CHAPTER 2

COUNTRY AND REGIONAL PERSPECTIVES

This chapter discusses how the global crisis is affecting the various regions of the global economy. The United States is at the epicenter of the crisis, and is in the midst of a severe recession that has resulted from a squeeze on credit, sharp falls in housing and equity prices, and high uncertainty. These three shocks are to varying degrees also affecting the rest of the world. Asia had little exposure to U.S. mortgage-related assets but is being badly affected by the slump in global trade, given its heavy dependence on manufacturing exports. In Europe, as in the United States, the financial system has been dealt a heavy blow, housing corrections are intensifying, and industrial production is being hit by the sharp drop in durables demand. Because of their heavy reliance on capital inflows to sustain income growth in order to catch up to Western levels, both the emerging European and Commonwealth of Independent States (CIS) economies are suffering heavily, with the slump in commodity prices adding to the pain in many CIS economies. In Latin America and the Caribbean, the fallout from the crisis is moving through both trade and financial channels, intensified by the drop in commodity prices. The Middle Eastern economies are suffering mainly because of the decline in energy prices, and hard-won gains in African economies are threatened by slumping commodity prices and potentially lower aid inflows.

The United States Is Grappling with the Financial Core of the Crisis

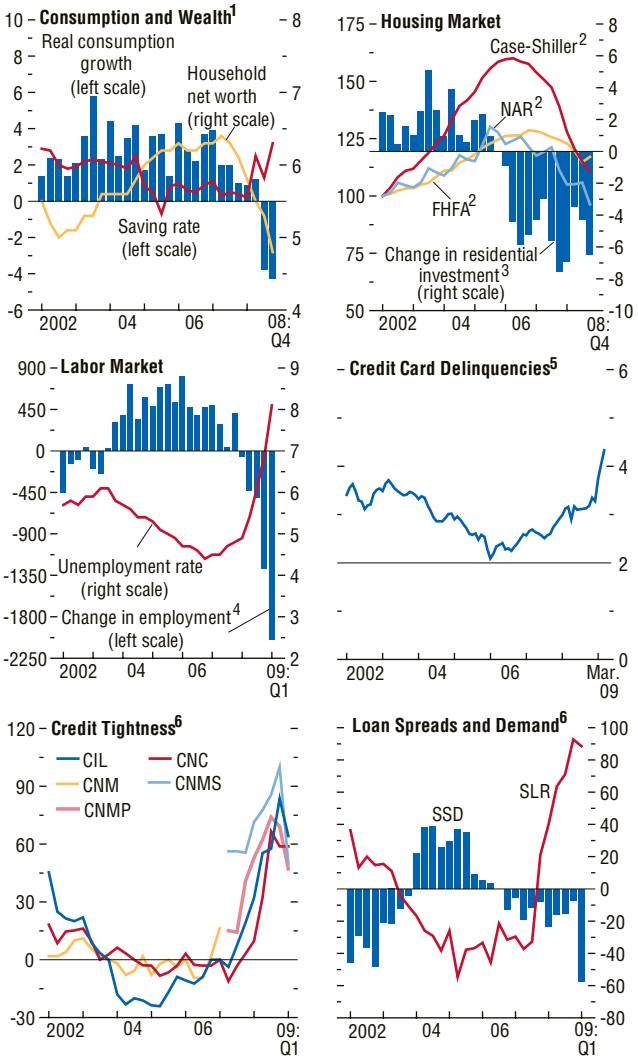
The biggest financial crisis since the Great Depression has pushed the United States into a severe recession. Despite large cuts in policy interest rates, credit is exceptionally costly or hard to get for many households and firms, reflecting severe strains in financial institutions. In addition, households are being hit by large financial and housing wealth losses (Box 2.1), much lower earnings prospects, and elevated uncertainty about job security, all of which have driven consumer confidence to record lows. These shocks have depressed consumption; the household saving rate, which had been falling for two decades, has risen sharply, to more than 4 percent in February 2009, up from about ¼ percent a year earlier (Figure 2.1).

Progress toward normalization of financial conditions has been much slower than envisaged a few months ago. Financial markets have stabilized somewhat since the failure of Lehman Brothers and the rescue of American International Group (AIG) in September, but they remain under heavy stress, despite unprecedented government actions. Interbank markets are still unsettled, and spreads remain far above normal levels. Despite some relief in recent weeks, equity markets are still down more than 40 percent from their peaks, as economic prospects have darkened and financial stocks have been hammered by heavy losses and questions about solvency. The dollar has strengthened significantly, reflecting flight to safety in government bonds as other economies have become more deeply embroiled in the crisis.

Real GDP contracted by 6.3 percent in the fourth quarter of 2008, and recent data suggest another substantial drop in the first quarter of 2009. There have been some tentative signs of improving business sentiment and firming consumer demand, but employment has continued to fall rapidly—5.1 million jobs have been lost since December 2007—pushing the unemployment rate to 8.5 percent in March. Monetary policy was eased quickly in response to deteriorating economic conditions, and policy rates are now close to zero. But credit market disruptions are undermining the effectiveness of rate cuts. The scope for further conventional monetary policy action is effectively exhausted, so the Federal Reserve has moved aggressively since the fall to use alternative channels to ease credit conditions and has been prepared not only to alter the composition of its balance sheet but

Figure 2.1. United States: The Center of the Crisis

Falling wealth, tight credit markets, and heightened uncertainty about job security and earnings are reining in private demand. Declining output and employment are causing declines in loan repayments. The damage to bank balance sheets is tightening access to credit, feeding back into private investment and consumption.



Sources: Haver Analytics; Fitch Ratings; Federal Reserve Board of Governors; and IMF staff estimates.

[1]Real consumption growth and saving rate are in percent; household net worth is ratio to disposable income.

[2]Index: 2002:Q1 = 100. National Association of Realtors (NAR); three-month moving average of 12-month percent change; Federal Housing Finance Agency (FHFA).

[3]Quarterly change in percent.

[4]Quarterly change in total nonfarm payrolls, thousands.

[5]Fitch's Prime Credit Card Delinquency Index.

[6]All series come from Senior Loan Officer Survey. CIL: banks tightening C&I loans to large firms; CNC: banks tightening standards for consumer credit cards; CNM: banks tightening standards for mortgages to individuals; CNMS: banks tightening standards for subprime mortgages to individuals; CNMP: banks tightening standards for prime mortgages to individuals; SSD: net percentage of domestic respondents reporting stronger demand for C&I loans for small firms; SLR: net percentage of domestic respondents increasing spreads of loan rates over banks' cost of funds for small firms.

to expand its size dramatically as well. A broad array of new facilities has been introduced to ensure that credit flows throughout the financial system, including to revive the markets for securities backed by a broad array of consumer credit assets.[1] In mid-March, the Federal Reserve announced plans to purchase long-term U.S. Treasury securities and increase its purchases of agency-backed mortgage-backed securities and agency debentures.

The economy is now projected to contract by 2.8 percent in 2009, even though the rate of decline is expected to moderate in the second quarter and beyond as fiscal easing supports consumer demand and the rate of inventory adjustment eases (Table 2.1). Contingent on fiscal stimulus (equivalent to about 5 percent of GDP) over 2009–11, a continued easy monetary policy stance, measures to stabilize house prices and stem the tide of foreclosures, and new policy measures to heal the financial sector (see below), the economy is projected to start recovering by the middle of 2010. Average GDP growth in 2010 is projected to be zero percent (on a fourth-quarter-to-fourth-quarter basis, growth is projected to reach 1.5 percent). There are upside risks to the forecast, as financial conditions could recover faster than projected. However, there are notable downside risks related to the potential for further intensification of the negative interaction between the real and financial sides of the economy: the housing sector could continue to deteriorate, further declines in asset values could increase insolvency problems for banks and further reduce credit availability, deflation could raise real debt burdens, and demand from other economies could fall more than anticipated.

Prospects depend critically on policy initiatives to mitigate the severity of the recession and spur recovery. The most pressing policy issue

[1]The Federal Reserve has created the Term Asset-Backed Securities Loan Facility (TALF), which allows it to lend on a nonrecourse basis to investors in securities backed by a variety of consumer loans (for example, auto loans and student loans), thus effectively providing both liquidity and protection against loan losses.

Table 2.1. Advanced Economies: Real GDP, Consumer Prices, and Unemployment[1]

(Annual percent change and percent of labor force)

	Real GDP				Consumer Prices				Unemployment			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Advanced economies	**2.7**	**0.9**	**–3.8**	**0.0**	**2.2**	**3.4**	**–0.2**	**0.3**	**5.4**	**5.8**	**8.1**	**9.2**
United States	2.0	1.1	–2.8	0.0	2.9	3.8	–0.9	–0.1	4.6	5.8	8.9	10.1
Euro area[2]	2.7	0.9	–4.2	–0.4	2.1	3.3	0.4	0.6	7.5	7.6	10.1	11.5
Germany	2.5	1.3	–5.6	–1.0	2.3	2.8	0.1	–0.4	8.4	7.3	9.0	10.8
France	2.1	0.7	–3.0	0.4	1.6	3.2	0.5	1.0	8.3	7.8	9.6	10.3
Italy	1.6	–1.0	–4.4	–0.4	2.0	3.5	0.7	0.6	6.1	6.8	8.9	10.5
Spain	3.7	1.2	–3.0	–0.7	2.8	4.1	0.0	0.9	8.3	11.3	17.7	19.3
Netherlands	3.5	2.0	–4.8	–0.7	1.6	2.2	0.3	1.1	3.2	2.8	4.1	5.0
Belgium	2.6	1.1	–3.8	0.3	1.8	4.5	0.5	1.0	7.5	6.8	9.5	10.5
Greece	4.0	2.9	–0.2	–0.6	3.0	4.2	1.6	2.1	8.3	7.6	9.0	10.5
Austria	3.1	1.8	–3.0	0.2	2.2	3.2	0.5	1.3	4.4	3.8	5.4	6.2
Portugal	1.9	0.0	–4.1	–0.5	2.4	2.6	0.3	1.0	8.0	7.8	9.6	11.0
Finland	4.2	0.9	–5.2	–1.2	1.6	3.9	1.0	1.1	6.8	6.4	8.5	9.3
Ireland	6.0	–2.3	–8.0	–3.0	2.9	3.1	–0.6	1.0	4.5	6.1	12.0	13.0
Slovak Republic	10.4	6.4	–2.1	1.9	1.9	3.9	1.7	2.3	11.0	9.6	11.5	11.7
Slovenia	6.8	3.5	–2.7	1.4	3.6	5.7	0.5	1.5	4.9	4.5	6.2	6.1
Luxembourg	5.2	0.7	–4.8	–0.2	2.3	3.4	0.2	1.8	4.4	4.4	6.8	6.0
Cyprus	4.4	3.7	0.3	2.1	2.2	4.4	0.9	2.4	3.9	3.7	4.6	4.3
Malta	3.6	1.6	–1.5	1.1	0.7	4.7	1.8	1.7	6.4	5.8	6.9	7.6
Japan	2.4	–0.6	–6.2	0.5	0.0	1.4	–1.0	–0.6	3.8	4.0	4.6	5.6
United Kingdom[2]	3.0	0.7	–4.1	–0.4	2.3	3.6	1.5	0.8	5.4	5.5	7.4	9.2
Canada	2.7	0.5	–2.5	1.2	2.1	2.4	0.0	0.5	6.0	6.2	8.4	8.8
Korea	5.1	2.2	–4.0	1.5	2.5	4.7	1.7	3.0	3.3	3.2	3.8	3.6
Australia	4.0	2.1	–1.4	0.6	2.3	4.4	1.6	1.3	4.4	4.3	6.8	7.8
Taiwan Province of China	5.7	0.1	–7.5	0.0	1.8	3.5	–2.0	1.0	3.9	4.1	6.3	6.1
Sweden	2.6	–0.2	–4.3	0.2	1.7	3.3	–0.2	0.0	6.1	6.2	8.4	9.6
Switzerland	3.3	1.6	–3.0	–0.3	0.7	2.4	–0.6	–0.3	2.5	2.7	3.9	4.6
Hong Kong SAR	6.4	2.5	–4.5	0.5	2.0	4.3	1.0	1.0	4.0	3.5	6.3	7.5
Czech Republic	6.0	3.2	–3.5	0.1	2.9	6.3	1.0	1.6	5.3	4.2	5.5	5.7
Norway	3.1	2.0	–1.7	0.3	0.7	3.8	1.5	1.9	2.5	2.6	3.7	4.7
Singapore	7.8	1.1	–10.0	–0.1	2.1	6.5	0.0	1.1	2.1	3.1	7.5	8.6
Denmark	1.6	–1.1	–4.0	0.4	1.7	3.4	–0.3	0.0	2.7	1.7	3.2	4.5
Israel	5.4	3.9	–1.7	0.3	0.5	4.7	1.4	0.8	7.3	6.0	7.5	7.7
New Zealand	3.2	0.3	–2.0	0.5	2.4	4.0	1.3	1.1	3.6	4.1	6.5	7.5
Iceland	5.5	0.3	–10.6	–0.2	5.0	12.4	10.6	2.4	1.0	1.7	9.7	9.3
Memorandum												
Major advanced economies	2.2	0.6	–3.8	0.0	2.1	3.2	–0.4	0.0	5.4	5.9	8.0	9.3
Newly industrialized Asian economies	5.7	1.5	–5.6	0.8	2.2	4.5	0.4	2.0	3.4	3.5	4.9	4.9

[1]When countries are not listed alphabetically, they are ordered on the basis of economic size.

[2]Based on Eurostat's harmonized index of consumer prices.

is to restore the health of the core financial institutions. At the same time, it is important to stimulate private demand (not just for the direct effects but also to break the cycle of falling asset prices, rising losses in financial institutions, and tighter credit); lower the risk of asset price overshooting on the downside, especially for house prices; and reduce uncertainty facing households, firms, and financial markets. In this regard, the main burden will fall on fiscal policy since the scope for monetary policy has become limited on multiple fronts.

Crucially, policies must address the problems at the core of the financial system: the growing burden of problem assets and uncertainty about banks' solvency. Balance sheets need to be restored, both by removing bad assets and by injecting new capital in a transparent manner, so as to convince markets of these institutions' return to solvency. The strategy for banks has

Box 2.1. The Case of Vanishing Household Wealth

The financial crisis has erased household wealth in many advanced economies. The precipitous fall in asset prices—across equity, bond, and housing markets—has eroded the value of financial and housing assets and the net worth of households.[1] For instance, during the first three quarters of 2008 alone, the value of household financial assets decreased by about 8 percent in the United States and the United Kingdom, by close to 6 percent in the euro area, and by 5 percent in Japan. As global equity markets plunged in the last quarter of 2008, household financial wealth declined further—for example, by an additional 10 percent in the United States. At the same time, the value of housing assets also deteriorated in line with falling house prices, especially in the United States and the United Kingdom.

The sharp deterioration in household wealth prompts a number of questions: How vulnerable were household balance sheets across countries before the crisis? What are the main channels through which balance sheet developments could affect real activity? What are the likely effects on the economy this time around? The purpose of this box is to address the above questions using available data and evidence on the topic.

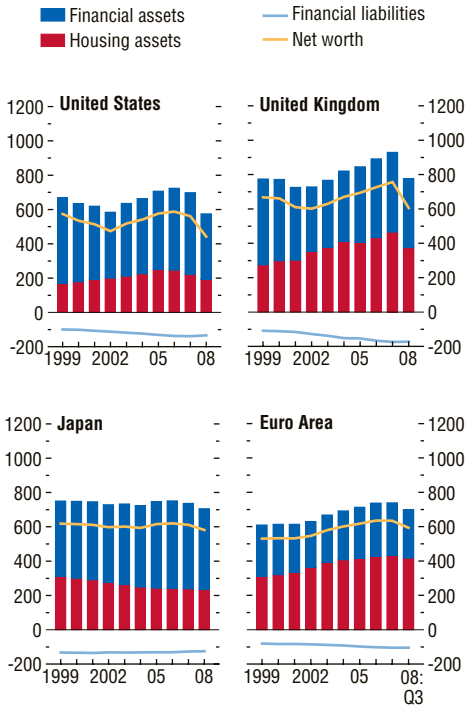
What Was the Starting Position?

In advanced economies, households faced the financial crisis with higher net worth but also with more vulnerable, leveraged balance sheets.

- Household net worth rose substantially in the four largest advanced economies during 2002–06 (first figure).[2] On the asset side, in tandem with asset prices, gross financial and housing wealth (as a percentage of disposable income) increased by more than 100 percentage points in the United States, euro area, and United Kingdom. On the liability side, gross financial obligations increased in these three economies by about 20–40 percentage points and remained broadly unchanged in Japan.

Household Assets, Liabilities, and Net Worth[1]

(In percent of gross disposable income)



Sources: Bank of Japan, Cabinet Office (Japan), European Central Bank, Eurostat, Office of National Statistics, Haver Analytics, and IMF staff estimates.

[1]Data cover households and non-profit organizations in the United States, and households and non-profit institutions serving households in the Euro area, the United Kingdom, and Japan. The housing wealth data refer to the value of residential buildings in the United States; the value of real estate holdings in the United Kingdom; housing wealth at current replacement value in the Euro area; and tangible non-produced assets (excluding fisheries) of households and private unincorporated enterprises in Japan. The housing wealth data are estimated for 2007 and 2008 in Japan and for 2008 in the Euro area and the United Kingdom, based on observed changes in house prices. Data for United States, the United Kingdom, and Japan are up to 2008:Q4; data for the Euro area are up to 2008:Q3.

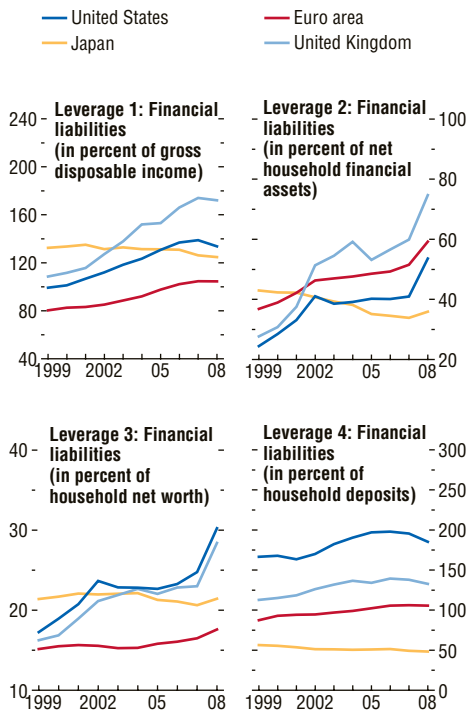
The main author of this box is Petya Koeva Brooks.

[1]Net worth is defined as total assets (housing and financial) minus financial liabilities.

[2]As a percentage of disposable income, net worth increased during 2002–06 by 114 percentage points in the United States, 90 percentage points in the euro area, 125 percentage points in the United Kingdom, and 23 percentage points in Japan during 2002–06.

- The increased size of household assets, coupled with their composition, implied higher overall vulnerability to equity and house price shocks, with notable differences across countries. The broad composition of assets reveals that gross household wealth is more dependent on housing assets in the United Kingdom and euro area and on financial assets in the United States and Japan (see first figure). As far as the composition of financial assets is concerned, most notable is the large share of deposits held by Japanese households. Taken together, these observations suggest that in relative terms, U.S. households were more vulnerable to equity price shocks and U.K. and euro area households to house price shocks.
- Household balance sheets generally became more leveraged (second figure). In the advanced economies other than Japan, financial liabilities rose—as a percentage of disposable income, net financial assets, net worth, and household deposits. But the leverage ratios also indicate substantial differences across countries. For instance, although household financial liabilities relative to net worth remained broadly unchanged in Japan and rose moderately in the euro area, they increased substantially in the United Kingdom and the United States—from about 17 percent of net worth in 1999 to more than 28 percent at end-2008.

Household Leverage Ratios[1]



Sources: Bank of Japan, Cabinet Office (Japan), European Central Bank, Eurostat, Office of National Statistics, Haver Analytics, and IMF staff estimates.
[1]For the Euro area, data refer to 2008:Q3.

How Do Household Balance Sheets Affect Economic Activity?

In theory, there are several possible channels of transmission.

- The most traditional channel is through *wealth effects*. In response to an unexpected loss in net worth, consumers are likely to cut their current spending by a fraction of the change in wealth and maintain the new level of spending over time. The existence of a housing wealth effect is somewhat controversial, however. Some have argued that even if house prices fall, the houses are all still there, and the services they provide for the future (in terms of shelter) are unchanged. Therefore, one could think about the fall in price as a mere change in relative prices (between houses/housing services and all other goods and services) that makes those long in housing poorer but those short in housing richer, with no obvious aggregate wealth effect.[3] This argument does not hold, however, if there is a bubble in the housing market, if the marginal propensity to consume differs between the two groups, or if housing wealth can be collateralized (see below).[4]

[3]For example, King (1998) and Buiter (2008).
[4]See Buiter (2008).

Box 2.1 *(concluded)*

- Another possible channel is through *credit/collateral effects*. Households can borrow against the equity in their homes and use it to finance consumption. If households face liquidity constraints, a decrease in their net worth could lead to higher costs for and reduced availability of borrowing, further lowering consumption.
- A third channel is through possible *distributional effects*. Because households may respond differently to shocks depending on their debt levels, aggregate consumption could also be affected by the amount of debt outstanding and by its distribution. In addition, the composition of household assets and their relative (il)liquidity may play a role in determining how consumption responds to shocks.

Disentangling and assessing the empirical importance of the various channels of transmission have been extremely hard, given the difficulties in controlling for the effects of income expectations and other unobserved factors.[5] Therefore, it may be more appropriate to treat the estimates of wealth effects (marginal propensity to consume out of financial and housing assets) as capturing a more broad (reduced-form) relationship between wealth and consumption, rather than a pure wealth effect. These estimates generally vary between 0 and 0.10, depending on the type of asset (housing, financial), data (micro, macro), financial system (bank based, market based), country, and so forth.[6]

Furthermore, there is no consensus on how wealth effects differ between housing and financial wealth, although some studies find a stronger housing wealth effect, despite theoretical arguments to the contrary.[7] Estimates of housing wealth effects tend to be larger in the United States and the United Kingdom than in the euro area and Japan.[8] In policymaking, the FRB/US model used by the Federal Reserve incorporates a 0.038 long-run marginal propensity to consume out of housing wealth, which is identical to that of financial wealth, whereas the Bank of England's model contains no such long-run effect.

What Are the Likely Effects of Household Balance Sheet Developments in the Current Circumstances?

Although its exact contribution is hard to assess, the recent destruction of wealth is likely to contribute to a rise in the household saving rate and weakness in consumption in advanced economies, especially in the United States and the United Kingdom, where the decline in net worth has been the largest so far. For instance, as shown in the table, the losses in household wealth during 2008 were about $11 trillion in the United States ($8.5 trillion in financial assets and $2.5 trillion in housing assets) and were estimated at £1 trillion in the United Kingdom (£0.4 trillion in financial assets and

[5]Quantifying the importance of the distributional channel has been particularly challenging, although there is some evidence suggesting that responses to shocks were stronger when indebtedness was higher (Balke, 2000). Based on the experience of the United Kingdom and the Scandinavian countries in the early 1990s, Debelle (2004) also argues that high household indebtedness amplified the transmission of other shocks.

[6]For advanced economies, the marginal propensity to consume out of financial wealth is typically estimated in a range between 0.00 and 0.09—if wealth rises by $1, spending rises by between zero and nine cents. For example, see Catte and others (2004) and chapter 3 in the April 2008 *World Economic Outlook*. The magnitude in the Federal Reserve FRB/US model is 0.0375.

[7]See Ludwig and Sløk (2004); and Case, Quigley, and Shiller (2005).

[8]For the euro area, Slacalek (2006) finds that the marginal propensity to consume out of housing wealth is zero, although there appears to be substantial variation across euro area countries, with positive effects in Italy and France (Sierminska and Takhtamanova, 2007; Grant and Peltonen, 2008; Paiella, 2004; and Boone and Girouard, 2002). For the United States and the United Kingdom, the estimates tend to be larger (in the range of 0.03–0.10). See Bertaut (2002); Carroll, Otsuka, and Slacalek (2006); Slacalek (2006); Skinner (1993); Lehnert (2004); Campbell and Cocco (2007); and Boone and Girouard (2002).

Illustrative Long-Run Effects of Wealth Destruction on Household Saving Rate

	2007:Q4–2008:Q4		2008:Q4–2009:Q4		Cumulative Long-Run Effect	
	United States	United Kingdom	United States	United Kingdom	United States	United Kingdom
(in percent)						
Change in housing wealth[1]	–11	–16	–10	–10		
Change in financial wealth[1,2]	–10	–9	–4	–3		
(in percentage points)						
Long-run effect on saving rate (low MPC = 0.02)[3,4]	2.6	3.2	0.7	1.2	3.3	4.5
Long-run effect on saving rate (high MPC = 0.07)[4]	8.9	11.2	2.5	4.1	11.5	15.6

Sources: U.K. Office for National Statistics; Haver Analytics; and IMF staff estimates.

[1]For the United Kingdom, housing wealth data are currently available until 2007:Q4. The assumed changes in housing wealth during 2007:Q4–2008:Q4 correspond to the average change in the Nationwide and Halifax price indices during the same period.

[2]The assumed changes in financial wealth during 2008:Q4–2009:Q4 are based on (1) the observed changes in equity markets (Wilshire 5000 Index for the United States and FTSE All Share Index for the United Kingdom) between December 31, 2008, and March 31, 2009, and (2) the assumption that the change in the value of nondeposit financial assets is one-half the change in equity prices.

[3]The marginal propensity to consume out of wealth (MPC) is assumed to be the same for housing and financial assets.

[4]The impact on the saving rate is computed by multiplying the MPC and the shortfall in wealth (relative to a scenario in which wealth grows in line with disposable income) and dividing by the initial level of disposable income. Nominal disposable income growth was 2.9 percent in the United States and 4.7 percent in the United Kingdom during 2007:Q4–2008:Q4 and is assumed to be 0 percent in the United States and 1 percent in the United Kingdom during 2008:Q4–2009:Q4.

£0.6 trillion in housing assets).[9] The long-run impact on the saving rate of these losses could be in the range of 2½–9 percentage points in the United States and 3¼–11¼ percentage points in the United Kingdom, depending on the assumed marginal propensity to consume.[10]

Equity and house prices have already adjusted significantly, especially in the United States. But they may continue to decline and—given the increased vulnerability of household balance sheets to asset price shocks—reduce household net worth and consumption further. For example, let us suppose that the value of household financial wealth decreases by 3–4 percent during 2008:Q4–2009:Q4—which is consistent with the observed decline in equity markets during the first quarter of 2009—and that there are no further changes in financial wealth during the rest of 2009 and the value of housing assets decreases by 10 percent. This could be associated with an additional increase in the household saving rate of about ¾–2½ percentage points in the United States and 1¼–4 percentage points in the United Kingdom over the coming years (see table). As a result, over the long run, the cumulative effect of the declines in housing and financial wealth on the household saving rate could be in the range of 3¼–11½ percentage points for the United States and 4½–15½ percentage points for the United Kingdom. In sum, household savings in these countries are expected to rise and remain substantially higher than in the past decade, even after the impact wanes of other factors that now constrain consumption (such as tighter restrictions on credit availability, concerns about unemployment, and precautionary saving).

[9]For the United Kingdom, housing wealth as of end-2008 is derived under the assumption that the value of housing assets declines in line with the change in nominal house prices (see also footnote 1 of the table).

[10]These estimates should be treated as illustrative only, since their inputs are subject to a large degree of uncertainty. Moreover, they do not capture the effects of all the other factors that are affecting private saving at the same time.

two aspects, both designed to improve the quality of banks' balance sheets and enable them to increase lending activity. First, banks with more than $100 billion in assets face a mandatory stress test to assess whether their existing levels of capital are robust to further declines in asset prices and economic activity. Banks that cannot raise additional capital from private investors to fill identified capital shortfalls will receive additional government funds. Second, the Public-Private Investment Program (PPIP) was announced to clear bank balance sheets of troubled assets. The multipronged plan intends to leverage private capital within public-private partnerships to purchase distressed assets, potentially allowing purchases of $500 billion to $1 trillion. Bank participation in the plan, however, is entirely voluntary, as banks are not required to sell their assets. The underlying idea behind the plan is that if financial institutions are purged of bad assets, they will be more likely to attract new capital from the private sector. Furthermore, creating a viable market in assets that are currently nearly impossible to price will reduce uncertainty over the solvency of financial institutions. Moreover, recognizing that further declines in the price of mortgage-backed securities will also hurt banks, the administration is applying $75 billion in public funds toward curbing foreclosures by offering cash incentives for lenders to modify loans, allowing borrowers with high loan-to-value mortgages to refinance into new, government-backed mortgages with a lower interest rate, and increasing the capacity of Fannie Mae and Freddie Mac to buy mortgages.

The challenge for any public attempt to remove bad assets is to induce banks to sell them—shareholders will be unwilling to accept "fire-sale" prices—while not paying too high a price, which would amount to a taxpayer subsidy to bank owners and bondholders and could quickly exhaust Troubled Asset Relief Program (TARP) funds.[2] The recently announced PPIP should be a useful step in improving liquidity and transparency in the underlying markets, but its effectiveness in removing problem assets will depend crucially on the willingness of the banks that hold these assets to sell them at a price consistent with the available resources under the program. The approach to recapitalization is also not without potential problems. At present, evaluating the long-term viability of financial institutions is a daunting task: the assessment must take into account the prospects for their future profitability and business model, as well as the quality of capital and management. Once a benchmark is established for the appropriate level of regulatory capital that reflects the need for buffers to absorb future losses, the recapitalization of viable banks with insufficient capital should proceed quickly, with public money if necessary. To improve confidence and funding prospects, the capital infusion should be in the form of common shares, even if the government becomes a majority shareholder. At the same time, nonviable institutions would need to be intervened promptly, leading to orderly resolution through closure or merger.

Much hinges on the ability of the strategy to restore financial stability, both in terms of direct effects and in terms of underlying monetary and fiscal policy measures. Although the political economy of policy implementation is complicated by the public's doubts about the wisdom of bailing out financial players, there is a grave danger that further delays, piecemeal action, and uncertainty could mean worsening conditions in the real economy, increasing the large collateral damage inflicted by the correction of past mistakes and thus the ultimate cost of bank resolution.

Fiscal policy must play an important part in supporting demand in the presence of restrictions on credit availability (see Chapter 3). Tax rebates helped boost consumption modestly in mid-2008, but their effects have now dissipated. A much larger discretionary stimulus package has now been passed into law, combining further tax relief with federal assistance to states and additional expenditures (mainly on social programs and infrastructure), which is expected

[2]The new budget proposal sent to Congress would add $250 billion to these funds on a net basis.

to provide a 2.0 percent of GDP stimulus in 2009 and 1.8 percent in 2010. This spending, together with the expected losses from financial system support operations, the impact of the cycle, and the fall in asset prices, is projected to bring the federal budget deficit to about 10 percent of GDP in 2010. Against this backdrop, it will be important to develop strategies to reverse the buildup of debt over the medium run. The current proposed budget is transparent about this issue but is based on growth assumptions that are more optimistic than contained in these projections. More may need to be done to ensure long-term fiscal sustainability. Otherwise, there is a risk of upward pressure on interest rates that will slow a recovery of the private sector.

Although there is no further room for interest rate cuts, the Federal Reserve should continue its efforts to use its balance sheet to support credit markets, mindful of the need for an exit strategy. Some positions could be quickly unwound once conditions normalize, but it may be more difficult to divest long-term assets, and thus there is a need to consider new instruments to absorb liquidity, for example, issuance of Federal Reserve paper. In addition, the authorities must be clear about the goals of unconventional policy measures.

Asia Is Struggling to Rebalance Growth from External to Domestic Sources

The impact of the global crisis on economies in Asia has been surprisingly heavy. There were many reasons to expect Asia to be relatively shielded from the crisis: unlike Europe, the region was not heavily exposed to U.S. securitized assets, and improved macroeconomic fundamentals and (with a few exceptions) relatively sound bank and corporate balance sheets were expected to provide buffers. Nevertheless, since September 2008, the crisis has spread quickly to Asia and has dramatically affected its economies. Japan's economy contracted at a 12 percent (annualized) rate in the fourth quarter. The newly industrialized economies (Hong Kong SAR, Korea, Singapore, Taiwan Province of China) declined at rates between 10 percent and 25 percent, and southeast Asian emerging economies have also been badly damaged. These falls resulted mostly from the collapse in demand for consumer durable goods and capital goods in (non-Asian) advanced economies and, to a lesser degree, the deterioration in global financial conditions. China and India have also been affected by contraction in the export sector, but their economies have continued to grow because trade is a smaller share of the economy and policy measures have supported domestic activity. Also, there were some signs of a turnaround in economic activity in China in the first quarter of 2009. At the same time, inflation pressures are subsiding quickly in most economies, owing to weaker growth and lower commodity prices.

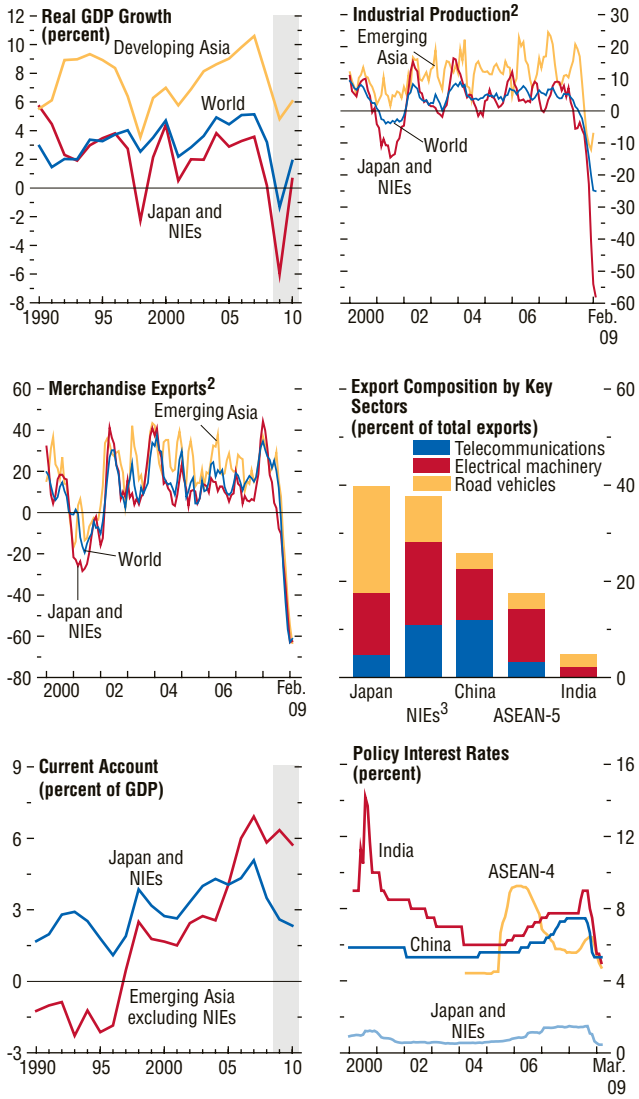
The impact on the real economy through the trade channel has been severe and similar across Asia. The drop in global demand has been particularly focused on automobiles, electronics, and other consumer durable goods that are an integral part of the production structure across east Asia. As a result, exports and industrial production have plummeted (Figure 2.2).

Spillovers from the global financial crisis to domestic financial markets across Asia have also been substantial. Equity and bond prices have plummeted, sovereign and corporate spreads have increased, and interbank spreads have risen. Real estate markets have remained under pressure in a number of economies (Singapore, China). Currencies have depreciated in most of the region's emerging economies, although the yen has appreciated considerably since September 2008 (as carry trades have been unwound), and the renminbi has remained broadly unchanged relative to the dollar. Portfolio and other flows have dwindled, implying tighter domestic credit conditions. As a result, many banks and firms have begun to experience serious stress.

Growth projections for Asia have been marked down to varying degrees, in line with weaker global demand and tight external finan-

Figure 2.2. Advanced and Emerging Asia: Suffering from the Collapse of Global Trade[1]

Asia has been hit hard by the global crisis, mainly through the trade channel, as production and exports have plummeted across the region. Advanced economies in the region are among the most affected, due to their high export dependence and large exposure to the drop in global demand for automobiles, electronics, and other consumer durable goods. Also constrained by lower capital inflows and tighter credit conditions, real activity in emerging Asia is slowing sharply too, despite a considerable boost from monetary and fiscal policies.



Sources: Bloomberg Financial Markets; Dealogic; Haver Analytics; United Nations Comtrade Database; and IMF staff estimates.

[1]Newly industrialized Asian economies (NIEs) comprise Hong Kong SAR, Korea, Singapore, and Taiwan Province of China. ASEAN-4 countries comprise Indonesia, Malaysia, Philippines, and Thailand. ASEAN-5 countries comprise ASEAN-4 countries and Vietnam. Emerging Asia comprises China, India, Indonesia, Malaysia, Philippines, and Thailand.

[2]Annualized percent change of three-month moving average over previous three-month average.

[3]Excluding Taiwan Province of China.

cial conditions and despite countercyclical macroeconomic policies. Activity in advanced Asia is expected to drop sharply, and some economies could even experience deflation. Emerging Asia is expected to continue to grow, led by China and India (Table 2.2). A modest recovery is projected in 2010, underpinned by a pickup in global growth and a boost from expansionary fiscal and monetary policies. Despite the collapse in exports, the current account surplus for Asia is projected to remain broadly unchanged at about 4¾ percent of GDP, with significant improvements in the current account positions of Korea and Taiwan Province of China in 2009 (Table 2.3).

The exact channels of transmission of the external shocks and the severity of their impact vary considerably across economies. The advanced economies in the region are taking the hardest hit, given their greater exposure to the decline in external demand in other advanced economies, especially for automobiles, electronics, and investment goods. For the group as a whole, real GDP is projected to contract by about 6 percent in 2009, after expanding by about 3½ percent before the crisis in 2007. The Japanese economy is projected to contract by 6¼ percent in 2009, since the yen's strength and tighter credit conditions more generally have added to the problems of the export sector; mild deflation is expected to persist at least through 2010. Given their extreme openness and high dependence on external demand, the other advanced economies in the region––Hong Kong SAR, Korea, Singapore, Taiwan Province of China—will also suffer. Among these economies, Singapore and Hong Kong SAR are particularly exposed, given their importance as global financial centers. Vulnerable corporate and household balance sheets will exacerbate the impact of external shocks in Korea.

Growth in China is expected to slow to about 6½ percent in 2009, half the 13 percent growth rate recorded precrisis in 2007 but still a strong performance given the global context. Two factors are helping sustain the momentum despite the collapse in exports. First, the export sector

Table 2.2. Selected Asian Economies: Real GDP, Consumer Prices, and Current Account Balance
(Annual percent change, unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Emerging Asia[3]	**9.8**	**6.8**	**3.3**	**5.3**	**4.9**	**7.0**	**2.5**	**2.4**	**6.6**	**5.5**	**6.3**	**5.8**
China	13.0	9.0	6.5	7.5	4.8	5.9	0.1	0.7	11.0	10.0	10.3	9.3
South Asia[4]	**8.7**	**7.0**	**4.3**	**5.3**	**6.9**	**9.0**	**7.7**	**4.5**	**–1.4**	**–3.4**	**–2.6**	**–2.7**
India	9.3	7.3	4.5	5.6	6.4	8.3	6.3	4.0	–1.0	–2.8	–2.5	–2.6
Pakistan	6.0	6.0	2.5	3.5	7.8	12.0	20.0	6.0	–4.8	–8.4	–5.9	–4.9
Bangladesh	6.3	5.6	5.0	5.4	9.1	8.4	6.4	6.1	1.1	0.9	0.9	–0.1
ASEAN–5	**6.3**	**4.9**	**0.0**	**2.3**	**4.3**	**9.2**	**3.6**	**4.5**	**4.9**	**2.8**	**2.2**	**1.5**
Indonesia	6.3	6.1	2.5	3.5	6.0	9.8	6.1	5.9	2.4	0.1	–0.4	–0.7
Thailand	4.9	2.6	–3.0	1.0	2.2	5.5	0.5	3.4	5.7	–0.1	0.6	0.2
Philippines	7.2	4.6	0.0	1.0	2.8	9.3	3.4	4.5	4.9	2.5	2.3	1.6
Malaysia	6.3	4.6	–3.5	1.3	2.0	5.4	0.9	2.5	15.4	17.4	12.9	10.7
Vietnam	8.5	6.2	3.3	4.0	8.3	23.1	6.0	5.0	–9.8	–9.4	–4.8	–4.2
Newly industrialized Asian economies	**5.7**	**1.5**	**–5.6**	**0.8**	**2.2**	**4.5**	**0.4**	**2.0**	**5.7**	**4.4**	**6.3**	**6.1**
Korea	5.1	2.2	–4.0	1.5	2.5	4.7	1.7	3.0	0.6	–0.7	2.9	3.0
Taiwan Province of China	5.7	0.1	–7.5	0.0	1.8	3.5	–2.0	1.0	8.6	6.4	9.7	10.7
Hong Kong SAR	6.4	2.5	–4.5	0.5	2.0	4.3	1.0	1.0	12.3	14.2	7.2	5.2
Singapore	7.8	1.1	–10.0	–0.1	2.1	6.5	0.0	1.1	23.5	14.8	13.1	11.2

[1]Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

[2]Percent of GDP.

[3]Consists of developing Asia, the newly industrialized Asian economies, and Mongolia.

[4]Includes Maldives, Nepal, and Sri Lanka.

is a smaller share of the economy, particularly after factoring in its high import content. Second, the government has acted aggressively to provide major fiscal stimulus and monetary easing, which are helping boost consumption and infrastructure investment.

Association of Southeast Asian Nations (ASEAN) economies are being severely hit by the combined effects of lower global demand and tighter credit conditions, although not as harshly as the advanced economies. For the group as a whole, growth is expected to decline from more than 6 percent in 2007 to zero percent in 2009. Although these economies have also been hurt by the drop in global trade, the composition of their exports is less concentrated in the durable goods that have been most affected by the global downturn.

With trade comprising a smaller share of the economy, India, like China, is less exposed to the decline in global demand. Nevertheless, its economy is still suffering from more difficult external financing for firms and banks. Because India has less room to ease macroeconomic policies, growth is expected to decline sharply from more than 9 percent in 2007 to 4½ percent in 2009. The slowdown is primarily a result of weaker investment, reflecting tighter financing conditions and a turn in the domestic credit cycle.

The risks to the outlook for the region remain tilted squarely to the downside. A key concern is that a deeper or longer recession in advanced economies outside Asia will reduce external demand even further, with negative repercussions for exports, investment, and growth. In addition, further deterioration in global financial conditions may additionally tighten financing constraints, hurting financial and corporate sectors in the region. Moreover, the impact of external shocks on the corporate and financial sectors could be larger than currently envisaged because of feedback effects: a combination of slower global demand and difficult external funding conditions would exert growing pressure on corporate Asia, which in turn would

Table 2.3. Advanced Economies: Current Account Positions
(Percent of GDP)

	2007	2008	2009	2010
Advanced economies	**–1.0**	**–1.1**	**–1.0**	**–1.0**
United States	–5.3	–4.7	–2.8	–2.8
Euro area[1]	0.2	–0.7	–1.1	–1.2
Germany	7.5	6.4	2.3	2.4
France	–1.0	–1.6	–0.4	–0.9
Italy	–2.4	–3.2	–3.0	–3.1
Spain	–10.1	–9.6	–5.4	–4.4
Netherlands	6.1	4.4	2.4	2.1
Belgium	1.7	–2.5	–2.4	–3.0
Greece	–14.1	–14.4	–13.5	–12.6
Austria	3.2	2.9	1.3	1.3
Portugal	–9.5	–12.0	–9.1	–8.8
Finland	4.1	2.5	1.0	0.6
Ireland	–5.4	–4.5	–2.7	–1.8
Slovak Republic	–5.4	–6.3	–5.7	–5.0
Slovenia	–4.2	–5.9	–4.0	–5.0
Luxembourg	9.8	9.1	7.6	7.0
Cyprus	–11.6	–18.3	–10.3	–10.1
Malta	–6.1	–6.3	–5.1	–5.2
Japan	4.8	3.2	1.5	1.2
United Kingdom	–2.9	–1.7	–2.0	–1.5
Canada	0.9	0.6	–0.9	–0.7
Korea	0.6	–0.7	2.9	3.0
Australia	–6.3	–4.2	–5.8	–5.3
Taiwan Province of China	8.6	6.4	9.7	10.7
Sweden	8.6	8.3	6.9	7.4
Switzerland	10.1	9.1	7.6	8.1
Hong Kong SAR	12.3	14.2	7.2	5.2
Czech Republic	–3.2	–3.1	–2.7	–3.0
Norway	15.9	18.4	11.0	12.6
Singapore	23.5	14.8	13.1	11.2
Denmark	0.7	0.5	–1.2	–1.1
Israel	2.8	1.2	1.1	0.3
New Zealand	–8.2	–8.9	–7.8	–7.0
Iceland	–15.4	–34.7	0.6	–2.1
Memorandum				
Major advanced economies	–1.4	–1.4	–1.2	–1.3
Euro area[2]	0.4	–0.7	–1.1	–1.1
Newly industrialized Asian economies	5.7	4.4	6.3	6.1

[1]Calculated as the sum of the balances of individual euro area countries.

[2]Corrected for reporting discrepancies in intra-area transactions.

reduce bank credit quality and put further strain on the banking sector.

The principal policy challenges are to cushion the effects of the crisis and achieve a sustained reduction in the region's reliance on exports as a source of growth. These objectives will require rebalancing the region's economies from exports and investment toward private consumption. The first line of defense is to provide vigorous countercyclical support to aggregate demand, along with strong policy actions to ensure financial and corporate sector health. Much has already been done across the region, but in many economies the policy measures introduced thus far may be insufficient to counteract the global slump, and more action may be needed.

Faced with a quickly deteriorating outlook, most economies have aggressively loosened monetary conditions. In Japan, to address the slowdown in growth and the tightening financial conditions, the central bank has cut rates to virtually zero, increased liquidity provision, broadened the range of eligible collateral, and started purchasing commercial paper and bonds to ease corporate funding pressures. In China, the central bank has reduced interest rates and reserve requirements and loosened credit ceilings. In India, the policy rate and reserve requirements have been cut, and large liquidity injections have eased pressure in money markets; foreign exchange liquidity shortages have been alleviated by easing controls on capital inflows and introducing foreign exchange swaps for banks. Other central banks in the region––in Cambodia, Korea, Malaysia, the Philippines, Singapore, and Thailand––have also cut policy (or other relevant) rates or decreased reserve requirements. In addition, they have injected liquidity into strained money markets, drawn on reserves, and boosted available liquidity buffers. Notably, Korea has arranged for foreign exchange swaps with the United States, Japan, and China.

Despite these actions, there is room for additional monetary easing in a number of economies. Policy rates remain high in real terms in India, and further rate cuts would help bolster credit growth. Given the sharp deterioration in activity, additional monetary easing also seems appropriate in economies including China, Korea, and Malaysia. In Japan, with the constraint of zero interest rates, the challenge will be to implement further easing by expanding and broadening the range of instruments that support credit to address tightening financial conditions.

Most economies in Asia have already implemented expansionary fiscal policies. The most ambitious plans have been announced in China and Japan. Nonetheless, there is scope to do more to bolster domestic demand in a number of economies that have fiscal room. In China, further measures to boost consumption would be helpful to rebalance the economy over the medium run as well as to offer short-term support. These could include improvements in public provision of health care and education, pension reform, transfers to lower-income groups, further investments for rural development, and reduction in consumption and income taxes. There is also ample room for additional fiscal support in Singapore and Korea. Room to maneuver is more limited in economies such as India and the Philippines, which already have high levels of public debt. In Japan, the government announced a substantial new stimulus package in early April, which should support activity in 2009 and 2010. With the deficit projected to be close to 10 percent of GDP in 2009 and net debt to exceed 100 percent of GDP, room for additional stimulus is close to being exhausted. Attention should shift now to putting in place an ambitious medium-term plan to secure fiscal sustainability.

In the financial sector, policies need to ensure that systems in the region remain well capitalized and that the risks of a credit crunch are minimized. To preserve financial stability, some economies have extended deposit guarantees (Hong Kong SAR, Malaysia, Singapore, Thailand) or have raised deposit insurance limits (Indonesia, Philippines). A number of economies have announced measures to boost capital in the financial system (India, Japan) and provide credit support to the corporate sector (China, Korea). However, the authorities should be prepared to do more if necessary. More generally, it will be important to ensure that sufficient tools exist to inject public capital into troubled institutions and that the incentive framework encourages early loss recognition, so that difficulties are resolved before they spread to healthy banks. Furthermore, frameworks for corporate restructuring need to be strengthened to deal with corporate stress.

Europe Is Searching for a Coherent Policy Response

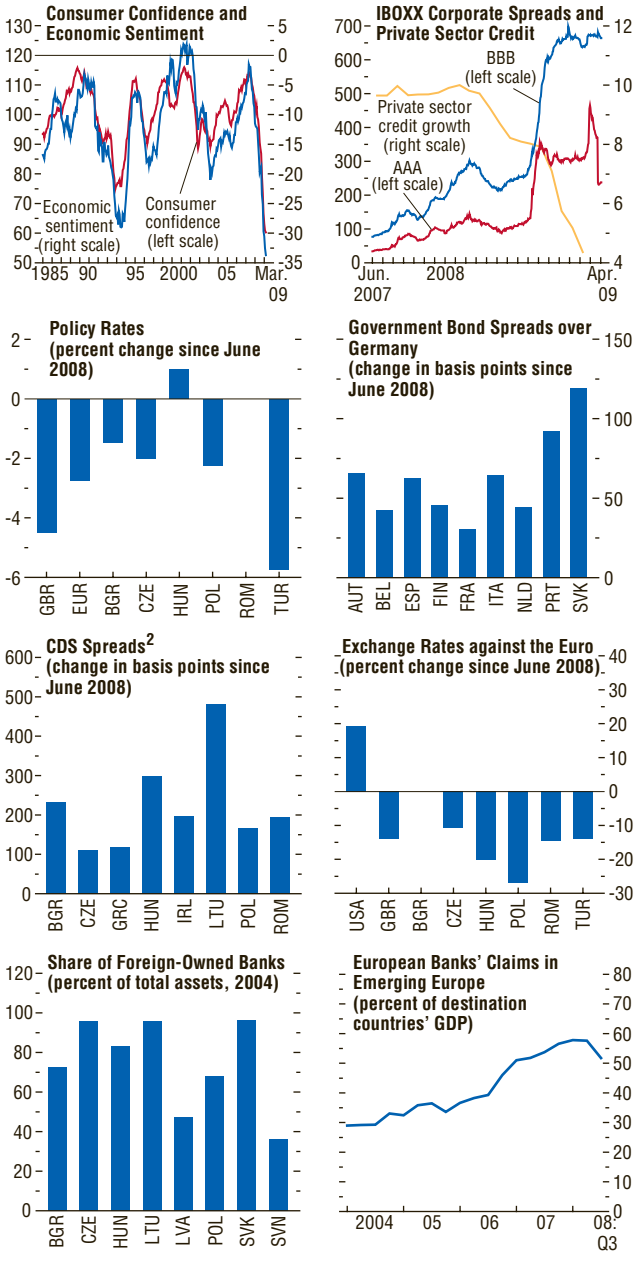
Economic activity in much of advanced Europe had begun to contract already before the September 2008 financial blowout, owing mainly to rising oil prices. Nonetheless, the initial perception was that advanced European economies would escape a full-blown recession, while the emerging economies would continue to grow at a lower but still healthy pace, despite their vulnerabilities. As in Asia, healthier household balance sheets in most major economies and different housing and financial market structures were considered protective factors. However, financial systems suffered a much larger and more sustained shock than expected, macroeconomic policies were slow to react, confidence plunged as households and firms drastically scaled back their expectations about future income, and global trade plummeted (Figure 2.3).

In the advanced economies, fears about growing losses on U.S.-related assets at major European banks caused wholesale markets to freeze in September 2008, with a number of failing banks requiring state intervention. Initially, problems were concentrated in a few banks, and their causes varied. The macroeconomic implications were generally not considered large, and thus fiscal and monetary policy responses were initially limited. But the problems quickly caused broad repercussions because of the close linkages between Europe's major financial institutions and their high leverage.[3] With funding markets frozen, the financial crisis rapidly transformed into a crisis for the real economy during the fourth quarter of 2008. Remedial

[3]Some 16 key cross-border players account for about one-third of European Union (EU) banking assets, hold on average 38 percent of their EU banking assets outside their home countries, and operate in just under half of the other EU countries (see Trichet, 2007).

Figure 2.3. Europe: Developing a Common Response[1]

Economic sentiment has plunged, and borrowing costs have risen sharply, despite widespread monetary easing. Soaring fiscal deficits have led to widening sovereign risk premiums. Amid the flight from risk, exchange rates in emerging Europe have generally depreciated. A key challenge is to avoid a disorderly unwinding of leverage, including for western European banks, given their large cross-border exposure to emerging Europe.



Sources: Bank for International Settlements; European Central Bank; European Commission; Eurostat; Haver Analytics; Thomson Datastream; and IMF staff estimates.

[1]AUT: Austria; BEL: Belgium; BGR: Bulgaria; CZE: Czech Republic; ESP: Spain; EUR: euro area; FIN: Finland; FRA: France; GBR: United Kingdom; GRC: Greece; HUN: Hungary; ITA: Italy; LVA: Latvia; LTU: Lithuania; NLD: Netherlands; POL: Poland; PRT: Portugal; ROM: Romania; SVK: Slovak Republic; SVN: Slovenia; TUR: Turkey; USA: United States.

[2]CDS: Credit default swap.

financial policies were put in place quickly but, as elsewhere, have not been (and still are not) sufficiently comprehensive and coordinated, undermining rather than reinforcing their cross-country effectiveness. Equity prices took a steep fall, and business investment has been slashed. In addition, residential investment has fallen in countries with housing booms (for example, Ireland, Spain, and the United Kingdom). Despite significant support from the large fall in oil prices, consumption declined toward end-2008, and further cutbacks are likely as unemployment spreads.

As a result, most advanced economies have suffered sharp contractions since mid-2008 (see Table 2.1). Real GDP fell at an annual rate of about 6 percent during the fourth quarter in both the euro area and the United Kingdom.

Real GDP is forecast to drop by more than 4 percent in the euro area in 2009, accelerating only gradually thereafter and continuing to fall for several more quarters, making this the worst recession since World War II. Growth is expected to contract by about ½ percent on an annual average basis in 2010; on a fourth-quarter-to-fourth-quarter basis, the turnaround is more apparent, from a drop of more than 3½ percent in real GDP in 2009 to an increase of about ½ percent in 2010. The recession is projected to be particularly severe in Ireland, as its construction boom is painfully reversed. Outside the euro area, the recession is expected to be exceptionally deep in Iceland, which is receiving IMF support following the collapse of its overextended financial sector, and quite severe in the United Kingdom, which is being hit by the end of the boom in real estate and financial activity. As a result of the broad-based fall in output, unemployment rates in the advanced economies are projected to reach more than 10 percent in late 2009 and climb further through 2011.

Economic activity has taken a particularly sharp turn for the worse in many emerging European economies (Table 2.4 and Figure 2.4). Because of their heavy reliance on all kinds of capital inflows—notably funding from Western banks to sustain local credit booms—these econ-

omies have been much more severely affected by the financial crisis than emerging economies in Asia. During the early stages, they held up well, and sovereign credit default swap spreads moved up only gradually. However, as Western export markets contracted and the flight from risk became generalized during fall 2008, the outlook for local exports, growth, and government revenues worsened drastically, causing sovereign spreads to jump from levels of about 50–100 basis points to 150–900 basis points. Hungary, Latvia, and Serbia have received IMF support to sustain their balance of payments, Romania has asked for such support, and Turkey is discussing the issue with the IMF. In addition, Poland is seeking access to a Flexible Credit Line from the IMF. Other countries with smaller exposures to Western short-term capital, including Bulgaria and Lithuania, have struggled with the loss of funding and foreign direct investment (FDI) but, thus far, have not needed IMF support.[4]

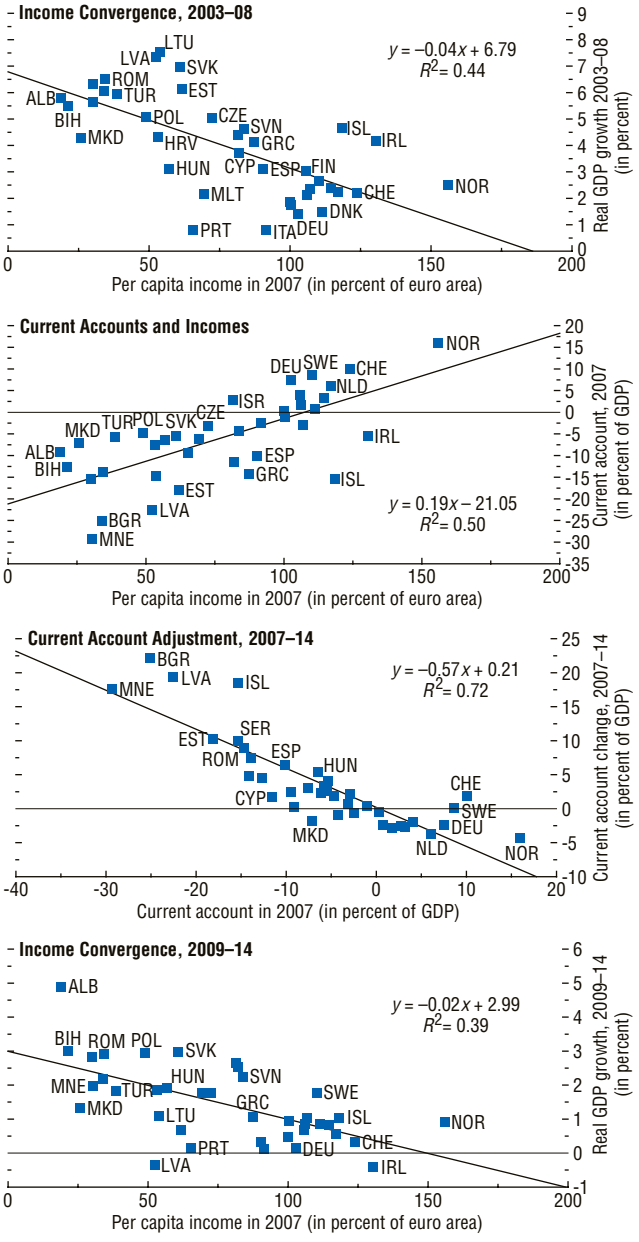
Accordingly, real GDP in the emerging economies is projected to contract by about 3¾ percent in 2009 and recover to about 1 percent in 2010, down from growth rates of 4–7 percent during 2002–07. The reasons for the sharp reversal in performance include, to varying degrees, overheating during pre-recession booms, excessive reliance on short-term foreign capital that funded these booms, ownership of banks by distressed foreign financial institutions, and a large share of manufacturing in activity. The fall in activity is expected to be especially large in the Baltic economies, where fixed exchange rate regimes leave limited the room to maneuver (Box 2.2).

The downside risks around the projections for both advanced and emerging economies are large, particularly for the latter, where external financial constraints could worsen further. The key risk is a disorderly deleveraging of large intra-European cross-border bank exposures.

[4]The European Investment Bank, European Bank for Reconstruction and Development, and World Bank have teamed up to provide financial assistance to strengthen banks and support lending to the real economy.

Figure 2.4. Europe: Subdued Medium-Run Growth Prospects[1]

Emerging European countries have grown faster than their western European peers during 2003–08. This convergence has been helped by significant capital inflows, which have supported large current account deficits in the less rich economies. However, current account deficits and capital inflows will diminish appreciably over the medium run. Growth is expected to be noticeably lower and income convergence slower in all European economies, as illustrated by the smaller intercept and flatter slope of the regression in the bottom panel compared with the top one.



Source: IMF staff calculations.
[1]See Figure 2.3 for country abbreviations. ALB: Albania; BIH: Bosnia and Herzegovina; CHE: Switzerland; CYP: Cyprus; DEU: Germany; DNK: Denmark; EST: Estonia; HRV: Croatia; MKD: Macedonia, FYR; IRL: Ireland; ISL: Iceland; MLT: Malta; MNE: Montenegro; NOR: Norway; SER: Serbia; SWE: Sweden.

Table 2.4. Selected Emerging European Economies: Real GDP, Consumer Prices, and Current Account Balance

(Annual percent change, unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Emerging Europe	**5.4**	**2.9**	**–3.7**	**0.8**	**6.2**	**8.0**	**4.7**	**4.2**	**–7.7**	**–7.6**	**–3.9**	**–3.4**
Turkey	4.7	1.1	–5.1	1.5	8.8	10.4	6.9	6.8	–5.8	–5.7	–1.2	–1.6
Excluding Turkey	5.9	4.1	–2.9	0.3	4.5	6.5	3.3	2.5	–9.0	–8.8	–5.6	–4.4
Baltics	**8.7**	**–0.7**	**–10.6**	**–2.3**	**7.3**	**12.2**	**3.6**	**–1.0**	**–18.0**	**–11.6**	**–5.4**	**–5.4**
Estonia	6.3	–3.6	–10.0	–1.0	6.6	10.4	0.8	–1.3	–18.1	–9.2	–6.5	–5.4
Latvia	10.0	–4.6	–12.0	–2.0	10.1	15.3	3.3	–3.5	–22.6	–13.2	–6.7	–5.5
Lithuania	8.9	3.0	–10.0	–3.0	5.8	11.1	5.1	0.6	–14.6	–11.6	–4.0	–5.3
Central Europe	**5.4**	**3.8**	**–1.3**	**0.9**	**3.7**	**4.6**	**2.4**	**2.6**	**–5.2**	**–6.1**	**–4.3**	**–3.8**
Hungary	1.1	0.6	–3.3	–0.4	7.9	6.1	3.8	2.8	–6.4	–7.8	–3.9	–3.4
Poland	6.7	4.8	–0.7	1.3	2.5	4.2	2.1	2.6	–4.7	–5.5	–4.5	–3.9
Southern and southeastern Europe	**6.1**	**6.1**	**–3.6**	**–0.2**	**5.1**	**8.4**	**4.9**	**3.2**	**–14.2**	**–13.8**	**–8.2**	**–5.5**
Bulgaria	6.2	6.0	–2.0	–1.0	7.6	12.0	3.7	1.3	–25.1	–24.4	–12.3	–3.6
Croatia	5.5	2.4	–3.5	0.3	2.9	6.1	2.5	2.8	–7.6	–9.4	–6.5	–4.1
Romania	6.2	7.1	–4.1	0.0	4.8	7.8	5.9	3.9	–13.9	–12.6	–7.5	–6.5
Memorandum												
Slovak Republic	10.4	6.4	–2.1	1.9	1.9	3.9	1.7	2.3	–5.4	–6.3	–5.7	–5.0
Czech Republic	6.0	3.2	–3.5	0.1	2.9	6.3	1.0	1.6	–3.2	–3.1	–2.7	–3.0

[1]Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

[2]Percent of GDP.

Such an event could make it impossible for many emerging economies to roll over large amounts of short-term debt and could potentially have a similar effect on some advanced economies that have seen a significant widening of sovereign risk premiums. The result could be a financial and real sector collapse in most emerging and a few advanced economies, with major feedback effects on the other economies. However, there are also some upside risks: if EU countries manage to put in place a forceful, comprehensive, and coordinated response to the financial sector travails, confidence and risk-taking might recover faster than expected.

Inflation pressures are subsiding fast, and risks for sustained deflation, although still low, are rising in advanced economies as oil prices have plummeted and demand is slumping. Inflation in 2010—the relevant horizon for policymakers today—is expected to be between ½ and 1½ percent in most advanced economies (see Table 2.1). This is down from 3–4 percent rates in 2008. Accordingly, monetary policy has been eased. The Bank of England moved early, cutting policy rates in successive steps from 5.75 percent in 2007 to 0.5 percent in 2009, and is now moving to less conventional credit-easing measures. The response of the Swedish Riksbank has been similarly aggressive, with the policy rate now also at 1 percent and further cuts expected. The reaction of the European Central Bank (ECB) came later but has since been sizable. Concerned about high inflation pressure, it raised rates in July 2008 to 4.25 percent but then changed its tack, lowering rates on its main refinancing operations to 1.25 percent. However, the effective overnight rate is closer to the 0.25 percent rate charged on the deposit facility. With inflation projected to stay well below the "below but close to 2 percent" objective over the medium run, there is room to further cut the main refinancing rate.

In emerging Europe, inflation rates are also projected to drop notably, from about 8 percent in 2008 to close to 4 percent in 2010. Consistent with the flight from risk, exchange rates have already depreciated sharply in emerging economies with floating currencies, but the effects on

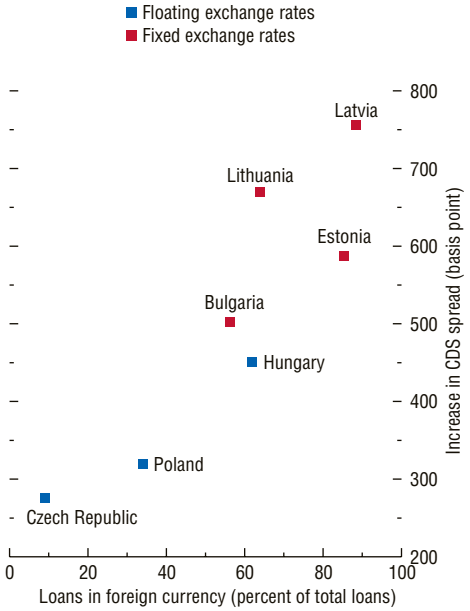
Box 2.2. Vulnerabilities in Emerging Economies

Housing and Credit Boom and Bust

Numerous emerging economies, including several in the central and eastern Europe (CEE) area, are experiencing large increases in country risk premiums and a collapse in property prices. Such a combination can have harsh economic effects, with limited and more expensive access to loans and foreign funds by households and businesses considerably undermining economic activity. If the shocks are accompanied by large currency depreciations, the situation may deteriorate even more in countries that have sizable balance sheet mismatches. Furthermore, even though balance sheets are currently sheltered by managed exchange rate regimes in some countries, uncertainty about the sustainability of these exchange rate policies may be driving up risk premiums. We illustrate this by plotting increases in the credit default swap spreads[1] against the percentage of loans held in foreign currencies[2] for seven CEE countries (first figure).

This box describes the mechanisms underlying the boom-bust cycle in response to changes in finance premiums using an open-economy model structured to represent a generic CEE economy.[3] We consider two types of finance premiums. First, the domestic interbank rates embody an exogenous premium over the world rates when adjusted for expected depreciation or appreciation. Second, households, which are net debtors, use housing wealth as collateral for loans, and the retail lending spread rises in the loan-to-value ratio.

Foreign Exchange Exposure is Strongly Linked to Market Perceived Default Risk, Regardless of the ER Regime



Furthermore, the economy has a sizable foreign debt and a financial system that relies heavily on refinancing from abroad. The import-to-GDP ratio is high because a significant share of imported goods are used to produce goods that are exported. Prices and wages are assumed to be more flexible than in advanced economies. A couple of differences among CEE economies make them more or less vulnerable to external shocks. The severity of the problems may be affected, in particular, by (1) the proportion of debt in foreign currencies, and (2) the monetary policy regime. We show how performance might change as the two characteristics vary.

To set relevant initial conditions, we first simulate a housing boom. Real estate prices rise above their fundamental levels and are believed to stay high permanently. This results in lower loan-to-value ratios and reduced risk premiums on household borrowing. Both lower financing

The authors of this box are Jaromir Benes, Kevin Clinton, and Douglas Laxton.

[1] Increases in five-year corporate euro CDS spreads (Bulgaria: five-year corporate U.S. dollar CDS spreads) between January 2008 and February 2009, based on data from Bloomberg Financial Markets and IMF staff estimates.

[2]Bank loans to the nonfinancial sector, including households, as of December 2008 (Hungary: 2008:Q4), based on data from the national central banks and IMF staff estimates.

[3]The details of the model can be found in Benes, Clinton, and Laxton, forthcoming.

Box 2.2 *(continued)*

costs and expectations of future capital gains boost consumption, further investment in real estate, and thereby GDP. Increases in demand cause a rise in imports, which is financed by foreign capital inflows. Foreign debt, therefore, builds up over time. The economy eventually becomes vulnerable to domestic and foreign disturbances. In the simulations, a country risk premium shock is imposed during the collapse in house prices. A house prices collapse triggered by a world financial crises reduces the value of collateral and raises the households' finance premium. At the same time, the country as a whole faces increases in the risk premium in international financial markets.

House Price Correction

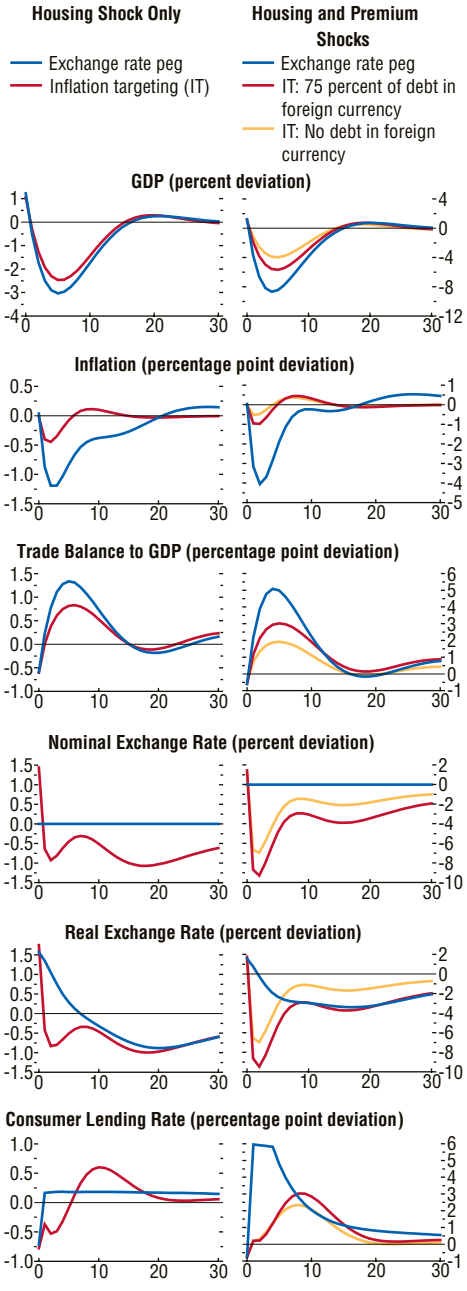
We first show the simulated response to a correction in house prices under a fixed and a flexible exchange rate (second figure, first column). The economy starts with a stock of external liabilities equal to 100 percent of GDP, of which 75 percent is denominated in foreign currency. At the peak, house prices are, by assumption, 20 percent above the pre-shock level, and the correction occurs over the next four quarters.[4] GDP declines for a prolonged period as the increased cost of credit, arising from the increase in the loan-to-value ratio, amplifies the effect on spending of the perceived loss in wealth. This financial sector feedback is known as the *financial accelerator*.[5] Lower demand translates into a drop in inflation. Because the decline in income reduces demand for imports, the trade balance improves. These changes apply whether the exchange rate is fixed or flexible. The currency regime nevertheless makes a difference in other aspects of the adjustment process. The house price correction implies a depreciation under the floating rate regime, since the central bank would reduce

[4] For instance, apartment prices in Riga, Latvia, fell by 35 percent year over year in 2008, compared with a 62 percent rise in 2006, according to Global Property Guide (available at www.globalpropertyguide.com).

[5] See, for example, Bernanke (2007).

Model Simulations

(Deviations from control; x-axis in quarters)



Source: IMF staff estimates.

its interest rate, given the lower level of output and inflation.[6] Improvements in the trade balance work to balance the increased cost of debt service implied by currency depreciation. The depreciation also results in a smaller decline in inflation, such that inflation does not move far below target.

In the fixed rate case, there can be no inflation target as such, and there is a substantial drop in inflation below the control value. This is reflected in a steady real depreciation while the nominal exchange rate remains fixed. In effect, the real exchange rate has to decline for a while. This happens quickly with the flexible rate, but slowly, via the inflation differential, under the fixed exchange rate. Wages and prices in the CEE economies are relatively flexible; if they were as inflexible as in advanced economies, the decline in the real rate and output would be more prolonged.[7] The lending rate rises immediately under the peg, as it fully reflects the increased finance premium after the collateral value falls. In the flexible case, a drop in the policy rate moderates the initial increase in the cost of credit. As output recovers, policy tightens, and for a while the rates overshoot the long-run levels.

House Price Correction Combined with Country Risk Premium Shock

To illustrate the impact of a shock to the confidence of international lenders, occurring at the same time as the housing bust, we simulate an increase in the country risk premium of 500 basis points for a period of four quarters;[8] the increase then tapers off gradually (second figure, second column).

For the flexible exchange rate, two cases are shown: 75 percent of external debt in foreign currency versus all debt in local currency only. The bottom panel of the second column shows the effects on the consumer lending rate. Under the flexible exchange rate, the increase is greatly moderated by a cut in the policy rate, which responds to the weakening economy.

In the first case, the decline in GDP, aggravated by higher lending rates, is very large. At the trough, after four quarters, it is almost 6 percent below its control value. The recovery takes almost four years. Inflation dips for a few quarters, and then fluctuates around the target rate. The trade balance as a proportion of GDP moves into a large and prolonged surplus relative to the control. This is a necessary part of the adjustment process. The depreciation raises the domestic currency cost of foreign debt service and erodes the services account of the balance of payments. At the same time, the deleveraging process reduces the capital inflow. To maintain balance of payments equilibrium in the face of these changes, net receipts from trade must rise. The increase is brought about by the decline in domestic spending and by currency depreciation.

The real exchange rate drops by almost 10 percent relative to the control after two quarters. This reflects Dornbusch-type overshooting, in response to the increased country risk premium and the cut in the policy rate.[9] The currency then appreciates slowly, remaining below the control for many quarters. The initial depreciation implies a sharp deterioration in the national balance sheet such that the domes-

[6]The household risk premium does not affect the wholesale interbank market or the exchange market in this model.

[7]For instance, the model-implied sacrifice ratio is about 1.4. For the evidence on real and nominal rigidities in new EU member states, see, for example, Gray and others (2007).

[8] This compares well, for example, to the increases observed in the levels of CDS spreads for some of the CEE countries. The five-year spreads have recently risen to as high as 300 basis points (Czech Republic), 600 basis points (Hungary), and more than 1,000 basis points (Latvia) from single- or double-digit levels in 2007, according to data from Bloomberg Financial Markets.

[9]The model contains an uncovered interest parity condition, which requires the exchange rate to fall below its long-run value when monetary policy keeps the interbank rate below its equilibrium value. Expectations that the domestic currency will rise provide the necessary incentive to hold it.

Box 2.2 *(concluded)*

tic currency value of the foreign debt rises by about 7.5 percent of annual GDP.

When all debt is denominated in local currency only, there are no adverse valuation effects on domestic wealth. The decline in GDP is much milder—about 4 percent at the trough. The implications for inflation and the trade balance are also less pronounced.

Under the pegged exchange rate, there is no immediate impact on the value of the debt, regardless of its currency composition. An important assumption of the simulation is that the peg is fully credible; absent credibility, the shock would be more damaging. Even with perfect credibility, the negative impact of the combined shock on GDP is larger than under the flexible exchange rate with high foreign currency debt. And the effect on inflation is much larger, as the fixed exchange rate forces the required real depreciation to take place through a decline in prices.

The difference between the two exchange rate regimes is much more marked for the combined shock than for the housing shock alone. This is because the cost of household borrowing bears the full weight of the increase in the country risk premium: the decision to maintain the level of the exchange rate fixed does not allow a reduction in the policy rate.

Policy Implications

The simulation experiments suggest that key macroeconomic variables respond to finance premium shocks better under the flexible exchange rate than under the fixed rate. This does not mean, however, that flexibility is necessarily the better option.

Following an adverse shock in the foreign exchange market, the central bank faces a choice between stabilizing the exchange rate and controlling interest rates. Under the first option, the high interest rates raise the cost of borrowing and increase the intertemporal price of expenditures today relative to tomorrow. This reduces domestic demand, with expenditures cut back both on domestic output and imports. Under the other option, the intratemporal price of domestic output relative to foreign goods drops, redirecting demand away from imports and toward domestic products, which improves export competitiveness. Judged this way, control of interest rates outperforms stabilization of the exchange rate.

This analysis, however, does not consider possible sources of instability that a flexible rate might encounter, particularly if the adjustment is large and rapid. Thin markets, currency mismatches in the balance sheets of households and businesses, or a preponderance of short-term foreign debt are cases in point.

In this sense, the model simulations are more informative about preventive measures than about actions that might be taken once a crisis starts. One of the main lessons for the future is to encourage more prudent behavior by avoiding rapid accumulation of debt and by discouraging asset-liability mismatches. The negative results for the exogenous shocks to risk premiums emphasize the role the advanced industrialized world will play in the resolution of the crisis: restoration of financial stability in the major financial centers will help ease the current severe financing constraints facing emerging market economies.

inflation are being contained by widening output gaps. Because pressures for currencies to depreciate have been (and remain) high and could destabilize household or corporate balance sheets in countries with significant foreign-currency-denominated lending, some central banks have opted to keep rates unchanged or have lowered interest rates only gradually (for example, Hungary). In Turkey, where household balance sheets are relatively less exposed to exchange rate depreciations, the central bank has lowered rates quite forcefully.

Fiscal policy has now joined monetary policy in combating the recession in many advanced

economies, even though a number are facing constraints from tough capital market conditions. Beyond the operation of automatic stabilizers, the European Economic Recovery Plan calls for discretionary fiscal measures to be taken mostly at the national level and is targeted to provide stimulus of about 1½ percent of EU GDP, with roughly 1 percent foreseen for 2009 and ½ percent in 2010. Thus far, EU countries have generally lived up to their commitments under this plan, which are conditional on initial deficits, public debt levels, and other factors. Hence, the general government deficit of euro area countries is projected to rise from about ¾ percent of GDP in 2007 to 5½ percent in 2009 and 6 percent in 2010 (Table A8). Stimulus is coming mainly from euro area countries that took advantage of the previous cyclical upswing to move their budgets close to balance or into surplus by 2007, for example, Cyprus, Finland, Germany, and Spain. Meanwhile, Belgium, Ireland, and Spain have seen a sharp widening of sovereign spreads—reflecting (to varying degrees) concern about contingent liabilities related to policies to support the financial sector—which limits their future fiscal options. Stimulus is expected to be small or nonexistent in Greece, Italy, and Portugal—countries with deficits close to 3 percent of GDP in 2008 and high public debt or elevated country risk premiums. Advanced economies outside the euro area are projected to record small deficits or surpluses, with the exception of Iceland and the United Kingdom. The U.K. deficit is projected to reach 11 percent of GDP in 2010, reflecting mainly automatic stabilizers and asset-price-related revenue shortfalls rather than discretionary stimulus.

In emerging Europe, countries are faced with an unprecedented widening of their sovereign risk premiums. With access to funding heavily restricted, most are not allowing automatic stabilizers to play freely, and none are implementing major stimulus.

Financial policies have generally been forceful and innovative in addressing liquidity strains but have lagged with respect to addressing solvency concerns and cross-country coordination. As elsewhere, this reflects a challenging political economy. Central banks are providing liquidity at longer maturities and are accepting a wide range of collateral in repurchase operations, including assets for which markets have essentially ceased to operate. In addition, most countries have adopted measures to guarantee wholesale funding and provide support for recapitalizing banks deemed viable. However, U.S.-originated toxic assets still must be cleaned off bank balance sheets, which is key to rebuilding confidence in banking systems. To achieve this, countries will need to devise and coordinate pricing mechanisms, and the European Commission and the ECB have offered guidance on how to achieve this. However, coordination has been far from optimal. Policymakers were repeatedly surprised by the virulence of the crisis and succumbed to national reflexes to "go it alone" in cobbling together responses that undermined rather than enhanced other countries' interventions, failing to live up to the May 2008 Economic and Financial Affairs Council (ECOFIN) commitments for crisis prevention, management, and resolution.[5]

Stanching the much broader problems that are building in Europe's financial systems—notably those related to deteriorating prospects for loan books, particularly for exposures to emerging Europe—requires a far more forceful and coordinated financial policy response to the crisis. There is an urgent need to build new or enhance existing EU schemes for mutual assistance so as to facilitate a rapid, common

[5]For example, blanket guarantees or public money for bank recapitalization provided by some European governments undermined bank business prospects in other countries, thus compelling their authorities to implement similar measures, putting severe strain on sovereign balance sheets and risk premiums. At present, pressure on banks is building to serve national markets first. These come in various guises: statements by the authorities, limits on the dividends subsidiaries are permitted to pay their parent companies abroad, threats to exclude subsidiaries or branches of foreign banks from participation in domestic monetary policy operations if credit lines are not maintained, and the establishment of national interbank clearinghouses.

response to emerging payment difficulties in all EU countries and ideally in any country in the neighborhood of the European Union. This is essential to avoid disorderly adjustment in one country that can drag down others. The recent EU decision to double the limit on its emergency lending (to 50 billion euros) for member countries from emerging Europe is a welcome step in this direction.

Looking further ahead, the current crisis has underlined the importance of strengthening institutional mechanisms for economic policy coordination and integration across the European Union. A key lesson is that the EU financial stability framework needs to be revamped. Useful steps in this direction were proposed in the February 25, 2009, report of the de Larosière Group. Ultimately, what is needed is an institutional structure for regulation and supervision that is firmly grounded on the principle of joint responsibility and accountability for financial stability, including the sharing of crisis-related financial burdens. Otherwise, deleterious national reflexes will continue to prevail during crises.

The CIS Economies Are Suffering a Triple Blow

Among all the regions of the global economy, the CIS countries are forecast to experience the largest reversal of economic fortune over the near term. The reason is that their economies are being badly hit by three major shocks: the financial turbulence, which has greatly curtailed access to external funding; slumping demand from advanced economies; and the related fall in commodity prices, notably for energy.

The large direct impact of the financial market turmoil on CIS economies reflects the abrupt reversal of foreign funding to their largest nonfinancial firms and, more important, their banking systems (Figure 2.5). Prior to the crisis, all but a few economies with less externally linked financial sectors (Azerbaijan, Tajikistan, Turkmenistan, Uzbekistan) relied significantly on external funding to sustain domestic borrowing that far outstripped domestic demand for bonds or deposits. Soon after the crisis struck, both nonfinancial firms and banks found it very difficult to renew funding from investors, who steered clear of anything but the safest assets. Adding to the pressure, households began to switch from domestic- to foreign-currency-denominated assets. Russia, Kazakhstan, Belarus, and Ukraine were hit hard, with the first two drawing down large amounts of foreign currency reserves to buffer the impact of the shock on the exchange rate. These economies are expected to have only very limited access to external financing over the near term, with the exception of Russia, which should be able to better sustain rollover rates. Belarus and Ukraine have faced difficulties meeting their external obligations and have received IMF financing; Armenia and Georgia are also receiving IMF support, although Georgia's arrangement predates the financial crisis.

The beginning of the financial crisis coincided with slumping prospects for exports and commodity prices because of rapidly weakening activity in the advanced economies. This has added to the pressure faced by CIS economies with open banking systems and severely undercut growth prospects for the commodity exporters, including Russia, Kazakhstan, and Ukraine, but also the less open economies, for example, Turkmenistan. Other countries, including the Kyrgyz Republic, Tajikistan, and Uzbekistan, are expected to suffer from falling foreign remittances, particularly from migrant workers in Russia. The current account balance for the area as a whole is expected to run a zero balance in 2009, a major switch from posting a large current account surplus in 2007–08 (Table 2.5). However, prospects differ noticeably between energy exporters and importers: the former are projected to see large current account surpluses evaporate because of falling commodity prices, while the latter see a sharp narrowing of their external deficits because of tightening financing conditions.

Although many CIS economies are better positioned to weather a crisis than they were

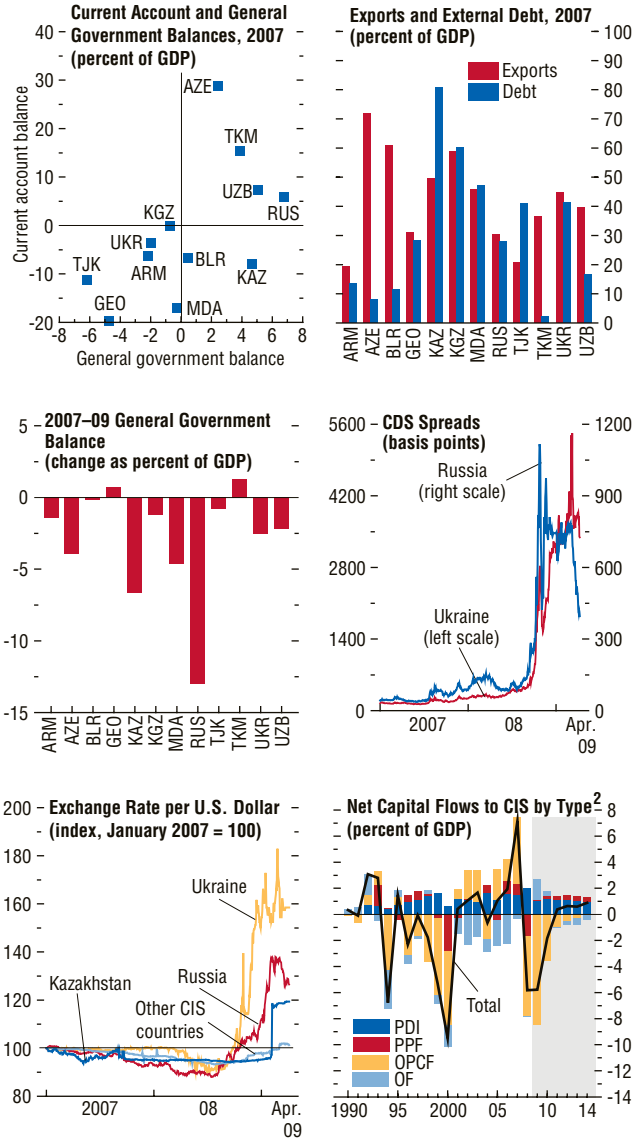
in the aftermath of Russia's 1998 debt default, the fallout will nonetheless be severe. Real GDP in the region, which expanded by 8½ percent in 2007, is projected to contract by just over 5 percent in 2009, the lowest rate among all emerging regions. In 2010, growth is expected to rebound to more than 1 percent. With currencies under pressure, inflation is expected to remain close to double digits in the net energy exporters, despite slowing activity. Inflation pressures are expected to recede more quickly for the net energy importers.

The key challenge facing policymakers in the CIS is to strike the right balance between using macroeconomic policies to buffer the effects of net capital outflows on activity and maintaining confidence in local currencies. With most countries operating under pegged exchange rate regimes, monetary policymakers have had to choose between drawing down reserves, raising policy rates to defend pegs, and allowing exchange rates to depreciate. Countries that could afford to, including Russia and Kazakhstan, initially drew down foreign exchange reserves. Faced with very strong pressures, however, they have since changed their tack: Russia has allowed the ruble to depreciate substantially below its earlier band and has raised interest rates, while Kazakhstan has opted for a step devaluation of some 18 percent (see Figure 2.5). Other countries, including Ukraine and Belarus, experienced large currency depreciations early in the crisis.

The problem these economies face is that rapid currency depreciation raises the effective debt burden on nonfinancial firms that have borrowed in foreign currency. In fact, the share of foreign-currency-denominated credit in domestic bank credit stretches from close to 30 percent in Belarus and Russia, to about 50 percent in Kazakhstan and Ukraine, and to some 70 percent in Georgia. Meeting these foreign currency obligations as exchange rates depreciate has required major cutbacks in investment and employment in several of these economies. By the same token, defaults would further exacerbate already intense strains on

Figure 2.5. Commonwealth of Independent States (CIS): Struggling with Capital Outflows[1]

Financial stress has seriously hit most CIS economies. Even those with current account and budget surpluses have suffered, mainly because of their external debt liabilities and slumping prices for energy exports. Countries that have room to do so are loosening fiscal policy. But with rising sovereign spreads, the room for fiscal stimulus has become limited. Exchange rates are depreciating. Capital flows will take many years to recover from the shock of the crisis.



Sources: Thomson Datastream; and IMF staff estimates.

[1]ARM: Armenia; AZE: Azerbaijan; BLR: Belarus; GEO: Georgia; KAZ: Kazakhstan; KGZ: Kyrgyz Republic; MDA: Moldova; RUS: Russia; TJK: Tajikistan; TKM: Turkmenistan; UKR: Ukraine; UZB: Uzbekistan.

[2]PDI: private direct investment; PPF: private portfolio flows; OPCF: other private capital flows; OF: official flows.

Table 2.5. Selected Commonwealth of Independent States Economies: Real GDP, Consumer Prices, and Current Account Balance

(Annual percent change, unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Commonwealth of Independent States	**8.6**	**5.5**	**–5.1**	**1.2**	**9.7**	**15.6**	**12.6**	**9.5**	**4.2**	**5.0**	**0.1**	**1.5**
Russia	8.1	5.6	–6.0	0.5	9.0	14.1	12.9	9.9	5.9	6.1	0.5	1.4
Ukraine	7.9	2.1	–8.0	1.0	12.8	25.2	16.8	10.0	–3.7	–7.2	0.6	1.4
Kazakhstan	8.9	3.2	–2.0	1.5	10.8	17.2	9.5	8.7	–7.8	5.3	–6.4	1.1
Belarus	8.6	10.0	–4.3	1.6	8.4	14.8	12.6	6.0	–6.8	–8.4	–8.1	–5.6
Turkmenistan	11.6	9.8	6.9	7.0	6.3	15.0	10.0	8.0	15.4	19.6	15.7	9.2
Azerbaijan	23.4	11.6	2.5	12.3	16.6	20.8	4.0	7.0	28.8	35.5	10.8	18.4
Low-income CIS countries	**14.3**	**8.8**	**2.7**	**7.2**	**12.6**	**15.9**	**7.4**	**7.9**	**8.1**	**12.0**	**1.5**	**5.2**
Armenia	13.8	6.8	–5.0	0.0	4.4	9.0	3.6	7.2	–6.4	–12.6	–11.5	–11.0
Georgia	12.4	2.0	1.0	3.0	9.2	10.0	5.0	6.5	–19.6	–22.6	–16.4	–16.7
Kyrgyz Republic	8.5	7.6	0.9	2.9	10.2	24.5	12.4	8.6	–0.2	–6.5	–6.3	–8.4
Moldova	4.0	7.2	–3.4	0.0	12.4	12.7	2.6	4.7	–17.0	–19.4	–19.4	–16.6
Tajikistan	7.8	7.9	2.0	3.0	13.2	20.4	11.9	11.5	–11.2	–8.8	–9.7	–8.3
Uzbekistan	9.5	9.0	7.0	7.0	12.3	12.7	12.5	9.5	7.3	13.6	7.7	6.8
Memorandum												
Net energy exporters[3]	8.6	5.8	–4.9	1.2	9.4	14.5	12.3	9.7	5.6	7.0	0.7	2.2
Net energy importers[4]	8.4	4.3	–6.1	1.3	11.4	21.3	14.2	8.7	–5.5	–8.7	–4.1	–2.8

[1]Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

[2]Percent of GDP.

[3]Includes Azerbaijan, Kazakhstan, Russia, Turkmenistan, and Uzbekistan.

[4]Includes Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Ukraine.

bank balance sheets and diminish prospects for renewed credit growth.

In these circumstances, public support for the banking system is critical. Countries whose banking sectors are struggling with the need to roll over foreign debt—for example, Belarus, Georgia, Kazakhstan, Russia, and Ukraine––have already deployed remedial measures. These include provision by the central banks of ample liquidity, public guarantees, funding for recapitalization (including from international financial institutions), and nationalization. It will be crucial to carefully assess bank balance sheets with a view to writing off bad assets in a proactive manner, determining which banks have sound medium-run prospects, and replenishing their capital as needed, drawing on budgetary resources rather than central bank support.

With significant public support needed for banks and difficult conditions in capital markets, room for fiscal policy stimulus is limited in most CIS countries. Belarus and Ukraine have needed to tighten. Georgia and the Kyrgyz Republic can afford to let automatic stabilizers work, provided sufficient donor support is forthcoming. Azerbaijan, Kazakhstan, Russia, and Uzbekistan––all of which posted fiscal surpluses ahead of the crisis—have allowed automatic stabilizers to operate and have eased fiscal policy to sustain growth.

Other Advanced Economies Are Dealing with Adverse Terms-of-Trade Shocks

The slump in demand in the United States and Asia and the drop in commodity prices are weighing on activity in Canada, Australia, and New Zealand. Households are also suffering wealth reduction, as equity markets and, to a lesser extent, house prices have fallen after rapid rises through 2007. These economies have benefited in recent years from highly favorable terms of trade, owing mainly to high prices for energy, minerals, and food exports. This has

allowed these economies to grow strongly: average growth rates in the five years before 2008 typically were in the range of 2½–4 percent.

With lower commodity prices, diminished household wealth, and prospects for weak export demand from the United States, Europe, and Asia, projections for 2009 envisage that output in Canada, Australia, and New Zealand will decline moderately in 2009 before picking up in 2010 (see Table 2.1). Downside risks include the possibility of more severe declines in world demand and elevated spreads on external finance, owing to increased risk aversion by foreign lenders. Risks seem greater in Australia and New Zealand, due to their relatively high levels of external liabilities: by end-2008, net foreign liabilities for Australia and New Zealand were over 60 and 90 percent of income, respectively, although most debt is in local currency or hedged.

Fortunately, conservative monetary and fiscal policy management in these economies now leave policymakers better placed than those in other economies to mitigate further declines in demand. Policy rates have been cut rapidly and can be cut still further. These cuts and terms-of-trade losses have led the exchange rates to depreciate substantially in nominal terms, so that commodity revenues in domestic currency have not declined nearly as much as world prices (Figure 2.6). Initiatives by central banks and governments, in the form of guarantees on deposits and other bank funding, have so far supported foreign credit flows, as have other measures to stabilize the financial systems. After years of running surpluses, fiscal positions are robust, and substantial fiscal stimulus is being provided. However, owing to relatively high dependence on demand from the United States and Asia and on external financing, there are limits to what domestic policy measures can achieve.

Latin America and the Caribbean Face Growing Pressures

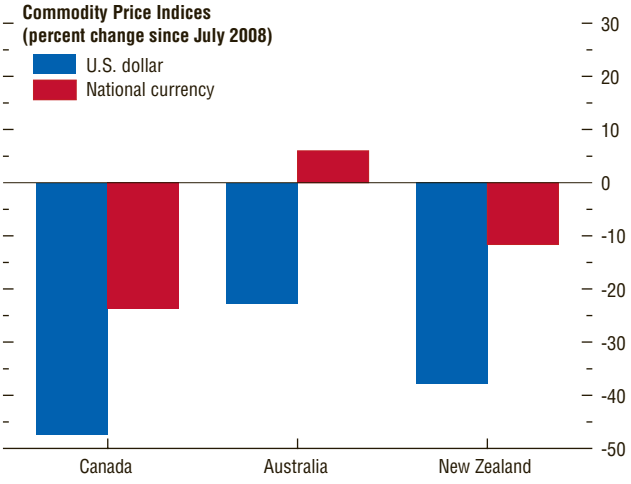
As in the other emerging regions, financial sector stress and deleveraging in advanced economies are raising borrowing costs and reducing capital inflows across Latin America and the Caribbean. In addition, the decline in commodity prices is pounding large economies in the region—Argentina, Brazil, Chile, Mexico, and Venezuela, which are among the world's major exporters of primary products. Moreover, the economic slump in advanced economies—especially the United States, the region's largest trading partner—is depressing external demand and lowering revenues from exports, tourism, and remittances. Hence, the region is suffering from the same trifecta of shocks as the CIS economies. In contrast, however, public and private balance sheets were relatively strong at the outset of the crisis in these economies, which were also less financially linked to advanced economies' banking systems. Thus, the decline in growth is generally projected to be less extreme than in the CIS or emerging European economies.

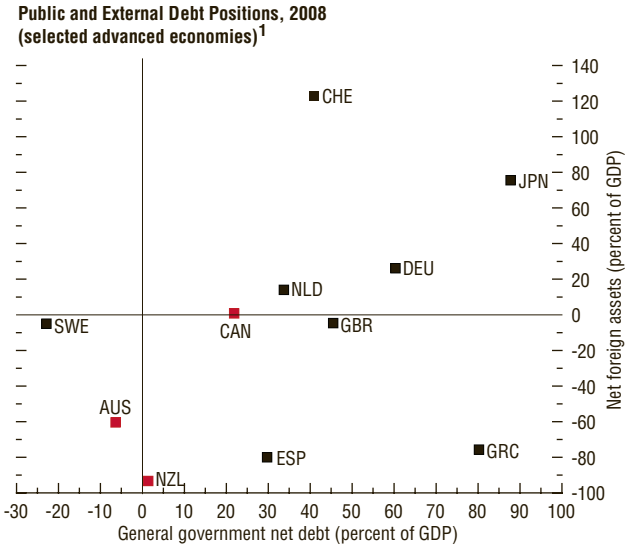
The global financial crisis spread quickly to Latin American and Caribbean markets after mid-September 2008. Local equity markets have sold off heavily, with the largest losses (about 25 percent) in Argentina (Figure 2.7). Domestic currencies have depreciated sharply, especially in Brazil and Mexico, which are large commodity-exporting countries with flexible exchange rate regimes. Local banks' funding costs have increased, particularly for small and medium-size banks. The cost of external borrowing has also risen, since higher spreads on sovereign and corporate debt have been only partially offset by lower yields on U.S. Treasury bills, and capital flows to the region dwindled in the last quarter of 2008. Nonetheless, financial markets have differentiated between borrowers: the cost of financing has increased substantially for some countries (for example, Argentina, Ecuador, and Venezuela) but remains relatively low for other countries with better initial positions and larger policy buffers, including Brazil, Chile, Colombia, Mexico, and Peru. Some of the latter have successfully issued foreign debt in recent months.

Adverse effects on real activity did not take long to surface. The slump in commodity

Figure 2.6. Canada, Australia, and New Zealand: Dealing with Terms-of-Trade Shocks

World commodity prices have fallen substantially from recent highs, but the effects have been mitigated by exchange rate depreciation. Governments have built up considerable room for fiscal stimulus, but larger net private external debt makes Australia and New Zealand more vulnerable to external financing shocks.





Sources: Haver Analytics and IMF staff calculations.

[1]Advanced economies for which 2008 data are available include: Australia (AUS), Canada (CAN), Germany (DEU), Greece (GRC), Japan (JPN), Netherlands (NLD), New Zealand (NZL), Spain (ESP), Sweden (SWE), Switzerland (CHE), and United Kingdom (GBR).

prices has dampened growth prospects for the region's commodity producers (mainly Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Trinidad and Tobago, Uruguay, and Venezuela), although it has helped commodity importers in the Caribbean and Central America. Furthermore, the collapse in growth in advanced economies, particularly in the United States, has lowered demand for exports, weakened tourism, and lowered workers' remittances—key supports in the Caribbean and Central America. With all these factors playing out, credit growth has slowed abruptly, industrial production and exports have collapsed, and consumer confidence has plummeted across the region.

Considering the very challenging external environment, most countries are weathering the storm well relative to earlier experiences with global turbulence, thanks to improvements in policy frameworks and balance sheet positions. Nonetheless, real GDP is forecast to contract by 1½ percent in 2009, before staging a modest recovery in 2010 (Table 2.6). Domestic demand would shrink by about 2¼ percent in 2009, due to more expensive and scarce foreign financing, as well as lower demand for domestic products. With the exchange rate acting as a shock absorber, activity is projected to decline modestly or even expand in a number of inflation-targeting economies (Brazil, Chile, Peru, Uruguay).[6] The contraction is expected to be more severe in Mexico, given its close linkages with the U.S. economy, notwithstanding the mitigating effect of a flexible exchange rate, in Venezuela, and in some very small economies dependent on tourism (Antigua and Barbuda, The Bahamas, Barbados, Jamaica).

As output gaps widen, inflation pressures are expected to subside, despite the pass-through effects of currency depreciation in a number of countries. For the region as a whole, inflation is projected to decline from 8 percent in 2008 to

[6]However, corporate sectors in some of these countries have experienced large losses on off-balance-sheet positions owing to currency depreciation.

about 6½ percent in 2009. At the same time, the region's current account deficit is projected to widen to slightly more than 2 percent in 2009 (from about ¾ percent in 2008), owing to negative terms-of-trade effects.

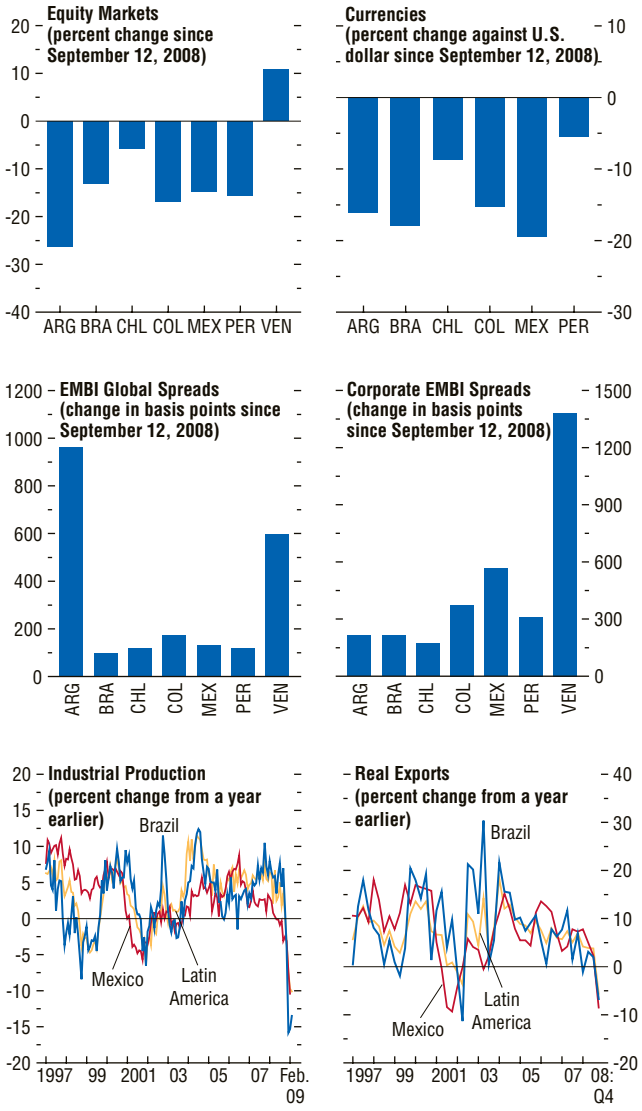
The risks to this outlook are firmly planted to the downside. The main danger is that a protracted financial deleveraging in advanced economies will lead to a prolonged halt in capital inflows, which would require an even sharper domestic adjustment. Given sizable rollover requirements, the corporate and public sectors would be particularly vulnerable in a number of countries. Moreover, a further drop in commodity prices would have a deleterious effect on exports and growth in most countries in the region.

The overarching policy challenge is to cushion the adjustment to the external shocks. Given the region's high degree of openness and dependence on capital flows, however, the potential benefits of countercyclical policies need to be balanced against the potential costs of destabilizing foreign investor confidence, raising external borrowing costs, and reducing capital flows further. Room for policy action differs greatly across countries: economies with better frameworks and larger buffers will be able to offset the effects of the global crisis to varying degrees, whereas other economies may be forced to tighten policies to avoid instability.

The task of monetary and exchange rate policy is particularly difficult. The region came into the crisis with relatively high inflation. For the inflation-targeting regimes, inflation was above the target ranges in all cases except Brazil. Faced with negative shocks to capital flows and demand pressure on exchange rates, central banks in these countries refrained from cutting rates until December, when Colombia's central bank lowered its policy rate by 50 basis points. As the sharp deterioration in real activity became increasingly evident and inflation started to decelerate, the central banks of Brazil, Chile, Mexico, and Peru followed suit. Across the region, existing reserve buffers have been used to alleviate currency pressures and smooth the adjustment to the shocks. Balancing

Figure 2.7. Latin America: Pressures Are Growing[1]

The global financial crisis spread quickly to Latin America and the Caribbean, as local equity markets sold off heavily and domestic currencies depreciated. External borrowing costs rose sharply, especially for countries with weaker fundamentals. It did not take long for the crisis to affect real activity. With external demand and commodity prices slumping at the same time, industrial production and exports have plummeted.



Sources: Bloomberg Financial Markets; Haver Analytics; and IMF staff estimates.
[1]ARG: Argentina; BRA: Brazil; CHL: Chile; COL: Colombia; MEX: Mexico; PER: Peru; VEN: Venezuela.

Table 2.6. Selected Western Hemisphere Economies: Real GDP, Consumer Prices, and Current Account Balance

(Annual percent change, unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Western Hemisphere	**5.7**	**4.2**	**–1.5**	**1.6**	**5.4**	**7.9**	**6.6**	**6.2**	**0.4**	**–0.7**	**–2.2**	**–1.6**
South America and Mexico[3]	**5.7**	**4.2**	**–1.6**	**1.6**	**5.3**	**7.7**	**6.7**	**6.3**	**0.7**	**–0.3**	**–1.9**	**–1.3**
Argentina[4]	8.7	7.0	–1.5	0.7	8.8	8.6	6.7	7.3	1.6	1.4	1.0	1.8
Brazil	5.7	5.1	–1.3	2.2	3.6	5.7	4.8	4.0	0.1	–1.8	–1.8	–1.8
Chile	4.7	3.2	0.1	3.0	4.4	8.7	2.9	3.5	4.4	–2.0	–4.8	–5.0
Colombia	7.5	2.5	0.0	1.3	5.5	7.0	5.4	4.0	–2.8	–2.8	–3.9	–3.3
Ecuador	2.5	5.3	–2.0	1.0	2.3	8.4	4.0	3.0	2.3	2.4	–3.5	–2.3
Mexico	3.3	1.3	–3.7	1.0	4.0	5.1	4.8	3.4	–0.8	–1.4	–2.5	–2.2
Peru	8.9	9.8	3.5	4.5	1.8	5.8	4.1	2.5	1.4	–3.3	–3.3	–3.2
Uruguay	7.6	8.9	1.3	2.0	8.1	7.9	7.0	6.7	–0.8	–3.6	–1.7	–2.4
Venezuela	8.4	4.8	–2.2	–0.5	18.7	30.4	36.4	43.5	8.8	12.3	–0.4	4.1
Central America[5]	**6.9**	**4.3**	**1.1**	**1.8**	**6.8**	**11.2**	**5.9**	**5.5**	**–7.0**	**–9.2**	**–6.1**	**–7.1**
The Caribbean[5]	**5.8**	**3.0**	**–0.2**	**1.5**	**6.7**	**11.9**	**4.0**	**5.8**	**–1.5**	**–2.8**	**–5.1**	**–4.1**

[1]Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.
[2]Percent of GDP.
[3]Includes Bolivia and Paraguay.
[4]Private analysts estimate that consumer price index (CPI) inflation has been considerably higher.
[5]The country composition of these regional groups is set out in Table F in the Statistical Appendix.

domestic and external pressures could become more difficult, especially if global financial conditions deteriorate further. Nevertheless, central banks in countries with more flexible exchange rates anchored in credible inflation-targeting frameworks (for example, Brazil, Chile, Colombia, and Mexico) would have room to cut policy rates further, particularly if inflation continues to decelerate rapidly.

Room for fiscal policy to mitigate the adverse effects of the external shocks differs greatly across countries. Slowdowns in activity and declines in commodity prices are projected to weaken fiscal positions across the region in 2009. In countries with high external borrowing costs and large financing requirements, policymakers' ability to conduct countercyclical fiscal policy will be severely limited. In fact, such efforts could backfire through higher borrowing costs and greater loss of reserves. In other countries, existing fiscal room is already being partly used, with stimulus packages announced in a number of countries with lower debt levels, including Brazil, Chile, Mexico, and Peru.

In light of the challenging external environment, the premium is high on preserving the smooth functioning of domestic financial markets. As global banks and foreign investors reduce their exposure to economies in the region, the relative importance of domestic financing will increase. To avoid a full-blown credit crunch, it will be important to maintain stable funding conditions (in domestic currency) and facilitate the flow of credit. Many countries have already taken steps to provide liquidity and support credit flows, especially to the corporate sector (notably in Brazil and Mexico). Several have sought IMF support, including under precautionary arrangements (Costa Rica, El Salvador), and Mexico has secured access to the new Flexible Credit Line. Although domestic financial systems are now more resilient than in the past, the possibility of bank problems cannot be discounted in some cases, given the unfavorable external environment. This calls for continued work on improving financial safety nets and bank resolution frameworks.

Middle Eastern Economies Are Buffering Global Shocks

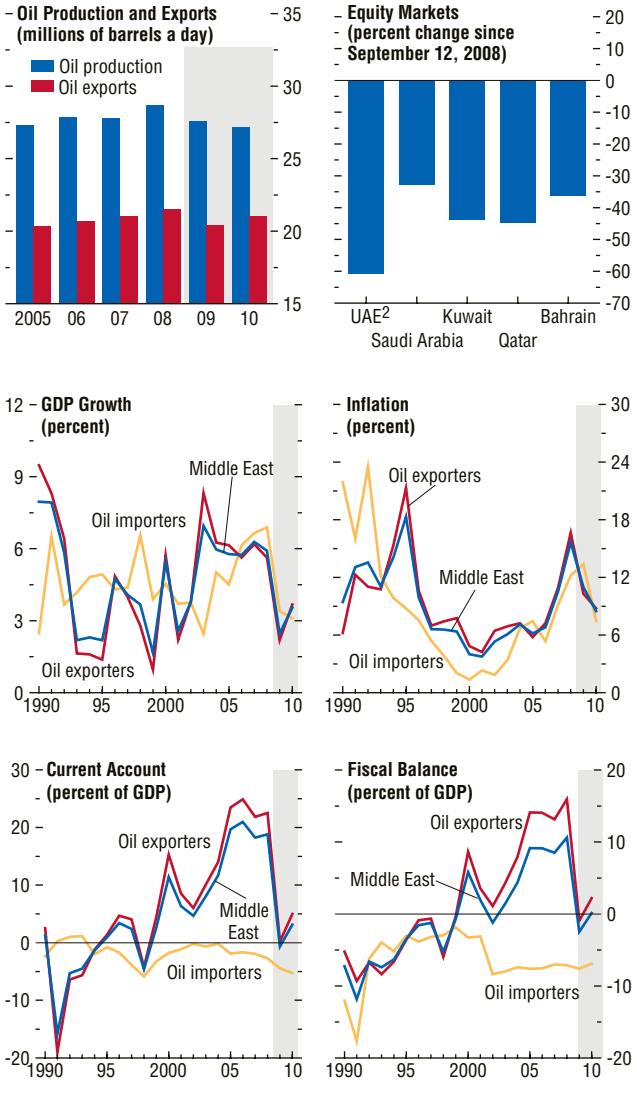
The global crisis has not spared the Middle East. The extremely large fall in the price of oil is hitting the region hard (Figure 2.8). The deterioration in external financing conditions and reversal of capital inflows are also taking a toll: local property and equity markets have come under intense pressure across the region, domestic liquidity conditions have deteriorated, credit spreads have soared for some firms, financial system strains have emerged in a number of countries, and sovereign wealth funds have suffered losses from investments in global markets. Furthermore, the substantial decline in external demand (including from countries in the Gulf region) is dampening export growth, workers' remittances, and tourism revenues (Egypt, Jordan, Lebanon).

Although highly expansionary policies are set to mitigate their impact, these adverse shocks are expected to have severe negative effects on economic activity. In the region as a whole, growth is projected to decline from 6 percent in 2008 to 2½ percent in 2009 (Table 2.7). The slowdown in growth is expected to be broadly similar in oil-producing and non-oil-producing countries,[7] even though the forces behind it are quite different. Among the oil-producing countries, the sharpest slowdown is expected in the United Arab Emirates (UAE), where the exit of external funds (which had entered the country on speculation of a currency revaluation) has contributed to a large contraction in liquidity, a sizable fall in property and equity prices, and substantial pressure in the banking system. A major financial center, UAE will also suffer from the contraction in global finance and merger and acquisition activity. At the other end of the spectrum is Qatar, which is projected to grow by 18 percent in 2009 (up from 16½ percent in 2008), since its production of natural gas is expected to double this year. Among the non-oil-producing

[7]The group includes Bahrain, Islamic Republic of Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, United Arab Emirates, and Republic of Yemen.

Figure 2.8. Middle East: Coping with Lower Oil Prices[1]

The steep decline in the price of oil is hitting the region hard. As external financing conditions have deteriorated and capital inflows reversed, many equity and property markets have suffered substantial losses. Despite supportive policies, growth is projected to slow and inflation pressures to subside considerably in 2009. At the same time, the external and fiscal balances are set to worsen sharply, as oil-exporting countries utilize the buffers accumulated during the boom years to cushion the impact of the crisis.



Sources: Bloomberg Financial Markets; and IMF staff estimates.
[1]Oil exporters include Bahrain, Islamic Republic of Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, United Arab Emirates, and Republic of Yemen. Oil importers include Egypt, Jordan, Lebanon, and Syrian Arab Republic.
[2]United Arab Emirates.

Table 2.7. Selected Middle Eastern Economies: Real GDP, Consumer Prices, and Current Account Balance

(Annual percent change, unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Middle East	**6.3**	**5.9**	**2.5**	**3.5**	**10.5**	**15.6**	**11.0**	**8.5**	**18.2**	**18.8**	**–0.6**	**3.2**
Oil exporters[3]	**6.2**	**5.6**	**2.2**	**3.7**	**10.9**	**16.7**	**10.3**	**8.8**	**21.9**	**22.5**	**0.2**	**5.0**
Iran, I.R. of	7.8	4.5	3.2	3.0	18.4	26.0	18.0	15.0	11.9	5.2	–5.2	–3.6
Saudi Arabia	3.5	4.6	–0.9	2.9	4.1	9.9	5.5	4.5	25.1	28.9	–1.8	4.5
United Arab Emirates	6.3	7.4	–0.6	1.6	11.1	11.5	2.0	3.1	16.1	15.8	–5.6	–1.0
Kuwait	2.5	6.3	–1.1	2.4	5.5	10.5	6.0	4.8	44.7	44.7	25.8	29.3
Mashreq	**6.7**	**6.9**	**3.4**	**3.1**	**9.1**	**12.2**	**13.4**	**7.5**	**–1.9**	**–2.7**	**–4.4**	**–5.3**
Egypt	7.1	7.2	3.6	3.0	11.0	11.7	16.5	8.6	1.4	0.5	–3.0	–4.1
Syrian Arab Republic	4.2	5.2	3.0	2.8	4.7	14.5	7.5	6.0	–3.3	–4.0	–3.1	–4.4
Jordan	6.6	6.0	3.0	4.0	5.4	14.9	4.0	3.6	–16.8	–12.7	–11.2	–10.6
Lebanon	7.5	8.5	3.0	4.0	4.1	10.8	3.6	2.1	–7.1	–11.4	–10.5	–10.0
Memorandum												
Israel	5.4	3.9	–1.7	0.3	0.5	4.7	1.4	0.8	2.8	1.2	1.1	0.3

[1]Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

[2]Percent of GDP.

[3]Includes Bahrain, Islamic Republic of Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, United Arab Emirates, and Republic of Yemen.

countries, Lebanon is set to experience the steepest slowdown, as difficult external liquidity conditions raise the cost of debt servicing and the downturn in the Gulf reduces remittances. At the same time, for the region as a whole, inflation pressures are projected to subside quickly, owing to lower commodity prices, rents, and economic activity. The current account balance of the region is expected to swing into a small deficit. With dwindling surpluses in oil-producing countries, fiscal balances are set to deteriorate substantially, as revenues decline and governments use the buffers accumulated during the recent boom to sustain domestic demand by maintaining ongoing investment projects.

As in the other regions, downside risks to the outlook are considerable. First, a prolonged period of global economic turmoil could prompt oil exporters to reassess their long-term oil price expectations and, consequently, curtail their infrastructure spending plans and oil-production-field investment, which would cloud growth prospects for the entire region. Second, deepening asset price corrections would feed through to corporate and, ultimately, bank balance sheets, placing even greater stress on financial institutions in the region. Third, a more protracted global recession would imply even weaker exports, tourism, and remittances for countries in the region.

Utilizing the buffers accumulated during the boom years, supportive policies are set to cushion the impact of the global crisis. In many countries, high government expenditures are filling the void left by the retrenchment of private sector activity (Kuwait, Libya, Oman, Qatar, Saudi Arabia) and will be essential for growth in the entire region. Regarding monetary policy, central banks across the region have reacted appropriately by providing liquidity, cutting reserve requirements, and lowering interest rates (Egypt, Jordan, Kuwait, Saudi Arabia, UAE). In this respect, countries with pegged exchange rates (Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, UAE) have benefited from the continued monetary easing in the United States. In the financial sector, pressures are building to varying degrees across the region, owing to banks' credit exposure to slumping property and stock markets and tightening external liquidity conditions. In countries that have been most affected so far, policy responses have been relatively swift, with authorities implementing a myriad of measures to shore up confidence

and prevent a systemic banking crisis. These have included introducing blanket deposit insurance (Kuwait, UAE), providing liquidity, and injecting capital into banks (Qatar, Saudi Arabia, UAE). However, additional government support in this area may be needed in a number of countries.

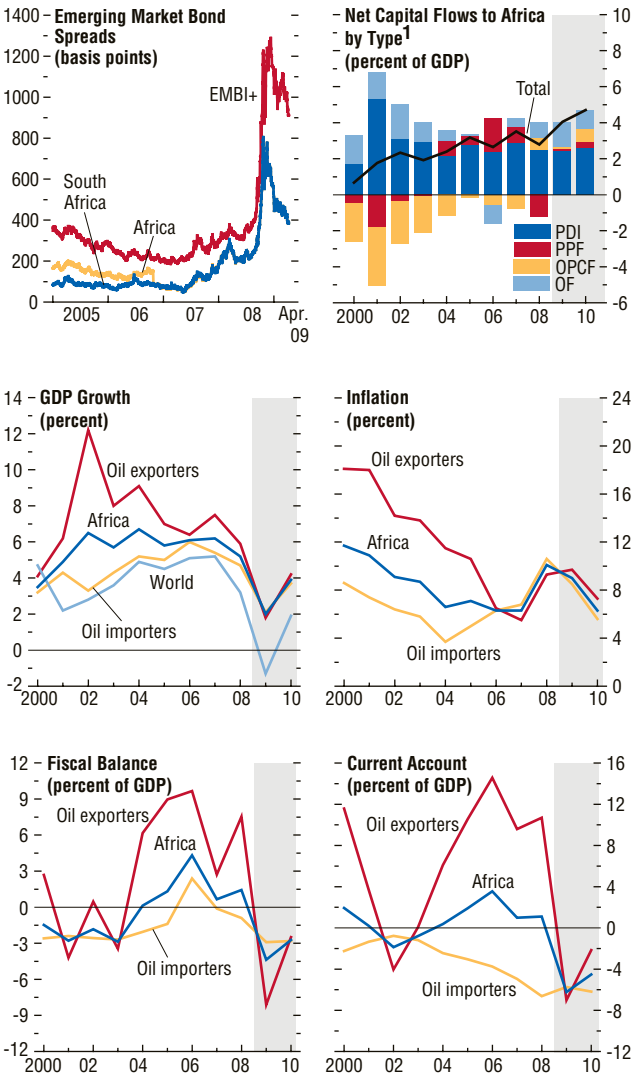
Hard-Won Economic Gains in Africa Are Being Threatened

Relatively weak financial linkages with advanced economies have not shielded African countries from the global economic storm (Figure 2.9). The main shock buffeting the continent is severe deterioration in external growth, which is reducing demand for African exports and curtailing workers' remittances. The sharp fall in commodity prices is also hitting the resource-rich countries in the region hard.[8] Moreover, the tightening of global credit conditions is reducing FDI and reversing portfolio flows, especially to emerging and frontier markets (Ghana, Kenya, Nigeria, South Africa, Tunisia). These external shocks are causing a severe slowdown in economic activity. For the region as a whole, growth is projected to decline from 5¼ in 2008 to 2 percent in 2009 (Table 2.8). On average, the downturn is most pronounced in oil-exporting countries (Angola, Equatorial Guinea) and in key emerging and frontier markets (Botswana, Mauritius, South Africa), which have suffered from all three shocks that are hitting the continent. South Africa's economy, for example, is projected to contract by about ¼ percent in 2009, its lowest growth rate in a decade, as capital outflows are forcing a sharp adjustment in asset prices (mainly in equity, bond, and currency markets) and in real activity.

[8]The group of oil-exporting countries includes Algeria, Angola, Cameroon, Chad, Republic of Congo, Equatorial Guinea, Gabon, Nigeria, and Sudan. The group of non-fuel-exporting countries includes Burkina Faso, Burundi, Democratic Republic of Congo, Guinea, Guinea-Bissau, Malawi, Mali, Mauritania, Mozambique, Namibia, and Sierra Leone.

Figure 2.9. Africa: Hard-Won Gains at Risk

The global financial crisis has not spared Africa, as external demand and commodity prices have plummeted and global credit conditions have tightened, thereby raising the cost of external borrowing and reducing capital inflows to the continent. As a result, growth and inflation are expected to slow considerably. Fiscal and external balances are set to deteriorate sharply, mainly for commodity exporters.



Sources: Bloomberg Financial Markets; and IMF staff calculations.
[1]PDI: private direct investment; PPF: private portfolio flows; OPCF: other private capital flows; OF: official flows.

Table 2.8. Selected African Economies: Real GDP, Consumer Prices, and Current Account Balance

(Annual percent change, unless noted otherwise)

	Real GDP				Consumer Prices[1]				Current Account Balance[2]			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Africa	**6.2**	**5.2**	**2.0**	**3.9**	**6.3**	**10.1**	**9.0**	**6.3**	**1.0**	**1.0**	**–6.5**	**–4.7**
Maghreb	**3.5**	**4.0**	**3.0**	**4.0**	**3.0**	**4.4**	**3.9**	**3.2**	**12.1**	**10.6**	**–2.1**	**–0.8**
Algeria	3.0	3.0	2.1	3.9	3.6	4.5	4.6	3.4	22.6	23.2	–1.7	1.4
Morocco	2.7	5.4	4.4	4.4	2.0	3.9	3.0	2.8	0.2	–5.6	–2.5	–3.0
Tunisia	6.3	4.5	3.3	3.8	3.1	5.0	3.2	3.4	–2.6	–4.5	–2.9	–4.3
Sub-Sahara	**6.9**	**5.5**	**1.7**	**3.8**	**7.2**	**11.7**	**10.4**	**7.1**	**–2.2**	**–1.8**	**–7.7**	**–5.9**
Horn of Africa[3]	**10.7**	**8.9**	**5.1**	**5.7**	**11.3**	**18.9**	**22.1**	**10.2**	**–10.3**	**–8.6**	**–9.4**	**–8.5**
Ethiopia	11.5	11.6	6.5	6.5	15.8	25.3	42.2	13.3	–4.5	–5.8	–5.8	–5.8
Sudan	10.2	6.8	4.0	5.0	8.0	14.3	9.0	8.0	–12.5	–9.3	–11.6	–10.0
Great Lakes[3]	**7.3**	**6.1**	**4.3**	**5.1**	**9.1**	**11.9**	**13.1**	**7.5**	**–4.8**	**–8.1**	**–8.6**	**–9.2**
Congo, Dem. Rep. of	6.3	6.2	2.7	5.5	16.7	18.0	33.9	19.9	–1.5	–15.4	–26.1	–28.7
Kenya	7.0	2.0	3.0	4.0	9.8	13.1	8.3	5.0	–4.1	–6.7	–3.6	–4.6
Tanzania	7.1	7.5	5.0	5.7	7.0	10.3	10.9	5.7	–9.0	–9.7	–8.7	–8.8
Uganda	8.6	9.5	6.2	5.5	6.8	7.3	13.7	7.4	–3.1	–3.2	–6.2	–6.5
Southern Africa[3]	**11.8**	**9.4**	**–1.7**	**7.2**	**10.1**	**11.6**	**10.3**	**7.6**	**7.0**	**8.1**	**–8.5**	**–4.0**
Angola	20.3	14.8	–3.6	9.3	12.2	12.5	12.1	8.9	15.9	21.2	–8.1	0.1
Zimbabwe[4]	–6.1	. . .	. . .	. . .	10,452.6	. . .	. . .	. . .	–1.4	. . .	. . .	. . .
West and central Africa[3]	**5.6**	**4.9**	**2.8**	**3.1**	**4.7**	**10.0**	**10.0**	**7.1**	**1.0**	**0.9**	**–8.2**	**–4.9**
Ghana	6.1	7.2	4.5	4.7	10.7	16.5	14.6	7.6	–11.7	–18.2	–10.9	–14.0
Nigeria	6.4	5.3	2.9	2.6	5.5	11.2	14.2	10.1	5.8	4.5	–9.0	–3.5
CFA franc zone[3]	**4.6**	**4.1**	**2.6**	**3.4**	**1.5**	**7.0**	**3.9**	**3.1**	**–3.3**	**–1.1**	**–6.8**	**–5.4**
Cameroon	3.5	3.4	2.4	2.6	1.1	5.3	2.3	2.0	0.8	0.4	–5.8	–5.1
Côte d'Ivoire	1.6	2.3	3.7	4.2	1.9	6.3	5.9	3.2	–0.7	2.4	1.6	–1.6
South Africa	**5.1**	**3.1**	**–0.3**	**1.9**	**7.1**	**11.5**	**6.1**	**5.6**	**–7.3**	**–7.4**	**–5.8**	**–6.0**
Memorandum												
Oil importers	5.4	4.7	2.1	3.7	6.8	10.6	8.5	5.6	–5.0	–6.9	–6.1	–6.6
Oil exporters[5]	7.5	5.9	1.8	4.2	5.5	9.3	9.7	7.3	9.6	10.7	–7.0	–2.2

[1]Movements in consumer prices are shown as annual averages. December/December changes can be found in Table A7 in the Statistical Appendix.

[2]Percent of GDP.

[3]The country composition of these regional groups is set out in Table F in the Statistical Appendix.

[4]No data are shown for 2008 and beyond. The inflation figure for 2007 represents an estimate.

[5]Includes Chad and Mauritania in this table.

The deep downturn in economic activity across the region and the sharp decline in food and fuel prices will temper inflation pressures. Nevertheless, for the region as a whole, inflation is projected to decrease only gradually from 10 percent in 2008 to 9 percent in 2009, since the pass-through of commodity price changes to consumer prices is more limited than in advanced economies.

At the same time, fiscal and external balances are expected to deteriorate substantially. As commodity-based revenues dwindle, the overall fiscal position of the region is projected to deteriorate by about 5¾ percentage points, to a deficit of 4½ percent of GDP in 2009. This is mainly as a result of a large swing in the fiscal balances of some oil-exporting countries (Angola, Republic of Congo, Equatorial Guinea, Nigeria). The current account balance of the region is also projected to worsen, from a surplus of 1 percent in 2008 to a deficit of 6½ percent of GDP in 2009. Again, the deterioration is projected to be most pronounced (in double digits) for many commodity exporters (Algeria, Angola, Gabon, Equatorial Guinea, Nigeria), as both export volumes and prices suffer. With

global credit conditions remaining tight, the financing of external deficits is expected to remain strained in a number of emerging and frontier markets (Ghana, Nigeria, South Africa, Tanzania).

As in all other regions, the risks to the outlook remain tilted to the downside. The main danger stems from a deeper and more prolonged slump in global growth, which would lower export demand, decrease tourism revenues, and further dampen workers' remittances. The global credit crunch could also reduce FDI and portfolio inflows much more than currently expected. Moreover, domestic banking systems could be weakened over time from a deterioration in credit quality (owing to the growth slowdown), losses on financial assets, and capital repatriations by (foreign-owned) parent banks. Most important, in the absence of well-functioning safety nets, the crisis could lead to a significant increase in poverty in a number of countries.

Against this backdrop, the key priority for policymakers must be to contain the adverse impact of the crisis on economic growth and poverty, while preserving the hard-won gains of recent years, including macroeconomic stability and debt sustainability. Specifically,

- Fiscal policy should, to the extent possible, cushion the pernicious effects of the crisis. Circumstances vary considerably across countries: some have the fiscal room for additional policy stimulus, as debt levels are quite low; others would be in a position to maintain (or adjust gradually) existing spending plans, letting automatic stabilizers operate at least to some degree.
- Monetary and exchange rate policy can play a supportive role in some cases. Although currency arrangements limit policy options in many countries, monetary policy can stimulate domestic demand in others with more exchange rate flexibility, especially if inflation pressures continue to subside. In fact, the South African Reserve Bank has already cut its policy rate by a cumulative 200 basis points since early December. Even in countries with less exchange rate flexibility—in the West Africa Economic Monetary Union (WAEMU) and the Economic Union of Central African Countries (CEMAC), for instance—there could be some limited room for policy easing, given the ECB's policy decisions, falling inflation, weakening demand, and, especially regarding the CEMAC, existing reserve buffers. In this regard, the new facility set up by the central bank in the WAEMU area has been helpful in alleviating the liquidity squeeze in domestic markets.
- In the financial sector, given the potential for knock-on effects from the slowdown in real activity, efforts should focus on monitoring closely the balance sheets of financial institutions and preparing to act promptly if necessary. In this regard, it will be important to clarify bank intervention powers and be ready to introduce deposit insurance schemes as needed.

Although a number of countries have policy room to maneuver, others face very tight external and domestic financing constraints. For the latter group, additional donor support is critical to limit the social fallout of the crisis and preserve the hard-won gains in macroeconomic stability.

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