crisis and the subsequent response have highlighted the need to articulate macroeconomic and financial policies to avoid the appearance of imbalances and to make progress in establishing a more stable economic and financial environment. This section reviews the progress towards this objective in three fundamental areas: i) financial system rationalisation and restructuring; ii) private sector balance sheet adjustment and fiscal consolidation in the main developed economies, and iii) the coordination of international economic policies, to mitigate the risks of re-emergence of global imbalances and of reappearance of financial excesses.

4.1 FINANCIAL SYSTEM REFORM: SITUATION, PROSPECTS AND PROCESSES

The processes to adjust and reorganise the banking sector moved forward last year …

In 2010 banking activity improved. Most banks reinforced their financial position during the year, with the support of strengthening balance sheets and progressive divestment, on one hand, and the gradual normalisation of certain wholesale funding and bond issuance markets, on the other (see Chart 3.5). Also, the profits of international banks recovered to around their pre-crisis levels. This behaviour was not homogeneous however: US and British banks achieved high profitability, while that of Japanese and euro area banks was more moderate. Capital ratios rose significantly, in line with this improvement and in response to the financial crisis. This bolstering of capital took place against a background of stricter regulatory requirements and, in some specific cases, with the injection of public capital. Cross-border activity remained relatively moderate, but international banks increased their exposure to emerging areas, in particular to Latin America and Asia, where the banking systems were only temporarily affected by the crisis. Notwithstanding these positive developments, the process of reorganising and reshaping the banking and financial system has yet to be completed, and bank lending and financing conditions continue to be constrained by supply-side factors. In addition, numerous segments of the securitisation markets have still to be reactivated. At the same time, the weakness of the demand for credit and the financial fragility of borrowers are also limiting growth in lending to the private sector, which is notably slack.

… driven by the continued existence of sizeable public support …

The improvement in the financial sector continued to be underpinned by sizeable support, both from governments and central banks. At the end of 2010, the total amount of public support actually used by the financial sector stood at around 20% of GDP in the main economies, which was almost the same as in the previous year (see Chart 3.10). In general, there was a reduction in the support in the form of Treasury guarantees and central bank liquidity and financing facilities, which was offset by the increase in central bank asset purchases. In the United States, public support stood at 22% of GDP as at end-2010 (5 pp less than at end-2009), with a notable reduction in the support in the form of capital injections. The level of financial support in the United Kingdom remains the highest among the main advanced economies, at more than 50% of GDP, although it has fallen slightly. In Japan and in the euro area there was a fresh increase in support in 2010, although from much lower levels (6% and 15% of GDP, respectively). Given the nature of this support, in which outright purchases and capital injections are gaining in weight, it is likely to be maintained for a prolonged period.

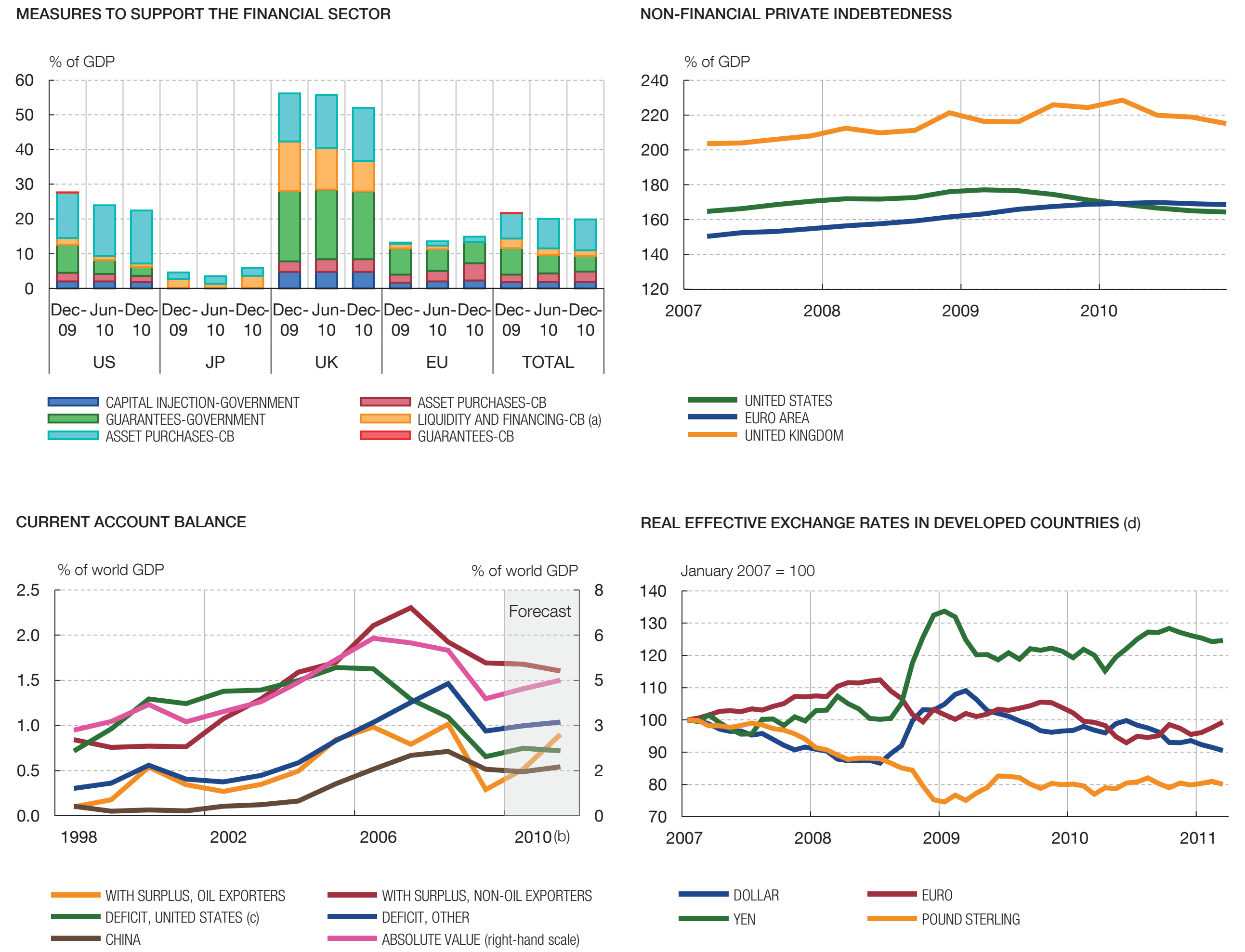
… and regulatory and financial reform

In 2010, the financial and regulatory reform initiatives coordinated at the global level lost some of their prominence to domestic ones. However, among the former, the approval by the G20 in November of the set of measures known as Basel III should be highlighted. These measures involve a strengthening of the capital and liquidity requirements to be met by financial institutions, at the global level, although some aspects have still to be developed (liquidity ratios, systemic institutions, etc.) and the period for full compliance is generous (until 2018, in some cases).

Among the reforms proposed at the national level, the Dodd-Frank law was passed in the United States and in the United Kingdom the government presented a consultative document outlining a new reform, which must be approved in 2011. The main characteristics of both these financial reform programmes are set out in Table 3.3. They have common elements, such as the far-reaching review of regulatory and supervisory structures and the creation of institutions in the macroprudential area and for the protection of financial service consumers. Unlike the gradual strategy adopted by European countries, the US reform proposes a global transformation, extending to most of the financial sector, to reduce the probability of new crises and to mitigate their potential effects on the economy

GLOBAL ECONOMIC AND FINANCIAL STABILITY

CHART 3.10



SOURCES: Datastream, Goldman Sachs, national statistics, Banco de España, Federal Reserve, ECB, Bank of England and Bank of Japan.

a Liquidity and financing-CB includes the increase in net lending since June 2008.
b IMF forecasts.
c Sign changed.
d CPI-based. An increase (decrease) denotes an appreciation (depreciation) of the currency.

and, in particular, on public finances. The reform proposed by the new British government focuses more on the regulatory architecture and assigns a larger role to the Bank of England.

4.2 DELEVERAGING PROCESSES

Private-sector indebtedness in the main advanced economies continues to hamper economic recovery and endanger financial stability

One adjustment that needs to be made following the crisis is linked to the excessive indebtedness of the private sector in the main developed economies and to the necessary deleveraging process (see Chart 3.10). In the United States, Japan and the United Kingdom (in contrast to the euro area) the ratio of non-financial private-sector debt tended to decline in 2010. In the case of households the decline reflects the increase in disposable income, high savings rates and weak lending. In the corporate sector, the fall was mainly the result of rises in financial asset prices. However, private sector deleveraging is proceeding slowly and, on historical evidence, can be expected to continue for several years. Persistently very high debt ratios not only hamper economic recovery (by limiting the leeway for private demand expansion), but also represent a risk to financial stability, since further adverse developments may lead to default, with negative repercussions for creditors.

COMPARATIVE SUMMARY OF FINANCIAL REFORMS **TABLE 3.3**

	UNITED STATES	UNITED KINGDOM
Nature and state of the reform	General: Dodd-Frank Wall Street Reform and Consumer Protection Act.	Partial, gradual and segmented reforms. Current institutional framework focus.
	Approved, but still to be implemented.	Approval of legislation foreseeable for mid-2011.
Financial stability coordination	Financial Stability Oversight Committee (FSOC).	Financial Policy Committee.
	Presided and coordinated by the Treasury.	Led by the Bank of England.
Supervision	Multiple supervisors.	Solvency supervisor separate from market performance (Twin Peaks).
Treatment of systemic institutions	Higher capital and liquidity requirements, strengthened supervision, new resolution regimes, living wills and stress tests.	
Separation of activities	Volcker rule and other limits.	Under study by the Independent Commission on Banking.
Consumer protection	Independent agency attached to Federal Reserve.	Independent agency.
Remuneration systems	Principles based: deferred salaries and conditionality based on medium-term performance.	

SOURCE: Banco de España.

In addition, there are problems arising from the increase in public-sector indebtedness

On top of these problems of excessive private-sector indebtedness has come the sharp increase in public debt (by 15 pp of GDP on average in the main advanced economies since 2008), which has offset the reduction in private debt. The upward trend in public debt is still far from being contained in most of the advanced countries, and highlights problems of fiscal sustainability and the general need for consolidation in the advanced economies, in addition to the adjustment imposed by the sovereign crisis in Europe. As discussed in Section 3.1, in countries like Japan and the United States, which also display unsustainable long-term fiscal trends (see Chart 3.7), fiscal consolidation has been postponed, since it has been subordinated to short-term priorities. In short, the need for fiscal adjustment and ongoing private-sector deleveraging will weigh on growth prospects in the advanced economies in the coming years.

4.3 GLOBAL IMBALANCES AND INTERNATIONAL POLICY COORDINATION

Global imbalances grew in 2010, following the significant correction in 2009

Following the sharp correction recorded in 2009, global imbalances grew moderately last year, in line with the recovery and the increase in commodity prices (see Chart 3.10). This growth was reflected in the slight increase in the absolute value of current-account balances, to 4.5% of world GDP, although this was well below its pre-crisis levels (around 6% in 2006). Among countries with current-account deficits, that of the United States increased slightly, to 3.2% of GDP, less than half its level in 2006. Among countries with surpluses, the increase in those of oil exporting countries was notable. By contrast, the surplus in China fell slightly, to 5.2% of GDP. As a result of this growth in imbalances, they have become one of the G20's main concerns once again.

The G20 has consolidated its position as the forum for economic policy coordination at the international level …

The financial crisis highlighted the complexity of the links between economies and financial systems, and the overriding need for international coordination of national actions in order to achieve balanced growth that is sustainable in the medium term. The G20 has consolidated its position as the main forum for this coordination, underpinned by the prominence within it of the emerging economies, in line with their greater importance at the world level (see Box 3.1). Against this background, reduction of global imbalances is one of its main objectives. In addition to repeating the need for orderly and gradual fiscal adjustment, the G20 has recommended countries with current-account deficits to take measures to stimulate saving and promote competitiveness, while urging surplus countries to adopt measures to stimulate internal sources of growth. With the aim of fostering greater commitment among its members, the G20 has based this debate on a "Mutual Assessment Process" and has just defined a set of indicators of macroeconomic imbalances for countries of major global importance, in relation to which assessments and policy recommendations can be made.

... although, the impetus for coordination has weakened

Notwithstanding the intense activity centred on the G20, the impetus for coordination weakened last year. The different rates of economic recovery and the different domestic priorities have given rise to diverging policy responses, as analysed in Section 3, which have not always been well received by the rest of the economies. In particular, the new expansionary phase of monetary policy in the United States acted as a trigger for significant intervention in the foreign exchange markets by emerging countries and some developed countries, such as Japan and Switzerland, and led to greater resort to administrative measures and capital controls, that ultimately run the risk of segmenting international capital markets, and thus acting against the climate of international coordination.

In short, the results of international policy coordination were ambiguous last year. On one hand, a certain fatigue can be perceived, following the peaks of tension in the economic crisis, and a trend towards the prevalence of national interests. At the same time, the G20 has consolidated its position as the forum for governance of the world economy and has an intense agenda.

5 Outlook and risks

The economic outlook is for continued growth at a somewhat more moderate rate, with significant downside risks, owing to the weakness of the fundamentals in the developed economies...

The baseline scenario of the economic outlook for 2011 is for continuity of the global recovery, although at a more moderate rate than in 2010. According to the IMF's latest forecasts, world growth in 2011 will be 4.4%, half a percentage point down from 2010, and the notable difference between the advanced and emerging economies will be maintained. This scenario is subject to notable downside risks, particularly in the developed economies, where the economic momentum continues to be based largely on policies of monetary and fiscal stimulus. Self-sustaining growth in domestic demand and, in particular, private consumption requires a significant improvement in labour markets (which is still insufficient, despite the positive signs in the United States, in the first quarter of 2011) and progress in deleveraging. At the same time, a stronger pick-up in private productive investment in the United States cannot be ruled out, owing to the strength of company balance sheets and the firming of confidence.

… intensified by the fragility of public finances…

The deterioration in public finances and its link to the fragility of the financial systems are another important source of risks. The new fiscal stimulus programmes in the United States have sustained growth in the short run, but have postponed fiscal consolidation, while concerns have been growing regarding the situation of state and local authority finances, which could erode the long-term fiscal position. In general, there is a risk of a sudden and substantial rise in the cost of financing public debt in the developed economies, given the imbalance between the supply and demand for public debt securities that may be generated during the recovery. The increase in long-term rates may have a further negative impact on domestic demand and financial stability.

... against a background in which the normalisation and reshaping of the financial system remains slow

At the same time, despite the improvement in the financial situation, the restructuring of some banking systems has still not been completed, and the necessary reshaping of the financial architecture will depend on the implementation of regulatory reform at the national and global levels. The impact of these developments on financing conditions, the flow of credit and, more generally, activity, is still uncertain.

The rise in commodity prices is a serious threat to global growth

The most palpable risks in the current situation arise from the upward trend in commodity prices (in particular, that of oil), which has intensified since early 2011 owing to the conflicts in the Arab countries. The direct impact on activity may be limited, but the possible monetary policy reactions to a sharp rise in inflation, and their impact on uncertainty, when confidence has still not been firmly established, would have more significant consequences. In addition, the policy dilemmas in the emerging economies may be exacerbated. In these economies risks of overheating and of increases in financial vulnerabilities are discernible, although the uncertainty associated with greater inflationary pressures may reduce the attractiveness of these economies and stem inflows. In any case, from a long-term perspective, the higher commodity prices, inevitably associated with growing demand from the emerging economies, may constrain global growth capacity and affect its distribution by region.

These risk factors require the implementation of policies to strengthen the outlook for growth and financial stability

In short, although the recovery in the world economy seems to be firming, the obstacles and challenges are notable, and the risks are on various fronts, including the inflation one. Against this background, economic policies designed to strengthen the foundations of growth and financial stability should prevail over more short-term stimuli, although these have been vital at the most acute moments of the crisis.