The advanced economies are in the midst of a financial and economic crisis considered the worst since the Great Depression. Determined policy efforts in developed economies appear to have prevented a financial meltdown and there are tentative signals that the sharp contraction in the global economy may be slowing (Box 4). The extent of the financial and real sector dislocations created earlier in the decade, however, will take time to repair, and the process of reducing excessive levels of debt and consumption relative to income in the U.S. and some other developed countries, and undue reliance on external demand in China, will likely last longer than currently envisaged. The crisis and the subsequent recovery present an important opportunity for rebalancing global and national growth – raising savings in the advanced economies, boosting domestic demand in East Asia where dependence on exports was the driver of expansion, and strengthening the role of policies and institutions to handle more effectively future financial crises and limit their impact on the most vulnerable members of society.

The crisis started in the U.S. sub-prime mortgage market. The financial turmoil then spread to other developed countries in early 2008, especially after the government-sponsored sale of investment bank Bears Stearns in March 2008 to JPMorgan, and fully impacted developing countries after the failure of Lehman Brothers in September 2008. As the decline in housing and equity prices hit consumers, companies and banks, the price of risk surged, leading investors in developed markets to liquidate portfolio investments at home and in emerging markets. As governments implemented a series of policy measures to prevent a financial meltdown and a deep and protracted global recession, they must now also work forcefully to prevent the current financial and economic crisis from turning into a human crisis.

Frozen credit markets, large losses in financial wealth, and shaken investor and consumer confidence have reinforced each other to depress aggregate demand. The contraction in demand has been led by the developed countries, most of which are now in recession. In the G-3 (U.S., the Eurozone and Japan), the decline in output accelerated to 7.5 percent in the fourth quarter, measured in seasonally adjusted annualized terms, faster than the 4.1 percent registered during the previous synchronized G-3 decline during the U.S. recession of 1981-82 and faster than in any period after World War II (Figure 29).

Countries far from the epicenter of the crisis have been hit as hard as the U.S., underlying the global reach of financial markets and putting to rest any claims of “decoupling”. The decline in output has been the steepest in Japan. The output collapse in the eurozone has been smaller than in the U.S., but the decline is still the largest for the region in half a century. In the U.K., the contraction in output has been underpinned by vulnerabilities similar to those in the U.S., including larger increases in housing prices over the last cycle (210 percent to the peak, compared with 180 percent in the U.S.), the largest levels of household debt in the OECD at 185 percent of GDP, compared with 100 percent in the US, and the largest share in OECD of financial services in

Box 4. The crisis in figures

- **$2.0 trillion**: the deterioration in US-originated financial assets
- **42**: the number of U.S. banks that have failed since September 2007
- **45 percent**: share of distressed transactions in U.S. home sales
- **520**: the number of financial institutions that have received capital injections under the TARP in the U.S.
- **32 percent**: the increase in corporate bankruptcy filings in the U.S. since 2007
- **$1.1 trillion**: size of fiscal stimulus packages in the U.S., UK, Germany and Japan
- **12.3 percent of GDP**: the 2010 U.S. fiscal deficit

Sources: U.S. Treasury, Federal Reserve, FDIC, Realtytrac, IMF and World Bank staff estimates.
output and government revenues. Eastern Europe’s troubles, meanwhile, stem from excessive reliance on foreign capital to boost growth in output, accumulating vulnerabilities that resembled those of many East Asian countries before the 1997-98 Asian financial crisis. Concerns that the region’s negative developments will spill to the rest of the EU and other emerging economies prompted the EIB, the EBRD and the World Bank to pledge $25 billion to help eastern European banks. These measures build on recent large rescue packages for several countries organized by the IMF, the World Bank and, in the case of the new EU member states, dominated by assistance from the European Commission.

The “sudden stop of capital flows” that characterized the first wave of the crisis has been followed by the second wave of a “sudden stop of export demand” that is affecting severely both developing and developed economies. Companies are responding vigorously to the decline in exports and domestic sales by cutting production, in many cases by a larger margin, as suggested by the decline in orders (Figure 30, Figure 31 and Figure 32).

The economic slowdown has amplified investor worries about risk, sustaining tensions in equity, credit, and interbank markets worldwide. Equity prices fell further this year, with equity prices in the U.S. declining to 12-year lows and those in Japan to 25-year lows before some rebound in March (Figure 33). Interbank rates have declined from their peaks late last year but remain elevated, as investors continue to worry about liquidity and counterparty risk (Figure 34). International bond issuance by emerging
markets has resumed, starting with Mexico’s $2 billion bond in December and has amounted to $12 billion over the last three months compared with nil during the earlier three months. Although emerging market bond spreads have fallen to an average of about 675 basis points (bps) in March after peaking at 740 bps in November, they still remain much higher than the 240 bps at the start of 2008 and the record low of 150 bps in June 2007 (Figure 35). Spreads on corporate bonds issued in emerging markets also remain elevated, leading companies to delay international bond issuance or substitute with issuance in local currencies in some of the more stable emerging markets (Figure 36).

THE POLICY RESPONSE IN THE U.S. AND OTHER DEVELOPED COUNTRIES HAS BEEN FORCEFUL

Most developed countries have taken actions to ease liquidity, unclog credit markets, ensure financial stability and stimulate domestic demand. In most developed countries, central banks have cut key policy rates to the lowest levels in decades, including to almost zero in the U.S. and Japan, facilitated by the sharp decline in inflation. The Federal Reserve, the ECB, the Bank of

\[ \text{Figure 33. Equity prices have collapsed after peaking in late 2007} \]
\[\text{(Jan 2007 = 1)}\]

\[\text{Source: Datastream.}\]

\[\text{Figure 34. Interbank rates have eased, but worries about liquidity, counterparty risks, and the economy remain} \]
\[\text{(in bps, three-month U.S. dollar LIBOR less three-month T-bill)}\]

\[\text{Source: Datastream.}\]

\[\text{Figure 35. Spreads on emerging market sovereign bonds have eased but remain much higher than before the crisis, 2007-2009} \]
\[\text{(in bps, EMBIG)}\]

\[\text{Source: JPMorgan.}\]

\[\text{Figure 36. Corporate borrowing spreads have also risen substantially, 2007-2009} \]
\[\text{(in bps, US corporate bonds and the CEMBI)}\]

\[\text{Source: Datastream and JPMorgan.}\]

19 As measured by JPMorgan’s EMBIG.
England and the Bank of Japan have boosted lending to banks and introduced a variety of facilities to provide credit to other financial institutions and companies in an attempt to unfreeze credit markets. All of these monetary authorities, except the ECB, have moved toward “quantitative easing,” a policy to buy government assets, following stepped-up purchases of corporate assets. Both the Fed and the ECB have doubled the size of their balance sheets since August, adding liquidity equivalent to about 8 percent of annual GDP in the U.S. and about 6.5 percent in the eurozone. The Fed’s balance sheet is set to rise a further 50 percent or more, following the central bank’s decisions in March to purchase $300 billion in U.S. government securities (10 percent of the total outstanding with maturities longer than two years and shorter than ten) and $750 billion in agency mortgage-backed securities (a fourth of the total outstanding), or a combined 7 percent of GDP. While these efforts are likely to have contributed to the thawing of credit markets, banks have so far preferred to hoard liquidity by keeping large excess reserves with both the Federal Reserve and the ECB (Figure 37).

The authorities in developed countries, primarily the U.S. and the U.K., have injected large amounts of capital in banks and provided insurance for risky assets. The U.S. government has injected $306 billion from the $700 billion TARP to boost the capital of about 500 financial institutions, becoming, inter alia, the largest shareholder of Citibank after converting $45 billion in preferred shares into common stock. The authorities have also insured about $420 billion in assets held by Citibank and the Bank

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**Figure 37. Excess reserves in the U.S. and the eurozone**
(In billions of dollars, LHS; and in billions of euros, RHS)

**Figure 38. Foreclosures in the U.S. have surged**

**Figure 39. And the CBO projects the impact on GDP in the U.S. to offset only partly the impact of the crisis */
(difference between potential and actual GDP, in percentage points in the last quarter of the year)
of America, in the latter case to facilitate the purchase of Merrill Lynch, the last independent U.S. investment bank. In the UK, the government has nationalized two of the country’s largest banks and in a bid to avoid further nationalization is now implementing a scheme to insure banking assets equivalent to about $0.7 trillion. Despite the authorities’ efforts, 45 banks have failed in the U.S. since the start of 2008, 20 of which in 2009.

After a prolonged period of hesitation on how to deal with the “toxic” assets on banks’ balance sheets, the U.S. authorities announced a two-pronged approach in late March. Under the plan, $75-100 billion from the TARP will be leveraged up by loan guarantees by the FDIC and equity injections by the Treasury to allow private investors to purchase up to $1 trillion in toxic assets held by banks. The authorities are supplementing this plan with a proposal announced earlier to stress test the 19 systemically important banks (those with assets larger than $100 billion) to assess their capital adequacy following the write-offs that will accompany the sales of toxic assets and in the face of a further economic downturn.

The U.S. is also implementing a $275 billion rescue package for the housing sector, the epicenter of the financial turbulence in the U.S.20 After months of hesitation, the authorities were compelled to act amid the now widespread recognition that unless the decline in housing prices and the accompanying quality of credit are arrested, nonperforming loans in U.S. banks could rise to levels last seen during the banking crisis in Sweden in 1991 (13 percent of assets) or Japan during the 1990s (35 percent of assets), with much larger fiscal deficits and government borrowing than anticipated at present. The program will share with lenders the cost of modifying mortgages for people facing hardship (either delinquent at their payments or at risk of falling behind schedule) by reducing the mortgage payment (to 38 percent of the borrower’s income or less) and cut the annual interest rate to as low as 2 percent. The government efforts come against a grim background. U.S. housing prices have fallen 27 percent from their peak in July 2006, reducing home values and housing wealth by about $3.5 trillion. More than 8 million mortgages (or one in 10) have negative equity (mortgages are larger than the value of the homes they are written on) and 1 million houses in the U.S. are in foreclosure.21 Housing sales in the U.S. are at record lows, with almost half of sales of existing homes involving distressed property transactions, including foreclosures. Although the oversupply of houses is down 40 percent from its peak a year ago, the sharply reduced pace of sales means it would take 13 months to dispose of current inventories. The decline in housing wealth has added to the drop in equity prices to reduce household wealth in the U.S. by $13.3 trillion (or 100 percent of GDP) from the middle of 2007 until the end of last year.22 This decimation of wealth has underpinned the weakness of U.S. consumption and caused households to increase saving.

Discretionary fiscal stimulus packages have been enacted in all developed countries, but most observers agree that these are short of what is needed to stem a deeper slowdown in activity. The headlines have been preoccupied with the $787 billion (5.3 percent of GDP) package introduced in February in the U.S (Table 6). The package is spread over 10 years, however, with tax cuts accounting for 38 percent of the amount and spending including transfers to state governments for the rest. The stimulus will add about 2 percent of GDP to the fiscal deficit for 2009 and 2.9 percent in 2010. This discretionary package, however, is supplemented by a sharply expansionary budget proposal for the fiscal year 2010, with the U.S. fiscal deficit projected to rise to 12.3 percent of GDP. Stimulus packages proposed in the other developed countries are substantially more modest compared to the U.S. package and to the packages Japan introduced during the 1990s. Authorities from some of the larger eurozone states have argued that Europe’s fiscal stimulus is smaller because automatic stabilizers play a much larger role in Europe than in the U.S.; for example, the extension of unemployment benefits under the U.S. stimulus plan, or the stepped-up transfers to states...

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20 Of the total, $75 billion is provided under the TARP and the rest represents new funds.
22 U.S. Federal Reserve, Wilshire Associates and Bank staff calculations.
(prohibited from running deficits) are part of the automatic stabilizers in Europe. Nonetheless, including both the stimulus and automatic stabilizers, the fiscal easing is smaller in Europe than in the U.S. In Japan, by contrast, the size of the fiscal stimulus is limited by concerns about increasing further government debt, already the world’s largest at 170 percent of GDP.

**COMMODITY PRICES HAVE FIRMED**

Announced and anticipated production cuts have helped commodity prices stabilize this year after a sharp decline in the second half of 2008 due to the slowdown in global growth. Recent increases for prices of cereals, for example, have reflected unfavorable weather in South America and China and increased demand in China, while rubber prices have firmed due to supply cuts in Indonesia and Malaysia (*Figure 40*). Oil prices have climbed 10 percent from the start of the year, as the two OPEC production cuts are being implemented, while copper prices have been supported by increased inventory buildup in China (*Figure 41*). The recent firming of commodity prices will have a modest positive impact on the balance of payments of commodity exporters, including Indonesia, Malaysia, Mongolia, Papua New Guinea, Thailand and Vietnam, but such improvements will pale compared with the decline in export volumes for most commodities. The increases, however, are reversing in a small measure the ameliorative impact on household budgets from the decline in commodity prices late last year.