The external environment of the euro area

1 Introduction

In 2009 the world economy further suffered the consequences of the financial crisis and underwent a deep recession...

In 2009 the world economy went through a deep recession and the first fall in global activity since 1946. The recession had its origin in the serious financial crisis unleashed in September 2008, the most virulent since the Great Depression, the consequences of which continued to bear on the performance of the economy and the global financial markets. The most acute point of the fall was in the early months of the year. After stabilising in Q2, the world economy embarked on a progressive improvement which, although showing fluctuations and significant differences between countries, has continued to date.

... which was particularly sharp in some developed economies

The collapse of financial and commercial transactions and the slump in domestic demand following the rapid increase in uncertainty accompanying the crisis brought about a contraction of -0.6% in global GDP in the year as a whole, reversing the previous growth trend and causing a substantial loss of output and wealth (see Table 3.1 and Chart 3.1). The fall in activity was particularly sharp in the developed economies (-3.1%), where the deterioration of financial systems was most severe. Among these, the decline in GDP tended to be largest in the more open economies, such as Japan (-5%) and the United Kingdom (-5%), while in the United States it was more moderate (-2.4%). The adjustment gave rise to substantial job losses and to marked rises in unemployment rates in many countries, including the United States.

The strong fiscal and monetary stimuli and the financial sector support measures mitigated the impact of the crisis

The fall in activity and employment would have been notably greater had it not been for the rapid economic policy response in the form of well-funded fiscal stimulus plans (amounting to nearly two percentage points of GDP in the advanced economies) and an extraordinarily strong monetary boost through near-zero interest rates in most industrialised countries and a variety of non-conventional measures, which gave rise to unprecedented growth of the balance sheets of the main central banks. Also, the financial sector support measures were decisive in preventing the collapse of the system and in limiting the negative feedback between the lower activity and the worsening situation of financial institutions. This support was deployed in an internationally coordinated drive, and that coordination has been continued in the financial, regulatory and supervisory reforms now being instituted under the auspices of the G20.

The depth of the crisis and the response of economic policy were generally more moderate in the emerging economies

Although the emerging economies were also notably affected by the crisis and most went into recession, they posted positive growth in overall terms in 2009 [2.3%, nearly four percentage points (pp) less than in 2008]. Most notable were China and India, which, with growth of more than 8.5% and 5.5%, respectively, were among the few economies which contributed positively to global growth during the recession. By contrast, in other emerging areas – particularly eastern Europe (-4.1%) and Latin America (-2.1%) – activity fell off notably. These economies, with the exception of China, tended to adopt smaller-scale fiscal stimuli than the advanced economies and implement them somewhat later, partly because of the uncertainties associated with the access to finance, but also because of the lower impact of the crisis. The monetary policy response was also notable, although it was generally more conventional than in the developed economies. Interest rates fell substantially, but did not approach the limit of 0%, save rare exceptions. External support (bilateral or multilateral) and the use of international reserves proved to be important factors in cushioning the crisis in many of these countries.

The recession was accompanied by a plunge in trade, capital flows...

The crisis severely affected international trade and financial flows. The volume of world trade fell by around 13% in the whole of 2009 and international capital flows plummeted (see Chart 3.2), although both recovered during the course of the year, most notably trade from the second quarter of the year. The global imbalances were partially corrected in the year, due particularly

MAIN MACROECONOMIC INDICATORS

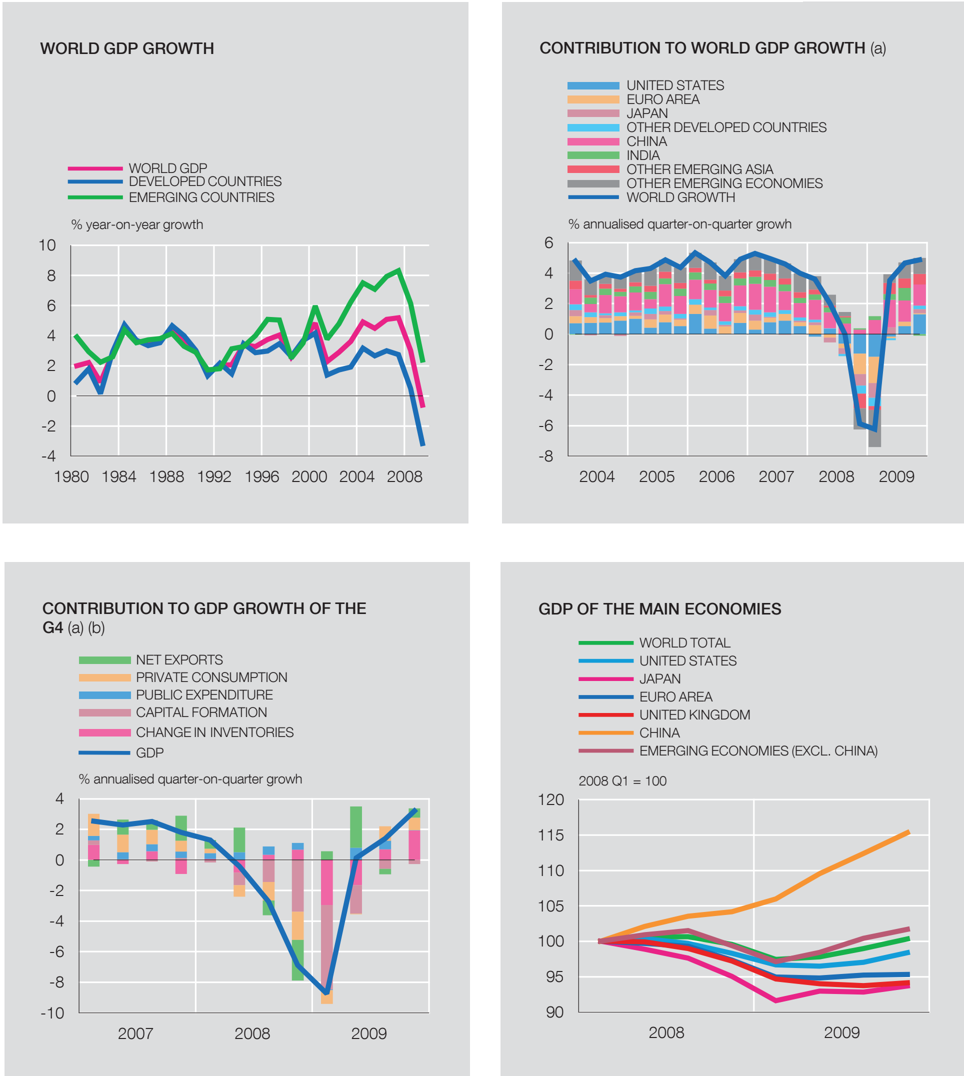
TABLE 3.1

	2007	2008	2009	2009			
				Q1	Q2	Q3	Q4
UNITED STATES							
GDP (a)	2,1	0,4	-2,4	-3,3	-3,8	-2,6	0,1
CPI (a)	2,9	3,8	-0,3	0,0	-1,2	-1,6	1,4
Current account balance (% of GDP)	-5,2	-4,9	-2,9	-4,4	-3,8	-3,2	-2,9
General government balance (% of GDP)	-2,7	-6,6	-12,5				
JAPAN							
GDP (a)	2,4	-1,2	-5,2	-8,9	-5,7	-5,2	-1,0
CPI (a)	0,0	1,4	-1,4	-0,1	-1,0	-2,2	-2,0
Current account balance (% of GDP)	4,8	3,2	2,8	2,6	2,4	2,4	2,8
General government balance (% of GDP)	-2,4	-4,2	-10,3				
EURO AREA							
GDP (a)	2,7	0,6	-4,1	-5,1	-4,9	-4,1	-2,1
CPI (a)	2,1	3,3	0,3	1,0	0,2	-0,4	0,4
Current account balance (% of GDP)	0,4	-0,8	-0,4	-1,7	-1,4	-1,1	-0,4
General government balance (% of GDP)	-0,6	-2,0	-6,3				
UNITED KINGDOM							
GDP (a)	2,6	0,5	-5,0	-5,4	-5,9	-5,3	-3,3
CPI (a)	2,3	3,6	2,2	3,0	2,1	1,5	2,1
Current account balance (% of GDP)	-2,7	-1,5	-1,3	-1,7	-1,8	-1,7	-1,3
General government balance (% of GDP)	-2,7	-4,8	-10,9				
CHINA							
GDP (a)	13,0	9,6	8,7	6,2	7,9	9,1	10,7
CPI (a)	4,8	5,9	-0,7	-0,6	-1,5	-1,3	0,7
Current account balance (% of GDP)	11,0	9,4	5,8				
General government balance (% of GDP)	0,6	-0,4	-2,2				
LATIN AMERICA (b) (c)							
GDP (a)	5,8	4,2	-2,1	-2,8	-4,0	-2,6	1,3
CPI (a)	5,4	7,8	6,4	7,6	6,7	5,9	5,4
Current account balance (% of GDP)	0,7	-0,5	-0,2	-0,7	-0,6	-0,7	-0,2
General government balance (% of GDP)	-0,3	-0,5	-2,6				
NEW EU MEMBER STATES NOT IN EURO AREA (b) (d)							
GDP (a)	6,0	4,1	-3,4	-3,6	-4,5	-3,7	-2,1
CPI (a)	4,4	6,5	3,6	4,2	3,8	2,5	2,0
Current account balance (% of GDP)	-8,2	-7,2	-1,6	-6,2	-4,5	-3,1	-1,6
General government balance (% of GDP)	-1,9	-3,5	-6,6				
PRO-MEMORIA: GDP GROWTH (e)							
World	5,2	3,0	-0,6	-2,8	-2,3	-1,1	1,4
Developed countries	2,8	0,5	-3,2	-4,5	-4,4	-3,5	-1,0
Emerging economies	8,3	6,1	2,4	-0,6	0,3	1,8	4,4
PRO-MEMORIA: INFLATION (e)							
World	4,0	6,0	2,5	2,2	1,1	0,5	1,9
Developed countries	2,2	3,4	0,1	0,6	-0,3	-0,9	0,7
Emerging economies	6,5	9,2	5,2	4,2	2,8	2,3	3,4

SOURCES: Banco de España, International Monetary Fund 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 the previous year, in PPP. Based on IMF information.
c. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
d. Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Bulgaria and Romania.
e. Quarterly data based on a sample of countries representing 90% of world GDP.

GLOBAL ECONOMIC ACTIVITY CHART 3.1



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

a. Contribution, in percentage points, to the annualised quarterly change in GDP.
b. Aggregate of the United States, the euro area, Japan and the United Kingdom.

to the impact of the recession (since domestic demand underwent a relatively higher decline in the countries with the highest deficits) and to the fall in commodity prices.

... and inflation rates

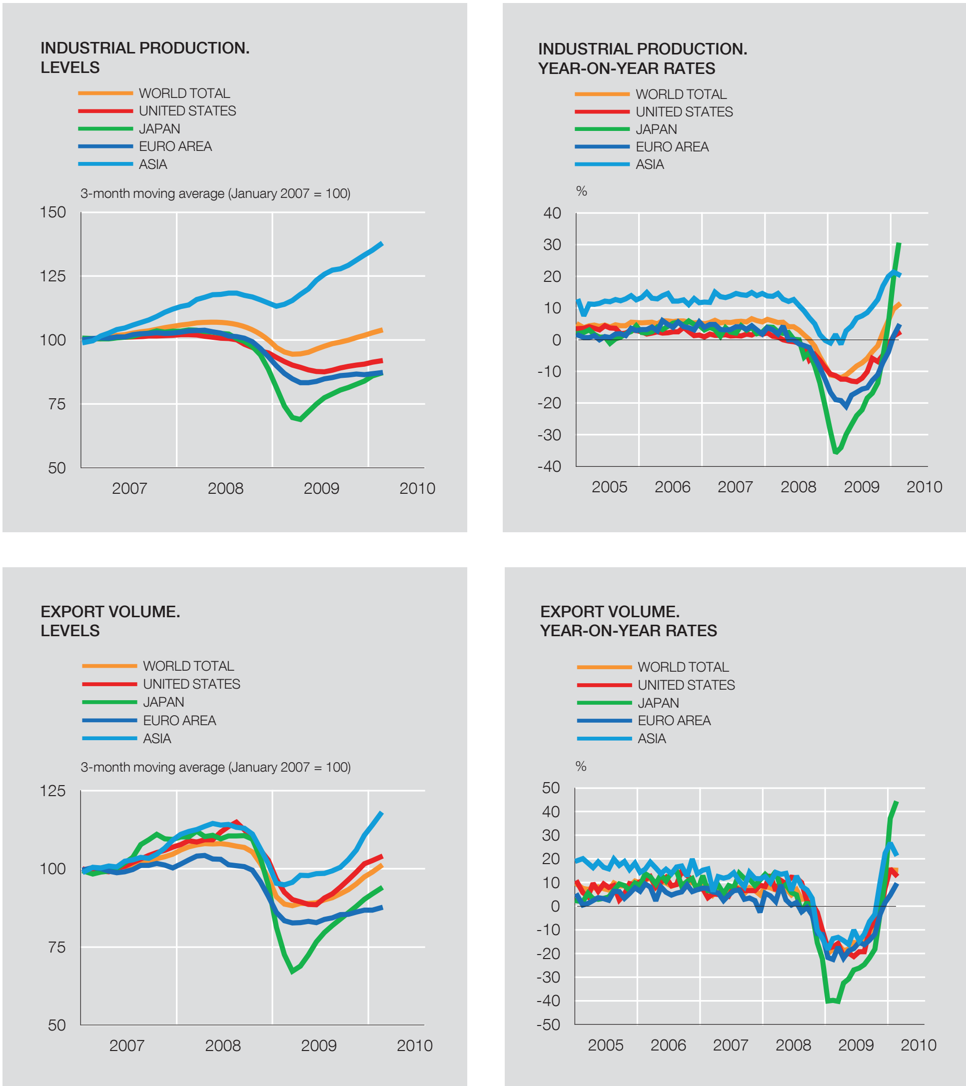
Inflation rates fell drastically in 2009 due to the opening-up of extraordinarily wide output gaps and to the sharp correction in commodity prices (energy, metals and food) between mid-2008 and 2009 Q1, which gave rise to a fall of 33% on average in the year (see Chart 3.3). Inflation was practically zero in the advanced countries in 2009 as a whole (3.3 pp less than in the previous year) and dropped by more than four pp to 3.1% in the emerging economies. Inflation remained negative in many countries in much of the year, rising from Q4. However, underlying inflation rates were much steadier. This absence of inflationary pressure made it easier to maintain monetary policies supportive of economic and financial activity.

After bottoming out in early 2009, activity tended to recover gradually, buoyed by government support

The figures for 2009 as a whole mask the gradual improvement in the economic and financial situation which took place during the course of the year. At the beginning of the year, the financial crisis of September 2008 was still spreading virulently: activity plummeted and the financial system was in a critical state. However, by year-end economic recovery was under way, amidst

INDUSTRIAL PRODUCTION AND INTERNATIONAL TRADE

CHART 3.2



SOURCE: CPB Netherlands Bureau for Economic Policy Analysis, Datastream and Banco de España.

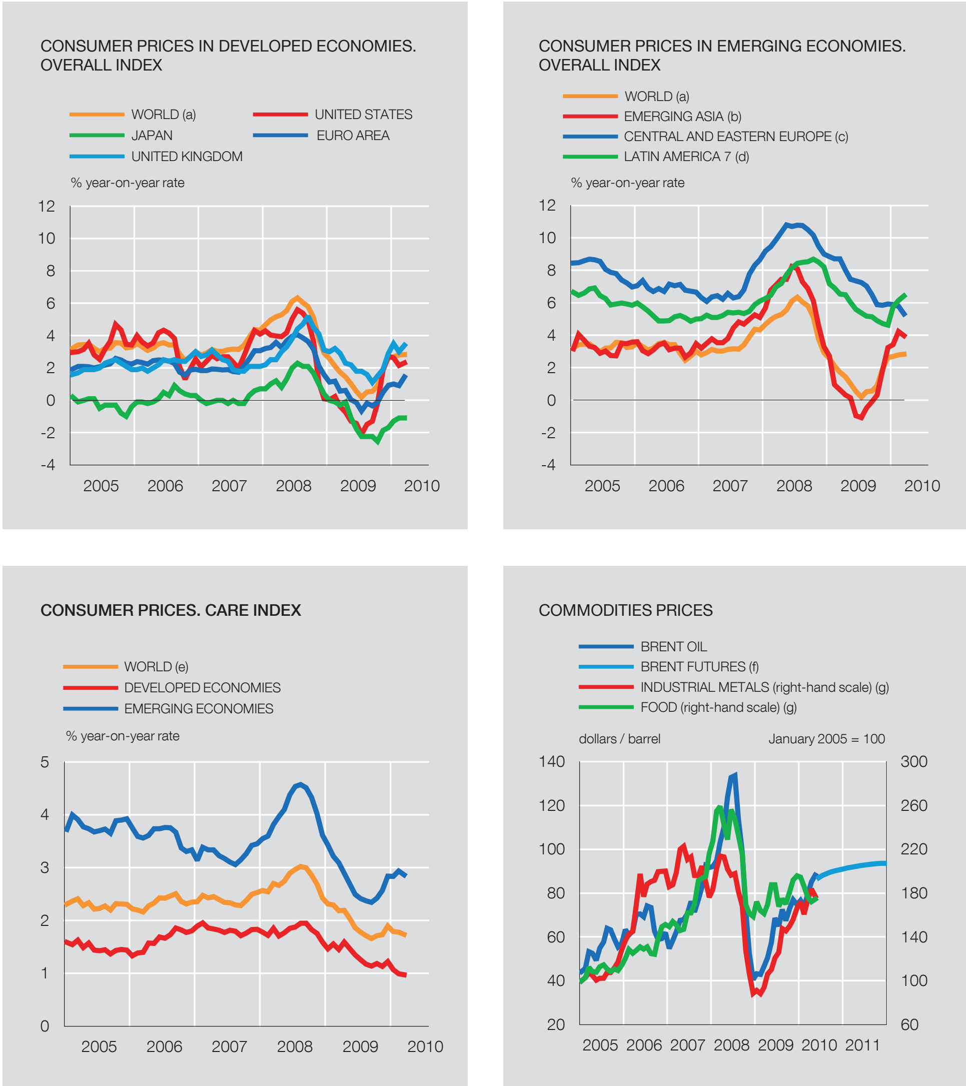
a certain financial normalisation, and, despite the scale of the crisis, the reversal was quicker than expected. In any event, although activity has rebounded strongly in the emerging economies, the pace of recovery in the developed economies is slower than on previous occasions. In any event, the recovery, which remains largely dependent on the fiscal and monetary stimuli still in place, is more vigorous in the United States and Japan than in the EU. For this reason, the withdrawal of support measures, particularly in the monetary and financial spheres, is proceeding cautiously and is basically passive, as and when those measures cease to be necessary.

However the medium-term economic outlook continues to be surrounded by notable uncertainty, due to the complex legacy left by the crisis

The economic and financial indicators continue to improve in early 2010, although the sharp deterioration in public finances due to the crisis also rekindled some tensions, which have manifested themselves most strongly from April onwards. The medium-term economic outlook is uncertain, since the consequences of the economic and financial crisis will burden the ability of economies (especially the developed ones) to grow in the coming years. Specifically, there are doubts as to whether, once government support is phased out, the recovery will retain sufficient momentum, given the background of high unemployment, financial system downsizing, yet-to-be-completed adjustment of financial balance sheets in the private sector

INFLATION AND COMMODITIES PRICES

CHART 3.3



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

a. Aggregate calculated drawing on the data from 57 countries accounting for 90% of world GDP.
b. India, China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.
c. Russia, Ukraine, Turkey, Poland, Czech Republic, Hungary, Estonia, Latvia, Lithuania, Bulgaria and Croatia.
d. Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
e. Aggregate calculated drawing on the data from 45 countries accounting for 83% of world GDP.
f. Brent futures from the week of 27 April 2010 to 3 May 2010.
g. Goldman Sachs indices.

and high public-sector financing requirements. However, this adjustment, which, given past excesses, was inevitable, can and should give rise to more sustainable growth for the world economy in the medium term.

2 *Economic and financial developments*

In 2009 global economic and financial developments went through various phases, beginning from a very difficult starting point in the early months when the effects of the crisis and the extreme uncertainty still held the financial markets and economic activity at a standstill. Towards the end of that first quarter, the economies began to bottom out and move into a phase of financial market recovery and of certain economic stabilisation. Finally, from Q2 the improvement in the financial situation progressively moved on to a firmer footing and activity recovered.

2.1 STARTING SITUATION: SLUMP IN ACTIVITY AND MARKETS AT A STANDSTILL

At the beginning of 2009, the capital markets were frozen and volatility was high...

At the outset of 2009 the risk of systemic collapse becoming a reality had not been completely ruled out, and the financial situation was extremely fragile and dependent on the support provided by the authorities. The financial markets remained frozen by the lack of confidence and the extreme uncertainty about the size of the losses to the financial systems of the main economies, as the extent of the impact of the crisis on economic activity became apparent. As shown by Chart 3.4, volatility remained high, the stock markets were falling, interbank spreads reflected the continuing extreme tensions on the bank funding markets and the dollar continued to act as a safe-haven currency. This situation required the reinforcement of the already-substantial financial support measures, which ended up inducing an incipient reactivation of debt issuance, although only in specific segments, such as financial sector issues backed by government guarantees and those of non-financial corporations with high credit ratings. For their part, the emerging financial markets continued under the effects of the paralysis of international capital flows, although the situation tended to stabilise, except in some eastern European economies, where volatility remained high as a result of the high dependence of their financial institutions on external funding and of the high private-sector indebtedness, often denominated in foreign currency.

... while the slump in activity and international trade sharpened

Meanwhile, economic activity began the year in a phase of paralysis and of sharp contraction in output, trade, investment and employment initiated in 2008 Q4. The fall in world GDP is estimated to have reached an annualised quarter-on-quarter rate of more than 6% in 2009 Q1 (even higher than in 2008 Q4), while job destruction proceeded apace and unemployment rates increased rapidly, most notably in the industrialised economies (see Chart 3.5). Output contracted practically across-the-board and simultaneously, save notable exceptions such as China and India, which, however, did see a slowdown. This sharp fall in activity was reflected especially in industrial output, which fell globally by 11.7% from May 2008 to March 2009, although in the case of Japan it contracted by 33.7%. At the other extreme was the positive performance of output in the two Asian economies mentioned above. In addition, the fall in activity and the decline in trade finance, against a background of growing importance of transnational production chains, led world trade to fall by 19% in the first four months of the crisis, and by 13% in 2009 as a whole (see Chart 3.2). This contraction in trade, the first since 1982, contributed to an extensive reduction in external imbalances, underpinned also by the downward correction of commodity prices.

Domestic demand contracted sharply in the developed economies

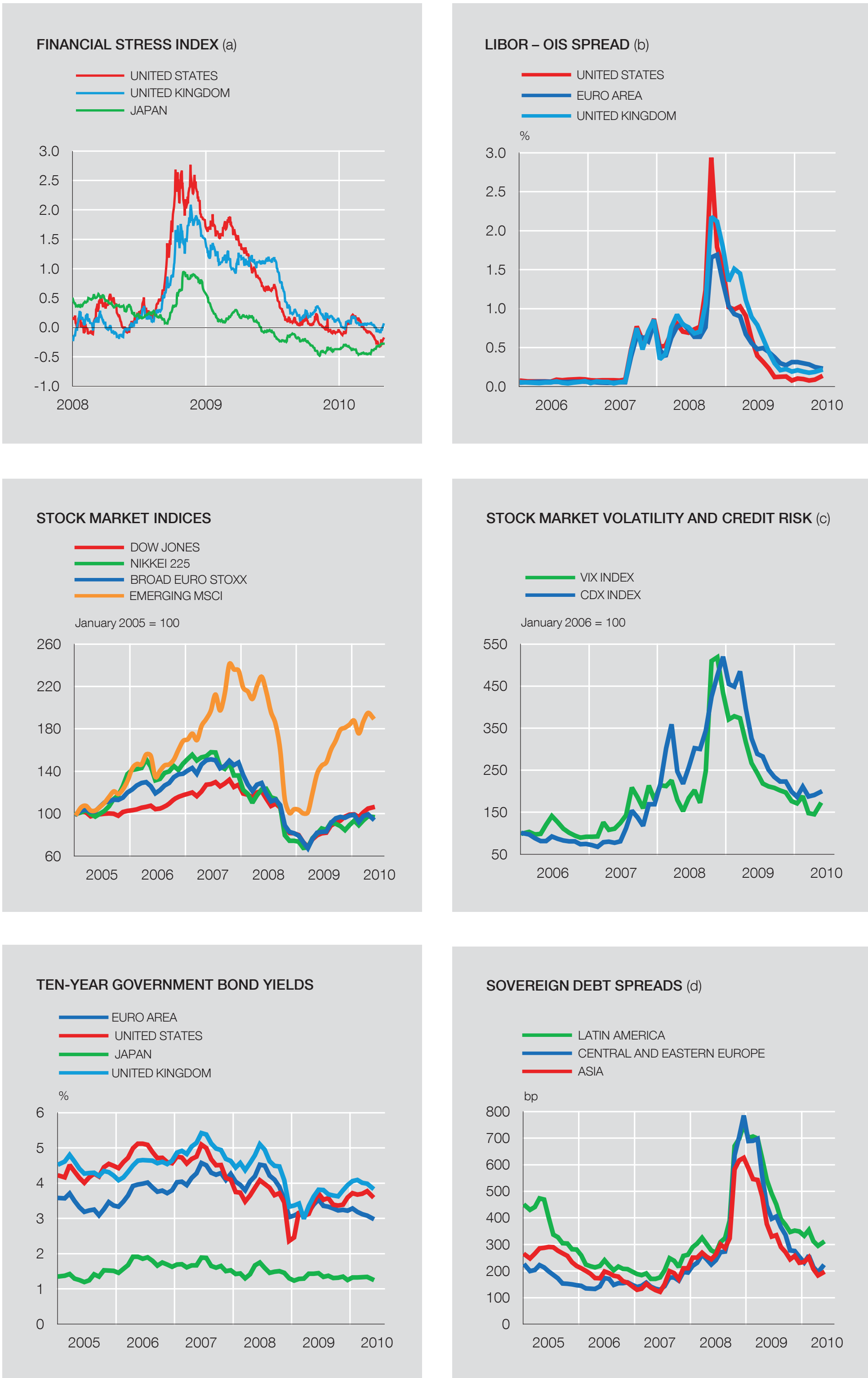
The recession which had begun in the previous year deepened in the advanced economies. The demand for consumer durables and investment goods, particularly sensitive to heightening uncertainty, underwent the largest adjustment and was the main factor behind the sharp decline in demand and activity in those quarters. The severe labour market deterioration and the credit crunch, derived from the financial situation, contributed to the contractionary behaviour of private-sector demand. Also, inventories commenced a profound process of adjustment. Thus, in 2009 Q1 the fall in investment and inventories explains nearly all the contraction in activity in the four main developed economies, as seen in Chart 3.1. For their part, the emerging economies were impacted simultaneously by the collapse in external demand and the drying-up of capital inflows, to which may be added a fall in commodity prices in some of these economies. Indeed, the emerging economies with greater openness in trade and finance and greater dependence on commodity prices were among those which were most affected. However, notably the impact of the crisis on the banking systems of these economies was limited, given their scant exposure to toxic assets and their limited dependence on external funding, with the exception of eastern Europe.

Inflation continued downward due to the fall in demand and the commodity price adjustment

After peaking in July 2008, inflation embarked on a steep downward path which continued in early 2009, stimulated by the slump in activity and the correction of commodity prices, which dropped by 60% between July 2008 and February 2009 (see Chart 3.3). However, long-term inflation expectations held steady in the advanced economies. In the emerging economies,

INTERNATIONAL FINANCIAL MARKETS

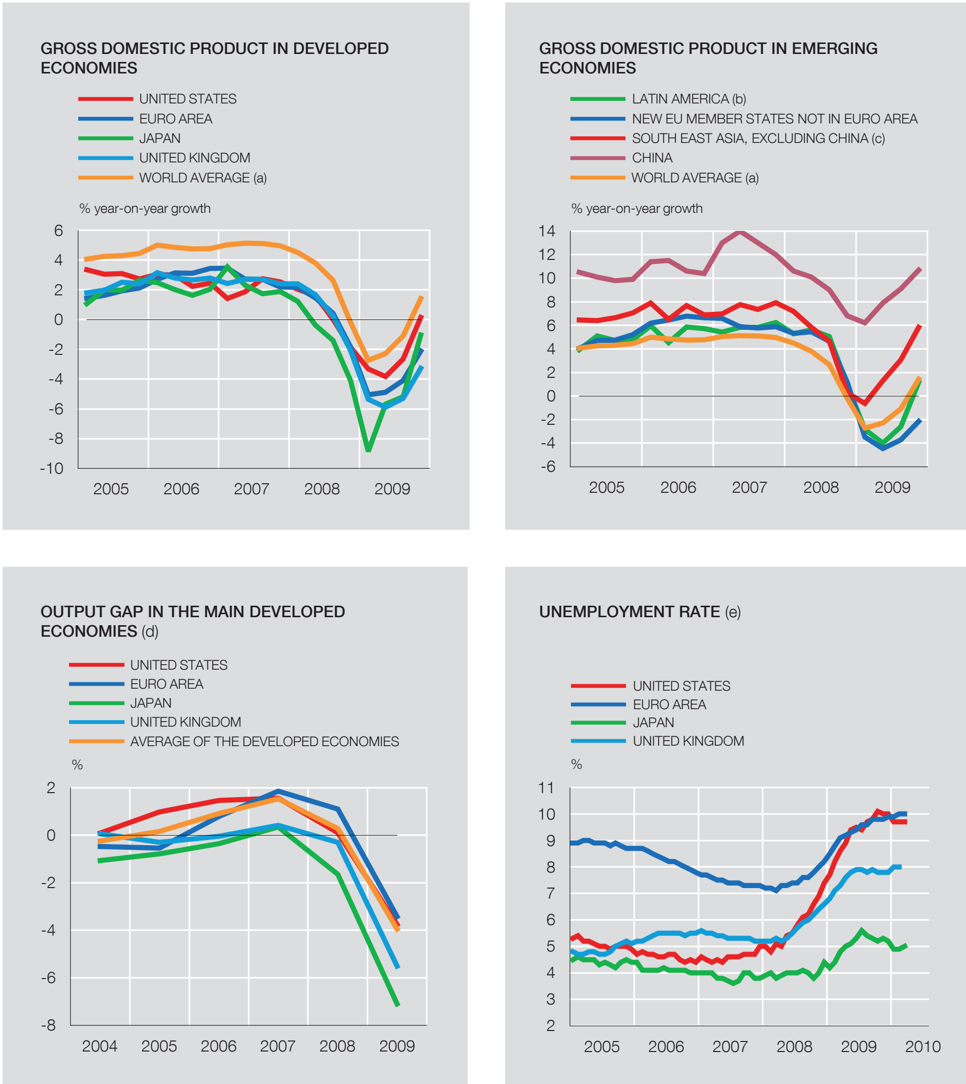
CHART 3.4



SOURCES: Datastream and Bloomberg.

a. Index which identifies bouts of financial stress using variables relating to the stock market, the banking sector and exchange rates. An increase (decrease) in the index denotes an increase (decrease) in financial market stress and thus a negative (positive) effect on economic activity.
b. 3-month spread. United States: LIBOR - effective Fed Funds rate OIS swap; United Kingdom: LIBOR - SONIA swap; euro area: EURIBOR - EONIA swap.
c. VIX index (stock market volatility of Standard & Poors 500 index) and CDX credit risk index (5-year US investment grade credit default swap index).
d. EMBI + for Latin America and global EMBI for Asia and central and eastern Europe.

ECONOMIC ACTIVITY AND EMPLOYMENT CHART 3.5



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

a. Banco de España calculations based on data from 57 countries representing 90% of world GDP. Aggregates calculated using countries' weights in the world economy in the previous year, in purchasing power parity (PPP), based on IMF data.
b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
c. India, Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines.
d. IMF estimates.
e. Percentage of labour force.

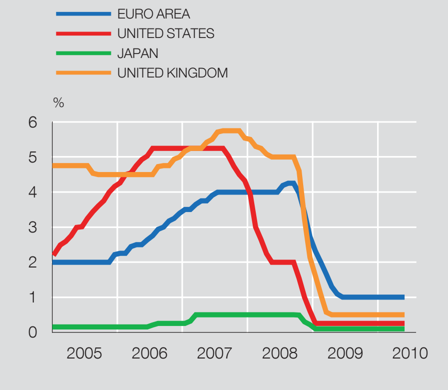
price moderation also continued, although to different extents across regions, being more marked in Asia and less so in Latin America where, moreover, it had begun with a certain lag.

Economic policy responses were rapid and blunt at the beginning of the crisis on three fronts: monetary policy, support to the financial sector and fiscal policy

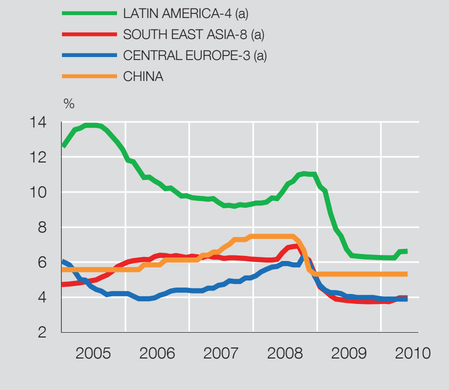
The urgent need to halt the contractionary spiral in which the world economy found itself explains the rapidness, intensity and coordination of economic policy responses from October 2008. These measures were intended to stabilise the markets, safeguard financial institutions, mitigate the fall in private demand and, in short, re-establish a minimum of confidence on which to base the economic recovery.

As regards monetary policy, the central banks of the main developed economies rapidly cut official interest rates following the outbreak of the crisis, on occasions simultaneously and coordinatedly. Hence, by the end of 2009 Q1 most of them had reached their lower limit, close to zero (see Chart 3.6). At the same time they strongly increased the provision of liquidity to the

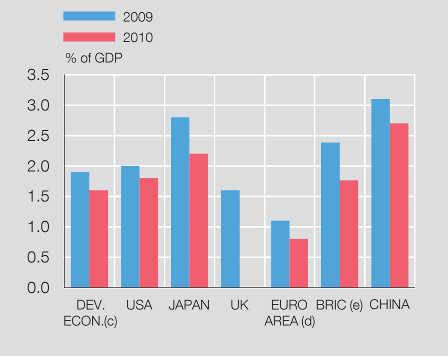
OFFICIAL INTEREST RATES IN DEVELOPED COUNTRIES



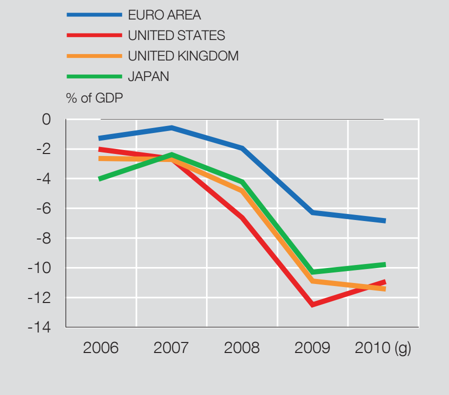
OFFICIAL INTEREST RATES IN EMERGING COUNTRIES



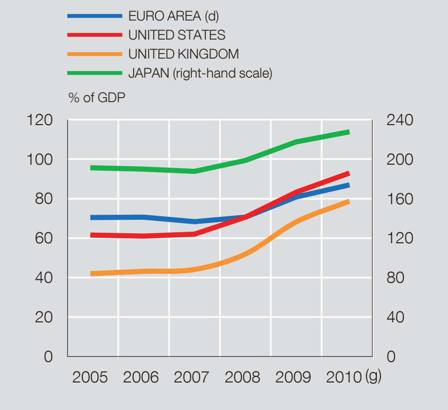
FISCAL STIMULI (b)



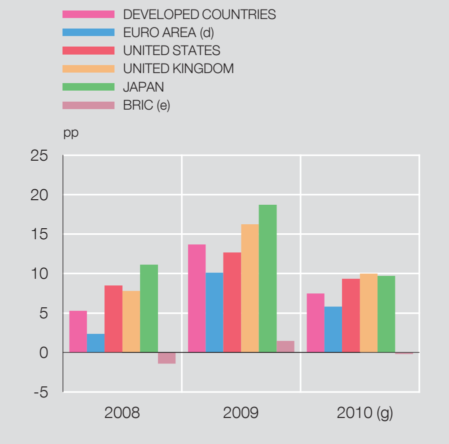
PUBLIC-SECTOR BALANCE (f)



PUBLIC DEBT



GROWTH OF PUBLIC DEBT



SOURCES: Datastream, national statistics, IMF, European Commission and Banco de España.

a. Areas analysed: South East Asia-8 (India, 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).
b. IMF estimates for 2009 and forecasts for 2010.
c. G20 developed economies.
d. The euro area includes four large economies: Germany, France, Italy and Spain.
e. Weighted aggregrate of Brazil, Russia, India and China.
f. Percentage of GDP. Surplus (+) or deficit (–).
g. IMF forecasts.

financial system and implemented a series of unconventional measures, which in some cases included direct support to specific segments of the financial markets and which gave rise to a substantial expansion of central bank balance sheets, as described in Box 3.1 for the cases of the Federal Reserve and the Bank of England.

Government support to the financial sector was provided through bank deposit guarantees, capital injections, guarantees of financial institution debt, bank balance sheet restructuring and impaired asset management, and, on occasions, was provided by central banks and Treasuries acting in coordination (see Chart 3.7). Finally, fiscal measures to support domestic demand were introduced through fiscal stimulus programmes, which represented nearly 2% of the GDP of the advanced economies, although the amount was very different across countries depending on their initial situation, on the power of their automatic stabilisers, on their perceived effectiveness and on their impact on the sustainability of public finances.

The response of emerging economies was generally less intense and somewhat delayed...

The authorities of the emerging economies generally responded less strongly and with a certain lag. The reasons for this were various. The differing impact of the crisis, caution in the face of possible difficulty in accessing the international markets and uncertainty about their ability to implement countercyclical policies shaped their response, which finally was also firm. Generally predominating were responses designed to maintain foreign-currency financing (via domestic facilities granted by central banks, governments and public-sector banks), and multilateral facilities, such as swaps with other central banks and new IMF loan types. Some countries, such as China and Chile, took significant monetary and fiscal stimulus measures, although generally the fiscal stimulus in the emerging economies was smaller than in the developed economies, and, moreover, the automatic stabilisers were more limited.

... and in protectionist measures did not increase significantly

Lastly, on the positive side, few protectionist trade measures were taken in response to the crisis. Much of the reason for this undoubtedly lies in the scale of international cooperation in addressing the crisis from the very start. This prevented a repetition of the upward spiral of barriers to trade which followed the Great Depression and prevented the recovery in output from being accompanied by a recovery in trade.

2.2 MARKET RECOVERY AND STABILISATION OF ACTIVITY

The strong economic policy action was key to re-establishing confidence and stabilising the financial markets...

The strong financial system support – boosted in the second half of March – was conducive to the gradual re-establishment of agents' confidence and to the stabilisation of the financial markets from then onwards. This improvement was further bolstered in April by the announcement of greater-than-expected first-quarter profits by some of the larger financial institutions and by the maintenance of the international coordination drive. The publication in May of the results of stress tests on the larger US banks confirmed the ability of most of them to withstand a negative scenario, although in some cases this required the existing capital cushions to be raised. These factors contributed to improving the market perception of the sector and of its outlook.

... which was reflected in a general improvement in financial indicators from March 2009

The perception that the worst was over began to take root in the markets and a certain recovery in risk appetite started to become apparent. This change of sentiment was reflected in lower volatility, narrower credit spreads and a stock market recovery from March. Against this background, the high demand for assets considered to have safe-haven status at times of high uncertainty (mainly US Treasury bonds) reversed, leading to depreciation of the dollar and the yen and raising US long-term government bond yields. Consequently, against a backdrop of still-accommodative monetary policy, the slope of the yield curve steepened to historically high levels. This led to a gradual (and slow) normalisation of some wholesale funding markets which had been hard hit by the crisis and strengthened

ACTION BY THE US AND UK CENTRAL BANKS DURING THE CRISIS

The central banks have been one of the main actors, often in close coordination with Treasuries, in supporting the financial system and demand in the last two years. During the crisis, the traditional central bank action through interest rate management, with the central aim of maintaining price stability, was supplemented with non-conventional financial stability measures notable for their intensity and scope. This box focuses on the response of the Federal Reserve (Fed) and the Bank of England (BoE), the two central banks of developed countries which, along with the Bank of Japan, implemented the greatest variety of non-conventional measures (see accompanying table) and which, as a consequence of those measures, most expanded their balance sheets as they sought to counteract the effects of the crisis.

As the crisis deepened in late 2008, there was an unprecedented response from central banks in terms of rapidness, intensity and breadth of measures. These measures initially included interest rate cuts (particularly rapid and aggressive in the United States and, subsequently, in the United Kingdom) to levels close to zero and ample liquidity provision to financial institutions[1] at lower cost and for longer terms than usual. The BoE had to adapt its monetary policy operations to broaden the types of collateral accepted in liquidity providing operations and, in the case of the Fed, also the number of counterparties. This response contrasts with that of the monetary authorities of other areas, such as the European Central bank, whose operational design allowed it to respond to the liquidity provision requirements without need for major changes in its operating framework.

The deterioration in the financial markets after September 2008 required governments support specific segments to re-establish confidence, increase their liquidity and reduce interest rates. As a consequence of the importance of the capital markets in the United States, the Fed was particularly active in this kind of action, which included financing the purchase of specific assets (mainly commercial paper and certain securitisations) and outright purchases of other assets, such as securitisations and debt of government sponsored enterprises (to the extent of 8.8% of GDP) with the aim of pushing down mortgage interest rates. The BoE also conducted direct purchases of private-sector financial assets but on an insignificant scale. From 2009 Q1, both central banks started outright purchases of Treasury bonds on the secondary market (the Bank of Japan had been doing so for a long time) to reduce long-term financing costs and lessen

1. Also, foreign currency swaps were arranged between central banks, particularly with the Federal Reserve, to ensure the international provision of foreign currency liquidity.

	Federal Reserve	Banck of England	European Central Bank	Bank of Japan	Bank of Canada	Bank of Sweden	Swiss National Bank
Reduction of official interest rates to historically low levels							
Increased provision of liquidity to financial institutions							
International foreign currency *swaps*							
Direct intervention in specific segments of the financial markets							
Commercial paper	*Financing for purchase or outright purchase* (a)	*Outright purchases*		*Outright purchases*			
Corporate debt		*Outright purchases*	*Outright purchases*	*Outright purchases*			*Outright purchases*
Securitised assets	*Financing for purchase*						
Covered bonds (including mortgage covered bonds)			*Outright purchases*				
Shares held by banks				*Outright purchases*			
Mortgage-backed securities (MBSs) and government-sponsored enterprises (GSEs)	*Outright purchases*						
Treasury bond purchases	Outright purchases	Outright purchases	Outright purchases	Increased pace of purchases			
Support to specific institutions	Bear Stearns, AIG	Northern Rock, RBoS, HBOS				Kaupthing Bank, Carnegie Investment Bank	UBS

SOURCE: Organisation for Economic Cooperation and Development.

a. Outright purchase through a special purpose vehicle.

credit market tensions at long time horizons. Purchases by the Fed totalled $300 bn (2.1% of GDP) and those by the BoE amounted to 200 billion pounds sterling (13.7% of GDP). Although the effect of these purchases on interest rates is difficult to calculate accurately, the downward pressure must have been particularly strong in the United Kingdom, where the acquisitions by the BoE in 2009 were even higher than the net issuance of public debt by the Treasury on the primary market. In May 2010, faced with financial tensions caused by the fiscal problems in the euro area, the ECB decided to intervene in the public and private debt markets to ensure they were functioning smoothly as a monetary policy transmission mechanism. Lastly, as can be seen in the accompanying table, both central banks (and the Swedish and Swiss central banks) directly supported some specific institutions, as in the case of Bear Stearns and AIG in the United States and Northern Rock in the United Kingdom.

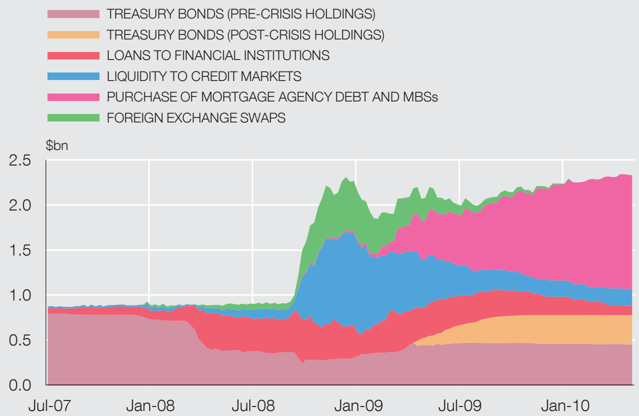
All these actions were reflected, especially from 2008 Q4, in an increase in central bank balance sheets and a substantial alteration of their traditional composition, especially in the case of the Fed, which accepted higher-risk assets (Chart 1). In particular, from the onset of the crisis to March 2010, the balance sheet of the Federal Reserve grew from 6% to 16% of GDP, while that of the BoE increased from 7% to 17% of GDP. That said, the substantial increases in the monetary bases resulting from these operations did not feed through to increases in other broader monetary and credit aggregates, due to the drastic fall in the money multipliers following the crisis.

As financial market normalisation proceeded (thanks to the measures implemented) and the liquidity tensions decreased, less use was made of the liquidity and credit facilities (the cost of which exceeded that of access to the market in normal conditions). Indeed, many of these facilities expired in the United States as scheduled at the end of 2009 and beginning of 2010, with a scant impact on the markets. Also, the outright purchase of private-sector assets (particularly important in the case of the Fed, which purchased commercial paper for an amount equivalent to 2.5% of GDP) was almost completely reversed and this facility also expired as scheduled.

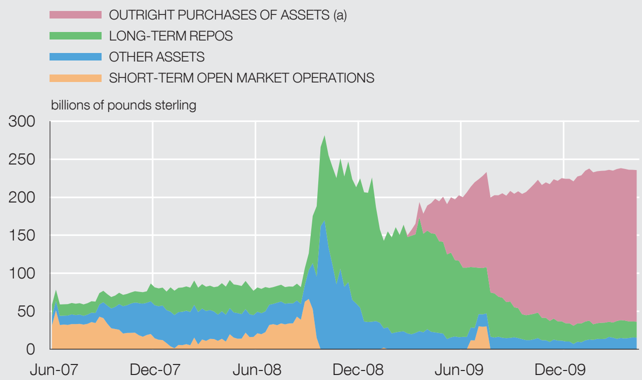
However, outright purchases of government assets (including, in the United States, the debt and securitisations of the main mortgage securitisation agencies) are keeping the size of the balance sheets of the Fed and the BoE (Charts 1 and 2) at high levels. It was precisely the future prospects of these programmes after purchases stopped at the end of 2010 Q1 which accounted for the main difference between these two institutions: while the Fed indicated that the purchase of these assets had definitively ceased, the BoE left open the possibility of resuming purchases depending on the state of the economy. In any event, these high holdings of outright purchases of assets may give rise to greater difficulties and risks for future monetary policy management due to the impact which their sale may have on long-term interest rates. This is significant different from the practice of the European Central Bank, where outright purchases of assets (covered bonds) have played a minor role.

It is likely that some of the operational changes implemented during the crisis (e.g. expansion of the types of eligible high-quality collateral and of the number of counterparties) will be retained because it has proven to be useful to have flexible liquidity-providing instruments in situations of market tension and even in normal circumstances. Furthermore, as the economic and financial situation normalises, monetary policy will also tend to do so and its central focus will shift towards price stability. In any event, reversing the strong increase in central bank balance sheets will take a long time and has required, particularly in the United States, a wide variety of additional instruments to help smooth the exit strategy.

1 FEDERAL RESERVE



2 BANK OF ENGLAND

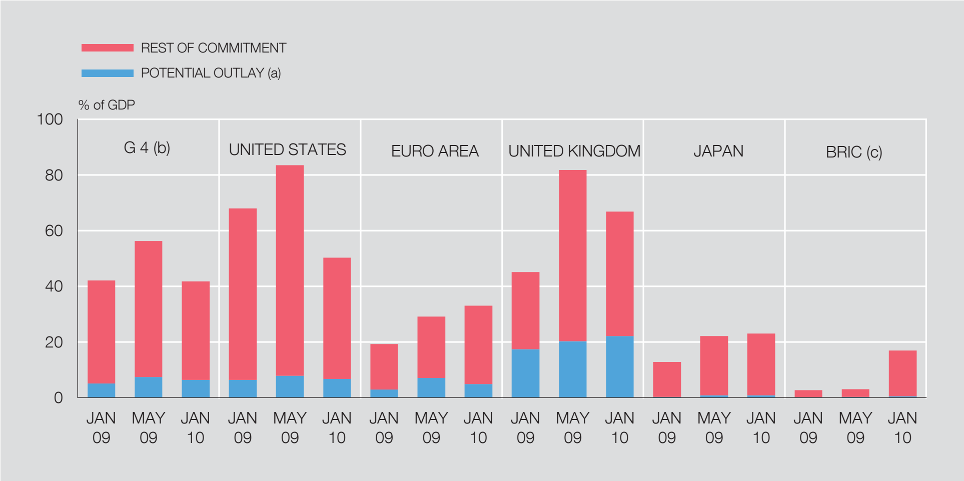


SOURCES: Federal Reserve and Bank of England.

a. Purchases under the Asset Purchase Facility (APF), mainly Treasury bonds.

SIZE OF FINANCIAL SUPPORT MEASURES

CHART 3.7



SOURCES: Eurostat, national statistics and Banco de España.

a. Support having an effective fiscal cost when used.
b. Aggregate of United States, euro area, Japan and United Kingdom.
c. Aggregate of Brazil, Russia, India and China.

the process of recovery of confidence in parts of the financial system. A similar turning point was also seen in stock market indices and in the sovereign spreads of emerging economies. The exchange rates of the main Latin American, South-East Asian and central European currencies appreciated in real terms, while, by contrast, the Chinese currency underwent a notable real depreciation due to its fixed exchange rate with the US dollar (see Chart 3.8).

In 2009 Q2 the world economy returned to growth, basically due to the contribution by Asia and, in particular, by China...

The turning point in economic activity came at about the end of Q1. In the second quarter of the year the developed economies still had negative, albeit very close to zero, quarter-on-quarter growth rates (some, such as that of Japan, were even slightly positive). The stabilisation of economic activity in this group of economies was based on a strong positive contribution from external demand (particularly in Japan), which offset the still-negative (although much more moderate than 2009 Q1) contribution from inventories and investment. At the same time, the strong monetary and fiscal stimuli started to be reflected in a certain recovery of consumption and in an expansion of public spending.

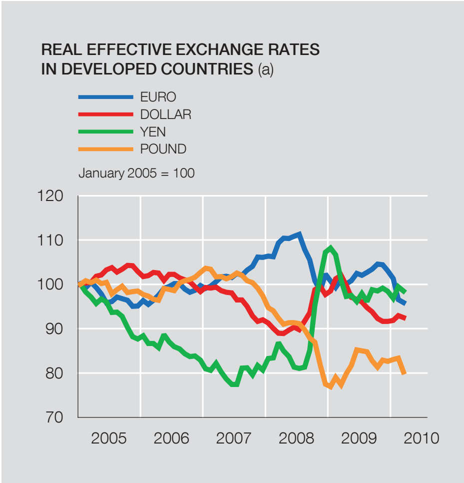
Since many emerging economies already had positive growth rates in that second quarter, the annualised quarterly world economic growth in that period was 3.6%. Three percentage points of that growth were explained by the Asian economies, particularly China (which contributed 1.9 pp, after annualised quarterly growth of nearly 15% in that period), on the basis of a strong fiscal stimulus and a sharp rise in credit, aimed particularly at financing infrastructure construction.

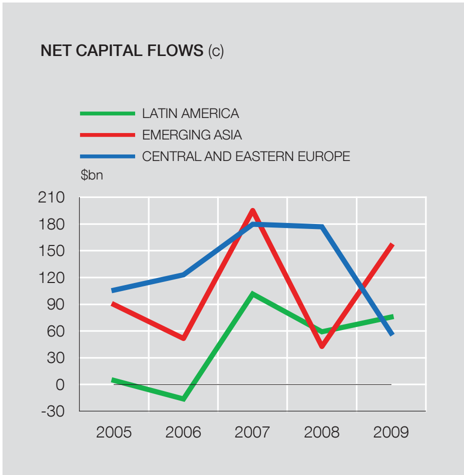
...thereby dissipating the threat of systemic collapse and paving the way for recovery

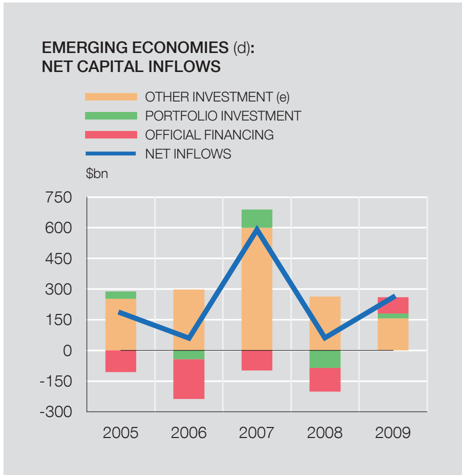
The change in the trend of activity was reflected in a favourable about-face in the global growth outlook, which in prior quarters had even traced out a central scenario of prolonged global depression. Thus from Q2 onwards growth forecasts for 2010 tended to improve, including those of most emerging economies (mainly Asia and Latin America), whose ability to resist the crisis became clear. In short, the firm economic policy response made it possible to curb the negative interaction between the financial situation and economic activity, and to gradually re-establish confidence. From this starting point, a positive spiral was set in train which progressively gained momentum throughout 2009.

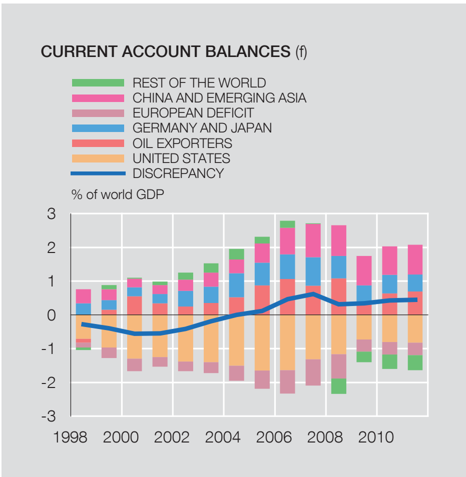
EXCHANGE RATES AND CAPITAL FLOWS

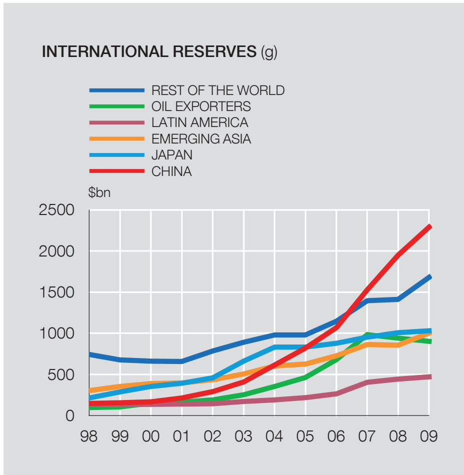
CHART 3.8









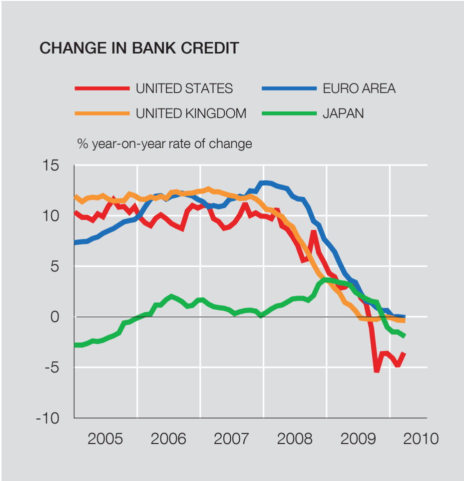


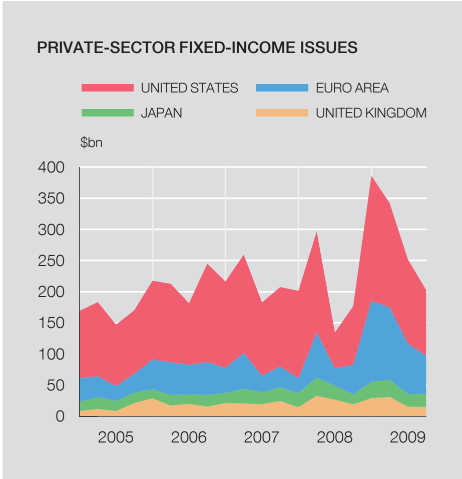
SOURCE: Datastream and IMF.

a. CPI-based. An increase (decrease) denotes an appreciation (depreciation) of the currency.
b. Areas analysed: South East Asia-9 (India, Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and Philippines), central Europe-3 (Czech Republic, Hungary and Poland) and Latin America-7 (Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru).
c. Country aggregates based on the IMF (WEO) definition.
d. Africa, Latin America, central and eastern Europe, Confederation of Independent States, Middle East and emerging Asia.
e. Includes FDI and bank loans.
f. WEO forecasts for 2010 and 2011.
g. 2009: 2009 Q3 data.

PRIVATE SECTOR FINANCING

CHART 3.9





SOURCE: Federal Reserve, ECB, Bank of England, Bank of Japan and Dealogic.

2.3 MARKET CONSOLIDATION AND RECOVERY OF ACTIVITY

In the second half of 2009 the financial market recovery moved on to a firm footing

The second half of the year saw the firming of the financial market recovery initiated in previous months. Thus some indicators, such as interbank market credit spreads and the sovereign spreads of numerous emerging economies moved back towards their levels before the bankruptcy of Lehman Brothers, and others, such as stock market prices and volatility indexes, improved substantially, although they did not recoup their previous levels. As a result of this improvement, the signs of recovery of some funding markets first perceived in the second quarter of the year moved on to a firmer footing. This meant that, for example, financial institutions resumed debt issuance without resorting to government guarantees (against a background of high liquidity), and that, from May onwards, some banks started to return the government-owned capital holdings and replace them with private capital. However, the recovery was not across-the-board. In particular, securitisation market activity remained low or nil in the most complex products.

The phase of recovery continued practically uninterruptedly throughout 2010 Q1. However, from end-2009 bouts of instability associated with doubts about the sustainability of public finances in some countries began to emerge. This brought a rise in volatility and uncertainty, which became more marked from the end of April.

The situation of the banking sector improved during the year, but lending continued to slow

Throughout 2009 the situation of the banking sector improved, as reflected in the announcement of higher-than-expected profits also in the second half of the year, as a result of gains from trading and holding financial instruments on the capital markets, particularly government bonds, given the steep yield curve. Nevertheless, lending activity continued to show signs of weakness and credit extension followed a gradually slowing path, to the extent that it contracted in year-on-year terms in late 2009 and early 2010 in the main industrialised economies, as shown in Chart 3.9. Although a part of this contraction reflects a tightening of credit conditions, the weak economic activity also dampened the demand for financing. Furthermore, this weakness continued to affect the traditional business of the banking sector, and bad debts continued to increase in various segments, such as commercial real estate in the United States. Thus smaller financial institutions more dependent on retail business continued to show high vulnerability, reflected in a growing number of institutions subjected to supervisory intervention. The difficulties in borrowing were reflected in a rise in debt security issuance by the non-financial private sector, intended, insofar as possible, to replace bank financing by recourse to the capital markets.

The recovery in activity firmed from Q3 and became widespread, although the momentum prior to the crisis was not regained

In the second half of 2009, global economic activity rose and the recovery spread to an increasingly large number of economies, including the developed ones. World GDP reached annualised quarterly rates above 4.5% in 2009 Q3 and 2009 Q4, and ended the year at positive year-on-year growth rates around 1.5% (see Chart 3.5), although the output levels still did not reach those prior to the crisis. For their part, trade flows recovered notably (bolstered by the recovery in activity and a certain remission of trade finance problems), although at the beginning of 2010 they were still 8% below those of early 2008.

Emerging economies led the recovery, which continued to be highly dependent on policy stimuli, particularly in the developed economies

The recovery in activity was led by the emerging economies, particularly China, India and Brazil, buoyed by the rapid recovery in their domestic demand and favoured by the lesser deterioration of their labour markets and financial system. The revival of trade and, in particular, the increase in commodity prices (particularly sharp in industrial metals) in 2009 H2 also underpinned the recovery in parts of Latin America and in the oil exporting countries. Thus the emerging economies continued growing at an average annualised quarterly rate of around 7.5% in 2009 H2, ending the year with a year-on-year rate of nearly 4.5% in Q4 and accounting for around four-fifths of world growth in the second half of the year. Meanwhile, the recovery of the developed economies continued to be strongly based on the extraordinary measures to support domestic demand (particularly through fiscal stimuli) and on the reversal of the inventory cycle, taking place at the same time as a certain stabilisation in investment. The growth of this group of countries, however, was still fairly weak in Q3 (annualised quarterly rate of 1.4%) and only became more vigorous in Q4, with quarter-on-quarter growth above 3%, led by the United States. Despite this, at the end of the year the GDP of the developed economies was still 1% below its level a year earlier.

The pace of exit from the recession differed between the developed and the emerging economies, and also within each of these two broad groups

Thus one of the features of the recovery in 2009, which became increasingly noticeable during the year, is the differing pace of exit from recession between the developed and the emerging economies, in contrast to the synchronised downturn in late 2008. These differences, however, exist not only between these groups of countries, but also within them. Among the developed economies, the recovery was most vigorous in the United States (annualised quarterly growth of 5.6% in Q4), where the strong boost to consumption by the demand support measures came on top of the aforementioned reversal of the inventory cycle from Q3. For its part, external demand was decisive in the (more moderate) recovery of Japan and the euro area.

In the emerging regions, the recovery (in 2009 Q2) was led by the Asian countries, partly because of the buoyancy of their internal demand and partly because of the recovery of trade. Economies such as China, India and Indonesia, which only slowed, but did not contract, during the crisis, returned to growth rates similar to the average for the decade and, in some cases, near to the rates of the years immediately preceding the crisis. In contrast, the effects of the crisis were greater in the emerging economies with financial systems more dependent on external financing and which had undergone strong credit growth, as in most eastern European countries. Latin America, unlike on other occasions in its recent history, weathered the global financial crisis without succumbing to domestic financial crises. Contributing to this relatively favourable performance were its lower vulnerability (due particularly to sounder financial systems and improved external accounts) in the years preceding the crisis, backed by higher macroeconomic stability and by better terms of trade as a result of higher commodity prices.

The dynamism of recovery was limited by a series of factors...

As noted above, the recovery of the developed economies in 2009 H2 did not fully offset the fall in activity during the crisis, so in 2010 Q1 the previous levels of output had not yet been recouped. The pace of exit from the recession was slower than in past recoveries, hindered by the need for deleverage of private agents, the sharp fall in household wealth and the tightening of credit conditions associated with the adjustments in the financial sector, all of which resulted in marked weakness in the labour market. Some of the negative effects of the fall in activity on the banking sector (e.g. increased bad debts) have a strong inertia, while the adjustments under way in the banking sector and its more cautious approach have led to restrictive credit standards and tighter access to credit in some customer segments. Also, the synchronised nature of the global recession made it harder to resort to exports as the engine of recovery in the different countries. Hence the wide output gaps generated in the crisis have barely narrowed, even taking into account the fall in potential output in most countries (see Chart 3.5).

... and job destruction continued in 2009 H2

Turning to the labour market, job destruction continued, albeit at a progressively slower pace, in most economies in the second half of the year, despite the recovery of activity. The most recent data suggest a certain stabilisation in employment behaviour and unemployment rates in the main developed economies. However, the labour market's response to the crisis also varied somewhat: while in the United States unemployment rose much more than in previous recessions (up 5 pp between early 2008 and late 2009 to 10%), in Japan and the euro area the rise was in the usual range. Furthermore, in the United States the phase of job destruction and sharply rising productivity (up 5.1% year-on-year in 2009 Q4) has been much longer than in previous crises. For their part, the emerging countries again created employment in the second half of the year, except for some eastern European economies, where the main labour market problems are concentrated.

Overall inflation rose with commodity prices, but inflation expectations held steady

Year-on-year inflation rates, which were even negative for a good part of the year in numerous developed economies, rose sharply from mid-year. Key to this surge were the marked fluctuations in energy product prices, which rose sharply after falling considerably at the end of 2008, thereby giving rise to a strong base effect from that time to the first quarter of 2009. As shown by Chart 3.3, world inflation recorded a minimum slightly above 0% in July 2010, and ended the year above 2%, although, once corrected for the aforementioned base effect, little further upward movement is foreseeable. In fact, underlying inflation remained relatively steady from mid-2009 and inflation expectations, as estimated from surveys and from financial variables, remain anchored on inflation targets, given the underutilised productive capacity and the weak labour market. Japan is an exception to the general recent behaviour of inflation, since its year-on-year rates continued to fall up to October and remain negative, with no change of sign being expected in 2010. At the other extreme is the United Kingdom, where inflation holds at higher rates than in the other developed economies, although the larger rise is attributed to the effect of the VAT rise of 2.5 pp in January.

In the emerging economies, inflationary pressures are now greater, given the greater buoyancy of domestic demand and the less firmly anchored expectations. Although varying notably across countries, inflation in Asia (especially in India) has increased more rapidly than in other emerging regions.

In 2009 global imbalances were partially corrected and capital flows returned to the emerging economies

The sum of the current account balances in absolute terms decreased from 4.8% of world GDP in 2007 to 3.1% in 2009 (see Chart 3.8). The United States reduced its current account deficit from 4.9% to 2.9% of its GDP (from 1.2% to 0.7% of world GDP) between end-2008 and 2009 Q4, while in the surplus of the oil exporting countries fell by 70% to represent only 0.3% of world GDP. This partial correction of global imbalances was explained by the relative changes in domestic demand, with a greater contraction in the developed countries, and by the average fall in commodity prices in 2009. However, the factors explaining this adjustment suggest that part of it was of a conjunctural nature. The last two quarters of 2009 also saw a recovery in global capital flows which was particularly conducive to the resurgence of inflows to the emerging countries, due to improved growth prospects, increased risk appetite and persistently wide interest rate spreads with respect to the developed economies. These capital inflows, which suggest that the aversion of investors to these regions during the crisis was temporary, may cause domestic economic and financial imbalances to reappear, a threat which has led some countries, such as Brazil, Peru and Taiwan, to introduce measures to restrict the entry of capital, and has prompted many others to start accumulating international reserves again to moderate their currency appreciation and to provide some self-insurance against possible sharp reversals of capital flows. By contrast, in other regions, such as eastern Europe, the recovery of private capital inflows acts as an alleviating factor in the short-term, due to their considerable borrowing requirements.

The financial support measures started to be wound down and preparations were made for withdrawal of the monetary stimulus...

As stability returned following the crisis, most Treasuries and central banks started to withdraw the financial support measures in both developed and emerging economies. The amount of support committed has been decreasing, although it continues to be high (see Chart 3.7). At the same time, many central banks, particularly in the developed economies, began to design their exit strategies and take the first steps in implementing them. Having said this, although there have already been some increases in official interest rates in small commodity-producing economies such as Australia and Norway, most developed economies will foreseeably withdraw the monetary stimulus very slowly.

By contrast, in the Asian and some Latin American economies, the greater dynamism of activity gave rise to monetary policy tightening from end-2009. At first the tightening did not include interest rate hikes, so as to prevent capital inflows from intensifying. Rather, other types of measures were taken, such as raising reserve ratios (as in China) or restricting the entry of external capital (as in Brazil). However, at the beginning of 2010, the first increases in official interest rates took place, beginning with Asia. Finally, as the high foreign currency liquidity needs subsided, the foreign currency swaps between the main central banks (one of the main internationally coordinated measures) were progressively reduced and mostly discontinued by the beginning of 2010, although the resurgence of financial volatility derived from fiscal problems in the euro area led them to be resumed between the central banks of the developed economies in May.

... while public finances deteriorated sharply

Public finances continued to deteriorate markedly (see Chart 3.6). This worsening has a large structural component in the developed economies and is unlikely to be reabsorbed to a significant extent during the recovery, while in the emerging economies (where the fiscal deterioration has been moderate), it has been of a predominantly cyclical nature. In the advanced economies as a whole, the deficit stood at 10% in 2009, up 5.4 pp on the previous year, and was higher still in the three main developed economies outside the euro area, where the deterioration was more moderate. More than half of this increase has passed through to the structural balance. Although Japan started from a more delicate fiscal situation, the deficit rose more sharply in those countries where the financial system was affected most strongly: the United States, where the deficit doubled to 12.6% of GDP, and the United Kingdom, where it increased by 6.5 pp of GDP to 11.3%. Debt also performed more unfavourably in these economies, where increases – in gross terms – exceeding 20 pp of GDP between 2007 and 2009 (somewhat less in the euro area), took it to levels of nearly 84% of GDP in the United States and of nearly 70% in the United Kingdom in late 2009. Moreover, the increasing trend in debt is expected to persist despite the economic recovery.

The concern over the sustainability of public debt has reduced the scope for expansionary fiscal policy action and has been reflected in bouts of financial volatility and upward pressure on sovereign interest rates in some countries.

3 The post-recovery environment

3.1 THE LEGACY OF THE CRISIS

Before assessing the short-term economic outlook, it is of interest to step back from the current conjuncture and analyse the legacy left by the crisis, which will largely determine the pace and duration of the economic recovery.

The crisis has reduced the potential output of the economy

A well-known consequence of the crisis is the contractionary impact on the factors of production (labour and capital) and on potential output. Aside from the cyclical nature of employment, the higher structural unemployment and lower participation rate associated with recessions not only reduce potential output, but may also have a persistent negative effect on its growth rate, thereby limiting the growth capacity of the economy for a prolonged period.

The depth and financial nature of the crisis, and the scale of the authorities' response, mean that it will leave considerable fallout which will affect growth in the medium term

But the crisis will leave another type of fallout in the economic and financial system which may also constrain medium-and long-term growth in the advanced economies, and therefore in the world economy. This legacy is a consequence of the depth of the crisis and of the scale of the authorities' response, but it also stems from the global imbalances which existed in the growth phase prior to the crisis and to which adjustments are still pending. More specifically, at least three factors may be mentioned which will bear on the economic outlook in the coming years: the downsizing and reorganisation of the financial system, the deleverage of non-financial private-sector agents and the deterioration of public finances.

There has been a lasting reduction in financial intermediation capability

The damage from recessions accompanied or induced by financial and banking crises is more lasting and deep-seated because they weaken an economy's financial intermediation capacity. The crisis considerably reduced the size of the financial system because some institutions failed and because the business of the survivors contracted. Part of this contraction is caused by the fall in activity, but another (not necessarily less significant) part may be much more persistent. In particular, some segments of the securitisation markets, particularly those dealing in structured products, were based on inadequate risk allocation structure and market institutions, which lay at the origin of crisis and have ceased to exist.

Moreover, after a crisis, the financial players usually exhibit more cautious behaviour and strategy, in marked contrast to their previous high preference for risk. This will tend to be reflected in a return by financial institutions to a more traditional business model . At a higher level stands the national regulatory development work, coordinated globally and intended to strengthen financial systems and mitigate the recurrence of future crises (see Box 3.2). This will probably give rise to less generous credit conditions than before the crisis, which will probably limit the availability of credit in the economy and entail higher financing costs, not only short-term, but also medium- and long-term. Nevertheless, the reforms are necessary to lay the foundations for a more solid and stable financial system in the future.

The reorganisation of private-sector balance sheets will take a long time

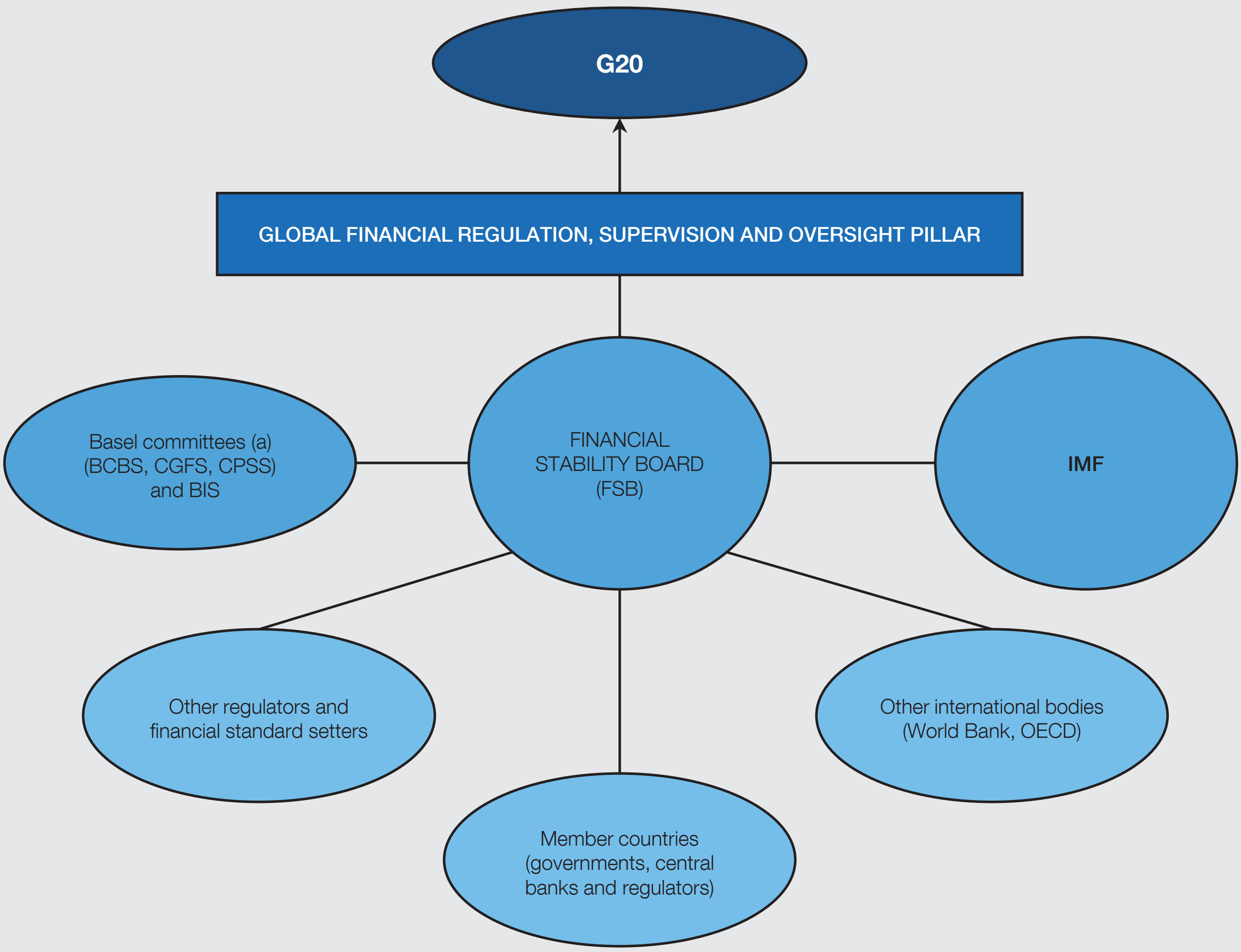
The second factor to be considered is the process of deleverage or debt reduction in the non-financial private-sector. After a recession there is usually a readjustment in the financial balance sheets of households and firms, in order to reduce the level of indebtedness. The high levels of debt in numerous developed economies, such as the United States, the United Kingdom or Spain, in the years prior to the crisis were prompted by high economic buoyancy, low borrowing costs, excessive risk-taking and inadequate risk assessment, and rising asset prices, which ultimately proved to be unsustainable. The change in the economic environment following the crisis, the asset price correction (particularly sharp in the case of real estate assets) and agents' greater preference for saving point to a substantial downward adjustment in debt ratios, particularly those of households. This adjustment is now under way (see changes in debt ratios in Chart 1.2) and, as shown by past experience, could take several years, which would represent an additional drag on growth in that period.

THE NEW COORDINATION FRAMEWORK FOR GLOBAL FINANCIAL REGULATION, SUPERVISION AND OVERSIGHT

BOX 3.2

The past year has seen major steps in establishing a new global framework of international coordination in financial system regulation and supervision. This new framework, which arose in response to the financial crisis, seeks to provide a more robust and stable international economic and financial system to help prevent new crises and mitigate the global impact in the future. The basic aims of this coordination are to strengthen the capital base and liquidity of banks; reduce the probability and impact of bankruptcy of systemic institutions; lessen their interconnectivity; avoid excessive risk-taking and promote adequate risk assessment; and broaden and deepen financial supervision and regulation in key segments and in cross-border business. These aims do not generally differ from national financial stability aims, but the increasingly global nature of financial systems requires extensive international coordination to achieve them.

The main impetus to cooperation in the financial area came from the creation of the Financial Stability Board (FSB) at the G20 summit in London in April 2009. The FSB was born out of the now-defunct Financial Stability Forum (FSF) consisting of the G-7 countries plus other countries affected by the Asian crisis. The FSB added the emerging countries of the G20, Spain and the European Commission. The FSB can be considered the new global pillar of financial stability, which supplements the three institutions created at Bretton Woods after the Second World War: the International Monetary Fund (IMF), focused on economic stability; the World Trade Organisation (WTO), entrusted with international trade; and the World Bank, working on development issues. This box briefly describes the architecture of international financial cooperation (see accompanying diagram) and the main tasks (financial regulation, supervision and oversight) being carried out within this framework.



SOURCE: Banco de España.

a. Acronyms:
BCBS: Basel Committee on Banking Supervision.
CGFS: Committee on the Global Financial System.
CPSS: Committee on Payment and Settlement Systems.

THE NEW COORDINATION FRAMEWORK FOR GLOBAL FINANCIAL REGULATION, SUPERVISION AND OVERSIGHT (cont´d)

BOX 3.2

The FSB ultimately reports to the G20, instituted as the central forum for global economic and financial coordination. The FSB's members are ministry authorities, central banks and supervisors of the G20 countries (plus Spain, the Netherlands, Switzerland, Singapore and Hong Kong), the European Commission, the ECB, the IMF, other international organisations (OECD, World Bank), the Bank for International Settlements (BIS) and the international standard-issuing committees [the Basel Committee for Banking Supervision (BCBS), the International Organization of Securities Commissions, the International Association of Insurance Supervisors and the International Accounting Standards Board]. Notable in this regard is the work of the BCBS, which coordinates the main central banks and banking supervisors in defining international banking regulatory standards (including most notably the capital accords known as Basel I, II and, now, III). Also, the IMF is cooperating closely with the FSB in certain respects, particularly global financial stability, which add to its habitual tasks of economic and financial oversight of countries and are carried out through Article IV reports and financial sector assessment programmes (FSAP). For its part, the FSB provides input to early warning exercises conducted regularly by the IMF. The new setup strengthens, moreover, the coordination and prioritisation of the reform projects auspiced by the various international committees entrusted with supervision and regulation (banking, accounting, insurance, securities market, etc). In short, the FSB has taken on a function of strategic management of the work of these institutions in the financial sphere. This new arrangement contrasts with their functional independence before the crisis and inaugurates a coordinated approach aimed at developing and implementing a regulatory, supervisory and oversight policy which strengthens national financial systems and ensures the stability of the global financial system.

In the past year, major proposals have been made under the auspices of the FSB to reform the global financial framework on various fronts: regulation, accounting and market infrastructure. The broad objectives of the proposed reforms are: to reduce systemic risk in the area of institutions, markets and instruments; to improve risk management practices in the areas of liquidity and funding; to strengthen accounting standards; to improve international supervision and regulation standards; to review and broaden the scope of regulation and supervision; and to develop a macroprudential supervision framework.

Noteworthy in the more specifically regulatory area is the work of the BCBS, which has given rise to proposals to increase the strength and the quality of the capital and the liquidity of financial institutions and to define the processes of resolution of internationally active systemic institutions. Specifically, the BCBS is reviewing the definition of regulatory capital and the measurement of counterparty risk and is considering the introduction of a leverage ratio, of procyclicality mitigation mechanisms and of a liquidity standard. In the area of markets, there are proposals to strengthen the infrastructure and promote the clearing of over-the-counter (OTC) derivative instruments through the establishment of central counterparties and to improve information available on agents' positions. Noteworthy in the area of accounting is the process of convergence between the institutions entrusted with setting accounting standards (IASB and FASB) and the work to improve the treatment of provisions for expected losses and the valuation of financial instruments and of loans, the convergence between the repro clearing and treatment approaches, and the initiatives to improve dialogue between institutions in the accounting, prudential and regulatory areas. In addition, calls have been made to improve the transparency and limit the leverage of hedge funds, and to improve the supervision of credit rating agencies. Lastly, it should be mentioned that some initiatives have sparked broad public debate. These include most notably those relating to the possible establishment of some kind of levy or tax on financial institutions as a means of raising revenue to pay for the government bail-outs in the sector, and those relating to financial institutions' compensation practices, particularly the schemes expressly backed by governments.

In short, the concerted efforts by countries in response to the deep financial crisis have progressively crystallised in a new framework for global economic and financial coordination which is still in the process of consolidation. In the area of financial system regulation, supervision and oversight, the advances have been notable, although most initiatives are still in the assessment, design and development phase. The challenges to be overcome in order to meet the ambitious objectives set for this new framework are considerable. Firstly, work is advancing on diverse fronts, so only a broad-based approach will achieve a coherent final result that does not straight-jacket the functioning of the financial system (particularly the flow of credit to the economy) or prevent innovation in the system. Secondly, a sustained effort in coordination is required, not only between countries, but also between institutions, such as the IMF or the BIS, which now share tasks and functions with the FSB. As the process advances, the division of work will be clarified and the specific functions will be delimited more sharply. Lastly, there is a risk that, as the economic and financial situation normalises, the incentives for international coordination will weaken and the process will lose the highly desirable momentum it has reached in the past year.

The fiscal imbalances will limit growth through increased financing costs of the economy or through fiscal consolidation

The sharp deterioration of public finances in many developed economies constitutes a third factor constraining the long-term outlook. Although part of the fiscal imbalance aims to sustain productive activity, the structural portion of the deterioration in fiscal balances will persist after demand has been firmly re-established and the fiscal stimuli have been withdrawn. In these circumstances, there is a risk of upward drift in public debt (amplified by the growing costs derived from population aging) if decisive measures are not taken to prevent it. In any case, public sector borrowing will persistently take a notable amount of funds from the other sectors of the developed economies. For this reason, once activity has been stabilised and monetary policy stance normalised, fiscal imbalances will tend to give rise to higher long-term interest rates. In addition, the doubts as to the debt sustainability in some countries may give rise to a further increase in the cost of borrowing of the public sector (and of the economy in general). It is thus essential for the developed economies to undertake fiscal consolidation (more urgent and intense in those countries which have a worse underlying fiscal situation) to halt and, if possible, reverse the upward trend of debt. Stabilising the debt would also allow greater room for manoeuvre if it were necessary to introduce stimuli in the future. Although this consolidation would have a contractionary affect on activity in the short term, this would not be any greater than that derived from permanently higher financing costs, the likelihood of which will increase as the likelihood of a credible and far-reaching fiscal adjustment decreases.

The emerging economies will be relatively less affected, although they may be prejudiced by lower external demand and lower availability of financing

The fact that this review of the legacy of the crisis has focused on the advanced economies reflects the differing impact of the crisis on the advanced and the emerging economies. Although the economic impact on the emerging economies has been severe, for them the crisis had a predominantly exogenous origin and has not substantially affected their financial systems, while their fiscal situation has deteriorated much less than that of the advanced economies. Hence the potential output of these economies seems to have fallen by less and the impact on the growth rate in the medium term has probably been scant and less persistent, except perhaps in the eastern European economies. Nevertheless, the external demand from the developed economies and the lower global availability of finance will affect their growth capacity in the coming years.

3.2 ECONOMIC OUTLOOK

A gradual recovery of the world economy, surrounded by notable uncertainty, is expected in 2010

Taking into account this medium-term setting, the economic outlook for 2010 is for a central scenario of gradual, albeit fragile, recovery against a background of progressive financial market normalisation, a certain recovery of private-sector demand in the advanced economies and gradual withdrawal of economic policy stimuli and support. However, this scenario is surrounded by high uncertainty, given the fragility which continues to be shown by both the financial system and the economy, the process of adjustment under way and the doubts posed by the factors analysed in the preceding section. Therefore the pace of withdrawal of the economic policy support will depend on the course of events.

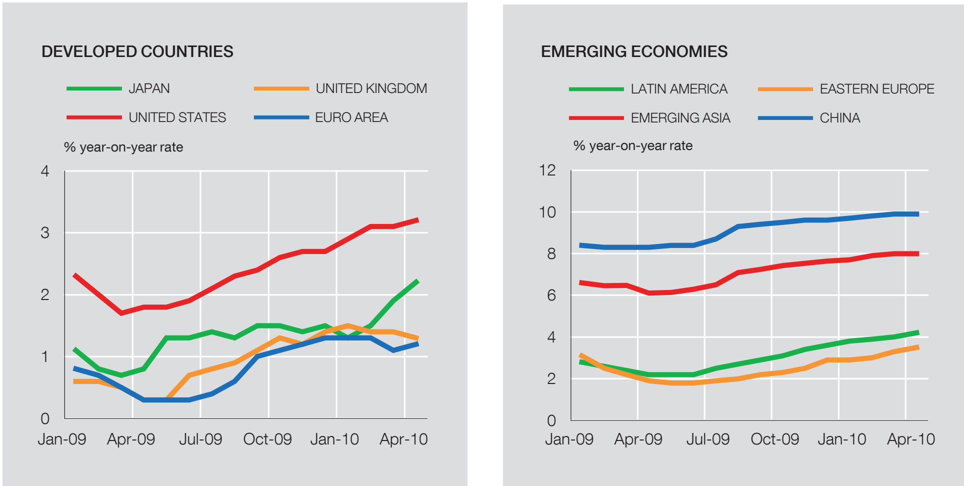
Despite the decrease in potential growth, significant output gaps will remain in place

In any event, the growth projections for 2010 have gradually been revised upward (see Chart 3.10). A part of this increase in the projections represents positive carryover effects derived from the strong growth in 2009 Q4, but also the expectation that in 2010 the momentum of domestic demand may exceed that in 2009 in many developed and emerging economies. Hence the projections of the main economic organisations point to world GDP growth of around 4% in 2010 and 2011. These figures are around 1 pp less than the world growth rate in the years before the crisis and represent the maintenance of still-significant output gaps, especially in the developed economies.

The emerging economies will be more dynamic

The emerging economies are projected to undergo a rebound in activity to rates slightly above 6% in the next two years, particularly sharp in Asia (China and India) and Brazil, on the back of a strong surge in domestic demand and greater buoyancy of trade, especially between the

GROWTH FORECASTS FOR 2010 (a) CHART 3.10



SOURCE: Consensus Forecasts.

a. Growth forecasts for 2010 issued as at the dates indicated on the horizontal axis.

emerging countries themselves. At the other extreme, the emerging economies of eastern Europe are expected to undergo a weak recovery, due to the need to strengthen private-sector balance sheets.

Private-sector demand will be a drag on the growth of the more developed economies

By contrast, according to the IMF projections, the developed economies will expand at a rate of around 2.3% in the next two years, which represents a slow recovery compared with previous recessions. On the one hand, the effect of the fiscal stimuli and of the reversal of the inventory cycle, which determined the dynamism of activity in the late 2009, will peter out during the course of the year. On the other, some of the factors identified above will slow the pace of recovery: the weakness of labour markets (with high unemployment rates in many economies), the still-high household indebtedness and the scant dynamism of credit will continue to curtail the growth of private-sector demand. Nevertheless, as in the case of the emerging economies, there are marked differences in the rate of recovery, with the dynamism of the United States being most notable among the developed economies, partly due to greater headway made by it in the reabsorption of some of its domestic imbalances, and partly due to the stabilisation of its financial system.

The output gaps will keep inflation in check in the developed economies, while there will be more upward pressure in the emerging economies

In line with the notable under-utilisation of productive capacity in the developed economies, inflationary pressure should, in principle, remain contained despite commodity price increases. What is more, rates are even expected to fall somewhat below the current levels. Contrastingly, the greater dynamism of domestic demand in the emerging economies may push inflation rates upward in 2010.

The correction of global imbalances currently under way will be interrupted and capital flows to the emerging economies may show a certain volatility

In this scenario, a progressive recovery of trade and capital flows is expected. The correction of external balances observed during the crisis will foreseeably be interrupted as the domestic demand of the countries with current account deficits recovers, and the global imbalances will foreseeably increase somewhat with respect to 2009. Finally, although capital flows to the emerging economies continue their recovery based on the latter's improved growth prospects, large differences in returns and a greater global appetite for risk, it is unlikely that they will reach the levels before the crisis and there may be a notable volatility in these flows, particularly as the liquidity conditions of the developed economies change.

Growth may increase if the favourable interaction between the financial sector and the real sector continues

The central scenario contains significant sources of uncertainty. First, as happened in the recovery phase, the positive interaction between the improvement in the financial sector and the real sector may have more favourable effects than expected. This will be more likely if the still-unclarified matters associated with the new regulatory framework of domestic and cross-border financial activity are resolved more rapidly.

A first downside risk is that of lower momentum of private-sector demand due to a weak recovery of employment and/or tighter credit

However, the uncertainties that could lessen growth in the coming quarters seem to predominate over the upside considerations. The principal downside risk is unquestionably the buoyancy of private-sector demand and the possibility that the factors weighing on consumption and private investment will be stronger than expected. Firstly, the recovery in employment, particularly in the United States, has been weaker than would be expected from the historical relationship between this variable and the level of activity, with the consequent risk that a larger-then-expected portion of the unemployed will join the ranks of those in structural unemployment (especially in economies with less flexible labour markets) and contribute to holding household consumption at its depressed level. Secondly, the dynamism of private-sector demand may be constrained if lending does not rebound in parallel with the recovery of activity, a prospect which cannot be ruled out given the fragile underlying financial situation and the current move to strengthen regulation. If lending is tighter than expected, the impact will fall mainly on households and small and medium-sized enterprises (which have less direct access to financing through the financial markets), with negative effects on consumption and job creation, the latter strongly influenced by the buoyancy of firms of this type.

Another downside risk stems from the exit strategies from monetary, financial and fiscal support...

A second type of risk derives from economic policy stances and developments in them in the future. The exit from monetary and financial support may run into complications if there are unforeseen economic and financial developments. There is always a likelihood of situations posing economic policy dilemmas with a negative outcome for activity and financial stability. As inflation expectations are generally well anchored, these dilemmas are more likely to arise in the fiscal sphere, which itself is one of the main sources of risk and uncertainty.

The fragile situation of public finances not only has significant implications for the long-term economic outlook, but also contains sources of additional risk for short-term economic recovery and financial stability, which may act through two possible channels. Firstly, an increase in agents' concern about the sustainability of public-sector debt or net borrowing may either force an earlier-than-expected fiscal adjustment or induce a general rise in credit risk premia and long-term interest rates, which would raise the cost of private-sector borrowing and financial volatility. Secondly, a sudden and unexpected rise in long-term interest rates could cause losses at financial institutions highly exposed to interest rate risk (attracted by the spread between long-and short-term interest rates) and lead to a tightening of credit conditions. This would compromise the recovery of activity and the process of financial normalisation if they were still not on a firm footing. It can thus be concluded that the fragile fiscal position of the developed economies represents one of the main risk factors in the current scenario and that fiscal consolidation is one of the main challenges facing the economic authorities.

... and commodity prices could become an upside risk to inflation

Lastly, commodity prices could rise substantially faster than the moderate growth expected in the next few years. This would pose a risk to the recovery of activity (particularly that of the developed economies) and would contribute to higher global inflation than envisaged in the central scenario described above.

3.3 ADDITIONAL CONSIDERATIONS

The global economy embarking on recovery has weaknesses both in the short term and on a longer time horizon. However, as noted above, the starting point is rather more favourable in the emerging economies than in the developed economies. It can thus be expected that the

The emerging economies will gain weight in the world economy

former will gain weight in the world economy, not only in terms of size or contribution to world GDP growth, but also as a possible factor sustaining global demand.

The developed economies will undergo far-reaching structural changes in the real and the financial sectors

The challenges facing the global economy (particularly the developed countries) are thus multiple and entail far-reaching structural changes. In the real sector, these changes include, inter alia, adjusting and restructuring the growth drivers of private-sector demand and redirecting public finances to a sustainable path through a credible, well-planned fiscal consolidation strategy. These aims would be easier to achieve if progress in structural reforms (which are different in each country) raised potential growth in the medium term. A major challenge is posed by the restructuring of the financial system to put it on a more solid and stable footing, and, in this respect, an active and effective contribution will have to be made by the new international coordination fora described in Box 3.2.

But it is also essential to uphold the credibility of monetary policies, so future growth rests on a solid foundation

In these difficult circumstances it is essential to have firm and credible economic policies to undertake far-reaching reforms in the real, fiscal and financial sectors which are different in each country. In this respect, it should be noted that preserving the credibility of monetary policy is a key part of economic policy development, since price stability is one of the basic pillars of long-term growth.

Lastly, it should be kept in mind that the crisis resulted from financial excesses and unsustainable growth patterns engendered during the previous expansionary phase. Thus the reforms and structural changes mentioned above (and the consolidation of the previous macroeconomic stability achievements) should allow future growth to take place on firmer foundations than in the past. In the long term, this will benefit the global economy as a whole and the countries which go farthest in making these transformations.