Global financial markets remain highly volatile.

Global imbalances are unwinding in disorderly fashion, heightening the risk of exchange-rate volatility.

Unemployment is increasing worldwide at an alarming pace.

Many countries see their fiscal positions deteriorate significantly.

Global issues

The economic downturn is putting pressure on growth, employment and fiscal balances

Global financial markets experienced a new wave of gyration in February as a result of heightened uncertainty about the viability of banks in major developed countries and intensified financial stresses in Central and Eastern Europe. At the same time, the adverse impact of the global financial crisis on economic activity continued to deepen, with a number of economies, including Japan, registering a more than 10 per cent (annualized) decline of GDP in the fourth quarter of 2008. Unemployment is escalating worldwide, accompanied by an increased number of reported incidents of social unrest, such as strikes and demonstrations. Meanwhile, many countries are seeing a rapid deterioration in their government revenues.

The global imbalances are unwinding in a disorderly and recessionary fashion, implying a retrenchment of imports in deficit countries and a decline in exports in surplus countries, accompanied by a collapse of world trade (see figure). In the United States, the major deficit country, the external deficit has narrowed. Among the surplus economies, Japan’s massive surplus has dropped to almost zero, the euro area is in sizeable deficit and the surpluses of the oil-exporting countries have moderated, while China’s surplus continued to rise. Such an abrupt and counter-productive adjustment of global imbalances could precipitate heightened uncertainty and volatility of exchange rates among major currencies.

The upcoming G20 summit in April is expected to provide an opportunity to enhance international cooperation in addressing the crisis.
Developed economies

United States: the fiscal position is increasingly burdened by the deepening recession

In the United States, GDP decreased at an annualized rate of 6.2 per cent in the fourth quarter of 2008. Initial jobless claims reached an historic high, with the number of people on unemployment benefits exceeding a record 5 million and an increasing number of businesses announcing massive layoff plans. New home sales fell to an all-time low in January. Although the inventory of unsold new homes declined further, its size is unchanged at the equivalent of 13.3 months of sales.

In the new budget proposal, the federal deficit is estimated to reach 12.3 per cent of GDP in the current fiscal year, the highest level since 1945. It also represents certain major changes in policy orientation, including an increase in taxes on high incomes while lowering taxes for other income brackets, as well as large spending increases for infrastructure and health care. Moreover, it envisages limiting greenhouse gas emissions through the adoption of a cap-and-trade scheme.

The United States government also introduced the Financial Stability Plan in a new attempt to stabilize the financial sector, which will offer banks access to government capital and provide capital to the private sector to purchase troubled assets from banks. The Federal Reserve will also purchase selected types of loans and securities. Furthermore, the plan contains additional requirements for transparency and more restrictions on dividends and executive compensation. In addition, it provides refinancing opportunities for responsible homeowners and funding to prevent foreclosures. Under the same plan, the United States Treasury injected $30 billion into AIG in exchange for preferred stock. Before this, it had also agreed to convert up to $25 billion of Citibank preferred stock into common equity.

Western Europe and the EU: indicators continue to point downward, with credit markets reflecting increasing skepticism

The situation in Western Europe continues to deteriorate, with no convincing evidence of even a stabilization of activity. In the euro area, GDP fell by 1.5 percent (not annualized) in the fourth quarter of 2008, the worst performance since the beginning of the European Monetary Union in 1999. Industrial production continued to deteriorate in December, while unemployment rates climbed further across the region. Some countries have been particularly hard hit, with Spain having seen an almost 6 percentage point increase in unemployment since mid-2007 to 14.8 per cent in January. Ireland is being equally hard hit, given its exposure to the current crisis through both a significant banking industry that is facing tremendous losses and through its property market which had experienced one of the largest bubbles during the expansion. In January, Anglo Irish, one of the biggest property lenders in Europe, had to be nationalized, while the Irish government budget deficit has deteriorated sharply.

The European Central Bank left interest rates unchanged in February, but is widely expected to loosen policy further at its March meeting. The Bank of England, the Bank of Sweden and the Bank of Norway all lowered their policy rates.

The impact of the sharp decline in activity on government revenues coupled with the substantial fiscal stimuli and financial sector bailouts enacted by many governments is resulting in major deteriorations in budget positions, which has already led to a significant increase in sovereign debt spreads. Greece, Portugal and Spain have had their debt ratings downgraded, which may impinge on the political willingness to engage in fiscal stimuli in these countries.

The new EU member States are hit by their exposure to international credit and currency markets

Central Europe and the Baltic States saw a sharp slowdown in economic activity, with Latvia recording a contraction in its GDP by 10.5 per cent year-on-year in the last quarter of 2008. In February, the currencies in Eastern Europe plunged after a massive asset sell-off as investors became worried about the sustainability of external debt. A large share of credit in the new EU member States is denominated in foreign currencies and the banking sector persistently rolled over short-term debt, channeling funds into long-term loans, especially mortgages. The devaluation of the Eastern European currencies and weak export prospects will complicate the repayment of loans and the massive withdrawal of capital by foreign investors threatens the stability of the financial system. The European Bank for Reconstruction and Development, the European Investment Bank and the World Bank announced their decision to allocate 24.5 billion euros to the new EU members to restore credit flows and to support small and medium-sized businesses. During their 1 March summit, EU leaders rejected the proposal by Hungary for a 190 billion euro aid package for Eastern Europe and pledged support on a case-by-case basis for these countries.

Japan sees a collapse in its exports

Japan’s real GDP declined by 3.3 per cent from the third to the fourth quarter of last year and exports plunged by 45.7 per cent year-on-year in January. Although the yen has fallen by 10 per cent against the euro and the dollar recently, the current account is likely to move soon into deficit for the first time since 1980. As public investment remains sluggish due to tight fiscal conditions and the high level of indebtedness, the government is considering buying shares to support the Japanese stock market.
Canada's fiscal budget will move into deficit, but its debt level remains relatively low

All major Canadian indicators released in February show a continuing decline of economic activity. After eleven straight years of surpluses, the government predicts a budget deficit as a result of the recession and fiscal stimulus. Nevertheless, Canada's debt-to-GDP ratio remains the lowest in the G7 economies and the country is expected to again achieve a balanced budget by 2011.

Australia and New Zealand: fiscal budgets follow the trend towards deficits

Australia and New Zealand have had fiscal budget surpluses for more than a decade, but their economies are now facing budget deficits over the next few years due to increased spending and pressure on tax revenues.

The economies in transition

Sharp contractions in GDP are accompanied by rising fiscal burdens

Economic activity in the Commonwealth of Independent States (CIS) continues to suffer from spillover effects of the global financial crises and weaker commodity prices, with the largest countries registering a severe downturn in January. In the Russian Federation, growth contracted at an annualized rate of 8.8 per cent in January due to a drastic decline in industrial output, falling investment and slowing construction. In addition, private consumption slowed in view of falling real wages and rising unemployment.

Contracting economic activity hit budget revenues throughout the region, triggering a further downward adjustment in 2009 budget balances. Recent revisions in the Russian Federation’s fiscal budget reflect a decline in revenues, causing a deficit of about 8 per cent of GDP. Growing needs for social expenditures are envisaged to be covered from the Reserve Fund.

Ukraine’s economy plunged further as domestic demand and exports fell sharply and credit markets remained frozen. Industrial output marked the steepest decline on record, causing a contraction of GDP by an estimated 20 per cent year-on-year in January. The outlook of a further deterioration is aggravated by continued political tension and uncertainties due to the deferral of the second tranche of the IMF loan caused by a higher than expected 2009 deficit. The country’s long-term sovereign foreign currency rating was downgraded by Standard & Poor’s to CCC+, while the growing indebtedness of banks and non-bank corporations to foreign creditors elevated the probability of a default.

In South-eastern Europe, many enterprises in February announced plans to cut production in response to weaker export demand, while many FDI projects in the region have been put on hold. In Croatia, reduced FDI inflows, strong demand for the euro and external debt payments led the central bank to act to protect the currency. The Croatian government borrowed 750 million euros from domestic banks to meet its debt-servicing obligation in the first quarter. To counteract the slowdown, a number of governments in the region increased public spending, mostly on infrastructure and information technology projects as well as on social services and benefits.

Developing economies

Africa: slowing trade and increasing public spending negatively affect external and fiscal accounts

The macroeconomic situation has been rapidly deteriorating in the African economies, also in those that previously had considerably improved economic and financial stability. The slowdown in trade, which has reduced government proceeds from exports and revenues from tax receipts, along with increased budget outlays to offset weakened demand, are the major factors behind the deterioration in both fiscal and external accounts. This is particularly the case in sub-Saharan Africa, such as in Botswana and Ghana, where the fiscal deficit is expected to reach double digits as a share of GDP in 2009. Egypt is also facing mounting fiscal problems as deficit spending has increased substantially to stem job losses and the economic contraction.

In South Africa, the economy witnessed a fourth-quarter reduction in GDP by 1.8 per cent (annualized) over the previous quarter and a record-level trade deficit in January that is threatening the country with its first recession in 17 years. The government introduced a 790 billion rand ($75 billion) budget, which includes increased spending on infrastructural development and targeted programs for the poor. Although the expenditure rise will create a budget deficit for the fiscal year to 2010, from a relatively balanced state in 2008/09, it amounts to less than one per cent of GDP. The implied fiscal stimulus may thus be insufficient to re-activate the slumping economy.

East Asia: weaker domestic demand and collapsing exports deepen economic crisis

East Asia faces a deepening economic crisis as exports plunge and domestic demand weakens. Many countries in the region have suffered a sharp contraction of economic activity in the fourth quarter of 2008, with real GDP declining by 3.4 per cent year-on-year in the Republic of Korea, 4.3 per cent in Thailand and 8.4 per cent in Taiwan Province of China. Rapidly falling export demand, combined

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1 See Monthly Briefing No. 4 (January 2009).
with drastically reduced capital inflows, has led to sharp declines in private investment across the region. At the same time, household consumption continues to weaken as a result of negative wealth effects, rising unemployment and increased economic uncertainty. On a positive note, liquidity in the Chinese banking sector has remained high as indicated by a surge in bank loans in the year to January.

With private demand, both domestic and external, falling in most East Asian economies, it is only increased government spending that can ameliorate the downturn. Given declining fiscal revenues, additional government expenditures will lead to significantly higher budget deficits in 2009 and 2010. China has reported a sharp decline of government revenues in January 2009 by 17 per cent compared to the year before, reversing the recent trend of more than 20 per cent annual growth. This, coupled with the large stimulus package, will likely lead to an increase of the budget deficit by about 2 percentage points of GDP in 2009, the largest deterioration since the Asian financial crisis in 1997/98. Nevertheless, budget deficits and public debt levels as a share of GDP remain small in China and most of the other East Asian countries.

**South Asia: manufacturing sectors suffer from falling domestic and international demand**

South Asian countries are increasingly being hit by the deteriorating global economy, most importantly the massive decline in international trade. In Bangladesh, Pakistan and Sri Lanka, export revenues fell significantly in the fourth quarter of 2008 compared to a year earlier. At the same time, economic growth in India decelerated to its slowest pace in six years, with GDP expanding by 5.3 per cent year-on-year in the fourth quarter of 2008, down from 7.6 per cent in the third quarter, as both manufacturing and agricultural output declined. With private spending on consumption and investment weakening, output growth has primarily resulted from significantly higher government expenditures.

Most countries in South Asia, including India, recorded considerable budget deficits in recent years and ratios of public debt to GDP are relatively high. Accordingly, there seems to be limited scope for further fiscal expansion. In 2009, increases in government spending coupled with slowing fiscal revenues will lead to budget deficits of more than 6 per cent of GDP in India, Pakistan and Sri Lanka.

**Western Asia: lower growth and inflation lead to further loosening of monetary policy**

The region saw a continued contraction in economic activity. On the output side, Turkey saw its second consecutive double-digit decline in industrial production, which fell by 17.6 per cent year-on-year in December, with all major sectors, especially motor vehicle manufacturers and output from textiles, being hit by the global weakening in trade. The picture is similar in other parts of the region, with Israel’s economy contracting in the fourth quarter of 2008 on the back of a sharp fall in exports.

At the same time, inflation continued to recede in several countries, including Israel, Jordan, Lebanon and Turkey. This created further room for interest rate cuts in an attempt to address slowing economic activity, with policymakers in Israel cutting interest rates by 25 basis points to a record low of 0.75 per cent, while Turkey’s main policy rate was cut by 150 basis points to 11.5 per cent.

**Latin America: further policy measures to address the deepening crisis**

In Latin America, economic activity continued to contract in January, dragged down by weakening external demand as well as an unexpected rapid contraction of domestic demand in several countries due to tight credit and rising fears about unemployment. In Brazil alone, one million people lost their jobs between December 2008 and January 2009.

Recessionary concerns continue to push governments and central banks to introduce counter-cyclical measures. In Chile, a fiscal surplus of $9 billion in 2008, equivalent to 5.2 per cent of GDP, was announced this month, enabling additional public spending through 2009. At the same time, in view of lower inflation and lower expected growth, the central bank of Chile decided to cut its interest rate aggressively by 250 basis points to 4.75 per cent. In order to boost trade finance in Brazil, the central bank has used foreign-exchange reserves to extend trade credits, but with only limited effect so far. However, not all countries have accumulated a similarly high level of reserves in 2008, with some of them, such as Argentina, facing a sharp deceleration in tax revenues. Therefore, in order to help Latin American countries in implementing fiscal stimuli, the World Bank tripled its loan portfolio for the region to an amount equivalent to $13 billion.

**The least developed countries are constrained by still high food prices and lower aid flows**

The least-developed countries, many of which suffered from high food and energy prices causing high inflation and balance of payments constraints, are now facing additional pressures from collapsing export demand and constrained aid inflows. In Bangladesh, net receipts of foreign aid were almost 10 per cent lower during July-December 2008 than during the same period in 2007. Meanwhile, donor appeals are still high in Ethiopia, which recently received IMF loan assistance, and in Kenya, which is facing an impending shortfall in agricultural production. The Democratic Republic of the Congo, which is reeling from the slowdown in mining exports, has been granted only one-quarter of the emergency funds it is seeking, after its foreign reserves dwindled to $36 million from more than $225 million last April.