Developments in the Global Economy and Financial Markets

Developments in the Global Economy and Financial Markets

On the heels of a major financial crisis that originated in advanced country markets in 2007, the global economy sank in 2008–09 into the deepest recession since World War II.[4] Although the IMF's 2008 *Annual Report* had highlighted the risks from the spreading financial crisis, the crisis advanced further and faster during FY2009 than expected, despite strong policy efforts in key economies. Emerging markets and low-income countries, which had been relatively sheltered from financial strains owing to their limited exposure to U.S. mortgage-related assets, were drawn into the storm, as international credit markets, trade finance, and many foreign exchange markets also came under heavy pressure.

This heightened financial stress led to an unprecedented contraction in global output and trade in FY2009 and was transmitted through a range of channels. The ramifications from the credit crunch and the sharp drop in asset prices were quickly passed on through banking systems to many sectors and countries in the global economy and were magnified by the collapse of consumer and business confidence. Wide-ranging and sometimes unorthodox policy responses made some progress in stabilizing markets in FY2009, although they were not able to arrest the circle of negative feedback between intensifying financial strains and weakening activity.

Economic activity and merchandise trade plummeted in the last quarter of 2008 across all markets and continued to fall rapidly in early 2009. Global GDP contracted by over 6 percent (annualized) in the fourth quarter of 2008 and the first quarter of 2009. Advanced economies suffered considerably from financial strains and the deterioration in housing markets. In emerging markets in Europe and the Commonwealth of Independent States, which had been relying heavily on capital inflows to fuel growth, significant damage was inflicted early through financial channels. Countries that relied heavily on manufacturing exports, like those in East Asia, Japan, Germany, and Brazil, were battered by falling demand in export markets. Countries in Africa, Latin America, and the Middle East suffered from plummeting commodity prices, drop in demand for exports, and lower remittances and foreign capital inflows.

Indeed, a sharp correction in the third quarter of 2008 brought an end to the commodity price boom. The IMF commodity price index declined by almost 55 percent during the second half of 2008. This sharp drop in commodity prices mainly reflected the adverse effect of the global slowdown on the demand for commodities. In particular, the sharper-than-expected downturn in emerging and less-developed economies in mid-2008—which had accounted for most of the incremental demand during the boom—was a key factor explaining the drop in commodity prices. Prices broadly stabilized at the end of 2008. Commodities closely tied to manufacturing of capital goods were affected the most, while commodities with a lower income elasticity of demand, like food, experienced a milder price decline.

In most areas of the world, inflation pressures subsided rapidly, and rising economic slack contained price pressures. Headline inflation in advanced economies fell below 1 percent in early 2009. Inflation moderated significantly in the emerging economies, although in some cases, depreciating exchange rates moderated the downward momentum.

Against this background, national and international policy initiatives were undertaken to spur a coordinated policy response to stabilize the financial system. The IMF, together with the World Bank and regional development banks, played a useful role by providing more front-loaded financing and streamlined conditionality. The Fund took actions to modernize its lending toolkit (see Chapter 3), including instituting the new Flexible Credit Line, to revamp the conditions on program loans and to expand its lending capacity.

ADVANCED ECONOMIES

The situation in advanced economies deteriorated rapidly after the default in September 2008 of a large U.S. investment bank (Lehman Brothers), public support for the largest U.S. insurance company (AIG), and intervention in a range of other systemic institutions in the United States and Europe. These events put in doubt the solvency of many established financial institutions. As a result, wholesale funding evaporated, external debt markets closed, and a disorderly deleveraging ensued across the rest of the global financial system. Gross global capital flows contracted, with flows favoring countries with more liquid, safe-haven markets. Consequently, the U.S. dollar and the yen appreciated sharply in real effective terms in the second half of 2008, while the euro remained broadly stable.

Financial markets had stabilized by late 2008, but remained under stress during the remainder of FY2009. Many equity markets remained down by more than 40 percent from their peaks. After years of building up record levels of debt, financial institutions and households began the painful process of reducing leverage. This was driven by mounting bank write-downs as credit quality deteriorated and also by the reversal of intertemporal savings choices made by households and some corporates. Many elements of the "shadow banking system" that were predicated on high leverage began the process of being unwound. Financial pressures from this deleveraging cycle were widespread and persistent, reflecting the damaging

Realtor advertisement for foreclosure home listings, Stroudsburg, Pennsylvania, United States.

feedback loop with the real economy. As output contracted, the risk of rising corporate and household defaults in turn widened credit spreads and increased credit-related losses on banks' balance sheets. In the fourth quarter of 2008, advanced economies experienced an unprecedented output decline of 70 percent (annualized).

The policy responses during the year were rapid and comprehensive but were not successful at arresting the downward spiral. Country authorities followed multifaceted strategies involving continued provision of liquidity, extended guarantees of bank liabilities, injection of public funds for bank capitalization, and programs to deal with distressed assets. However, some of these policies, particularly regarding the treatment of impaired assets, lacked detail, as they were rushed, and thus at first did not adequately reduce uncertainty about distressed assets. Central banks used conventional and unconventional policy tools to ease credit market conditions and reduced policy rates to unprecedented lows, but still overall credit growth contracted. Large discretionary fiscal stimulus packages were introduced in China, Germany, Japan, Korea, the United Kingdom, and the United States. However, the impact from increased spending will mostly be felt in late 2009 and 2010.

In the United States, the biggest financial crisis since the Great Depression pushed the country into a deep recession. The credit crunch intensified and asset prices continued to fall. High uncertainty, large wealth losses, and lower earnings prospects drove consumer confidence to record lows and caused a big jump in savings rates. With consumption depressed, real GDP contracted by more than 6 percent in the fourth quarter of 2008 and by 5.7 percent in the first quarter of 2009, and the unemployment rate rose to 8.5 percent.

In Europe, financial systems suffered a much larger and more sustained shock than expected, macroeconomic policies were generally slow to react, and confidence plunged as households and firms drastically scaled back. Exposure to U.S.-based assets caused major repercussions in the banking system because of the close linkages among Europe's major financial institutions and their high degree of leverage. Most advanced countries suffered sharp contractions in FY2009.

In Asia, the advanced economies took the hardest hit because of their greater exposure to the decline in external demand, especially for consumer goods. Japan's economy contracted at a 14 percent annualized rate in the fourth quarter of 2008 as the yen's strength and relatively tighter credit conditions added to the problems in the export sector. However, parts of the region began to show modest signs of recovery in 2009.

Other advanced economies like Canada, Australia, and New Zealand dealt with adverse terms-of-trade shocks, the impact of sizable private wealth reduction, and for Canada, weak demand in the United States. However, after years of prudent fiscal policy management and more conservative financial system regulation, these countries were better placed than other advanced economies to mitigate further declines in demand.

Rows of auto imports at port, United Kingdom.

EMERGING MARKETS

Emerging Europe was hit very hard by the contraction in gross global capital flows and flight from risk. Many countries in the region relied heavily on capital inflows from Western banks to sustain local credit booms. There were large intra-European cross-border bank exposures, and many banks in emerging European countries were owned by distressed foreign financial institutions. The situation deteriorated sharply in the fall of 2008, with sovereign spreads jumping across the board and exchange rates depreciating sharply in countries with flexible regimes. The combination of a drop in import demand in advanced country markets, a collapse in property prices, limited access to credit, and currency depreciations in the context of sizable balance sheet mismatches led to a very hard landing, and even full-blown crises in some countries. With exports and output plummeting and government revenues worsening, a number of countries received support from the IMF and other international financial institutions to sustain their balance of payments.

Countries in the Commonwealth of Independent States (CIS) experienced the largest reversal last year. CIS economies were hit by three major shocks: external funding was shut off or greatly curtailed; demand in CIS export markets dropped; and commodity prices, especially those for energy, collapsed. Financial systems in several CIS countries were very open and more susceptible to financial turbulence from abroad. After years of strong growth, output is expected to contract by more than 5 percent in 2009. Inflation did not ease as much as in other emerging markets because of depreciation pass-through effects. The impact of weaker currencies imposed a major burden on nonfinancial firms in CIS countries that borrowed in foreign currency, requiring massive cutbacks in investment and employment.

Latin America suffered from the same trio of shocks as the CIS countries, but the overall impact was less severe than in Europe because public and private balance sheets were relatively strong, financial systems were less exposed on the liabilities side to advanced economies' banking systems, and several large economies were able to use the exchange rate as a shock absorber. The financial crisis nonetheless led to a sell-off in equity markets in late 2008, a spike in funding costs, and a jump in spreads on corporate and sovereign debt. Capital flows dwindled and domestic currencies depreciated sharply in countries with flexible regimes. This was followed rapidly by a slowdown in credit growth and collapse in industrial production and exports. Central American and Caribbean countries were hit also by a sharp decline in tourism receipts and remittances to the region, and several countries in Central America and the Caribbean sought support from the IMF and other international financial institutions.

The large drop in the price of oil in FY2009 had a substantial impact on the economies of the Middle East and South America. Other countries were affected by declines in exports, tourism, remittances, and foreign direct investment. As external conditions deteriorated and capital flows reversed, several equity and property markets declined. High government expenditure programs were launched swiftly to pick up the slack, drawing on the large buffers accumulated during the boom years.

LOW-INCOME COUNTRIES

Although financial linkages between low-income countries (particularly those in sub-Saharan Africa) and advanced economies were relatively limited, few countries were able to escape the economic storm. Demand for exports weakened and was compounded by a decline in the prices of most goods from low-income countries. On the one hand, the declines in world commodity prices did help to reduce inflation and had offsetting terms-of-trade effects. While the prices of commodity exports declined, the prices of commodity imports such as food and fuel also declined, often raising the real incomes of the poorest parts of the population.

However, a drop in workers' remittances, tighter global credit conditions, and lower foreign direct investment caused external balances to deteriorate. The overall fiscal position in LICs weakened, mainly as a result of a large swing in fiscal balances of some oil-exporting countries. For other countries, weaker fiscal positions were generally justified and were supported under IMF arrangements. Policymakers took measures to maintain macroeconomic stability and preserve the hard-won gains against poverty achieved in recent years. However, as the availability of financing to cover external deficits became more limited, those with tight domestic and external financing constraints sought additional donor support.